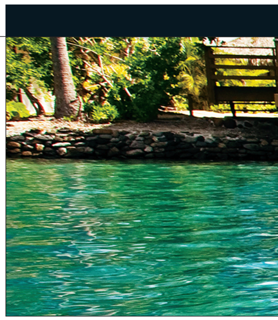

New Opportunities for Old Charitable Remainder Trusts

A sale for cash or rollover to a differently designed CRT can reposition wealth tied up in an old CRT to better satisfy a client's current circumstances.

EVAN UNZELMAN AND SAM NAVARRO

Clients set up charitable remainder trusts (CRTs) for a variety of reasons. These include: the ability to diversify without triggering immediate capital gains tax when an investment has substantially increased in value; the ability to convert an appreciated asset into a lifetime income stream; the deferral of capital gains tax associated with selling appreciated property; a potential reduction in estate tax; an up-front income tax deduction; and the ability to make a large charitable donation while retaining the use of the assets, usually for the rest of their lives. These benefits carry significant appeal for many clients, particularly those who are charitably inclined. The downside of CRTs is inflexibility. Because CRTs are irrevocable, clients have few options for changing or unwinding their trusts.

Clients with CRTs that no longer fit their circumstances are not stuck. Since the mid-2000s, individuals have been able to sell their income interest, usually for cash. Furthermore, a recent innovation, the "CRT rollover," offers huge benefits for many higher-end CRT clients.

Sale for cash

Rev. Rul. 72-243[1] provides that an income interest in a trust is a private capital asset. As such, a CRT income interest is a capital asset that can be bought, sold, or reinvested—just like other private capital assets (e.g., real estate). This was confirmed by several private letter rulings in the early 2000s that looked specifically at the salability of an income interest in a CRT and the tax treatment of the sale proceeds.[2] The status of CRT income interests as capital assets opens up exciting planning possibilities.

Advantages of selling

Before buying and selling CRT income interests became popular in the early 2000s, the only option for a client seeking to exit a CRT was a termination. A client can terminate a CRT in two ways:

1. By gifting the income interest to the charitable remainderman.
2. By splitting the trust's assets with the charitable remainderman according to an IRS formula—the "7520 rules."

Before the sale option, clients who set up their CRTs mainly to benefit charity tended to gift their income interest to the charitable remainderman. Clients who needed income from their CRTs pursued an actuarial split of the trust.

Sale vs. termination or split-up. Any clients who are seeking cash

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should consider a sale of their CRT income interest. Selling a CRT income interest is usually much faster than a termination, and frequently results in the clients receiving more money than they would in a termination. The typical sale is a quick, relatively painless two- to four-week endeavor. By contrast, a termination—which requires going to court and may require notifying the attorney general—can take several months (or even more than a year in some states) to complete. Because clients may get more money from selling a CRT income interest than they can by terminating a CRT (and because they can usually access that money more quickly), a sale of the income interest can be an attractive option for accessing liquidity.

Another common driver of CRT income interest sales is divorce. For a divorcing couple with a joint life interest in a CRT, the optimal solution is often to sell the interest and split the proceeds so that both parties can go their separate ways. A divorcing couple could go to court and split a CRT, creating a smaller income stream for each beneficiary, but a sale is typically much easier than what can be an involved, expensive process (especially during an even more involved, more expensive divorce process). Moreover, each income beneficiary would have to appoint his or her own trustee and complete an additional tax return each year, further complicating matters. Selling the income interest is typically the easiest and most prudent course of action.

Reasons to sell. A partial list of the many other reasons that people sell the interests in their CRTs is as follows:

- *Value maximization.* Clients with CRTs may net more by selling their income interests than they can by retaining the interests and waiting for future income.
- *Flexibility.* Many clients prefer the flexibility of a lump sum of cash to a future income stream.
- *Simplification.* Many clients grow tired of the hassles and costs associated with maintaining a CRT and wish to simply their financial affairs. In these cases, a sale can offer a welcome respite from the administrative costs and obligations.

Regardless of the exact reason, most sales occur because something has changed since the CRT was created. The following case studies, based on real-life client experiences, highlight some of the common motivations for pursuing a transaction.

Case study #1. *Value maximization.* Sue was a C-Suite executive at one of the largest private food processing companies in the world. Toward the end of the bull market in the late 1990s, she had some very large unrealized gains in her stock portfolio. While she did not need the money, she was interested in converting some of her highly appreciated stock into income.

Wary of the market's rising tide and the capital gains taxes she would incur by selling her appreciated shares, she opted to set up a CRT. By contributing her holdings to a standard CRUT, Sue realized that she could generate an immediate tax deduction, diversify her shares, and create an annual lifetime income stream. She set up the CRT, which sold the shares and invested in a portfolio designed to earn more than the CRT's annual 7% distribution.

