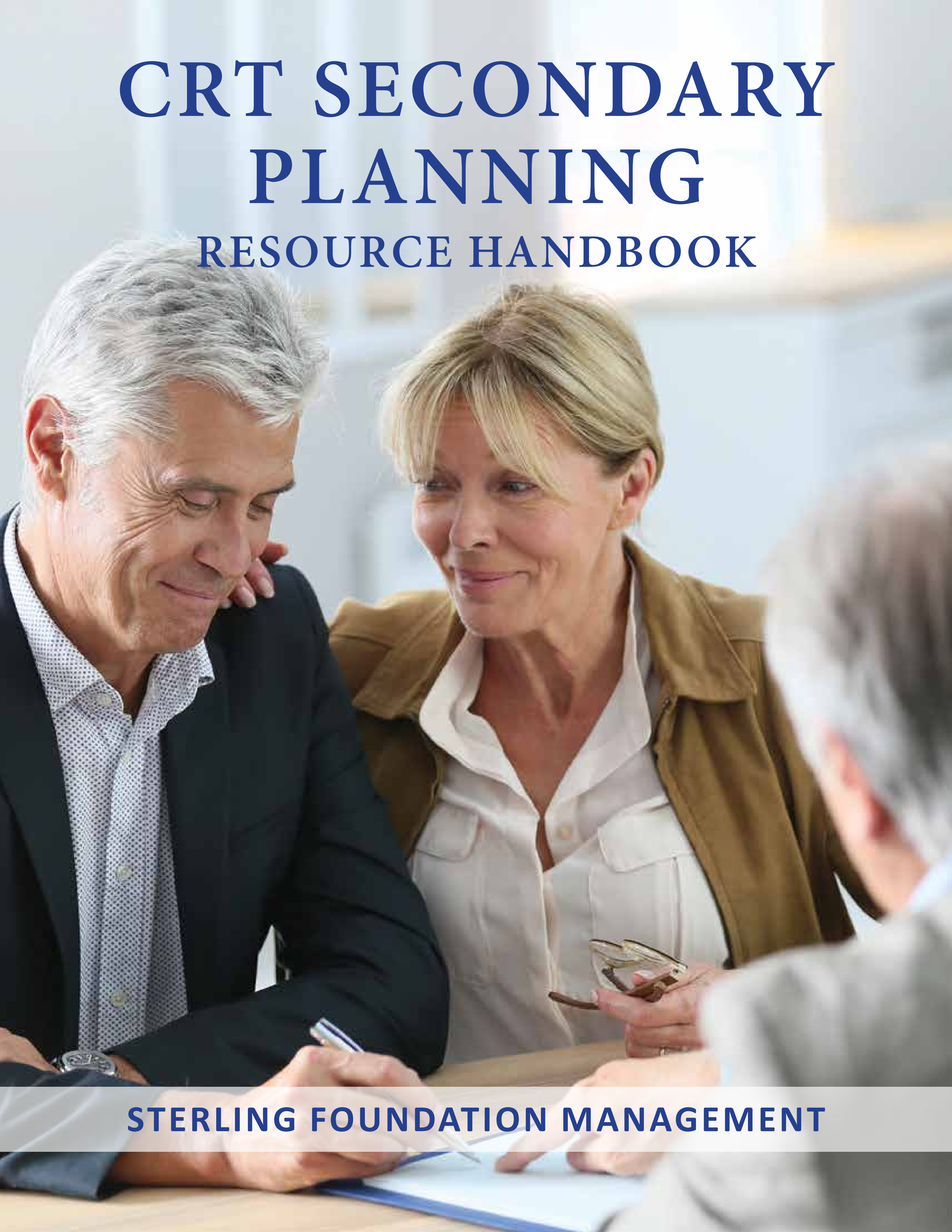
CRT SECONDARY PLANNING

RESOURCE HANDBOOK



STERLING FOUNDATION MANAGEMENT

CRT Secondary Planning Resource Handbook

CHARITABLE REMAINDER TRUSTS (CRTs)

Secondary Planning Options

At its inception, a CRT is usually a perfect fit for a client's situation. It's just the right kind of CRT, has just the right payout rate, has just the right beneficiaries, etc. But a CRT is an irrevocable trust—its terms cannot be changed—and usually spans decades of a client's life. Over time, this combination—an inflexible trust on one hand and a client's changing life on the other—can lead to a misalignment between the client's situation and the CRT.

