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Return of principal is a distribution to an individual of property that was used to fund the distributing trust or fund in the first place. Typically, such property was taxed before it was used to fund the trust or fund. Therefore, return of principal typically is not taxed to the recipient.

In the context of planned giving, the tax-free portion of a gift annuity payment represents a return of principal to the annuitant. Also, the fourth tier of distributions from a charitable remainder trust (CRT) is return of principal. If a CRT does not have enough undistributed income in the first three tiers -- ordinary income, capital gain income, and tax-free income -- to meet its payment obligation, it then must return principal to fill in the shortfall.

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