In the late 1990s, Sue's financial advisor Tony became drawn to the high yields and low valuations of REITs. After selling Sue's highly appreciated stock, he urged her to invest heavily in REITs, which she did. One year later, when the tech bubble burst and the stock market came crashing down to earth, the REITs not only helped Sue hold her position in the CRT, it actually grew the trust corpus.

The REITs continued to outperform into the early 2000s, eventually reaching what Tony considered "stratospheric" heights in 2004. Tony urged Sue to cut back on her position and sell some of her REITs, only to watch some of her former holdings double in value over the next couple of years. While Sue did not complain, Tony began to realize that, without the REITs and with bond yields at historic lows, it was becoming increasingly difficult for the CRT to earn the distribution amount. He was forced to sell assets inside the trust to make the required distributions—an idea he was not crazy about but one that he preferred to investing in overvalued assets. He watched, concerned, as the value of the CRT declined for three straight years.

When Tony learned that Sue could sell her income interest—for an amount that exceeded the after-tax value of Sue's interest, no less—he sprang into action. Tony explained the process to Sue, who quickly grasped its benefits and urged him to move forward.

Case study #2. *Simplification.* Kevin had always been a bit of a maverick. While enrolled at CalTech University, he used the money he made teaching guitar lessons to his classmates to fund his gambling pursuits at a local pool hall. When a jealous roommate reported Kevin's activity to University officials, he was promptly suspended for a semester. Kevin's parents were livid—until he informed

1 1972-1 CB 233.

them that he had earned enough money playing pool to finance the rest of his degree (once he was allowed to return to school).

Several years later, Kevin was selling cars in Los Angeles when he decided that he wanted a career change. He became fascinated by the New York Stock Exchange after watching a documentary on the subject, recognizing that the same savviness and calmness that had enabled him to succeed in pool halls would serve him well in floor trading. He packed his bags and headed to New York, where he was able to talk himself into a clerk position on the floor of the Exchange. Shortly thereafter, he secured a position as a trader, where he promptly made a lot of money, then lost everything he had—three times. Undeterred, Kevin stuck with it. After a while, he became adept at identifying "pump-and-dump" schemes. In an industry in which timing is everything, buying low and selling high came naturally to Kevin.

Kevin's ability to analyze the market without succumbing to the emotional pull of its "herd mentality" was well-suited to floor trading. He won more often than he lost, but every time he made money on a large trade, his thoughts reverted to the several times he had "bottomed out" at the start of his career. As Kevin became older, he hedged his bets and set up a CRT with highly appreciated stock from his personal portfolio. He liked the CRT for two reasons:

1. Its structure enabled him to sell the stock inside the trust and avoid a hefty capital gains tax.
2. It provided him a consistent income stream for the rest of his life, a buffer that could offset the financial pain of a sudden loss of most or all of his net worth.

As it turned out, Kevin's paranoia was unjustified. He enjoyed a very lucrative career, retiring at the age of 52. By that point, he did not need or even want his CRT—he thought it burdensome, and he hated paying the taxes. One day, Kevin received a call from his CPA, who told him that he had mistakenly distributed capital gains to Kevin as income two years prior. According to the CPA, Kevin would have to repay the trust. One month later, Kevin's trustee announced his retirement, sending Kevin a curt email announcing the pending termination of their relationship and pursuing a shortlist of replacement options.

Exasperated, Kevin began to consider other options. For someone who had spent his entire life working, he certainly did not want to spend his retirement years dealing with CRT-related headaches and paying a bunch of unnecessary taxes and fees. After learning that he could sell his CRT income interest, he opted to do so. Two weeks later, he had a lump sum of cash equivalent to the after-tax present value of his income interest in the CRT; most importantly, he was finally freed from the restrictions and hassles of the trust.

CRT rollover: evolution of a planning option

While selling the income interest in a CRT is a great option for many clients who are dissatisfied with their trusts, it is not the best option for everyone. Some clients simply do not need a large lump-sum payment; others might balk at paying the associated capital gains tax. Many clients like their CRTs; they just wish that they could somehow change the trust terms and conditions. Some might want to add beneficiaries to their CRTs, such as their children or spouses; others with standard CRUTs might become curious to

know if they can defer their distributions, either because they do not need money, dislike paying taxes on the income, or both; and still others express an interest in changing an underperforming NIMCRUT to a standard CRUT to get a larger and more consistent payout. The rollover is a way for clients with CRTs to fix these (and other) misalignments.

