CRTs
A Powerful Tool for Income-Tax Planning

Charitable Remainder Trusts have been around a long time. But in cases involving extraordinary income events or certain kinds of underperforming assets, they offer estate planning advantages that deserve a fresh look.

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Charitable Remainder Trusts (CRTs) have long been considered useful estate planning tools to reduce the grantor's liability for income and estate taxes while satisfying a philanthropic objective at the same time. The purpose of this article is to take a grantor's personal objectives with respect to CRTs two steps further.

First, CRTs are a means to potentially avoid the 23.8 percent capital gains tax rate (including the 3.8 percent tax on net investment income that affects high-income tax payers) and reduce the aggregate amount of state and federal taxes incurred as a result of an extraordinary income-creating event concerning the grantor. Second, they can provide an escape route to a grantor who feels trapped by being forced to hold an underperforming, low-basis asset. CRTs can be valuable income and estate planning tools to people who, for instance, plan to sell a business or who simply want to access or diversify their low-basis investments. This second group is a very broad group of people, including many employee shareholders in Minnesota-based Fortune 500 companies, for instance, as well as owners of other highly appreciated low-basis assets such as ownership interests in closely held businesses and/or real estate.

Since the passage of the American Taxpayer Relief Act (ATRA) on January 2, 2013, and the annual inflation adjustments to the federal estate tax exemption amounts, fewer persons will be subject to the federal estate tax. As a result, the focus on wealth management is shifting from estate minimization to income tax planning. It follows, then, that people who wish to leave a gift to a charitable beneficiary will receive no deduction if their estate is not subject to federal estate tax. Thus, the non-charitable motivations behind a CRT will shift toward *inter vivos* gifts providing income tax benefits as well as accomplishing charitable objectives.

What is a CRT?

A CRT is a split-interest irrevocable trust, described at IRC §664, in which a grantor transfers assets to a trustee who will manage such assets for the ultimate benefit of a qualified charity recognized by IRC §170(c) (income tax), § 2055(a) (estate tax), and § 2522(a) (gift tax). In the interim, whether measured by the life of an individual or individuals living when the CRT is executed or for a set period of time (not in excess of 20 years), the trustee must distribute, at least annually, a predetermined payment, to one or more persons who are non-charitable beneficiaries, who may be the grantor/trustee and his or her spouse.

A CRT may be an "annuity trust" or a "unitrust." An annuity trust pays *a fixed sum* annually to the non-charitable beneficiaries. A unitrust pays a *fixed percentage* of the trust principal annually to the non-charitable beneficiaries. To best take advantage of the strategies set forth below, this article will focus exclusively on the use of charitable remainder unitrusts (CRUT).

Why a CRUT?

A CRUT provides a vehicle that allows the grantor to ultimately donate an asset to a charity of his or her choice and yet immediately receive several personal financial benefits.

First, a CRUT is a tax-exempt entity capable of creating a tax efficiency that, in many instances, may increase a grantor's return on an existing investment stream. A grantor does not realize any gain or loss for tax purposes on the contribution of an appreciated asset to a CRUT (unless the contributed asset is subject to indebtedness in excess of the grantor's tax basis in the asset).

Second, the CRUT is not subject to income taxes when the trustee sells the asset or diversifies its holdings. As a result, the trustee may reinvest all of the sale proceeds into other assets which may grow tax-free within the CRUT to possibly yield a greater overall return to the grantor (or other non-charitable beneficiaries) than if the grantor sold the asset, paid the tax, and reinvested the proceeds himself or herself. Instead of paying a 33 percent effective tax rate (such as would apply in Minnesota, for instance) that would apply if the grantor took all of the proceeds at once, the corpus is allowed to grow in a tax-free environment, and the non-charitable beneficiary will receive a periodic, tax-efficient payment stream.

Third, the grantor will receive a current income, gift or estate tax charitable deduction equal to the charity's interest in the CRUT. In the case of an *inter vivos* transfer where the grantor is the recipient of the unitrust income interest, there will be no gift or estate tax consequences to the grantor. The deduction is typically not the primary motivation for a grantor, but rather the proverbial "cherry on top."

The deduction is effective when the trust is funded, even though the charity will not receive its interest until later. A CRUT's deduction is based off the present value of the charitable remainder interest as calculated at Treas. Reg. §1.664. *et.seq*. In its simplest terms, the deduction is based upon the fair market value of the grantor's gift to the CRUT, less the projected return to the non-charitable beneficiaries. The charity's remainder interest is based off the Section 7520 interest rate (120 percent of the applicable federal midterm rate) for the month CRUT is funded (or the grantor may choose to use the Section 7520 rate for either of the two previous months). The greater the Section 7520 rate, the greater the grantor's deduction. Most grantors should require their advisors to run sophisticated modeling programs to best illustrate the deduction.

