TIPS FOR EVERY STAGE OF A CRT

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As the industry leader in secondary planning for charitable remainder trusts (CRTs), the CRT Department at Sterling Foundation Management has reviewed nearly 6,000 CRTs over the last two decades. Drawing on this experience, we performed a meta-analysis of every stage of the CRT process, findings that we've reduced here to helpful tips.

For questions about this report, or to discuss a particular CRT, please contact us at (703) 677-8747 or CRT@SterlingFoundations.com.

INCEPTION

Tip: Make Sure the Client Understands a CRT Is Not Necessarily a Lifetime Lockup

While most CRTs will remain good fits for clients throughout their lifetimes, certain situations (often related to a major life event) can lead to misalignment between the client's current situation and the CRT they established many years before. At the CRT's inception, or even when discussing the CRT conceptually, practitioners should ensure clients understand that at any time they have the ability to:

- Sell their income interest for cash
- Terminate the CRT and accept the 7520 valuation for their income interest
- Give their income interest to the CRT's remainderman (thus terminating the CRT) and receive an additional tax deduction
- Use their income interest to create a new CRT with different terms ("CRT rollover")

This awareness is not only good practice, but in our experience, it ***also leads to more CRT creations***. Why? If a client understands that a CRT isn't necessarily a lifetime obligation, they are often more willing to pull the trigger on creating one in the first place.

DRAFTING

Tip: Give the Grantor Maximum Flexibility

Flexibility usually comes at no tax or economic cost to the client, so there's no reason not to give the client maximum flexibility with respect to the trust.[1] In our experience, lack of flexibility is often related to the charitable beneficiary designation and trusteeship. Be sure to:

- Include language permitting the grantor to change the charitable beneficiary[2]
- Include language permitting a change of situs and controlling law

[1]A possible exception is for CRTs that aren't self-settled (i.e., the grantor is creating the CRT to distribute income to someone else). In these cases, the grantor may wish to purposely restrict some of the flexibility afforded to the CRT's income beneficiaries.

[2]A possible exception is if the charitable beneficiary is paying for the CRT's creation. However, we'd encourage the grantor to weigh the related savings against the forgone flexibility. Most CRTs can be created for a few thousand dollars. To save that amount, is the client willing to irrevocably give up control over what charity ultimately receives the trust's assets? We routinely field inquiries from clients who regret giving up control over the charitable beneficiary to save a few thousand dollars in creation fees.

- Include clear language regarding successor trusteeship (in particular, resignation and power of removal/appointment for the grantor and/or recipients)

Tip: Maximize the Nuances of NIMCRUTs

Using the net income with make-up CRUT (NIMCRUT) structure can allow for flexibility over the timing/amount of CRT distributions. Additionally, in cases where the asset contributed to the trust is not immediately liquid, using the NIMCRUT structure is often a necessity. Be sure to:

- Include capital gain in the definition of trust accounting income
- In the case of NIMCRUTs holding a partnership interest or a variable annuity, ensure that the definition of trust accounting income is limited to distributions from the partnership or the annuity

Tip: Consider a Private Foundation as a Permissible Remainderman

Including a private foundation as a permissible remainderman of the CRT means the client's contribution is considered a gift to a private foundation (as opposed to a public charity).[3]

While this could negatively affect the up-front charitable deduction, many clients would accept that to ensure their private foundation is a permissible remainderman.

ONGOING TAX RETURNS

Tip: Watch the Calculations for Reporting Distributions to Beneficiaries

The most common problems we see with respect to the CRT's tax return (IRS Form 5227) relate to calculating the income distributions. Namely:

- Most trust documents state that the unitrust amount should be calculated using the beginning-of-year values, but it is often calculated based on the end-of-year values
- Once the unitrust distribution is calculated, the *timing* of the distributions is often incorrect
  - Many trust documents state that the distributions should be monthly or quarterly, but the distribution is made annually
  - Distributions are often made at the beginning of the following year. When determining the required distributions, this is sometimes forgotten and the beneficiaries have taken too much

Tip for CPAs: Watch Out for These Common Pitfalls

Listed below are other, more specific problems we commonly see.

- Undistributed income on the balance sheet in the net assets section doesn't tie to the accumulation schedule on page 7

[3]Most CRTs restrict the definition of a permissible remainderman to a charitable organization of a type described in Sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Internal Revenue Code. Requiring the charity to qualify under both 170(b)(1)(A) and 170(c) restricts the permissible charitable remainderman to be a charitable organization that qualifies as a public charity rather than a private foundation.

