Completing Charitable Remainder Trust Reviews: An Advisor's Guide

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Abstract: *Ever since the charitable remainder trust (CRT) was introduced to the Tax Code in 1969, most advisors have considered CRTs to be "buy-it-and-forget-it" vehicles, and for good reason. Until the last few years, there were few or no alternatives for clients once they had funded their CRTs.*

Now that there are alternatives, it makes sense to do what advisors always do: continuously review their clients' situations, the markets, and "other factors," as recommended by the North American Securities Administrators Association.

This article walks you through a procedure you can use to determine if your client's CRT is still the best vehicle to meet the client's objectives. If you determine that the CRT is no longer meeting these goals, you may want to consider discussing alternatives that may be more advantageous.

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The SEC requires public companies to file extensive reports every three months. Auto makers recommend changing your oil every 5,000 miles. And the annual physical has been a part of life for a century. Now, many advisors are finding that the annual review idea also applies to charitable remainder trusts (CRTs).

"What a difference a year makes!" While the statement is a cliché, it nevertheless is true, especially so in times of economic flux. Ever since the CRT was introduced to the Tax Code in 1969, most advisors have considered CRTs to be "buy-it-and-forget-it" vehicles, and for good reason. Until the last few years, there were few or no alternatives for clients once they had funded their CRTs.

Now that there are alternatives, it makes sense to do what advisors always do: continuously review their clients' situations, the markets, and "other factors," as recommended by the North American Securities Administrators Association in its "Investment Adviser Guide."[1]

This article walks you through a procedure you can use to determine if your client's CRT is still the best vehicle to meet the client's objectives. If you determine that the CRT is no longer meeting these goals, you may want to consider discussing alternatives that may be more advantageous.

CRTs: A Primer

A CRT is a split-interest trust to which a client donates assets in exchange for tax benefits and the right to receive income for the remainder of his life (or joint lives with a spouse) or a specified term up to 20 years. When the donor dies or the term expires, whatever is left in the trust goes to charity (hence the name).

CRTs are primarily income tax-planning vehicles, generally used for charity-minded clients who own appreciated property. When a donor establishes a CRT, he avoids any capital gain tax that he would have paid on the sale of the appreciated assets, removes the assets from his estate, and gets a charitable deduction for the amount that is projected to go to charity.

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 duration of the trust.

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 with a cost basis of $500,000. If the donor sells the stock, he will pay capital gains taxes of approximately $75,000 (more in many states) on the $500,000 gain. This would leave the donor with $925,000 to invest. If the donor puts the stock into a CRT instead and the CRT sells the stock, he postpones paying the capital gains tax and the CRT can invest the entire $1 million. In addition, the donor gets an immediate income tax deduction for the present value of the remainder interest.

There is a cost for these benefits. Instead of having $925,000, the donor only has the right to receive payments from the CRT. The actual value of these payments may turn out to be more or less than $925,000. These tax benefits are designed to help charity, so the law requires that the remainder beneficiary, i.e. the charity, gets at least 10% of the initial amount put into the CRT. In practice, this limits the amount the donor can receive as annual payments.

There are two types of CRTs. They differ only in how the cash flows to the donor are calculated. The first is a charitable remainder annuity trust (CRAT), in which the cash flows are fixed as a percentage of the trust assets valued 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 revalued annually. Thus, the cash flows from a CRUT change as the value of the trust assets changes, i.e., they can grow or diminish. 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, but the disadvantage is that they cannot grow.

The Benefits of a CRT Review

Most clients set up their CRTs for one or more of the following reasons:

1. To take advantage of the opportunity to escape capital gains tax on the sale of a highly appreciated asset
2. To generate an ongoing income stream
3. To generate an immediate income tax deduction
4. To demonstrate their support for charity

As you conduct your review, both you and your client should keep in mind the client's original and current goals.

Since the tax benefits are realized early, an effective review focuses on confirming that the income stream still addresses your client's financial and personal goals and that there are no better alternatives.

There are a number of variables that affect the ongoing desirability of the CRT. Some are controllable; others are not. For example, investments don't always perform as expected; tax laws change; people die and/or get divorced; unexpected cash needs arise; and, sometimes, unforeseen opportunities present themselves. Any of these changes, as well as dozens of others, might make a change in CRT strategy beneficial for your client.

Only by thoroughly reviewing your client's situation and their CRT can you determine what changes, if any, are appropriate for your client.

The following provides a step-by-step guide to help you plan and execute a thorough CRT review.

