Selling CRT Lead Interests

Once thought of as lifetime deals, lead interests in charitable remainder trusts now are being sold—for a profit.
Now, advisors may have a duty to inform clients of this option

By **Roger D. Silk**, principal, and **James W. Lintott,** principal, Sterling Foundation Management, LLC, Reston, Va.

Over the last 20 years, investors have been increasingly demanding liquidity in nearly every aspect of their financial lives. Real estate investment trusts that trade daily, like stocks, have replaced limited partnerships as the preferred choice; mutual funds offer daily liquidity; retirement funds are accessible through loans or early withdrawals; most living trusts are revocable or changeable. Even hedge funds rarely require more than a relatively short commitment. Yet charitable remainder trusts (CRTs) have so far resisted the trend toward greater liquidity.

Traditionally, a CRT meant locking up funds for life. Belief in the CRT's permanence is rooted in the fact that, to qualify for the special tax treatment, a CRT must be irrevocable. But that understanding of CRTs is beginning to change, as clients and advisors realize that illiquidity has been an institutional, rather than a fundamental necessity. During the last three to four years, we've seen many CRT grantors look for an alternative to the CRT lifetime lockup. And we found that in most of our cases there was ultimately no legal, regulatory or economic barrier to a successful transaction. In other words, the clients were able to sell their interests in the CRT for a price that made it worthwhile for

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them to do so. Of course, the market for these interests is, and probably will remain, a specialized niche. Also, each transaction must be evaluated on its own merits, and an appropriate buyer matched with a seller.

WHY SELL?

A CRT is a split-interest trust in which the grantor retains the right to receive an income stream, usually for life. At the end of the life of the last income beneficiary, the remainder goes to charity. Clients typically create CRTs to take advantage of the immediate income tax deduction, to be able to diversify a highly appreciated asset without incurring income tax, to obtain an income stream, and because they have an interest in ultimately benefiting charity.

There seem to be two main reasons why people seek to sell their lead interests in CRTs. The first reason is value maximization. Clients and their advisors are doing the math and concluding that it simply makes more economic sense to convert a long and uncertain stream of payments into an immediate and certain lump sum.

Contrary to my expectation, the less common reason is that they are in distress due to divorce, unforeseen reversals in business, investment losses, an "upside down" NimCrut (that is to say, a net income with a makeup charitable remainder unitrust has declined in value and/or is not generating enough income to pay the grantor his full income currently), fear of Medicaid/nursing home assistance ineligibility, and threat of litigation between one or more of the parties (including advisors) associated with the trust. There is nothing like ready cash generated from the sale of a lead interest to help with these situations.

Clients who sell their interests in CRTs sometimes find they can receive a lump sum payment that is greater than the net present value of their interest. In fact, the typical seller of a CRT income interest sells because he can net more cash by selling than by holding the CRT for the rest of its term. Differential tax rates between buyer and seller are a primary factor here. The income that

comes out of a CRT is mostly or all taxable income. At an assumed average tax rate of 30 percent, the typical CRT holder gets to keep 70 percent of what comes out of the CRT.

If the buyer of a CRT interest has tax attributes (for example, net operating losses (NOLs)), capital loss carryforwards, etc.) that allow them to keep the entire dollar, then there is a 30 cent spread that can be earned.

There is nothing unusual about this tax rate differential. Different potential owners of assets, distinguished by their tax status, is the same principle that makes the municipal bond market possible. This makes it possible for the seller to get a premium, and the buyer to get a discount. It's a classic win-win situation.

LEGAL ISSUES

Any analysis of the legal status of a potential sale of a lead interest in a CRT must, of course, begin with the CRT document itself. However, as a general rule, in most of the larger states and a number of smaller ones, state law does not prohibit the sale of CRT lead interests. Every case must be looked at individually because each trust is different.

Once the "is it permitted?" is cleared, practitioners should look into whether the CRT has an anti-alienation clause.

Although well-drafted CRTs usually will not contain a spendthrift or anti-alienation clause, some do. What complicates this analysis in the case of a CRT is the widely held prohibition on self-settled spendthrift trusts.[1] The bulk of CRTs are self-settled.

In at least one case of a self-settled CRT,[2] the U.S. Court of Appeals for the Eleventh Circuit held that the creditor could attach the income stream, which was the debtor's property, but not the trust corpus (which common sense says should not be attachable, because the trust corpus does not belong to the grantor).

A number of lawyers have commented that no self-settled CRT should include a spendthrift clause, because such clauses are unenforceable yet still possibly detrimental to clients; for example, by raising the cost of borrowing using the income stream as collateral, or reducing the value of that same stream in a potential sale.

Self-dealing is generally not a problem. CRTs are subject to some of the rules in Internal Revenue Code Sections 4940 to 4946.[3] Attention should be paid, in particular, to Section 4941, which prohibits self-dealing in cases to which Section 4941 applies. Remember, however, that the right to receive income from a trust is a separate thing from the trust itself. The trust is subject to Section 4941, but the

right to receive income is not. According to the Internal Revenue Service, the self-dealing provision under Section 4941 and certain other private foundation rules "do not apply to amounts payable under the terms of a split-interest trust to income beneficiaries."[4]

TAX CONSIDERATIONS

While the taxation of amounts paid periodically to income beneficiaries under a CRT are complex,[5] the taxation of the sale of that income stream is surprisingly simple. The income stream is a capital asset, and the sale is taxed under the capital gain rules. The IRS provides the following analysis: "Rev. Rul. 72-243,1972-1 C.B. 233, provides that a sale of an income interest in a trust is a sale of a capital asset within the meaning of Sections 1221 and 1222. The holding period for purposes of determining whether gain or loss from the disposition of an income interest is long term or short term, commences on the date the taxpayer first held such interest."[6] The sale of a lead interest does not affect the deduction taken for the remainder interest, because the lead interest represents that portion of the trust value not given to charity. The seller of a lead interest sells exactly that: the lead interest. A qualified charity remains—whether named specifically or as to a class as in most trusts—as the remainder beneficiary.