The CRT rollover is an ideal strategy for clients who want to change something about their CRT. While the nature of a rollover can vary based on a client's situation, the process and technique are always the same—a client uses his or her ownership interest in the current CRT to form a new CRT that is better aligned to the client's situation.

CRT rollover: common drivers and case studies

CRT clients can use a rollover to make any number of changes to their trusts. Some of the common drivers include:

- Adding children as income beneficiaries.
- Adding a spouse as an income beneficiary.
- Deferring taxable income from a CRT.
- Fixing an underperforming NIMCRUT.
- Increasing total trust income.

The following case studies, based on real-life client experiences, highlight some of the common motivations for pursuing a rollover.

Case study #1. *Standard CRUT to standard CRUT, add spouse as beneficiary.* Six years after founding Tellabs Inc., a telecom company that would eventually grow to a $3 billion international giant, Marty Hambel decided to pursue other interests; namely, real estate and the raising of thoroughbred racing horses. He established a CRT funded by highly appreciated Tellabs stock, and listed himself and his wife Grace as income beneficiaries.

Nearly 20 years later, Grace passed away from cancer. While grief-stricken, Marty tried his best to move on, adhering to his daily routine and immersing himself in various pursuits. He sought the comfort of Carole, a long-time friend he had met at church. Over time, their friendship blossomed into a much stronger bond. Eventually, the two of them decided to marry.

Marty felt reborn after his marriage to Carole, but the passing of Grace still haunted him. He started to become increasingly concerned about what would happen to his new wife (who was several years younger) if he predeceased her. If he did, he knew that Carole would suffer a dramatic decline in living standards. As the last surviving income beneficiary, Marty understood that his CRT was set to end upon his death and pay the remaining balance to charity.

After consulting with an estate planner, Marty and Carole determined that their best option was to roll Marty's current CRT income interest into a new CRT and add Carole as an income beneficiary. Now, instead of ending when Marty dies, the trust is guaranteed to continue until the last of them—Marty or Carole—passes. Marty can rest assured that Carole will be cared for after he is gone, and the two of them can fully devote themselves to their new passion: cross-country RV excursions.

Case study #2. *Standard CRUT to NIMCRUT, add children as beneficiaries and structure for deferral.* By the time he was 30, Josh was the principal of a California-based commercial real estate firm that had leased and developed millions of square feet of real estate. As California grew, attracting millions of new residents and businesses from across the U.S., Josh's biggest challenges became managing his company's rapid growth and juggling an expanding project portfolio. When a promising new venture materialized in the early 1980s, Josh suddenly found his resources stretched too thin. He opted to sell some vacant lots he owned to another developer so he could sharpen his focus on the most promising projects in his pipeline.

Josh knew that the value of the land he planned to sell had appreciated significantly since he had purchased it. Not wanting to pay a hefty capital gains tax bill, Josh decided to set up a CRT and fund it with the undeveloped land. He added his wife, Elaine, as an income beneficiary. Josh then sold the property inside the CRT, which helped him avoid the up-front capital gains tax and create a steady stream of future income.

Over the course of a career that spanned four decades, Josh invested in countless ventures. By the time he and Elaine approached retirement age, these ventures were producing more income than the couple knew what to do with. Not only did they not need the income from their CRT, they did not like that they were paying what was close to a 50% effective tax rate on the distributions. More importantly, their children's lives had become very complicated. One had developed a rare blood disease that required costly treatments, and another had become the mother of seven children. It was not uncommon for Josh and Elaine to use part of their annual CRT distribution to support their children and their children's families.

As time passed, Josh and Elaine started to become increasingly concerned about their children's well-being. They wanted to know if there was a way to use their CRT—which was set to expire at the last of their

EXHIBIT 1
Authorities Regarding Certain Aspects of CRT Transactions

Below is a summary of the legal authorities regarding different aspects of CRT transactions.

Lead Interest as a Capital Asset:
- *McAllister*, 157 F.2d 235, 35 AFTR 91 (CA-2, 1946), *cert. den.* 330 U.S. 826 (1947); Rev. Rul. 72-243, 1972-1 CB 233.
- Ltr. Rul. 200152018.
- Ltr. Rul. 200127023.

Charitable Deduction:
Conditions under which contribution of a CRT lead interest can qualify for the income tax charitable deduction under Section 170 and the gift tax charitable deduction under Section 2522:

- Rev. Rul. 86-60, 1986-1 CB 302.
- Rev. Rul. 79-295, 1979-2 CB 349.
- Ltr. Rul. 201321012.
- Ltr. Rul. 201249002.
- Ltr. Rul. 200630006.
- Ltr. Rul. 200524014.
- Ltr. Rul. 200205008.