Step 1:
Review the Reasons for Creating the CRT

Begin by revisiting your client's reasons for creating the CRT in the first place. The following is a discussion of some of the more common reasons.

Defer or Avoid Capital Gains Tax

Here's a common scenario: Mr. & Mrs. Smith have worked years on an investment—maybe in a piece of real estate, maybe a business interest, or even stock that they've owned for years. They sacrificed a significant portion of their lives, or avoided consuming while others spent freely, and are now rewarded with a large unrealized capital gain. The Smiths have an opportunity to sell the investment but are shocked by the reality that they will have to give so much of their hard-earned gain to the government if they sell.

By contributing the appreciated asset to a CRT before selling it, the Smiths avoid, or at least put off, paying that big tax. This is because the CRT, which is tax exempt, keeps all the proceeds when it sells the assets. The proceeds are then invested and used to generate more gains, which can be distributed to the Smiths. While the Smiths avoided the capital gains tax on the donated assets, they will pay tax on the distributions they get from their CRT.

Generate an Immediate Income Tax Deduction

When the Smiths, or any clients, set up their CRT and fund it, they get an income tax deduction. They get this deduction even if they were primarily interested in not paying capital gains and even if they are not interested in benefiting charity. The size of this up-front tax deduction depends on many factors (e.g., the trust's payout rate and the ages of the income beneficiaries or length of the trust's term), but it must be at least 10% of the value of the assets contributed.[2]

Note that the clients get the benefit of the tax deduction up front. Please keep this in mind as you perform your review.

Cash Distributions from CRTs

As we discussed, there are two main kinds of CRTs: CRATs and CRUTs. The difference between the two types of trust can be enormous.

Consider two hypothetical trusts, each created in 2006, funded with $1 million, and scheduled to pay out 5%. The CRAT will pay out $50,000 a year, come what may, until the client dies, the term expires, or the CRAT runs out of money. The CRUT, on the other hand, will rarely pay out exactly $50,000. Instead, the payout will depend on the performance of the CRUT's assets.

For example, suppose that on January 1, 2006, each of these two hypothetical CRTs had been set up with $1 million and were invested into a diversified portfolio. The distributions from each over the next three years might have been:

CRAT	CRUT
$50,000	$50,000
$50,000	$50,500
$50,000	$33,835

As this table illustrates, the fact that a CRUT's payout is a percentage of trust value instead of a fixed dollar amount means that the income it distributes will vary from year to year depending on the underlying return of its investments. In this example, the trust value increased to $1,010,000 after the first year, so it paid the client $50,500 (5%). But the trust's drop in value to $676,700 over the next year led to a decreased distribution of $33,835.

The CRAT's payouts, on the other hand, remained the same at $50,000 over this same period. If these hypothetical CRTs were invested mostly in equities, as many CRTs are, the variation would have been even more extreme.

If the CRT you are evaluating is a CRUT, keep in mind that, depending on how it is invested and how the markets perform, it may be an unreliable income source. If your client needs steady, reliable income, there may be other vehicles available that would provide a more predictable stream of income.

To Support Charity

There is a fairly long list of ways that clients can support charity. These range from direct contributions of cash all the way up to complex plans such as CRTs. When a client sets up a CRT, it represents an irrevocable commitment of assets to charity. However, that commitment does not turn into cash for the charity until the end of the CRT, which may be years or even decades in the future. If your client has a strong desire to support charity, it is likely that the client has options available, such as a private foundation or outright gift to a charity, that will help the charity sooner than the CRT will.

Step 2: Assess the Current Situation

Client Goals Today

Your client had certain specific goals when he set up the CRT. You and your client might find it enlightening to reconsider those goals afresh, given the client's current situation.

Taxes—Current and Future

A CRT is an income-deferral vehicle; that is, it defers to the future the tax a client must pay on the assets donated to the CRT. This deferral is usually a good thing. Everything else equal, if you can pay a tax this year or next year, you'll choose to pay it next year. But when tax rates are going to rise, this deferral can be costly. For example, suppose you have $100,000 of income and the option of paying income tax now at 35% or next year at 40%. Most people would rather pay $35,000 now than pay $40,000 next year. So, with tax rates rising, waiting becomes a bad idea. With this in mind, you should give careful consideration to the following:

1. Your client's current tax bracket (both state and federal)
2. Your client's expected future tax brackets (both state and federal)[3]
3. Expected and likely future tax rates (both state and federal)
4. If your client is likely to move to a different state or otherwise be taxed by a different jurisdiction

Family/Personal Situation

What, if anything, has changed in your client's family or personal situation? For example:

1. Has your client divorced, or is it a possibility?
2. Does your client have dependent children whose situation has changed?
3. Is any income beneficiary of the CRT ill or facing health problems?
4. Have your client's business or career prospects improved or worsened?
5. Does your client need capital for a business or an investment opportunity?

