Advise Your Clients on How They Can Increase Their Incomes, Avoid Capital Gains Taxes, Reduce Estate Taxes and Become a Saint

By Robert J. Kolasa

Charitable Remainder Trusts ("CRTs") can reap tremendous tax and financial benefits. Once relegated to the very wealthy, CRTs are becoming increasingly popular for middle class clients holding appreciated assets. In general, a CRT is a tax-exempt trust a donor establishes which designates the donor or family members as income beneficiaries, with a charity as remainder beneficiary. This article briefly explores the basic mechanics and benefits of CRTs.

MARKETING CRTS - THE CONCEPT OF SOCIAL CAPITAL

Fundamental to the marketing of CRTs is a revised concept of charitable giving. Gifts to charity are often seen by attorney and client alike as the transfer of valuable consideration without any corresponding return. This view is erroneous and ignores the concept of "social capital" which can be defined as that part of our wealth we cannot control which goes to social uses beyond us and our families (*i.e.*, income and estate taxes).

However, paying taxes relinquishes *control* of such wealth with little understanding of where it goes. Through CRTs a client effectively captures his or her social capital and retains control of its use. CRTs turn what would have been tax dollars spent at the government's discretion (social capital) into charitable gifts made to institutions that the client selects. Although somewhat philosophical, this view of charitable giving must be communicated to the client rather than the rote question of "Do you want to leave moneys to charity?", which invariably sets up a negative response. Once the tax and financial benefits of CRTs are explained, it becomes readily apparent that charitable giving can be mutually advantageous for both charity and donor.

BENEFITS OF CRTS

1. Avoids long-term capital gain tax on the sale of appreciated assets;
2. Increases income from low-yielding assets;
3. Reduces or eliminates estate taxes;
4. Generates charitable income tax deduction;
5. Diversifies the donor's assets;
6. Protects trust assets from creditors;
7. Enables the donor to make a substantial gift to charity instead of paying capital gains and estate taxes.

BASIC STEPS IN IMPLEMENTING A CRT

Determine the Type of CRT - CRATs, CRUTs, NIMCRUTs. There are three basic types of CRTs: (1) Charitable Remainder Annuity Trusts ("CRATs"); (2) Charitable Remainder Unitrusts ("CRUTs"); and (3) Net Income with Make-up Unitrusts ("NIMCRUTs").

A CRAT annually pays a *fixed amount* of at least 5% of the initial value of trust assets to one or more noncharitable beneficiaries for the life or lives of such beneficiaries (or for a term no longer than 20 years). A CRUT annually pays a *fixed percentage* of at least 5% of trust assets valued annually to one or more noncharitable beneficiaries for the life or lives of such beneficiaries (or for a term no longer than 20 years). "NIMCRUTs" are a derivation of a CRUT providing for the payment of the *lesser of* the trust's income for the year or a fixed percentage of at least 5% of trust assets valued annually. The amount by which the trust's income falls short of the fixed percentage may be "made up" in subsequent years when income exceeds the fixed percentage.

CRATs are preferred by older clients who like the fixed amount of a guaranteed payout, but such payout is vulnerable to erosion from inflation. If trust assets grow, CRUTs provide an inflation hedge as the payout to noncharitable beneficiaries also grows (as the payout rate is applied to a greater principal amount). CRATs are well-suited for fixed income investments producing a dependable stream of income. However, a donor contemplating

making more than one contribution to a CRT should avoid the CRAT format since such a trust is forbidden to receive additional contributions in later years.

NIMCRUTs are preferred for illiquid or nonsalable assets as the payout to noncharitable beneficiaries can be delayed to later years when the trust has sufficient income. Since NIMCRUTs pay the lesser of a fixed percentage of asset value or ordinary income (not capital gains), this trust may enable the donor to "turn off" payments to noncharitable beneficiaries by investing in assets generating primarily capital gains. An exciting extension of this theme (beyond the scope of this article) is the placement of a variable annuity in a NIMCRUT. Since income is considered distributed to the NIMCRUT only when it is withdrawn from the annuity contract, it is a simple matter for the donor to "turn on" or "turn off" payments to noncharitable beneficiaries by making annuity withdrawals.

Select the Beneficiaries. Typically for married clients, the payout of a CRT is over the joint lives of husband and wife. Sometimes a nonspousal person such as a child is added on as a current or successive income beneficiary. This may trigger a gift tax to the donor based on the present value of the child's income interest. The donor can preclude the immediate recognition of a taxable gift by reserving the power in the trust instrument to revoke the child's income interest, thereby making the transfer incomplete for gift tax purposes. However, if the power of revocation is not exercised, at the donor's death the child's income interest is included in the donor's estate. Prior to the donor's death, payments to the child would qualify for the $10,000 annual gift tax exclusion.