Assignment of Income Considerations:
- *Blair*, 300 U.S. 5, 18 AFTR 1132 (1937) (distinguishing the key assignment of income authorities, such as *Lucas v. Earl*, 281 U.S. 111, 8 AFTR 10287 (1930)) and holding that the irrevocable assignment of an equitable interest in a trust is sufficient to shift the taxability of the income interest to the assignees.
- *Harrison v. Shaffner*, 312 U.S. 579, 25 AFTR 1209 (1941) (distinguishing *Blair* on the specific facts of the case).
- *Raymond*, 247 F. Supp. 2d 548 (2002) (in the context of the taxability of a contingent fee agreement).
- *Farkas*, 170 F.2d 201 (CA-5, 1948).
- *Hawaiian Trust Co., Limited v. Kanne*, 172 F. 2d 74 (CA-9, 1949).
- Rev. Rul. 55-38, 1955-1 CB 389.
- Ltr. Rul. 9031010.
- Ltr. Rul. 8932040.
- Ltr. Rul. 8650024.

***Palmer*-Type Issues:**
- *Palmer*, 62 TC 684 (1974), *aff'd. on other grounds* 523 F. 2d 1308, 36 AFTR2d 75-5942 (CA-8, 1975), *acq.* 1978-1 CB 2.
- Rev. Rul. 78-197, 1978-1 CB 83.
- *Rauenhorst*, 119 TC 157 (2002).
- *Blake*, 697 F.2d 473, 51 AFTR2d 83-445 (CA-2, 1982).
- Ltr. Rul. 201012050.
- Ltr. Rul. 200321010.
- Ltr. Rul. 200230004.
- Ltr. Rul. 9611047.
- Ltr. Rul. 8639046.

deaths—to continue to benefit their children after they passed away.

After several conversations with their financial advisor, the couple determined that their best option was to roll their current CRT income interest into a new NIMCRUT and add their children as contingent income beneficiaries. Now, instead of ending when Josh and Elaine pass away, their trust will last for the rest of their children's lives. Although the couple had to take a slight haircut on the CRT assets, the NIMCRUT is currently enabling them to support their children when necessary and defer any taxable CRT income distributions their children do not need into the future.

By the end of Josh and Elaine's joint life expectancy, the value of the trust will be much greater than it is today. At that point, their children will be able to begin taking substantially larger income distributions than their parents ever received.

Case study #3. *NIMCRUT to standard CRUT.* Walter is the vice president of marketing of the North American division of a multina-

tional bank; his wife, Rhonda, is a CPA at a mid-sized firm. The two met in the early-1990s while working for a technology startup outside of San Francisco. A couple of years later, they were married with two small children. As the tech bubble developed, the young family watched the shares of their company stock skyrocket. During one particularly frenetic week, their share prices soared by over 1,000%.

Ever the skeptic, Walter began to sense that the entire industry had become afflicted with a speculative mania. After the company announced some modest changes to its website and its stock price doubled (again), he decided to take action. He set up a CRT, added himself and his new wife as joint income beneficiaries, put the majority of their stock inside the trust, sold the shares (deferring a huge capital gain in the process), and reinvested the proceeds in marketable securities. Six months later, the bubble burst.

Walter and Ronda had not owned a huge piece of the company, but they cashed out at exactly the right time. They decided to take some time off and spent six months traveling with their young daughters around Europe, South Africa, and the Far East. Eventually, they relocated to the East Coast to be closer to their families and settled into more stable careers at established firms.

While the couple was on strong financial footing, they were not completely immune to financial pressures. In early 2015, Walter and Rhonda's elder daughter, Christina, got engaged, and their younger daughter, Vicki, was accepted to Harvard. Walter and Rhonda were proud of their children, but they were also facing the high costs of a wedding and four years of massive tuition payments. Walter had two objectives:

1. Free up cash to help pay for Christina's wedding.
2. Generate more income from the CRT to pay for four years of Vicki's Harvard tuition.

After speaking with their estate planner, Walter and Rhonda determined that the best strategy would be to roll their current CRT into a new CRT with a higher payout rate. First, Walter received a large tax deduction in connection with the rollover, which reduced the family's taxable income. Second, even though the starting value of the new CRT was 90% of the value of the original CRT, its higher payout rate is projected to generate more income for Walter and Rhonda over the next five to seven years. The tax deduction relieved a lot of the pressure of the cost of Christina's wedding, and the higher projected distributions should put Walter and Rhonda in a much better position to be able to afford Vicki's Harvard tuition.

Answers to frequently asked questions

Various myths are associated with the secondary market for CRT income interests. This section highlights (and debunks) nine of the most common.