- The questions on Part V-B and/or Part VI-B are not all answered or answered incorrectly. In particular:
  - CRUT Information (most commonly, classifying a NIMCRUT as a Standard CRUT)
  - Self-dealing
- Having liabilities against the CRT (line 55 of Part IV) that may cause self-dealing or other excise taxes

ONGOING MANAGEMENT

Tip: Include Professional Advisors

Clients often make mistakes going it on their own: they don't have a financial advisor in place to properly manage the CRT's assets and/or a CPA or administrator in place to prepare the CRT's annual tax return and ensure the CRT remains in full compliance.

Here are some common mistakes we see clients make when going it on their own (and which most professional advisors would prevent):

- Trading on margin or otherwise using debt (e.g., CRT uses a mortgage to acquire real estate)
- Disqualified persons borrowing money from a CRT
- Disqualified persons lending money to a CRT[4]
- Not taking the required distribution (while clients might think this is okay because it benefits the remainderman, this could ultimately disqualify the CRT and jeopardize the tax benefits the grantor received when creating the CRT[5])

SECONDARY PLANNING

Tip: Give CRTs Periodic Reviews

For trust and estate attorneys, CPAs and financial advisors alike, evaluating the appropriateness of a CRT should be a routine part of any regular financial or trust and estate review. No matter how much a client has benefited over the years from having a CRT, does retaining their income interest in the trust still benefit the client? If not, what kind of secondary planning best serves the client's needs? Options include:

- Selling income interest
  - *Provides immediate, maximum liquidity*
- Gifting income interest
  - *Creates additional tax deduction*
  - *Eliminates CRT income stream*
- CRT termination
  - *Provides liquidity, though not as much as with sale option*
- CRT rollover
  - *Reduces taxable income for CRT clients who don't need/want the income*

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[4]Treas. Reg. § 53.4941(d)-2(c)(2) provides that an interest-free loan from a disqualified person to a private foundation (or an entity treated as a private foundation, such as a CRT) is not an act of self-dealing. However, an interest-free loan to the CRT likely creates adverse tax consequences to the lender because § 7872 generally treats such loans as if the borrower (e.g., the CRT) had paid a statutory rate of interest to the lender (i.e., the AFR). Although Treas. Reg. § 1.7872-5T(b)(9) provides that loans of up to $250,000 to a charity are exempt from these rules, the CRT is not technically a charitable organization (notwithstanding the fact that the CRT is subject to many of the tax rules that apply to private foundations).

[5]In *Estate of Atkinson*, the 11th Circuit affirmed the Tax Court's ruling that a CRAT was disqualified when the income beneficiary did not receive the required annual distributions. The Tax Court reasoned that the regulations governing CRTs provide that the CRT must meet the statutory requirements and operate strictly within those terms from its creation, and failure to do so disqualifies the CRT from its date of creation.

- *Creates income streams for children or grandchildren*
- *Generates additional tax deduction*

To quote the late Steve Jobs, *"A lot of times, people don't know what they want until you show it to them."* An easy way to show a client their alternatives is including the discussion in your normal reviews with the client.

Tip: Choose the Best Secondary Planning

The decision to engage in some form of secondary planning is an important first step. Given that there are several secondary planning options available, however, it's equally important that a client chooses the option that is best suited to their needs. Choosing the wrong option can be very costly for clients. The decision to terminate a CRT instead of sell the income interest, for example, can easily cost a client hundreds of thousands of dollars, or more. Below are common mistakes we see.

Terminating a CRT when a client wants maximum liquidity

In our experience, the real-world value for an income interest (i.e., what a third-party buyer would pay for the interest) usually exceeds the 7520 value of the same interest, which the income beneficiary is limited to in a termination. Clients who terminate their CRTs without checking to see what third-party buyers would pay are almost certainly worse off/harmed financially.

Taking taxable income from a CRT when it's not needed or desired

These clients should look at either gifting their income interest to the CRT's remainderman or completing a CRT rollover to reduce/eliminate the income stream and, in the case of a rollover, transfer its benefit to their children, grandchildren or other family members.

Giving an income interest to charity instead of rolling the interest for family

Some clients who no longer want their CRT income choose to give their income interest to charity to remove the income stream. If given the choice, however, many of these clients would have instead elected to roll the interest into a new CRT, usually with children or grandchildren as income beneficiaries.

