

STERLING RESEARCH SERIES

New Frontiers in Charitable Remainder Trusts

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Why People Set Up CRTs

There are three main reasons people set up CRTs. These are to defer taxes on gain; to use pre-tax money to generate income; and to obtain an income tax deduction.

Defer Taxes

The majority of CRTs are set up when the CRT donor wishes to sell an asset that has a big gain. By contributing the asset to a CRT before selling the asset, the donor can defer tax on the sale, because the CRT does not pay taxes. That means that the CRT can sell the asset, and keep 100% of the proceeds.

Generate Income With Pre-Tax Dollars

Because the CRT keeps 100% of the proceeds from the sale of the assets the donor put into the CRT, that entire amount, without being reduced by taxes, is able to grow and earn income inside the CRT. Most CRT donors receive a lifetime income from their CRT, and pay tax only as they receive the income.

Income Tax Deduction

When you contribute an asset to a CRT, you are making a charitable contribution. Charitable contributions are deductible for federal income taxes, and for most states that have an income tax. Depending on the specifics of the CRT and the donor's tax situation, the charitable deduction can, in effect, make several years of CRT income tax-free for the donor.

Kinds of CRTs

There are two families of CRTs: CRATs and CRUTs. CRAT stands for Charitable Remainder Annuity Trust. CRUT stands for Charitable Remainder Unitrust. An annuity trust pays you the same dollar amount every year, and a unitrust pays you the same percentage of the trust assets every year.

There is only one kind of CRAT.

There are four kinds of CRUTs. These are the regular or straight CRUT, also known as a SCRUT; the Net-Income-Only-CRUT, also known as a NICRUT; and the Net-Income-with-Makeup-CRUT, also known as a NIMCRUT; and a Flip-CRUT.

A SCRUT pays a fixed percentage each year, regardless of how much income the trust has earned. A NICRUT pays out only the amount earned each year, up to a maximum percentage stated in the trust document. A NIMCRUT also pays out only the amount earned each year, but if there are years that the NIMCRUT earns less than the stated distribution amount, those unpaid amounts can be accrued and paid out later if they are eventually earned. A Flip-CRUT begins life as a NIMCRUT, and then, when a specified trigger event occurs, 'flips' to become a SCRUT.

Payment Rates

The payment rate on a CRT must be at least 5%, and no more than a maximum which is deter-

mined by an IRS formula. The formula is based on the life expectancy (determined from an IRS table) of the beneficiaries in the case of a lifetime trust, and on the term of years in the case of a term trust.

The exact formula is complicated. But, in essence, the older the people, the higher the possible payout rate. Here are a few examples, based on the formula results at the time I'm writing this. For a couple who are both 70 years old, the maximum rate possible is about 14%, and if both are 60, the maximum rate possible is about 9%. For a single 65 year-old, about 19% is possible.

There are a number of factors that go into selecting an appropriate payout rate, but the selected payout rate must always be at least 5% and no more than the permitted maximum given the ages of the beneficiaries.

Payment Frequency

When you set up a CRT, you have the choice of taking your payments monthly, quarterly, or annually, at the end of each month, quarter, or year. The choice you make can affect the maximum rate you can set, and it can affect your tax deduction. Everything else equal, the lower the frequency of payments, the higher the maximum possible payout rate. And also, everything else equal, the lower the frequency, the higher your tax deduction.

To set the rate as high as possible, use annual payments. But if more frequent payments are important, the difference in possible payout rate or in the size of the tax deduction is usually not large.

Who Are the Beneficiaries

A CRT must have at least one charitable beneficiary and at least one non-charitable beneficiary. A charitable beneficiary is called a remainderman, and the non-charitable beneficiary is called an income beneficiary.

The income beneficiaries are the people who get the payments from the trust every month, quarter or year.

It is possible to have a single income beneficiary, or several. It is very common to have a husband and wife be joint beneficiaries.

It is less common, but possible, for parents to include children, and perhaps even grandchildren, depending on the ages of everyone.

Usually, the donor retains the right to change the remainderman any time during the life of the trust, provided that the remainderman is a qualified beneficiary.

CRTs Are Irrevocable

Trusts can be revocable or irrevocable. A revocable trust can be changed or cancelled at the discretion of the grantor, that is, the person who funds it. An irrevocable trust, once created and funded, cannot be changed or cancelled.

In order to qualify for the special tax treatment that Charitable Remainder Trusts receive, a trust must be irrevocable.