VALUE

The value of a lead interest to a client is the after-tax net present value of the cash flows that he expects to receive. To value an interest, therefore, it's first necessary to estimate these cash flows. The cash flows will last until the end of the trust, which either is the end of the last lead beneficiary's life, or the stated term of the trust. For a term trust, the expected duration number can be calculated with a calendar. For a life trust, a life expectancy can be looked up in a table.[7]

Once the number of expected payments is determined, the next step is to estimate the amount of each payment. That amount depends on the returns earned by the trust assets and the payout rate of the trust. For trusts with payout rates higher than the annual return, the amount of each payment will decline over time.

Now that we have a known number of known payments we should apply the usual discount analysis to bring each payment to a present value.[8] Then we add each payment to get a pre-tax net present value. Finally, we apply the appropriate income tax rate to get an after-tax value.

OPPORTUNITIES

Clearly, there is a potential opportunity for a value-maximizing client. If a potential buyer and seller can agree on the assumptions, the stream of cash flow is worth more to whomever pays the lower tax on the stream.

Here's an example of a simple hypothetical case where husband and wife are 65 and 60 years old respectively, the payout rate on the CRUT is 8 percent, and the trust is currently worth $1 million. We'll simplify the analysis by assuming an 8 percent investment return, so we'll see $80,000 in pre-tax cash flow each year to the lead interest holder. The life-expectancy table (table 90CM) tells us to expect the stream to last for 25 years. The pre-tax present value of this expected cash flow discounted[9] at 8 percent adds up to about $854,000. To a buyer who can keep the entire amount, that's what it's worth. To a potential seller looking at paying 30 percent tax on the amount, it's worth only $598,000.

Note that just because a client is selling his CRT today doesn't mean he made a mistake in setting it up. Suppose that a couple buys a house, lives in it for a few years, then sells it. Does that mean the original purchase was a mistake? Of course not. A man buys a new car, drives it for three years, and sells it for less than he paid. Was the purchase a mistake? Few would say so based solely on the fact of the sale. In fact, the entire value of every company traded on the New York Stock Exchange, about $13 trillion, is bought and sold every year. Far from meaning that every purchase was a mistake (though of course some were), virtually all economists agree that greater liquidity in the markets for assets is a good thing, because it helps the economy allocate resources better, which in turn enhances productivity and raises the standard of living.

Similarly, a sale of a CRT lead interest does not mean that the original CRT was a mistake. The couple lived in the house; the man drove the car; and the CRT grantor got an upfront tax-deduction and income while he held the CRT interest. All sell when they have a reason to.

Moreover, the ability to sell a CRT lead interest means that a client considering a CRT no longer has to make the leap of committing to this strategy for life. By lowering this psychological hurdle, more CRTs should be created, generating more gifts to charity that would otherwise not occur.

DUTY TO INFORM

Most CRT grantors, and many attorneys and other fiduciaries, are not aware that the CRT lead interest is a potentially liquid asset. They should be.

According to Alan P. Dye, senior partner in the Washington-based law firm Webster, Chamberlain & Bean: "All advisors ought to know that this potential for liquidity exists. It creates important flexibility for the client, which may have significant economic value." Dye, who also is the chair of the influential Washington-based Non-Profit Legal and Tax Conference, goes further saying, "Professional advisors may even have a duty to be aware of, and to inform their clients, about the potential for sale of a lead interest."

In fact, Dye has this warning: "If you make the client aware and he doesn't want to do anything, no one is out. But if you don't tell him and he might have benefited, he could be injured and that could be actionable. So it's clearly a case where it makes sense to inform all clients who have CRTs that they may be able to benefit from a sale of their lead interest." ▌

Endnotes

1. *See, for example,* Gideon Rothschild, *et. al.,* "Self-Settled Spendthrift Trusts: Should a Few Bad Apples Spoil the Bunch?" *Journal of Bankruptcy Law & Practice,* Vol. 9,

2. *Menotte v. Brown,* 2002 U.S. App. Lexis 18237 (11th Cir. Aug. 28, 2002).

3. Generally, IRC Sections 4940 to 4947 deal primarily with private foundations. CRTs are subject to some but not all of these rules.

4. Private Letter Ruling 200127023, para. 19.

5. *See* IRC Section 664(b).

6. PLR 200127023, para 15.

7. The standard life expectancy table used in relation to CRTs is table 90CM, available in IRS publication 1457, Actuarial Values; Book, Aleph, p. 866.

8. The formula for each payment is "Present Value = Future Payment/(1+Discount Rate)n," where 'n' represents the number of years from now when the future payment is to be received. For example, the present value of $100 to be received in ten years, discounted at 10 percent a year is $38.55. The net present value of the entire interest is the sum of the present values of each payment.

9. 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 this 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's not true, and my discount rate is 10 percent and I can invest risk-free to earn 11 percent. 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 which 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 it, 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 percent, and my discount rate is only 10 percent, 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.