Increasingly, advisors are informing their clients with CRTs about the secondary planning options available to them.

CRT Income Interest Sale

A client's income interest in their CRT is a capital asset that can be bought, sold, or reinvested—just like other capital assets (e.g., stocks, bonds, real estate). The list of reasons that people sell their CRT income interests is much longer than the list of reasons they set them up in the first place. Most CRTs creations are driven, in one form or another, by tax considerations. Most sales of CRT income interests, on the other hand, occur because something has changed since the CRT was created. A partial list of things that can changes follows.

- Cash needed for an investment opportunity
- Desire for increased flexibility
- Desire to maximize value of CRT interest*
- Desire for simplification
- Divorce
- Lack of cash for charitable needs

CRT Rollover

A CRT Rollover enables clients to, in effect, make strategic changes to their CRTs. Although each Rollover has a unique set of circumstances, some of the typical benefits include:

- Adding children as income beneficiaries
- Adding a spouse as income beneficiary
- Deferring taxable income from a CRT
- Increasing total trust income
- Fixing underperforming NIMCRUTs

Rollovers can also benefit advisors, as they often extend the life of a CRT—and the advisor's responsibilities with respect to the CRT (e.g., tax returns, trusteeship, asset management)—for years into the future.

** Most often, an income beneficiary can sell their income interest for more than the value of holding it or what they would receive if they terminated the CRT according to 7520 rules.*

Surprisingly, many clients with CRTs are still unaware that there are options available outside of waiting for future distributions from their CRTs. At Sterling, our goal is to fix this lack of awareness by working with advisors to review their clients' CRTs. We are happy to review any CRT on a no-name basis and without charge. Please direct review requests to:

Evan Unzelman, President
Phone: (703) 437-9720
Email: EUnzelman@SterlingFoundations.com

Examples on reverse side

Example—Income Interest Sale

Kim Edgar set up a CRT in the mid-1990s with her husband Bruce. Two decades later, her life circumstances had fundamentally changed. First, she and her husband had decided that a divorce was in their best interests, as they had simply grown apart over the years. Second, Kim, a self-described "health junkie," had reached a point in her career in which she was looking to launch her own nutrition consulting business. She came to Sterling with two goals: 1) to decouple herself from the CRT that she and her husband were joint beneficiaries of, and 2) to access liquidity so she could launch her new business.

Kim's advisors determined that a sale of her CRT income interest was the best option. We broached the subject with Bruce, who quickly agreed that selling the income interest and going their separate ways would be an ideal scenario. Three weeks later, Sterling completed the transaction and Kim and Bruce split the proceeds. Not only does Kim now have greater financial freedom and the means to start her own business, she's also been able to travel and spend more time with her kids.

Visit our website to hear Kim's story first-hand and learn more about Sterling's CRT Program.

Example—CRT Rollover

To illustrate one of the benefits of the Rollover, consider the story of Marty and Carole Hambel. Marty had used appreciated stock to fund a 7% net income with makeup charitable remainder unitrust (NIMCRUT) with himself and his wife listed as income beneficiaries. Unfortunately, Marty's wife passed away after he set up the trust. After he remarried several years later, Marty started to become concerned that his new wife, Carole, would suffer a reduction in living standards if he predeceased her. (Because Marty was the only beneficiary listed on the trust, all the assets in the trust were set to go to charity upon his death.) Marty wanted to take care of his wife, but he also didn't want to pay a hefty capital gains tax. He ultimately decided to roll his current NIMCRUT into a SCRUT and add Carole as a beneficiary. Now the trust will continue to make payments for Carole's entire lifetime, instead of stopping when Marty passes.

Visit our website to hear Marty and Carole's story first-hand and learn more about Sterling's CRT Program.

About Sterling

Sterling Foundation Management is the oldest national foundation management firm in the United States and a leading provider of charitable consulting services to some of the country's largest and most active private foundations. Sterling is also the nation's preeminent provider of secondary planning services for charitable remainder trusts. Sterling's critically acclaimed book, *Managing Foundations and Charitable Trusts*, is largely regarded as the definitive guide to managing charitable entities.

Sterling Foundation Management, LLC does not provide tax or legal advice, and nothing in this document is to be construed as such. Any information or analysis provided is believed to be accurate but is not guaranteed or warranted.