Once you set up a CRT, you cannot change it. If you want to change the payout rate, you cannot change the trust. If you want to add an income beneficiary, such as a wife or husband or child, you cannot change the trust. If you want to change from annual payments to monthly payments, or the other way around, you cannot change the trust.

You Can't Change Your CRT, But That Doesn't Have to Mean You're Stuck

As noted above, your CRT is irrevocable, which means that you can't change the trust or reverse the transaction that created your trust. Your CRT is irrevocable because it has to be, according to sec-

tion 664 for the Internal Revenue Code, in order to qualify as a CRT.

You can't change the trust itself (except possibly for administrative changes which might be required to keep the trust qualified). You don't own the entire CRT.

Instead, you own the right to receive payments from the CRT. And you are free to do pretty much anything with that right, from keeping it as-is, to giving it away to charity or heirs, or selling it, or using it in a CRT Rollover.

How Do You Tell If Your CRT Is a Perfect Fit?

Assuming your CRT was a good fit for you when you set it up, you might wonder how you can tell if it still fits as well. You might want to consider the following issues:

1. Would you like a higher payout?
2. Do you not need the money, and would prefer to have it compound tax-deferred?
3. Would you like an additional income tax deduction now?
4. If you have a NIMCRUT, is it earning its payout? Would you like a higher payment, or a more stable payment?
5. If you have a SCRUT, would like the flexibility, or the ability to take less income and compound it tax-deferred to take even more later?
6. Would you like to add a beneficiary, for example a wife, husband, child or grandchild?
7. If you expect not to have a taxable estate, would you like to leave more to your children or grandchildren?
8. If you do expect to have a taxable estate, would you like to take advantage of modern planning techniques to get more money to your heirs and less to taxes?

If you answered yes to any of these questions, then your CRT might not now be the best possible fit

for you. You may, or may not, be able to improve your situation. What follows now are several examples of situations, based on actual cases, that illustrate some of the possible ways that the fit of an old CRT can be improved. We respect our clients' confidentiality, so all the names have been changed, and specific identifying information has also been changed.

Couple Discovers Silver Lining to Being Older — Rollover to Higher Payout

Are you older than you were when you set up your CRT? Yes, that is a silly question.

But people sometimes forget the maximum payout rate permissible on a CRT rises as you get older.

For example, Bob and Dorothy have a 7% SCRUT that they set up during the last decade. They anticipated that the trust would easily earn the 7%, and still be able to grow, increasing their income. However, although the last two years have seen nice growth in the trust's assets, their income has not grown as they had hoped.

They were pleased to learn that given their current ages of 65 and 60, they can qualify for a CRT with a 10% payout, up from their current trust payout rate of 7%. They are looking at a CRT Rollover into a higher paying SCRUT.

Underperforming NIMCRUT — Rollover to SCRUT

The Grants are facing a different problem than Dorothy and Bob. The Grants have a 6% NIMCRUT but their investments rarely produce 6%. Over the last decade, they've been able to get an average of only 3 to 4% income, and therefore their payments are much lower than the 6% that they had expected when they set up the trust. They've accumulated a large unpaid deficiency, and are getting quite fed up.

They considered selling their income interest outright, but they didn't want to pay a large tax bill.

So, is there anything they can do?

Yes. They are looking to roll from their underperforming NIMCRUT into a 7% SCRUT. The new SCRUT, their advisors tell them, should be able to earn an average total return (not just interest and dividends) of 7%. But even if it falls short, because it is a SCRUT, and not a NIMCRUT, the Grants will receive their 7% each year, regardless of whether the trust accounting income is greater, less, or equal to 7%. The Grants want income, and this new SCRUT should give it to them.

By rolling over, they'll also get an income tax deduction.

Aging Grantor Wants to Add Children — Rollover SCRUT to NIMCRUT

Mildred S. has done well. She and her husband William set up their 6.35% SCRUT almost two decades ago. William has since passed on, but a strong allocation to value stocks enabled them to almost skip the 2001–2003 bear market, they rode the market down in 2008–9, and all the way back up. Mildred now has over \$2 million in the trust, and doesn't need the income. She wants to provide more to her children.

One alternative is to take the income, currently over \$120,000 a year, pay income tax, and give what's left to the kids. Unfortunately, Mildred lives in a state with a high income tax, and her accountant told her that she'd pay almost half of each payment in taxes, leaving little for the kids.

He suggested instead that she rollover her SCRUT to a new NIMCRUT, and add her two sons as income beneficiaries. Given everyone's ages, she is

able to do this and still keep the payout rate the same, at 6.35%. And, she'll get an income tax deduction, which she and her accountant like too.