Step 3: Identify the Factors Affecting the CRT's Present Value

Your client owns the right to receive cash flows from the CRT. The value of these cash flows is the value of the CRT to the client. There are several factors determining the current value of the CRT to your client. The most important of these are:

1. the current value of the trust assets
2. the liquidity of the trust assets
3. the tax character of the income these assets generate
4. the payout rate of the trust
5. your client's expected future marginal tax rates
6. the remaining term of the trust if the trust is a term trust
7. the remaining life expectancy if the trust is a lifetime trust
8. the expected future return on the trust's assets
9. the applicable discount rate
10. the costs of maintaining and administering the trust

Step 4: Estimate the Present Value of the CRT Cash Flows

Of the items on above list, three—current value, payout rate, and remaining term—are unchanging facts that can simply be looked up. Four of the others—asset liquidity, life expectancy, the tax character of the income distributed from the CRT, and the costs of maintaining the trust—are easily estimated from past data or tables. That leaves three factors that require the most thought.

Expected Future Returns

Expected returns will be influenced by a variety of familiar factors. Primary among these are the asset allocation of the portfolio over time, the expected returns on each asset class held, the skill level or "alpha" of particular managers, the expected rate of inflation, and expectations for the "risk-free" rate.

Applicable Discount Rate

The determination of applicable discount rate should follow after the determination of an expected rate of return, because the discount will depend, at least partly, on the expected return. The discount rate applied to a series of cash flows should reflect the effect of several factors. These include a) lack of control, b) uncertainty about the size of future payments, c) uncertainty about the number of future payments, and d) lack of daily liquidity of the income stream.

Selecting the appropriate discount rate is probably the most difficult, and most important, aspect of the present value analysis. Since this is a widely misunderstood area, it's worth explaining in detail here. The critical point is that the discount rate cannot be lower than the expected rate of return.

This is an assumption based on the following logic: A discount rate answers the question, "How much would I have to receive in one year to make it worth waiting a year instead of taking one dollar now?" The proposition we want to demonstrate is that an investor's discount rate cannot be lower than the expected rate of return he believes he can earn on investable funds. Suppose that it is not true, and my discount rate is 10% and I can invest risk-free to earn 11%. Clearly, I will not trade my $1.00 today—which will be worth $1.11 in a year—for $1.10

in a year. The argument does not depend on the risk-free investment. It follows just the same if the underlying investments (that is to say, the one I will make with the $1.00 in my hand and the one that generates the future payment if I wait) will be the same investments.

Now let's put this logic in a CRT context. If the investments available to me are the same inside a CRT as outside a CRT, then the discount rate can never be less than the expected rate of return. Let's assume the opposite of what we want to demonstrate. Let's suppose the CRT will last only one year and will pay out the entire balance at the end of that year. Suppose the CRT has $1.00 now. If I believe the CRT's investments will earn 11%, and my discount rate is only 10%, I am saying that I value the future payment from the CRT at $1.01 (that is to say 1.11/1.1, rounded). But this is absurd because I would never pay $1.01 for the future CRT payment when I could instead take just $1.00, invest it the same way as the CRT, and end up with the same $1.11 I would have gotten from the CRT.

In fact, the discount rate should probably be higher than the expected rate of return because the CRT payment stream is not liquid. Everything else equal, most investors always prefer free access to their money than having to wait for it.

Future Tax Rates

Tax rates fluctuate quite a bit over time. Predicting future tax rates is probably at least as much art as science.

Keep in mind that the type of income produced by the portfolio may affect the effective tax rates. CRT distributions are taxed under the so-called "worst-in, first-out" rules of Section 664. Any ordinary income or short-term gains earned by the trust will be deemed to be distributed and, therefore, taxed at their higher rates, before any long-term gains or tax-exempt income, regardless of the ratio in which the trust earns the income. In addition, some types of assets, e.g. bonds and annuities, will likely produce mostly or all ordinary income.

Actuarial Considerations

Life expectancy is usually determined by reference to an actuarial table. In the case of a husband and wife, you need to refer to the joint life expectancy. The standard IRS life expectancies for CRTs are derived from the IRS Table 2000CM.