Selected Press

“I've been speaking with Sterling for years so was well aware of their service for facilitating the sale of CRT income interests. I just had my first opportunity to work with Sterling when a client sold their CRT income interest. The transaction was completed very efficiently and my client was happy. Sterling was obviously very experienced and I was able to see first-hand that Sterling is a top-notch firm.”

Robert K. O’Dell
Coyle Financial Counsel
Naples, FL

FROM ***JOURNAL OF ESTATE & TAX PLANNING***, 2016
(NATIONAL ASSOCIATION OF ESTATE PLANNERS & COUNCILS)

Secondary Planning for CRTs

Charitable remainder trusts (CRTs) can be powerful tax-planning tools, particularly for clients with strong charitable intent. Clients who set up CRTs have the ability to generate an up-front income tax deduction, defer capital gains, diversify concentrated positions, and convert an appreciated asset (or assets) into a lifetime income stream.

On the other hand, CRTs are highly inflexible assets. A CRT is "irrevocable" by law, meaning that its payout rate, income beneficiaries, and trust structure cannot change post-inception. Because CRTs are typically tied to a client's lifetime, they can be in place for decades. For example, a CRT that's set up for a client who is 50 years old might last forty years (or more). Because CRTs are irrevocable and life circumstances change, CRTs tend to fall out of alignment with a client's needs and goals over time.

Most clients with CRTs don't understand their full range of secondary planning options; they naturally assume that because their CRT is irrevocable, they're stuck with it for life (or until the end of the trust term). It's therefore becoming increasingly important for advisors to inform their clients with CRTs of all the available secondary planning options, so that clients are in a position to make changes if the need arises.

CRT Income Interest Sale

If a client is looking to exit their CRT and/or get the most income possible, the best option is often to sell their income interest on the secondary market to a third-party buyer. By selling, most clients can get a premium to the present value of their income interest.

Clients can exit a CRT in a couple of ways in addition to selling — they can simply gift the income interest to charity (and receive a tax deduction in the process), or they can terminate the CRT, splitting the trust according to an IRS Formula — the so-called 7520 rules — between the income beneficiary(ies) and the remainder beneficiary(ies).

Because third-party buyers are not bound by the IRS 7520 rules, they are generally willing to pay more than a client would receive by terminating. Also, a termination can be a costly, time-consuming process to complete (6–9 months or more in some cases), while a sale can be finalized in 2–4 weeks.

Selling a CRT income interest tends to make the most sense for clients who:

- Need cash for an investment opportunity, a business or charity

- Desire increased flexibility
- Want to maximize the value of their CRT interest (sale proceeds › value of income stream)
- Wish to simplify their financial affairs
- Are going through a divorce
- Have a spouse that's passed away
- Are tired of waiting/paying for CRT tax returns
- Need cash for other reasons (e.g., grandchildren's college tuition)

CRT Rollover

Many clients would rather change something about their CRTs than exit their trusts entirely. By using their CRT income interest to fund a new CRT — an innovative new technique called a "CRT Rollover" — clients can, in effect, alter the terms and conditions of their trusts.

CRT Rollovers make the most sense for clients seeking to:

- Add children as income beneficiaries
- Add a spouse as income beneficiary
- Defer (highly) taxable income forced out by Standard CRUTs (SCRUTs)
- Increase total trust income
- Fix underperforming NIMCRUTs

Case Study 1: SCRUT to NIMCRUT, Add Daughters as Beneficiaries

Problem: A 63-year-old client was the sole lifetime beneficiary of a $2,185,000 SCRUT with a 5% payout. She had plenty of income sources outside the CRT and did not like how the CRT was forcing income to her. She was even more dissatisfied about the related tax, which in some years approached 50%. In addition, she had two daughters she would rather see benefit from the trust, but neither was listed as a beneficiary of the CRT. As it stood, everything in the trust was set to be distributed to charity upon her death, and her daughters would receive nothing.

Solution: Her advisors rolled her SCRUT income interest into a new NIMCRUT and added her two daughters as contingent income beneficiaries. Her attorney added structure to the NIMCRUT that allows her to decide whether to draw income from the trust. 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 for some reason she needs income, in any year she can elect to take the accrued gain the trust has built up. At her 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).

