The Mortmain

Summer 2017

Official Publication of the Atlanta Bar Association Estate Planning & Probate Section

Secondary Planning Options for CRT Clients

By Evan D. Unzelman, *Sterling Foundation Management*

Evan D. Unzelman

The Estate Planning and Probate Section and the Tax Law Section of the Atlanta Bar Association welcomed Evan D. Unzelman of Sterling Foundation Management at their Joint Reception, held on May 16, 2017, to discuss recent developments in the use of the Charitable Remainder Trust ("CRT") as an estate planning tool.

Although CRTs may be a perfect fit for clients upon inception, many clients fall out of alignment with their CRTs over time. These misalignments, which are mostly unavoidable, are caused by two factors: time (a CRT can be in place for decades, during which time a client's life circumstances can change significantly) and the inherent inflexibility of CRTs (they are irrevocable, so their key terms cannot be changed).

Common misalignments include:

- Clients who need or desire liquidity and would prefer a lump sum of cash to their future CRT income stream;
- Divorcing couples displeased with the prospect of their joint life CRT tying them together financially in the future; and
- Clients seeking to simplify their affairs by removing their CRT (and the associated administrative costs and hassles) from their financial picture

Historically, clients in these situations could choose one of two options: they could gift their income interest to charity, or they could terminate their CRT.

Contribute It All to Charity

Clients who do not wish to receive any value for their income interest can simply gift it to the charitable beneficiary. This will generally result in an additional tax deduction to the client, and the termination of the CRT.

Termination

A CRT can be divided on a strictly pro-rata basis between the income and remainder beneficiaries. The division must comply with procedures established by the IRS. At most, the income beneficiary receives a value calculated in accordance with IRC Section 7520. If the income beneficiary receives more than the IRC Section 7520 value, he will have run afoul of the self-dealing rules under IRC Section 4941 and will be subject to penalties under IRC Section 4941(a)(1). If the division is not corrected within the taxable period, the income beneficiary will be subject to further penalties under IRC Section 4941(b)(1). These penalties can be severe (excise taxes of more than 200% of the amount involved). Clients terminating their CRTs should be careful to do so in accordance with IRC Section 7520.

In recent years, a thriving private market for CRT income interests has led to a third option for clients: selling.

Sale

Clients who want to get the most value from their CRTs can sell their income interests to a third-party buyer, typically at significant premiums over what they could get from terminating their CRTs.

There are several reasons why clients tend to net more by selling their income interests than they would by terminating, but the primary reason is that the IRS uses a static formula to calculate the market value of a CRT interest. A buyer may anticipate higher future investment returns than a seller. Further, actuarial risk, which is costly for a client to hedge, can be diversified away at reduced or no cost to some buyers.

In addition, because a CRT does not terminate when clients sell their interest – rather, the income stream is simply redirected to a third party – there is no need for involvement by a court or by the Attorney General. Most CRT income interests can be sold in just two to four weeks, whereas a termination can take several months or more to complete.

Example of Income Interest Sale

A husband and wife, both 75 years old, were joint beneficiaries of a 7% Standard CRUT with $1.5 million in assets. For a number of years, the trust worked well for the couple, enabling them to defer capital gains taxes on some highly appreciated real estate and, upon the sale of that property, generate a substantial income stream.

Over the past few years, however, their circumstances had changed. The husband had developed a heart condition that led to some high (and unanticipated) medical expenses. Instead of waiting for the trust to distribute income, the couple wanted to know if they could exchange their future distributions for cash today.

They approached their attorney, who told them that they had two options: 1) sell their interest, or 2) terminate the CRUT. Based on the IRC Section 7520 value of their interest, their attorney (correctly) told them that they could expect to receive about $930K in a termination, minus any court and legal fees.

The attorney then reached out to Sterling to see what the couple might be able to get by selling their interest. He was pleased to learn that Sterling could arrange the sale of the couple's interest in the CRUT for $1.06 million, net of fees.

After a brief consultation with the rest of their advisory team, the couple decided to move forward with the sale of their income interest. Two and a half weeks later, they received their $1.06 million, which was more than enough to cover the husband's medical costs.

CRT Rollover
While some clients desire an outright exit from their CRTs, others just wish they could *change* something about their CRTs. Common examples include:

- Adding non-charitable beneficiaries. As clients age, many begin thinking about end-of-life planning and how to ensure that their loved ones will be taken care of after their passing. Many CRT grantors would prefer to add younger spouses or children as beneficiaries of their CRTs, as a way of generating income for these persons after the grantor's death.
- Changing the type of CRT. There are four types of CRTs: the Standard CRUT (Charitable Remainder Unitrust), the NIMCRUT (Net Income with Makeup Charitable Remainder Unitrust), the NICRUT (Net Income Charitable Remainder Unitrust), and the CRAT (Charitable Remainder Annuity Trust). Each type functions differently with respect to how it pays income. Over time, clients who established one type of CRT can find themselves in situations in which they would be better served by a different type of CRT.