The remainder interest of a CRT should be transferred to or for the use of one or more charities described in sections 170(c), 2055(a) and 2522(a) of the Internal Revenue Code. The CRT instrument may permit the donor to change the charity receiving the remainder interest. If the trust permits the remainder interest to be transferred to a private foundation, the income tax deduction relating to the donor's contribution will be limited to the basis of the transferred assets (rather than its fair market value).

Select the Payout Rate. The payout rate to noncharitable beneficiaries cannot be less than 5% of the initial contribution (for CRATs) or 5% of the annual asset value (for CRUTs). The higher the payout rate the smaller the income tax deduction and ultimate gift to charity. One approach might be to select a high payout rate and make payment to noncharitable beneficiaries from principal if income is not sufficient. For CRUTs the donor may select a lower payout rate with the expectation that the trust will grow and the payout rate will apply over time to an increasing principal amount. Although there is no magical answer, payout rates in the 6-9% range appear to be common.

Select the Trustee. In light of the complicated accounting and tax rules which apply to CRTs, it is paramount to ensure that the trust is administered properly. Banks acting as trustees normally provide competent trust and investment services. Donors wishing to act as trustees should consider the services of Renaissance Inc., a trust administrator which provides administrative and technical support services.

Establishing an Irrevocable Life Insurance Trust. A major objection of some donors is that they do not want the CRT to cause a lesser amount to be inherited by children. However, many times the inheritance to lower generations is *not decreased* as long as the donor outlives the creation of the trust for a mid-range period such as fifteen years.

Nevertheless, in order to guarantee the children's inheritance, it has become fashionable to implement an irrevocable life insurance trust ("ILIT") along with the CRT. In an ILIT the insurance proceeds are typically nontaxable to the children for income and estate tax purposes. Significantly, the premiums for the life insurance policy are paid by the increased cash flow and income tax deductions generated by the CRT. For minimal cost the insurance acts as a replacement fund if the donor dies at an early stage. Although insurance skews the analysis of benefits to be derived from a CRT, insurance projections are routinely submitted to clients which show the children

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are better off by implementation of the CRT plan with an irrevocable life insurance trust.

Traps for the Unwary. In transferring an asset to a CRT for resale there are a number of traps for the unwary which must be taken into account. First, if the trustee's sale of the asset is a "prearranged sale" negotiated by the donor prior to creation of the CRT, the IRS will impute the gain to the donor. Accordingly, all negotiations should be by the trustee subsequent to receipt of the property in trust. In the case of a donor-trusteed CRT, the selection of a "special" independent trustee for valuing and selling assets, or sprinkling income among income beneficiaries may be advisable. Second, the contributed property should generally not be subject to indebtedness as this may jeopardize the trust's tax-exempt status and result in recognition of gain to the donor. Third, there are special risks that arise when appreciated property is contributed to a CRT and sold soon afterward with the proceeds being invested in tax-exempt securities. Fourth, it is imperative to obtain a computer software program in order to correctly make the applicable calculations and projections related to a CRT. The three most popular programs are Crescendo, PhilanthroTec and PG Calc.