Of course, life expectancies are statistical and do not tell us when any specific person will die. Researchers tell us that most people think they are above-average drivers, think they have better social skills than the average person, and expect they will live longer than average. This widespread tendency to believe that we are better than average has been called the "Lake Wobegon effect," named after Garrison Keillor's town of that name. In Keillor's Lake Wobegon, all of the children are above average.

But, alas, we can't all live longer than average. In fact, by definition, half of us will die at an age younger than our life expectancy. It may be worth discussing with your client that their CRT exposes them to a financial risk of premature death, and that there may be alternatives they can consider should they desire to reduce or eliminate that risk.

Step 5: Evaluate Opportunities to Increase the Present Value of a CRT

In our experience, we have identified a number of potential adjustments that could be made to improve the value of the CRT to your clients.

Allocate Assets to Produce More Long-Term Capital Gains

While it is usually a poor idea to let tax considerations drive investment decisions, it may be worthwhile to discuss the taxability of different kinds of income and return with the trust investment manager. It may be possible to adjust the portfolio to optimize the after-tax value of the cash flows without sacrificing any other portfolio objective.

For Net Income with Make-Up Charitable Remainder Unitrusts (NIMCRUTS), Defer Income Longer or Shorter Than Planned

Some CRUTs distribute the lesser of their actual net income or their stated distribution rates. These are frequently called NIMCRUTs. This conditional distribution of income means that it is sometimes possible to time the distribution of cash from the NIMCRUT by arranging the investments in the trust to produce more or less income. If tax rates are expected to rise, it may make sense to try to accelerate income from the trust into a period before rates rise. If tax rates are expected to decline, it may make sense to try to defer income further into the future until such time as tax rates may be lower.

Determine Whether It Is Possible to Reduce Administrative and/or Compliance Costs

For most CRTs, administrative and compliance costs are fairly small factors that do not have a large effect on the present value of the CRT income stream. Nevertheless, it may be a simple matter to effect some small improvement by reducing the CRT's expenses.

Donate Some or All Distributed Cash to Charity

Taxes on CRT income distributions are one of the major factors affecting the value of the CRT cash flow stream to your client. One way to offset income under current law is to donate some of the income to charity. Probably most CRT clients will not be interested in making charitable contributions to offset income, but it may be worth discussing with some clients.

Contribute Some or All of the Rights to Future Income to Charity

Instead of receiving income and then distributing that income to charity, which is just a wash, it may be possible to directly contribute the right to receive the income. In other words, the client who owns an income stream can contribute the income stream to charity. Such a contribution is analogous to the contribution of an appreciated asset to charity. The gift, provided the asset has been held for over a year, is deductible if the recipient charity is a qualified public charity. The same is true if the client gives the entire right to receive income from the CRT to a public charity. Such a strategy could make sense when a client no longer needs or desires the income from their CRT.

Consider the Sale of the CRT Income Interest

In many cases, the best way to maximize the value of the CRT interest to the client is to sell the entire right to receive income from the CRT. This right to receive income is considered a capital asset.[4] As a capital asset, it may be sold, and if sold, the sale is treated as a capital gain transaction for tax purposes.

In our experience, the owner of a CRT interest can often sell the interest for a price that nets the seller more, after all costs and taxes, than the expected present value of holding the interest.

This is especially true in an environment where tax rates are low or are expected to rise and in an environment where there is a significant difference between the tax rate on capital gains and the tax rate on ordinary income.

Step 6: Concluding the Review

The IRS considers an income interest in a CRT a capital asset. As such, and like any asset, portfolio, or investment, there should be a routine review that considers whether continuing to hold that asset is in the client's best interest. In other words, the fact that the CRT made sense at its inception doesn't mean that holding the income interest years later is going to make sense given the client's personal or financial situations.

None of this is to say that the decision to create the CRT is a bad one. In fact, the decision to create the CRT and any decision that a client makes years later with respect to the income interest created by the CRT are largely independent of one another. What it does mean, however, is that because that income interest is a capital asset and the client has options with respect to it, the client should be aware of the options, and the advisor should ensure the client is utilizing the option that best fits his current situation. ■

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(1) North American Securities Administrators Association, "Investment Adviser Guide"; www.nasaa.org/industry_regulatory_resources/investment_advisers/456.cfm.
(2) Under IRC § 664, when a CRT is funded the value of the remainder interest must be at least 10% of the value of the assets contributed to the trust.
(3) The notion that state laws change in concert with federal tax laws should never be assumed.
(4) Rev. Rul. 72-243, 1972-1 C.B. 233.