Case Study 2: SCRUT to NIMCRUT, Add Daughters as Beneficiaries

Problem: A 75-year-old client was the sole beneficiary of a $5,000,000 SCRUT with a 5% payout. He had set up the SCRUT shortly after divorcing his first wife, while he was still single. Several years later, he married a woman 10-years his junior. The client and his new wife relied on the distributions from the SCRUT, which constituted a large percentage of their overall income. As time passed, the client became increasingly concerned that his new wife would suffer a cut in living standards if he predeceases her, which is likely given their difference in age. As it stood, everything in the trust was set to be distributed to charity upon his death. The client needed to provide not only for himself and his wife during his lifetime, but also for his wife after he passes.

Solution: The client's advisors rolled his 5% SCRUT to a new 10% SCRUT and added the client's wife as an income beneficiary. Because the payout rate on the new SCRUT is higher, the couple expects to receive more income up front, during the husband's lifetime. By the time the husband is expected to pass away, the SCRUT will be distributing less income (unless the CRT can earn 10% each year). However, at that point, less income will be needed, since only his wife will be dependent on the SCRUT distributions. More importantly, the client can rest assured knowing that his wife will be taken care of after he passes.

For clients who have CRTs that are no longer a fit for their circumstances, a Rollover or sale of the income interest can be attractive options. Because CRTs are irrevocable assets that are typically tied to clients' lifetimes, most CRTs become misaligned with clients' situations at one point or another. Advisors should inform their clients of their ability to sell a CRT income interest or do a Rollover, should the need arise down the road.

About NAEPC

The National Association of Estate Planners & Councils (NAEPC) is a national organization of affiliated estate planning councils and professional estate planners focused on establishing and monitoring the highest professional and educational standards. NAEPC provides public awareness of the services rendered by multi-disciplinary professionals who meet these standards and believes that the team approach to estate planning best serves the client.

FROM *ESTATE PLANNING*, 2017
(REPRINTED: *TAXATION OF EXEMPTS*, 2017)

New Opportunities for Old Charitable Remainder Trusts

A sale for cash or rollover to a differently designed CRT can reposition wealth tied up in an old CRT to better satisfy a client's current circumstances.

EVAN UNZELMAN AND SAM NAVARRO

Clients set up charitable remainder trusts (CRTs) for a variety of reasons. These include: the ability to diversify without triggering immediate capital gains tax when an investment has substantially increased in value; the ability to convert an appreciated asset into a lifetime income stream; the deferral of capital gains tax associated with selling appreciated property; a potential reduction in estate tax; an up-front income tax deduction; and the ability to make a large charitable donation while retaining the use of the assets, usually for the rest of their lives. These benefits carry significant appeal for many clients, particularly those who are charitably inclined. The downside of CRTs is inflexibility. Because CRTs are irrevocable, clients have few options for changing or unwinding their trusts.

Clients with CRTs that no longer fit their circumstances are not stuck. Since the mid-2000s, individuals have been able to sell their income interest, usually for cash. Furthermore, a recent innovation, the "CRT rollover," offers huge benefits for many higher-end CRT clients.

Sale for cash

Rev. Rul. 72-243[1] provides that an income interest in a trust is a private capital asset. As such, a CRT income interest is a capital asset that can be bought, sold, or reinvested—just like other private capital assets (e.g., real estate). This was confirmed by several private letter rulings in the early 2000s that looked specifically at the salability of an income interest in a CRT and the tax treatment of the sale proceeds.[2] The status of CRT income interests as capital assets opens up exciting planning possibilities.

Advantages of selling

Before buying and selling CRT income interests became popular in the early 2000s, the only option for a client seeking to exit a CRT was a termination. A client can terminate a CRT in two ways:

1. By gifting the income interest to the charitable remainderman.
2. By splitting the trust's assets with the charitable remainderman according to an IRS formula—the "7520 rules."

Before the sale option, clients who set up their CRTs mainly to benefit charity tended to gift their income interest to the charitable remainderman. Clients who needed income from their CRTs pursued an actuarial split of the trust.

Sale vs. termination or split-up. Any clients who are seeking cash

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should consider a sale of their CRT income interest. Selling a CRT income interest is usually much faster than a termination, and frequently results in the clients receiving more money than they would in a termination. The typical sale is a quick, relatively painless two- to four-week endeavor. By contrast, a termination—which requires going to court and may require notifying the attorney general—can take several months (or even more than a year in some states) to complete. Because clients may get more money from selling a CRT income interest than they can by terminating a CRT (and because they can usually access that money more quickly), a sale of the income interest can be an attractive option for accessing liquidity.