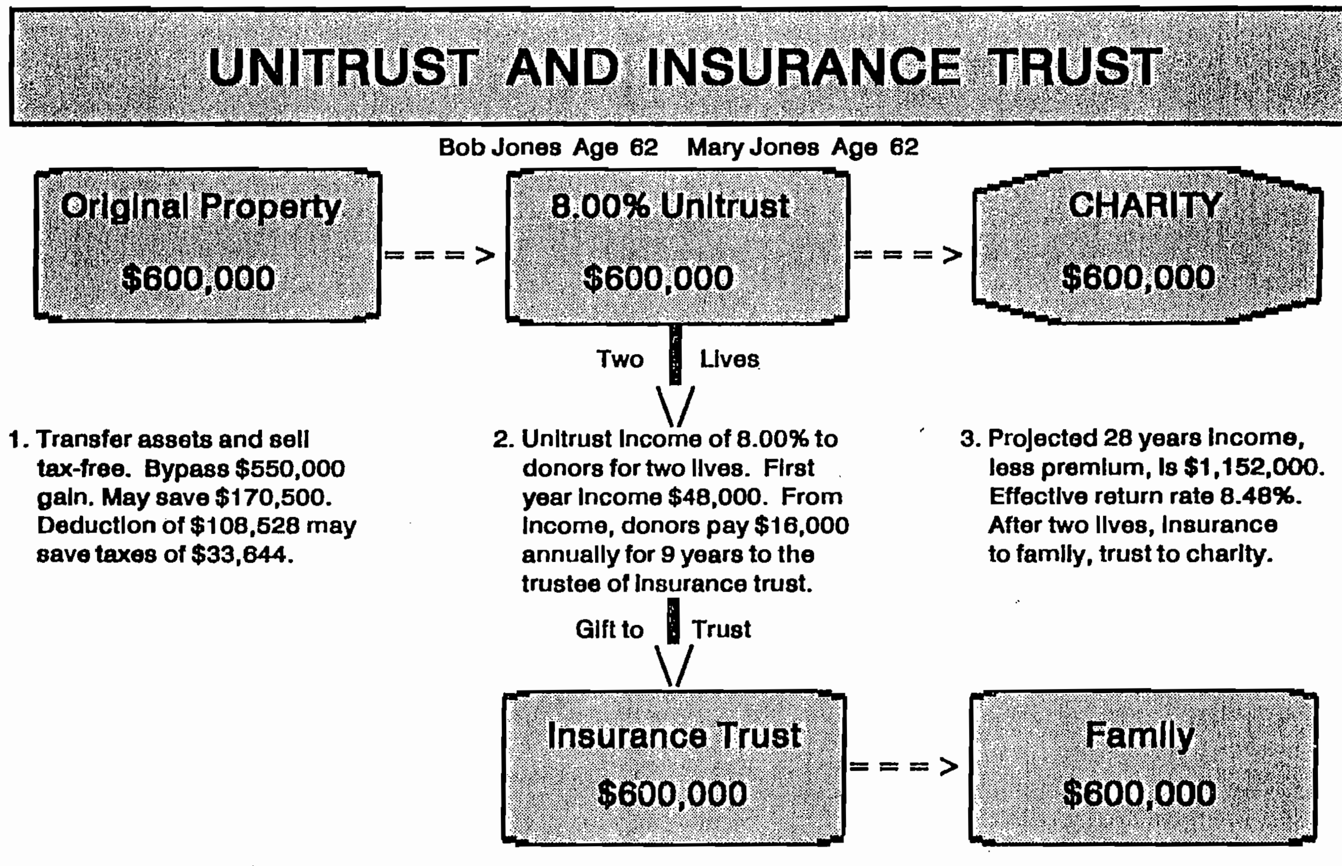
CASE STUDY

Facts. Bob and Mary Jones are both age 62 and are in the 50% estate tax bracket and 31% income tax bracket. A substantial portion of their wealth is $600,000 of stock in a public corporation having a $50,000 basis. Though the stock has appreciated steadily over the years, its dividend yield has never exceeded 3%. Bob and Mary would like to sell the stock to diversify their portfolio and purchase investments that will produce more income. However, the capital gain tax consequences have discouraged them from doing so. In a stock sale, only $429,500 of the $600,000 would be available after taxes for reinvestment.

The Plan

1. The Jones transfer $600,000 of stock to a joint life CRT, bypassing a capital gains tax of $170,500 and receiving a current income tax charitable deduction of $108,528. The deduction generates $33,644 in cash to mitigate the purchase of insurance by an irrevocable life insurance trust ("ILIT") (step 3 below);

2. The CRT then sell the stock free of capital gain tax and reinvests the proceeds in a diversified portfolio of higher-yielding investments. If the payout rate for the CRT is 8% and the CRT earns 8%, the Jones should receive at least $48,000 per year for as long as they live. This *payout rate is significantly higher* than if the Jones had



continued to hold the stock or had sold and reinvested such asset;

3. For each of the next nine years, about $16,000 of the $48,000 CRT distribution would be contributed to an **irrevocable life insurance trust to purchase a $600,000** life insurance policy for the benefit of the Jones children.

4. Upon the death of Bob and Mary, their **favorite charity would receive a gift of $600,000. Their children would receive the $600,000 insurance proceeds from the ILIT free of estate taxes.** If Bob and Mary died right away, this is *double the amount* that the children would have received if the $600,000 stock investment was subject to a 50% estate tax. Also, by virtue of the CRT Bob and Mary increased their retirement income, diversified their portfolio, and made a substantial gift to charity.

CONCLUSION

The substantial financial and tax benefits of CRTs must be properly communicated to demonstrate that under the right circumstances, charitable giving can be mutually advantageous to the donor and charity. Admittedly, implementation of a CRT imposes a considerable level of complexity and illustrations are often based on assumptions that vary widely. However, the rewards for those who choose to venture this path can be outstanding. What client wouldn't like to see **income and estate taxes mitigated, their children taken care of, and a substantial gift given to charity?.** Finally, do *not* underestimate the pleasure a client will attain from knowing a portion of his or her wealth will go to an earmarked charity rather than the public fisc. It is likely that such client is aware that he or she will also be ordained a saint by society as a compassionate benefactor. Not a bad price to pay for a technique serving the client's financial and tax objectives as well.

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