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Alternatives to CRT Terminations

In some situations, it may make sense for the donor to sell the income interest of an existing charitable remainder trust

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In a recent *Trusts & Estates* column (November 2010), my colleague Laura Peebles correctly observed that many donors with existing charitable remainder trusts (CRTs) may be well-advised to consider terminating those trusts. When a CRT is terminated, typically, the trust assets are divided between the donor and the charitable remainder beneficiary. The division is done according to an Internal Revenue Service formula, the so-called "7520 rules." The formula is generally the same one used to calculate the charitable deduction for a new CRT containing the same terms. (Note: This might not apply to some net income make-up charitable remainder unitrusts (NimCruts). Private Letter Rulings 200725044 and 200733014 both seem to suggest that in calculating the fraction of a CRT allocable to the income interest holder, the formula requires use of the then-current 7520 rate if it's lower than the stated pay rate of the NimCrut.)

However, termination of the trust and division of the assets isn't the only course available to a donor looking to exit a CRT. There are two other viable alternatives: contribution or sale. Both deserve a closer look.

Contribution

A CRT donor, who owns the right to receive income from a trust, can give outright his remaining income interest to the remainder beneficiary. The remainder beneficiary would then terminate the trust and receive all the trust assets. This is a viable alternative as it doesn't create any taxable income for the donor, and in fact should create a charitable deduction for the value of the income interest donated. The value of this income interest would be calculated under the same 7520 rules that would apply if the trust were terminated and the assets were split between the donor and beneficiary, as described above.

Sale

The donor/creator of a CRT owns the right to receive the income from the trust. We've seen that the donor can give away this interest. Another alternative might be to sell it.

For donors seeking to maximize the cash they can get from the CRT, a sale may be attractive. A CRT income interest has a market value that depends primarily on the expected size and frequency of the payments and the applicable tax rates.

In my experience, it's often the case that a buyer is willing to pay a price that results in the seller netting more than he would if he terminated the trust. There are several reasons for this, but the primary one is that the IRS formula is just that — a static formula; 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.

The IRS Formula

The IRS formula price, used to calculate the price at which a donor will sell the CRT, can be obtained by plugging the relevant data into a formula. In practice, due to the formula's complexity, virtually everyone uses software to calculate the result. Common software packages used for the purpose include *Zcalc* from Thompson/OneSource, *NumberCruncher* from Leimberg Associates, and *TigerTables* from Larry Katzenstein.

The original purpose of the IRS formula was to eliminate the hassle, expense and uncertainty in valuing the gift portion of a split-interest trust. In this role, the formula serves admirably. When the rules call for the formula, as they do in the termination and division of a trust between the income and remainder beneficiaries, the IRS formula is the only way to go.

Note that the formula will yield a true market value only by chance. In some cases, the formula is too low and in other cases, too high. There are several reasons why the real world market value of an income interest may diverge from the formula value.

Valuing a Stream of Cash Flows

The real world market value of a CRT income interest is based on the expected cash flows. If the cash flows were certain, then the market value of those cash flows could be calculated in a similar manner to the value of a bond. A riskless bond (if there's such a thing) is simply a series of cash flows of known amount and date. I'll spare you the surprising complex bond-math here, and simply say that the value today of a known stream of cash flows is basically the discounted net present value of those cash flows.

However, the cash flows in a charitable remainder unitrust (CRUT) aren't certain. Most CRUTs have two main sources of uncertainty regarding their cash flows: the variability of returns on assets and the variability of actual lives from the table expectancies.

Advising Clients

The bottom line is that in a significant percentage of cases, the real world market value of an income stream is greater than the 7520 termination value.

Of course there may be other considerations to factor in when a client is considering terminating a CRT. But for those clients that are seriously considering termination, it makes sense to at least check the value they could get by selling their income interest.