Another common driver of CRT income interest sales is divorce. For a divorcing couple with a joint life interest in a CRT, the optimal solution is often to sell the interest and split the proceeds so that both parties can go their separate ways. A divorcing couple could go to court and split a CRT, creating a smaller income stream for each beneficiary, but a sale is typically much easier than what can be an involved, expensive process (especially during an even more involved, more expensive divorce process). Moreover, each income beneficiary would have to appoint his or her own trustee and complete an additional tax return each year, further complicating matters. Selling the income interest is typically the easiest and most prudent course of action.

Reasons to sell. A partial list of the many other reasons that people sell the interests in their CRTs is as follows:

- *Value maximization.* Clients with CRTs may net more by selling their income interests than they can by retaining the interests and waiting for future income.
- *Flexibility.* Many clients prefer the flexibility of a lump sum of cash to a future income stream.
- *Simplification.* Many clients grow tired of the hassles and costs associated with maintaining a CRT and wish to simply their financial affairs. In these cases, a sale can offer a welcome respite from the administrative costs and obligations.

Regardless of the exact reason, most sales occur because something has changed since the CRT was created. The following case studies, based on real-life client experiences, highlight some of the common motivations for pursuing a transaction.

Case study #1. *Value maximization.* Sue was a C-Suite executive at one of the largest private food processing companies in the world. Toward the end of the bull market in the late 1990s, she had some very large unrealized gains in her stock portfolio. While she did not need the money, she was interested in converting some of her highly appreciated stock into income.

Wary of the market's rising tide and the capital gains taxes she would incur by selling her appreciated shares, she opted to set up a CRT. By contributing her holdings to a standard CRUT, Sue realized that she could generate an immediate tax deduction, diversify her shares, and create an annual lifetime income stream. She set up the CRT, which sold the shares and invested in a portfolio designed to earn more than the CRT's annual 7% distribution.

In the late 1990s, Sue's financial advisor Tony became drawn to the high yields and low valuations of REITs. After selling Sue's highly appreciated stock, he urged her to invest heavily in REITs, which she did. One year later, when the tech bubble burst and the stock market came crashing down to earth, the REITs not only helped Sue hold her position in the CRT, it actually grew the trust corpus.

The REITs continued to outperform into the early 2000s, eventually reaching what Tony considered "stratospheric" heights in 2004. Tony urged Sue to cut back on her position and sell some of her REITs, only to watch some of her former holdings double in value over the next couple of years. While Sue did not complain, Tony began to realize that, without the REITs and with bond yields at historic lows, it was becoming increasingly difficult for the CRT to earn the distribution amount. He was forced to sell assets inside the trust to make the required distributions—an idea he was not crazy about but one that he preferred to investing in overvalued assets. He watched, concerned, as the value of the CRT declined for three straight years.

When Tony learned that Sue could sell her income interest—for an amount that exceeded the after-tax value of Sue's interest, no less—he sprang into action. Tony explained the process to Sue, who quickly grasped its benefits and urged him to move forward.

Case study #2. *Simplification.* Kevin had always been a bit of a maverick. While enrolled at Cal-Tech University, he used the money he made teaching guitar lessons to his classmates to fund his gambling pursuits at a local pool hall. When a jealous roommate reported Kevin's activity to University officials, he was promptly suspended for a semester. Kevin's parents were livid—until he informed

1 1972-1 CB 233.

them that he had earned enough money playing pool to finance the rest of his degree (once he was allowed to return to school).

Several years later, Kevin was selling cars in Los Angeles when he decided that he wanted a career change. He became fascinated by the New York Stock Exchange after watching a documentary on the subject, recognizing that the same savviness and calmness that had enabled him to succeed in pool halls would serve him well in floor trading. He packed his bags and headed to New York, where he was able to talk himself into a clerk position on the floor of the Exchange. Shortly thereafter, he secured a position as a trader, where he promptly made a lot of money, then lost everything he had—three times. Undeterred, Kevin stuck with it. After a while, he became adept at identifying "pump-and-dump" schemes. In an industry in which timing is everything, buying low and selling high came naturally to Kevin.