Fourth, the CRUT corpus will not be included in the grantor's estate for state or federal estate tax purposes.

Capital Gains Tax Advantages

A well-planned and properly drafted CRUT will allow a person or family to avoid paying high capital gains taxes. Instead of paying those taxes, the grantor accomplishes the following: (i) an income stream, (ii) tax-free growth of the investments, and (iii) a meaningful contribution to a charity of his or her choosing.

The only question is: Who needs this planning? The answer becomes apparent with an understanding of the applicable estate taxes and capital gains taxes as they apply to individuals and couples of high income and/or high net worth.

ATRA increased the federal estate and gift tax exemption to $5 million (indexed annually for inflation) and the maximum estate, gift, and generation-skipping transfer (GST) tax rates from 35 percent to 40 percent. For 2015, taking into account the inflation adjustment, the federal estate and gift tax exemption is $5.43 million for each individual or $10.86 million for a married couple. ATRA also made permanent "portability," first introduced in 2010. The portability provisions allow a surviving spouse to combine the deceased spouse's unused exemption with the surviving spouse's exemption, thereby effectively providing married couples an opportunity to utilize their full exemptions.

With respect to the federal income tax, ATRA increased the top individual income tax rate from 35 percent to 39.6 percent and the top capital gains rate from 15 percent to 20 percent. Specifically, capital gains on appreciated assets will be taxed at a 20 percent rate for taxpayers with taxable income over $450,000 (joint filers), $400,000 (single filers), $425,000 (heads of households) and $225,000 (married taxpayers filing separately). The capital gains tax is either 15 percent or 0 percent for taxpayers below these thresholds. Also under ATRA, a 3.8 percent net investment income tax may apply, with a significantly lower threshold. In addition, the Affordable Health Care and Patient Protection Act (commonly referred to as "Obamacare") added the 3.8 percent income tax on net investment income.

Therefore, taking into account the 3.8 percent tax, the top federal individual income tax rate can reach 43.4 percent for ordinary income, and the top rate on dividends and long-term capital gains can reach 23.8 percent exclusive of state and local taxes.

The 3.8 percent tax only applies to individual taxpayers whose modified adjusted gross income ("Magi") exceeds $200,000 (or $250,000 for married taxpayers filing jointly). The 3.8 percent tax also applies to trusts when the adjusted gross income of the trust exceeds $12,150.

For instance, a Minnesota resident would pay a total tax rate of 22.85 percent versus the rate of 33.65 percent if he or she were to be in the highest state and federal tax brackets and subject to the Obamacare surtax. One of the benefits of a CRUT is to smooth capital gains income over time by staying below the income thresholds described above and thus not be subject to imposition of the highest tax rates. This strategy is particularly applicable in situations where, for one reason or another, the grantor has higher-than-usual income in any particular year. The income can be unusually high because of an "extraordinary taxable event" such as a stock swap, merger, or other organic corporate transaction.

The same technique is appropriate when a person simply feels trapped because he or she cannot access the value of his or her highly appreciated low-basis property. The "extraordinary taxable event" may not be an external force like a merger, in other words; instead, it may be the result of the person's desire to gain access to the value of the investment or to diversify his or her investment holdings. In the absence of any additional planning, the person will pay capital gains taxes based on the value of the asset on the date of sale and the basis held in the asset. Implementing a CRUT allows the tax-free sale and diversification of the asset and spreads distributions over time, thereby providing an opportunity for the avoidance of significant capital gains tax exposure.

Charitable Income Tax Deduction

An additional benefit to the grantor is the charitable income tax deduction that he or she will receive in the year that the CRUT is funded. The income tax charitable deduction available to the grantor will depend upon the nature of the asset contributed to the CRUT and the type of charitable remainder beneficiary. A key issue is whether the charitable beneficiary is a "50 percent charity" (a public charity such as a school, church, hospital, or publicly supported organization) or a "30 percent charity" (any charitable organization that is not a 50 percent charity, including private foundations).