Grandparents Use CRUT to Help with Grandchildren's College

Henry and Blanche T. have four grandchildren between the ages of 3 and 12. They want to help with the children's college tuition. Henry and Blanche also have 7% SCRUT with a value of about \$600,000 now. They've been paying tax at high rates for years, but for them the Obamacare 3.8% tax is, in Henry's words, "The straw that broke the camel's back."

So Henry and Blanche are doing something about it. They're rolling their SCRUT into a new Flip-CRUT. The trust will flip when the oldest grandchild turns 18. They figure that the income will then go to the grandkids, and be taxed at their lower rates. In the meantime, the assets will grow tax-deferred, and they won't miss the income because they're not spending it now anyhow.

Remarried Man Uses a CRT Rollover to Add His Younger Wife

Arnoldo and his first wife emigrated from Argentina during the period of the Junta and settled in Seattle. Arnoldo flourished in the software boom, but his wife hated the cold and the rain. They divorced and she moved to Miami. Arnoldo enjoyed a huge gain in his employer's stock. Wanting to diversify to reduce the risk of a market reverse, he used a large part of his appreciated stock to fund a 6% SCRUT. Because he was divorced, he is the only beneficiary. Some time after he funded his CRT, Arnoldo retired. He was, and is, able to live very comfortably on the 6% of a CRUT which is still valued in the millions.

About a decade after setting up the trust, Arnoldo, then in his late fifties, married a woman 23 years

his junior. They had children together. Arnoldo has been involved in other business ventures, but none have paid off like that first one.

Arnoldo likes his SCRUT, and likes the income. But he is concerned that his wife will suffer a cut in living standards when he dies. He doesn't want to sell and pay a big capital gains tax.

The solution for Arnoldo is to roll his current SCRUT into a new SCRUT which also includes his wife as a beneficiary. Their annual income will drop somewhat, but instead of stopping when Arnoldo dies, it will continue for his wife's entire life too. And they'll get an income tax deduction which for the first couple of years will almost completely offset the reduced income.

Selling a CRT to Leave More to Children

Donald and Helen don't like taxes more than anyone else. Yet they found a silver lining in the tax law that took effect January 1, 2013. That law raised the estate-tax exempt amount to over \$5 million per person, or over \$10 million per couple. Donald and Helen don't have that much, and never will.

But they care, because they have a CRT they funded years ago when the exemptions were only \$600,000 per person. Helen remembers when her mother died in 1993 and the government gutted her \$2 million estate. "The [expletive deleted] government got more than any of us kids," she said bitterly. "I don't want our money feeding their greedy maw."

Now it won't, because of the higher exemption. But Donald and Helen's kids won't get anything if they die with their CRT in place, because when they die, they get no more out of it.

So Donald and Helen decided to sell their income interest, invest the capital, live off the income, and

leave the entire lump sum, which is under \$5 million, to their two children.

Time Changes Things

Few things in our lives are unaffected by the passage of time. People get married, and divorced. Children are born. People pass away. Incomes rise, and fall. The stock, bond, and real estate markets rise and fall. Needs change.

Because of changes like these, and others, old CRTs are not always great fits for their beneficiaries after a number of years.

Can You Be Made Better Off?

Your situation is unique. You know it better than anyone else. It is possible that your CRT fits your needs better than any available alternative. It is also possible that a better alternative exists. In most cases, a better alternative does exist, and we can help find it.



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Roger D. Silk is the CEO of Sterling Foundation Management. He is a widely recognized expert in the field of private foundations and charitable trusts and his articles have appeared in magazines such as *Estate Planning*, *Philanthropy*, the *Journal of Financial Planning* and *Trusts & Estates*. Dr. Silk earned a Ph.D. and an M.A. in applied economics from Stanford University, as well as a B.A. in economics (with distinction). He is the author, along with James Lintott, of *Creating a Private Foundation* (2003) and *Managing Foundations and Charitable Trusts* (2011).

About Sterling Foundation Management

Sterling Foundation Management has been advising charities, charitable donors and their advisors since 1998. Over that time, Sterling has reviewed thousands of CRTs, foundations, charitable trusts, and other non-profits; set up numerous charitable trusts, foundations and non-profit corporations; and advised hundreds of charities, donors and their professional advisors.



Resources

If you'd like to learn more, or find out how your situation might be improved, you can contact Sterling Foundation Management by calling (703) 437-9720. If you refer to this Research Report, New Frontiers, or report number 1501, we'll be happy to discuss any of the approaches and help you determine whether any might make sense for you.