Kevin's ability to analyze the market without succumbing to the emotional pull of its "herd mentality" was well-suited to floor trading. He won more often than he lost, but every time he made money on a large trade, his thoughts reverted to the several times he had "bottomed out" at the start of his career. As Kevin became older, he hedged his bets and set up a CRT with highly appreciated stock from his personal portfolio. He liked the CRT for two reasons:

1. Its structure enabled him to sell the stock inside the trust and avoid a hefty capital gains tax.
2. It provided him a consistent income stream for the rest of his life, a buffer that could offset the financial pain of a sudden loss of most or all of his net worth.

As it turned out, Kevin's paranoia was unjustified. He enjoyed a very lucrative career, retiring at the age of 52. By that point, he did not need or even want his CRT—he thought it burdensome, and he hated paying the taxes. One day, Kevin received a call from his CPA, who told him that he had mistakenly distributed capital gains to Kevin as income two years prior. According to the CPA, Kevin would have to repay the trust. One month later, Kevin's trustee announced his retirement, sending Kevin a curt email announcing the pending termination of their relationship and pursuing a shortlist of replacement options.

Exasperated, Kevin began to consider other options. For someone who had spent his entire life working, he certainly did not want to spend his retirement years dealing with CRT-related headaches and paying a bunch of unnecessary taxes and fees. After learning that he could sell his CRT income interest, he opted to do so. Two weeks later, he had a lump sum of cash equivalent to the after-tax present value of his income interest in the CRT; most importantly, he was finally freed from the restrictions and hassles of the trust.

CRT rollover: evolution of a planning option

While selling the income interest in a CRT is a great option for many clients who are dissatisfied with their trusts, it is not the best option for everyone. Some clients simply do not need a large lump-sum payment; others might balk at paying the associated capital gains tax. Many clients like their CRTs; they just wish that they could somehow change the trust terms and conditions. Some might want to add beneficiaries to their CRTs, such as their children or spouses; others with standard CRUTs might become curious to know if they can defer their distributions, either because they do not need money, dislike paying taxes on the income, or both; and still others express an interest in changing an underperforming NIMCRUT to a standard CRUT to get a larger and more consistent payout. The rollover is a way for clients with CRTs to fix these (and other) misalignments.

The CRT rollover is an ideal strategy for clients who want to change something about their CRT. While the nature of a rollover can vary based on a client's situation, the process and technique are always the same—a client uses his or her ownership interest in the current CRT to form a new CRT that is better aligned to the client's situation.

CRT rollover: common drivers and case studies

CRT clients can use a rollover to make any number of changes to their trusts. Some of the common drivers include:

- Adding children as income beneficiaries.
- Adding a spouse as an income beneficiary.
- Deferring taxable income from a CRT.
- Fixing an underperforming NIMCRUT.
- Increasing total trust income.

The following case studies, based on real-life client experiences, highlight some of the common motivations for pursuing a rollover.

Case study #1. *Standard CRUT to standard CRUT, add spouse as beneficiary.* Six years after founding Tellabs Inc., a telecom company that would eventually grow to a $3 billion international giant, Marty Hambel decided to pursue other interests; namely, real estate and the raising of thoroughbred racing horses. He established a CRT funded by highly appreciated Tellabs stock, and listed himself and his wife Grace as income beneficiaries.

Nearly 20 years later, Grace passed away from cancer. While grief-stricken, Marty tried his best to move on, adhering to his daily routine and immersing himself in various pursuits. He sought the comfort of Carole, a long-time friend he had met at church. Over time, their friendship blossomed into a much stronger bond. Eventually, the two of them decided to marry.

Marty felt reborn after his marriage to Carole, but the passing of Grace still haunted him. He started to become increasingly concerned about what would happen to his new wife (who was several years younger) if he predeceased her. If he did, he knew that Carole would suffer a dramatic decline in living standards. As the last surviving income beneficiary, Marty understood that his CRT was set to end upon his death and pay the remaining balance to charity.

After consulting with an estate planner, Marty and Carole determined that their best option was to roll Marty's current CRT income interest into a new CRT and add Carole as an income beneficiary. Now, instead of ending when Marty dies, the trust is guaranteed to continue until the last of them—Marty or Carole—passes. Marty can rest assured that Carole will be cared for after he is gone, and the two of them can fully devote themselves to their new passion: cross-country RV excursions.