CRUT: Modelling One Scenario

Calculated using Brentmark Estate Planning Tools

Year	Beginning Principal	Principal Growth	Income Rec'd/Accr'd	Distribution	Remainder
1	$411,095.00	$20,656.17	$4,487.81	$58,605.70	$377,633.28
2	$377,633.28	$18,974.83	$4,122.52	$53,835.40	$346,895.23
3	$346,895.23	$17,430.34	$3,786.96	$49,453.38	$318,659.15
4	$318,659.15	$16,011.57	$3,478.72	$45,428.05	$292,721.39
5	$292,721.39	$14,708.28	$3,195.56	$41,730.36	$268,894.87
6	$268,894.87	$13,511.08	$2,935.45	$38,333.65	$247,007.75
7	$247,007.75	$12,411.32	$2,696.52	$35,213.42	$226,902.17
8	$226,902.17	$11,401.08	$2,477.03	$32,347.17	$208,433.11
9	$208,433.11	$10,473.08	$2,275.41	$29,714.22	$191,467.38
10	$191,467.38	$9,620.60	$2,090.20	$27,295.59	$175,882.59
11	$175,882.59	$8,837.52	$1,920.06	$25,073.82	$161,566.35
12	$161,566.35	$8,118.18	$1,763.78	$23,032.90	$148,415.41
13	$148,415.41	$7,457.38	$1,620.21	$21,158.10	$136,334.90
14	$136,334.90	$6,850.38	$1,488.33	$19,435.90	$125,237.71
15	$125,237.71	$6,292.78	$1,367.19	$17,853.89	$115,043.79
Summary	$411,095.00	$182,754.59	$39,705.75	$518,511.55	$115,043.79

The most common contributions to a CRUT consist of appreciated long-term capital gain property. If the contribution is to a CRUT with a 50 percent charity as its remainder beneficiary, the grantor's deduction is equal to the contributed asset's fair market value, but limited by a 30 percent AGI deductibility ceiling. If the limit is exceeded, the remaining deduction may be carried forward for up to five years.

If long-term capital gain property, other than publicly traded stock, is contributed to a CRUT with a 30 percent charity remainder beneficiary, then no deduction is given for any of the appreciation over the grantor's tax basis in the contributed asset. This creates a chilling effect that is likely to discourage a grantor from making a gift of appreciated property to a CRUT with a 30 percent charity as its remainder beneficiary. The deduction is further limited by a 20 percent AGI deductibility ceiling. Where a grantor contributes publicly traded stock to a CRUT in which the charitable remainder beneficiary is a 30 percent charity, he or she may deduct the fair market value of the stock; however, any such deduction is limited by a 20 percent AGI deductibility ceiling. In each case described herein with the 30 percent charity, any remaining deduction may be carried forward for up to five years.

The financial and tax benefits are perhaps easiest to understand when depicted as above. This financial model is premised on an initial funding of $411,095, a growth rate of 5.78 percent, and a percentage payout of 14.256 percent over 15 years. In this scenario, the present value of the remainder interest is $41,115.26, which is the amount of the grantor's deduction. That amount is just above the 10 percent minimum required to permit the trust to qualify as a CRUT. The scenario modeled here is for demonstrative purposes only, and each CRUT requires independent modelling to pass the 5 percent test and the 10 percent test (as defined above). Modelling is required to optimize the framework of the CRUT to achieve the grantor's financial and charitable objectives.

Grantor Retains Control

The grantor can serve as trustee and—subject to the terms of the CRUT—maintain control over the trust. Oftentimes, CRUTs are recommended to potential grantors by charities or others motivated to effectuate a gift transaction. Prior to engaging in substantive discussions with such groups, potential grantors are encouraged to meet first with their own team of advisors to assure the grantor's objectives are attained.

The charity cannot lose in the transaction, as it is required to be the remainder beneficiary. For the charitable organization, the issues are: What will its remainder interest be worth? And when will it receive its asset? The grantor, however, has so many opportunities to control the transaction that his or her interests should be fully explored. For instance, the grantor may determine who serves as trustee, including the grantor himself or herself. This right gives the grantor the ability to control the sale and reinvestment of the trust corpus. The grantor determines the term of the CRUT, whether it be for a term of years, the grantor's lifetime, or the lifetimes of others living when the CRUT is created. The grantor determines the non-charitable beneficiaries of the CRUT, who may be any individual, including the grantor, or a trust, estate, partnership, association, company, or corporation. Of course, the grantor also selects the charitable beneficiary; in fact, with proper drafting of the CRUT, the grantor may change the remainder charitable beneficiary to another charitable beneficiary subject to possible imposition of additional tax consequences.