With a rollover, a client creates a new CRT reflective of the changes he or she would like to make to the current CRT. The client then contributes income interest from the current CRT (a private capital asset, per Rev. Rul. 72-243 C.B. 233) to the new CRT. In most cases, the trustee of the new CRT seeks to monetize the contributed asset (the income interest in the old CRT), which it can do by selling it to a third party buyer. The third party buyer brings cash to escrow, which it pays to the new CRT in exchange for the income interest in the old CRT. The end result is two CRTs. The third party buyer collects income from the old CRT – with the terms (measuring life, trust type, etc.) unchanged – and the client has the new CRT, which is aligned with the client's current goals and future outlook.

Example of CRT Rollover
A 63-year-old client was the sole lifetime beneficiary of a $2.19 million Standard CRUT with a 5% payout. She had plenty of income sources outside of the CRT and did not like how the CRT was forcing income to her – income which she would have elected to defer, given the choice. She was even more dissatisfied about the related tax, which in some years approached 50%. She figured she would pay about a million dollars in taxes over her remaining lifetime, and viewed those taxes as completely unnecessary, since she didn't want the income in the first place. She had two daughters whom she would rather have benefited from the trust, but neither daughter was a beneficiary of the CRT. As it stood, everything in the trust went to charity at the client's death, and her daughters would receive nothing.

Sterling helped her advisors roll her Standard CRUT to a NIMCRUT and added her two daughters as contingent income beneficiaries. Her attorney added structure to the NIMCRUT that gave her discretion as to whether to receive income in any given year. She can defer the distributions in full, year after year (as she expects to do), and the trust will grow those deferred distributions tax-free over that time. If she needs income in any given year, she can elect to take the accrued gain which has built up in the trust. At the client's death, her daughters will split the future distributions for their joint lifetimes, and, because she plans to defer distributions tax-free over a 19-year period, her daughters will be receiving distributions from a much larger trust (her financial advisors estimate between $3.5 and $4 million).

Conclusion

When thinking about secondary planning options, it's helpful to draw comparisons between CRTs and another type of capital asset: real estate.

Most people who purchase a house probably won't live in that house forever – children grow up and move out, retirees move to Florida in search of warmer climates and income tax relief, and older couples downsize to more manageable accommodations. However, that doesn't mean the purchase of the original home was a mistake.

The same logic applies to CRTs. Just because a client has a CRT that is no longer a good fit doesn't mean the CRT shouldn't have been set up to begin with. Because CRTs are irrevocable assets that can be in place for decades, most clients report some type of misalignment at one point or another. Regardless of whether the severity of that misalignment warrants the pursuit of a rollover or sale, advisors should inform their clients with CRTs of the available secondary planning options, so that those clients are in a position to make changes, should the need arise.

Authorities Regarding Certain Aspects of CRT Transactions:

1) Lead Interest as a Capital Asset

- McCallister v. Comm'r, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947); Rev. Rul. 72-243, 1972-1 C.B. 233
- PLR 200152018 (September 26, 2001)
- PLR 200127023 (April 4, 2001)

2) Charitable Deduction

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

- Rev. Rul. 86-60, 1986-1 C.B. 302
- Rev. Rul. 79-295, 1979-2 C.B. 349
- PLR 201321012 (February 1, 2013)
- PLR 201249002 (September 7, 2002)
- PLR 200630006 (April 14, 2006)
- PLR 200524014 (March 15, 2005)
- PLR 200205008 (October 23, 2001)

3) Assignment of Income Considerations

- Blair v. Comm'r, 300 U.S. 5 (1937) (distinguishing the key assignment of income authorities, such as Lucas v. Earl, 281 U.S. 111 (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 (1941) (distinguishing Blair on the specific facts of the case).
- Raymond v. United States, 247 F. Supp. 2d 548 (2002) (in the context of the taxability of a contingent fee agreement).
- Farkas v. Comm'r, 170 F. 2d 201 (5th Cir. 1948)
- Hawaii Trust Co., Limited v. Kanne, 172 F. 2d 74 (9th Cir. 1949)
- Rev. Rul. 55-38, 1955-1 C.B. 389
- PLR 9031010 (May 3, 1990)
- PLR 8932040 (May 16, 1989)
- PLR 8650024 (September 12, 1986)

4) Palmer-Type Issues

- Palmer v. Comm'r, 62 T.C. 684 (1974), aff'd. on other grounds, 523 F. 2d 1308 (8th. Cir. 1975), acq., 1978-1 C.B. 2
- Rev. Rul. 78-197, 1978-1 C.B. 83
- Rauenhorst v. Comm'r, 119 T.C. 157 (2002)
- Blake v. Comm'r, 697 F.2d 473 (2d Cir. 1982)
- PLR 201012050 (December 30, 2009)
- PLR 200321010 (Feb, 13, 2003)
- PLR 200230004 (April 10, 2002)
- PLR 9611047 (December 15, 1995)
- PLR 8639046 (June 30, 1986)

NOTE: Click here for the materials that accompanied Mr. Unzelman's presentation.

STERLING
FOUNDATION MANAGEMENT LLC

Evan Unzelman is President of Sterling Foundation Management (www.SterlingFoundations.com) in Reston, Virginia. More information about Mr. Unzelman may be found at www.sterlingfoundations.com/our-company/our-team/evan-unzelman/, and he may be reached by phone at (866) 479-7186.