Answer #1. *A seller of a CRT income interest pays long-term capital gains tax on the sale proceeds.* Rev. Rul. 72-243 confirms that an income interest in any trust is a private capital asset, and proceeds from the sale of that interest are capital gains property in the hands of the seller. A series of letter rulings that came out in the early 2000s,[3] which reference the original 1972 revenue ruling as their basis, confirm the salability and tax treatment of an income interest in a CRT specifically.

Answer #2. *A seller may have significant basis in his or her income interest, saving significant tax on a sale.* In January 2014, the IRS released proposed basis regulations involving sales of CRT interests. Those regulations, which were finalized without change in August 2015:

1. Are limited in scope to basis issues and application of Section 1001(e)(3) and do not in any way affect the ability of an income interest holder to sell his or her interest.
2. Reject a set zero-basis rule for the seller.
3. Adopt a rule that the seller's basis is his or her portion of the uniform basis of the underlying assets reduced (but not below zero) by undistributed ordinary income and net capital gain in the CRT.

Answer #3. *Selling or rolling a CRT income interest often makes sense for beneficiaries regardless of their age.* While younger people do have longer life expectancies, and therefore, the value of their income interest would be greater than an older person's interest (all else equal), anybody can sell or roll their interest for an amount that is (typically) greater than the after-tax present value of their income stream. In other words, selling a CRT income interest almost always makes financial sense, regardless of a client's age. By that same reasoning, if a client pursues a rollover, the starting value of the new CRT will typically be greater than the value of the interest in the former CRT.

Answer #4. *A CRT interest can usually be sold or rolled even if the CRT trust agreement contains a spendthrift clause.* A spendthrift clause is

[2] See, e.g., Ltr. Rul. 200739004.

[3] *Id.*

[4] See Blair, 300 U.S. 5, 18 AFTR 1132 (1937) and Lucas v. Earl, 281 U.S. 111, 8 AFTR 10287 (1930).

[5] 62 TC 684.

typically not a barrier to a sale or rollover. Many experts believe that a spendthrift clause in a self-settled trust is not enforceable. And in most cases, the risk (if any) associated with purchasing the income interest of a trust with a spendthrift provision can be handled contractually among the parties involved.

Answer #5. *A CRT rollover does not generate "assignment of income."* The irrevocable assignment of a CRT income interest is sufficient to shift the taxability of the income interest to the new CRT (the assignee).[4] Because the new CRT is exempt, no taxes are owed. As with all contributions of nonpublicly traded assets, advisors should be sensitive to *Palmer*[5]-type issues (i.e., gifts of stock to a charity that are subsequently redeemed pursuant to a prearranged plan).

Answer #6. *A client who wishes to sell or roll a CRT income interest generally does not need to be medically underwritten and insurable.* In general, the seller is not required to be medically underwritten. In addition, sellers who may not be insurable can often still sell their income interest in a CRT. In fact, a person's lack of insurability can be a reason for considering selling the income interest, because the client is uncomfortable bearing the financial risk of not receiving all of the expected payments.

Answer #7. *A grantor who sells or rolls an interest in a CRT gets to keep the entire original tax deduction received upon setting up the trust.* A CRT is a split-interest trust. When the trust is created, the life interest (typically, or term interest in the case of a term trust) at a stated rate (or dollar amount in the case of a CRAT) belongs to the grantor. This is the income interest that may be sold. The remainder interest is given irrevocably to charity when the trust is created. It is this gift which gives rise to the initial tax deduction. The sale of the lead interest does not change the fact the remainder is still assigned to charity.

Answer #8. *An arm's length transaction with an unrelated party with not give rise to an "excess benefit transaction."* The proceeds of a sale or rollover of a CRT income interest cannot be considered "excess benefit" as long as the buyer is an independent third party. Also, the price the buyer pays for the income interest is irrelevant because the assets inside the CRT—and therefore the future income stream and the amount eventually distributed to charity—are unaffected by the transaction.

Answer #9. *A sale or rollover is often possible even if the trust owns illiquid assets.* While illiquid assets need to be looked at on a case-by-case basis, they are not necessarily a barrier to a sale. Numerous transactions have been completed in the past in which illiquid assets were among the assets of the CRT.

Conclusion

Well-designed CRTs can fulfill a variety of planning objectives. Yet, a client's circumstances could subsequently change sufficiently that the CRT drafted for a prior stage of his or her life no longer fits the client's needs. In this situation, a sale or rollover of the CRT may assist in reallocating the client's assets to better meet current and future desires. Exhibit 1 lists sources of IRS guidance that should be consulted when structuring CRT transactions. ■