Essential Technical Requirements

A CRUT is required to pay the non-charitable beneficiaries, at least annually, a minimum of 5 percent but not more than 50 percent of the net fair market value of the trust estate, which must be valued at least annually (the "5 percent test"). Accordingly, while the unitrust percentage is constant, the value of the unitrust payments vary from year to year. If the CRUT fails to earn a return greater than its required unitrust amount, the trustee will be required to invade CRUT principal to distribute the unitrust amount. This unitrust amount must be paid to a non-charitable beneficiary for a term of years (not more than 20) or for the life or lives of the recipients living when the CRUT was created.

In addition, the trust will not be treated as a CRUT unless the present value of the charitable remainder with respect to each contribution to the trust is at least 10 percent of the net fair market value of the property contributed to the trust (the "10 percent test").

At the end of the unitrust payment term to the non-charitable beneficiaries, the remainder interest must be distributed to a charitable organization that conforms to the description at IRC §170(c) and satisfies IRC §2055(a) and §664(d)(2)(C). The rules and tests described above are designed to objectively ensure there is a charitable interest in the CRUT.

What if the CRUT fails to qualify?

If a trust fails to qualify as a CRUT because, for instance, it does not to pass the 10 percent test, the trust may be treated as void *ab initio* (void since inception) or, in some instances, may be reformed if permitted, possible and timely (a complex set of requirements and deadlines one would do best to avoid). If the CRUT is deemed void *ab initio*, then the trust will essentially be "unwound." For example, no income, gift or estate tax charitable deductions will be permitted and the transfers and other dealings the grantor entered into on behalf of the trust will be treated as though they were made directly by the grantor in his individual capacity. Accordingly, the income earned by the CRUT and the gain created by the sale of the property contributed to the CRUT would instead become income- and gain-taxable to the grantor without any charitable deductions.

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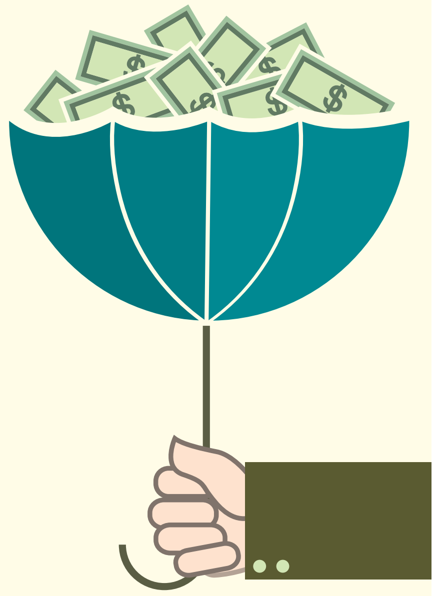
23.8%

capital gains tax rate (including the 3.8% tax on net investment income that affects high-income tax payers).



The Disadvantages of CRUTs

Despite all of the benefits and opportunities a CRUT may offer under the right circumstances, they are not without shortcomings of their own. Chiefly, once the unitrust term ends, the income payments to the non-charitable beneficiaries cease forever. Likewise, CRUT income may fluctuate with the market. If the CRUT's investments diminish in value due to poor management, market conditions or other factors, the income stream will decline. Another disadvantage includes the requirements and burdens placed upon the trustee to manage the assets, make distributions, annually value CRUT assets, create and distribute trust accountings to CRUT beneficiaries, and comply with tax reporting obligations. A CRUT is an irrevocable trust. As such, it is generally not subject to amendment, and the assets are removed from the grantor's reach. If the CRUT is not modeled correctly, there is limited, if any, room for relief. Finally, if a CRUT is deemed to have been created for an impermissible purpose (i.e. for tax evasion or as a conduit for self-dealing), the grantor may be subject to IRS examination, penalties or other action, and the trust may risk disqualification as a charitable remainder trust and subsequent termination.

Conclusion

CRUTs can be very valuable instruments to help a wide range of people avoid paying high taxes on an extraordinary taxable event and/or upon the sale of low-basis property. If modeled and drafted properly, the grantor can avoid high taxes on an extraordinary capital exchange event and/or unlock access to highly appreciated low-basis property without creating a tax-prohibitive transaction. In essence, the grantor will receive a payment stream from the CRUT for a term of years and ultimately provide for a charity of his or her choosing. In the meantime, the grantor may maintain a degree of control over the assets and enjoy significant income and estate tax savings. Consult your team of financial and tax advisors to determine how valuable this tool could be for you and how you may optimize the benefits of a CRUT. ▲

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