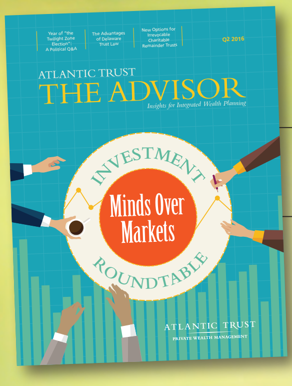

Excerpted from *The Advisor by* Atlantic Trust

Charitable Remainder Trusts:

A New Look at an Old Planning Strategy

When does "irrevocable" mean "Yes, you can make a change"? New options for charitable remainder trusts can satisfy your philanthropic intent and give you more flexibility for changing life circumstances.

Philanthropy is an integral part of both estate planning and tax planning. In addition, making gifts to charities provides the opportunity to leave a legacy, make a generational connection or fulfill a personal objective. Of all the giving strategies available, the charitable remainder trust (CRT) stands out for its ability to pay donors an annual income stream for a set number of years *and* satisfy charitable desires because the trust's remainder passes to one or more charities at the trust's end. A CRT pays a fixed or variable income stream, with a minimum of 5% and a maximum of 50% of the trust's value, during the term of the trust.

"One of the most appealing features of a CRT has always been the income tax deduction you receive, an amount equal to the present value of the remainder interest," says H. Arthur Graper, CFP®, managing director and wealth strategist for Atlantic Trust. "CRTs were popular with clients interested in charitable giving in past higher interest rate environments. Now, even though we're in a low interest rate environment, income taxes are a bigger consideration, especially for people who live in high tax states. The tax deduction benefit has once again become very attractive for many people. In addition, CRTs should continue to get more attention as interest rates begin rising."

What About When a CRT No Longer "Fits"?

Sometimes, even with the initial best intentions for setting up a CRT, it makes good sense to re-examine the CRT's purpose and impact on the client's financial situation *today*, says Graper. "A CRT usually spans decades of clients' lives. Taking a fresh look is asking the question, 'If we could have a do-over on this CRT, what would we do differently?' A client's life can change dramatically in 10 years, for example, especially in regard to beneficiaries. So, you have an inflexible trust—remember that a CRT is irrevocable and its terms can't be changed—with naturally occurring changes in a client's life, resulting in a possible misalignment."

Until fairly recently, clients with CRTs had only two options: stay the course or exit the trust. Exiting, or terminating the trust, is typically a court-driven process in which the trust donor splits the assets in the trust with the remaindermen based on an IRS formula. This option involves attorney fees and court time, not particularly attractive to many clients, although the sale proceeds are taxed at capital gains rates rather than ordinary income rates.

Now, a relatively new technique—a CRT Rollover—offers new options to clients who might be better served by a different type of trust than what they originally established, primarily because of three drivers: fresh thinking in their later years on how loved ones will be taken care of financially, perhaps wishing to add children or a spouse as an income beneficiary; deferring taxable income, such as can be done by moving from a standard CRT to a type of trust called a Net Income Make-Up Charitable Remainder Unitrust (NIMCRUT); and fixing underperforming NIMCRUTs.

Comparison of CRT Options for a 6% CRUT, 21 Years of Life Expectancy

	NO ACTION[1]	SELL[2]	TERMINATE[3]
Gross Proceeds	$1,012,894	$1,200,000	$999,191
Fees	Unknown	($84,000)	Unknown
Taxes	($235,498)	($223,200)	($199,838)
Net, After-Tax Proceeds	**$777,396**	**$892,800**	**$799,353**

Loss From No Action: ($115,405) or -14.8%
Loss from Termination: ($93,447) or -11.7%

1 *Does not include trustee, administration or similar fees.*

2 *Includes all associated fees.*

3 *Does not include fees associated with termination. Calculated using Estate Planner module of ONESOURCE Trust & Estate Administration.*

Source: Sterling Foundation Management LLC.

In addition, says Evan Unzelman, president of Sterling Foundation Management LLC, "Clients today are demanding liquidity in *many* aspects of their financial lives. That ranges from daily trading of real estate investment trusts to mutual funds to retirement funds accessible through early withdrawals. In the world of trusts, most *living* trusts are revocable or changeable. But with an irrevocable CRT, it's always been viewed as 'for life,' primarily because a CRT's permanence is rooted in the fact that, to qualify for special tax treatment, a CRT must be irrevocable. However, that understanding of CRTs is beginning to change, as clients and advisors alike realize that illiquidity has been an institutional, rather than a fundamental, necessity. We're seeing more clients express an interest in getting beyond the CRT lifetime lockup."

Benefits of Two CRT "Do-Over" Options

A **rollover strategy** can be right for clients who wish to change the terms of a CRT. The rollover itself is "mechanically" always the same: Clients use ownership in a current CRT to form a new CRT that better aligns with their life situation *(see Case Study on next page)*. "It's not *changing* the existing CRT, but it is a blank slate and a fresh start with a new CRT," says Unzelman. "Perhaps the most important point about the rollover is that it should be done in the context of a review of the client's philanthropic intent and current life situation. The vast majority of clients with CRTs have little idea what they own. Clients' other capital assets—stocks, bonds, real estate holdings—typically get an annual, if not much more frequent, review to make sure the assets are still working for them. The CRT as a capital asset is often overlooked, in part because for many clients it was set up years ago."