PARTNERING WITH A TRUSTED PROVIDER

If you have clients who haven't had their CRTs reviewed, or if you are just interested in learning more about CRT secondary planning, Sterling offers valuable expertise and resources — anonymously, and at no cost or obligation.

In short, we support your service to your clients and stand ready to work with you.

For more information, please contact our CRT Department.

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Planning with Charitable Remainder Trusts

Charitable Remainder Trusts (CRTs) are called "split interest" trusts because they have both charitable and non-charitable beneficiaries. This split personality creates some interesting planning opportunities. This reports discusses how CRTs function, situations in which they are most commonly used, and how they compare to the primary alternative strategy.

CRTs are primarily income tax planning vehicles. Charitably-minded individuals who own appreciated property are often advised to create a CRT because a CRT allows the tax-free sale of appreciated property inside the trust. However, in many cases, they might be better off simply selling the property and using the proceeds to fund a private foundation or other charitable entity. To determine which strategy is better, it helps to understand how CRTs work.

A CRT is a trust with two beneficiaries. The donor and/or the donor's spouse get the annual payments for their lifetime(s) or a pre-specified term, and a charity gets the remaining assets in the trust at the last of the income beneficiaries to die or the expiration of the term. There are two primary tax benefits: The donor gets an immediate income tax deduction for the value of the amount donated to charity, and the CRT itself is not subject to income tax. (A CRT is not a very useful estate planning tool, although it is sometimes misperceived as one.)

The amount of the tax deduction is determined by four variables: the value of the assets placed in trust; the present value of the payments the income beneficiary will receive; the interest rate (set monthly by the IRS); and the projected length of the trust, which will be either a set number of years up to 20, or based on life expectancy.

Because a CRT can be used to defer capital gains tax, it is particularly useful for donors who own highly appreciated stock. Suppose a donor owns stock worth $1 million, for which he originally paid $500,000. If he sells the stock, he will pay capital gains taxes of at least $75,000 on the $500,000 gain. This would leave him with $900,000 to invest. If he puts the stock into a CRT instead and the CRT sells the stock, he postpones paying the capital gains tax, and the CRT can reinvest the entire $1 million. In addition, he gets an immediate income tax deduction based on the remainder amount that will go to charity.

Of course, clients pay a price for these benefits. Instead of having $900,000, the donor has only the right to receive payments from the CRT. The actual value of these payments may turn out to be more or less than $900,000. These tax benefits are designed to help charity, so the law requires that the remainder beneficiary—the charity—get at least 10 percent of the initial amount. In practice, this limits the amount the donor can receive as annual payments.

There are two types of CRTs. They differ only in how they calculate the cash flows to the donor. The first is a Charitable Remainder Annuity Trust (CRAT), in which the cash flows are fixed at the beginning of the trust and don't change. The second is a Charitable Remainder Unitrust (CRUT), in which the cash flows are set as a percentage of the value of the trust assets. Thus, the cash flows from a CRUT change as the value of the trust's assets change, which means they can grow (as well as shrink). The drawback is that the cash flows are not known in advance. The advantage of a CRAT is just the opposite—the cash flows are known in advance and cannot decline—but the disadvantage is that they cannot grow.

Let's look at an example. Suppose a client owns $5 million of highly appreciated, publicly traded stock. He's owned it for more than one year. If he puts the stock into a CRUT, with 10 percent, or $500,000, going to charity, he gets an equivalent tax deduction—$500,000.

Suppose instead that the client does not use a CRT. He puts the $500,000 into a private foundation, sells the remaining $4.5 million of stock, and reinvests the proceeds. Not only does his contribution generate a $500,000 tax deduction, he avoids paying any tax on that $500,000 gain. Both approaches produce the same up-front income tax deduction, and both will irrevocably set aside assets for charity. However, there are a number of important differences, summarized in the following chart.

Comparison of CRT to Sale and Gift

Issue	Contribute $5 Million of Stock to CRUT	Contribute $500,000 to a Private Foundation and Sell $4.5 Million of Stock (No CRT)
What's the deduction?	$500,000	$500,000
How liquid?	Limited to annual cash flows	Both personal and foundation assets remain completely liquid
Risk that more money than intended will end up going to charity	Risk of not living to life expectancy (if donor dies early, charity will get more and the family less than planned)	None
Any potential for conflict of interest between beneficiaries?	Yes	No
Subject to private foundation rules?	Yes (some)	Yes
Can clients defer income taxes for added benefit?	Yes	No
How much flexibility in investing?	Limited by trust rules and by need to protect remainder interest	Almost unlimited

Source: Trusts and Estates, Sterling Foundation Management

In this example, either a CRUT or a private foundation would produce an income tax deduction of $500,000. However, the CRUT requires the irrevocable commitment of ten times as much money as the private foundation. With the CRUT, the donor's liquidity is limited to the annual cash flows, which constitute the "retained unitrust" interest. By placing assets into a CRUT, the donor basically gives up liquidity. Furthermore, the charity does not have access to the CRUT assets, either. The CRUT assets are tied up for the term of the trust. Only at the conclusion does the remainder amount become available for charity. Selling stock and then using the proceeds to fund a foundation, on the other hand, leaves the donor with fully liquid assets.