A second option for a trust that no longer "fits" is **sale of the income stream**, which can be an attractive option in terms of maximizing the cash that the donor can receive. "In our experience,

Selling a CRT Income Interest: What You Need to Know

1. **What authority allows sale of a lead interest in a CRT?**
   An income interest in a trust is generally an asset under state law and is therefore salable under state law in the same manner as other such assets.

2. **Is there a recapture of the initial tax deduction taken by the grantor?**
   No. The seller of an income interest sells only his or her income interest—the portion of the trust value not given to charity. A qualified charity remains, whether named specifically or as to a class, as the remainder beneficiary.

3. **Are there age requirements or restrictions?**
   No. A person of any age can sell an interest. The younger the person, the longer the life expectancy and, therefore, everything else being equal, the greater the value of the income interest.

4. **What if the trust owns illiquid assets?**
   These assets need to be reviewed on a case-by-case basis. They're not necessarily a barrier to a sale.

5. **Who is an ideal buyer for an income interest?**
   The ideal buyers of a CRT income stream have the following characteristics, among others: They have large net worth with good liquidity, are able to tie up a significant sum for a potentially long time in an illiquid asset, may have various tax attributes such as NOLs and loss carry-forwards and are able to withstand the potential sudden drop in the value of their investment to zero in the event of a premature death of a measuring life. Perhaps most importantly, they have an understanding of and appreciation for philanthropy.

Source: Sterling Foundation Management LLC.

many times there is a buyer willing to pay a price that results in the seller receiving more than he or she would if the trust were simply terminated," says Unzelman. "There are several reasons for this, but the primary one is that the IRS formula is just that—a static formula, in which a buyer may anticipate higher future investment returns than a seller; and actuarial risk, which is costly for a donor to hedge, can be diversified away at reduced or no cost to some buyers."

Sale of an income interest provides a donor with a lump sum over which he or she has complete control, giving greater flexibility to the grantor. "Having direct control over these funds may provide the grantor with a greater sense of financial security than simply having a right to annual but uncertain distributions from a CRT," says Unzelman. "Often, clients and advisors are 'doing the math' and discovering that it makes more economic sense to convert a long and uncertain stream of payments into an immediate and certain lump sum. And as for taxes, the taxation of the sale of a CRT income stream is surprisingly simple—the income stream is a capital asset and the sale is taxed at capital gains rates. In addition, the sale of a lead interest does not affect the deduction taken for the remainder interest. A qualified charity remains as the remainder beneficiary."

Flexibility as life changes is an important part of estate, tax and philanthropic planning, says Graper. "Very often, we and our clients have to look at trade-offs of complexity vs. simplicity, not just in their wealth strategies and management, but in their lives. The ability to offer options for more flexibility is always desired. With new options for CRTs, we have the ability to at least evaluate one more option for flexibility and responsiveness to changing situations."

Please talk with your advisor and your attorney for all of the options available on CRTs.

Case Study: The Rollover Option SCRUT to NIMCRUT - Adding Children as Beneficiaries

A Standard CRUT (often referred to as a "SCRUT") pays a fixed percentage of the trust's assets each year. The income beneficiaries do not have a choice as to whether or not they take the income. They must take it, and pay the related tax.

This structure can create problems for clients who have significant income outside of their SCRUTs and don't need or want the additional (taxable) income. If given the choice, many of these clients would rather have a NIMCRUT, which gives them the ability to defer the income to future years and allows the trust to grow the deferred distributions tax-free over that time. Using the CRT Rollover strategy to move these clients from their SCRUT to a NIMCRUT is often an effective planning technique.

In addition to the flexibility to take less income and compound it tax-deferred to take even more later, the rollover allows these clients to add beneficiaries, such as spouses and children, to their CRTs, extending the duration of the income stream to include loved ones who were not previously benefiting from their CRT. This can be a powerful way to build tax-free wealth for future generations.

SITUATION: A 63-year-old client was the sole lifetime beneficiary of a $2,185,000 SCRUT with a 5% payout. She had plenty of income sources outside of the CRT and did not like how the CRT was forcing income to her that she would elect to defer if given the choice. She was even more dissatisfied about the related tax, which in some years approached 50%. She figured she'd pay about a million dollars in taxes over her remaining lifetime, and viewed those taxes as completely unnecessary since she didn't want the income in the first place. She had two daughters she would rather see benefit from the trust, but neither was a beneficiary of the CRT, so as it stood everything in the trust went to charity at her death. Her daughters would receive nothing.

SOLUTION: Sterling helped her advisors roll her SCRUT to a NIMCRUT and added her two daughters as contingent income beneficiaries. Her attorney added structure to the NIMCRUT that gave her complete discretion on whether or not she receives income in any given year. She can defer the distributions in full year after year (as she expects to do), and the trust will grow those deferred distributions tax-free over that time. If for some reason she needs income, in any year she can elect to take the accrued gain the trust has built up. At her death, her daughters will split the future distributions for their joint lifetimes. And because she plans to defer distributions tax-free over a 19-year period of time, her daughters will be receiving distributions from a much larger trust—her financial advisors estimate that at between $3.5 and $4 million.

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