Because a CRUT is a split-interest trust, the trustee owes a fiduciary duty not only to the donor, but also to the charitable remainder beneficiary. At times, the donor's interest and the charity's may conflict. This is particularly likely in cases in which the charity's interest is threatened by poor investment returns. This conflict of interest, combined with the trustee's fiduciary obligations, can cause a trustee to behave in a manner that is not to the donor's liking. For donors who have been led to think of the CRUT as "theirs," this can be a nasty surprise.

The one clear advantage of the CRUT is that it defers income taxes. The question then becomes: When does the value of this deferral outweigh the other considerations?

It depends on a number factors. But in some cases the answer is never. This is because the deferral value depends heavily upon the ratio of the property's cost basis to its current value. The lower this ratio, the more valuable deferral is; the higher the ratio, the less valuable the deferral. For basis ratios greater than about 45:1 (that is, when the basis is more than 45 percent of the current value), the deferral of tax on the gain may never make up for the fact that the donor only gets cash flows and never gets the principal.

If the basis ratio is below 45 percent and the donor can wait long enough, he can eventually realize more value from the CRT alternative than from the private foundation alternative. But this waiting period can be long. For example, assume 8 percent returns over the long run on invested assets, a 20 percent effective income tax rate for the donor, and a lifetime CRUT (that is, one whose term is defined as the life of the donor). This table shows how long would be needed to wait for the accumulated cash flows (distributed to the donor and reinvested) to exceed the amount the donor would have accumulated by selling his appreciated stock and reinvesting the net proceeds.

Years Needed to Break Even with a CRUT

	Basis as Percentage of Current Value			
Age	**10%**	**20%**	**30%**	**40%**
35	32	34	36	43
45	25	28	31	Never
55	18	21	Never	Never
65	12	14	Never	Never
75	6	7	Never	Never
85	4	5	Never	Never

Source: Trusts and Estates, Sterling Foundation Management

Several patterns quickly emerge. First, the younger the donor, the longer he has to wait to break even. Second, whatever the donor's age, the break-even period is almost as long as his life expectancy. For example, at age 35, life expectancy is an additional 42 years, and a donor will have to wait 34 years to break even if the basis ratio is 20 percent (or 43 years if it's 40 percent).

At older ages, notably above 65, the break-even periods are much shorter. However, the corresponding annual payment rates are also high.

Even when the deferral benefits exceed the costs, there is no simple right answer as to whether to use a CRUT. The answer depends on the donor's willingness to wait for the deferral benefits to add up, expectations about future tax rates, and his or her level of concern over the other negatives associated with a CRUT.

When a CRUT is used, it is may be advisable to name a private foundation as the charitable beneficiary (unless the CRT is funded with appreciated property other than publicly traded stock). This option is often overlooked but may be the best way to maintain flexibility as to the ultimate recipients of the charitable interest. Too often, donors set up a CRUT, name a public charity as the charitable beneficiary, and then, long before the CRUT term is over, regret their choice of charity. Naming a private foundation as the charity eliminates this problem. It also makes it possible to keep the assets in the family's control and thus build a legacy after the donor is gone. But even if your client doesn't name a private foundation, it is easy to retain the flexibility to change the charitable beneficiary.

Flexibility and Irrevocability

In the past, one of the biggest barriers to setting up a CRT or CLT has been the fact that such trusts are and must be irrevocable. That requirement has not changed.

Irrevocablility means that a donor who puts, say, $2,000,000 into a 5 percent CRT has given up the liquidity of that money permanently. He does have the cash flow stream, but that is not the same as access to the principal.

However, in the past decade, a market has developed for the income streams of CRTs. The possibility of selling a CRT income stream means that even though the trust is irrevocable, and the gift to charity irrevocable, the donor is not necessarily stuck with an income stream for the rest of his life. He may be able to turn it back into a lump sum via a sale.

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