Case study #2. *Standard CRUT to NIMCRUT, add children as beneficiaries and structure for deferral.* By the time he was 30, Josh was the principal of a California-based commercial real estate firm that had leased and developed millions of square feet of real estate. As California grew, attracting millions of new residents and businesses from across the U.S., Josh's biggest challenges became managing his company's rapid growth and juggling an expanding project portfolio. When a promising new venture materialized in the early 1980s, Josh suddenly found his resources stretched too thin. He opted to sell some vacant lots he owned to another developer so he could sharpen his focus on the most promising projects in his pipeline.

Josh knew that the value of the land he planned to sell had appreciated significantly since he had purchased it. Not wanting to pay a hefty capital gains tax bill, Josh decided to set up a CRT and fund it with the undeveloped land. He added his wife, Elaine, as an income beneficiary. Josh then sold the property inside the CRT, which helped him avoid the up-front capital gains tax and create a steady stream of future income.

Over the course of a career that spanned four decades, Josh invested in countless ventures. By the time he and Elaine approached retirement age, these ventures were producing more income than the couple knew what to do with. Not only did they not need the income from their CRT, they did not like that they were paying what was close to a 50% effective tax rate on the distributions. More importantly, their children's lives had become very complicated. One had developed a rare blood disease that required costly treatments, and another had become the mother of seven children. It was not uncommon for Josh and Elaine to use part of their annual CRT distribution to support their children and their children's families.

As time passed, Josh and Elaine started to become increasingly concerned about their children's wellbeing. They wanted to know if there was a way to use their CRT—which was set to expire at the last of their

EXHIBIT 1
Authorities Regarding Certain Aspects of CRT Transactions

Below is a summary of the legal authorities regarding different aspects of CRT transactions.

Lead Interest as a Capital Asset:

- *McAllister*, 157 F.2d 235, 35 AFTR 91 (CA-2, 1946), *cert. den.* 330 U.S. 826 (1947); Rev. Rul. 72-243, 1972-1 CB 233.
- Ltr. Rul. 200152018.
- Ltr. Rul. 200127023.

Charitable Deduction:

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

- Rev. Rul. 86-60, 1986-1 CB 302.
- Rev. Rul. 79-295, 1979-2 CB 349.
- Ltr. Rul. 201321012.
- Ltr. Rul. 201249002.
- Ltr. Rul. 200630006.
- Ltr. Rul. 200524014.
- Ltr. Rul. 200205008.

Assignment of Income Considerations:

- *Blair*, 300 U.S. 5, 18 AFTR 1132 (1937) (distinguishing the key assignment of income authorities, such as *Lucas v. Earl*, 281 U.S. 111, 8 AFTR 10287 (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, 25 AFTR 1209 (1941) (distinguishing *Blair* on the specific facts of the case).
- *Raymond*, 247 F. Supp. 2d 548 (2002) (in the context of the taxability of a contingent fee agreement).
- *Farkas*, 170 F.2d 201 (CA-5, 1948).
- *Hawaiian Trust Co., Limited v. Kanne*, 172 F. 2d 74 (CA-9, 1949).
- Rev. Rul. 55-38, 1955-1 CB 389.
- Ltr. Rul. 9031010.
- Ltr. Rul. 8932040.
- Ltr. Rul. 8650024.

***Palmer*-Type Issues:**

- *Palmer*, 62 TC 684 (1974), *aff'd. on other grounds* 523 F. 2d 1308, 36 AFTR2d 75-5942 (CA-8, 1975), *acq.* 1978-1 CB 2.
- Rev. Rul. 78-197, 1978-1 CB 83.
- *Rauenhorst*, 119 TC 157 (2002).
- *Blake*, 697 F.2d 473, 51 AFTR2d 83-445 (CA-2, 1982).
- Ltr. Rul. 201012050.
- Ltr. Rul. 200321010.
- Ltr. Rul. 200230004.
- Ltr. Rul. 9611047.
- Ltr. Rul. 8639046.

deaths—to continue to benefit their children after they passed away.

After several conversations with their financial advisor, the couple determined that their best option was to roll their current CRT income interest into a new NIMCRUT and add their children as contingent income beneficiaries. Now, instead of ending when Josh and Elaine pass away, their trust will last for the rest of their children's lives. Although the couple had to take a slight haircut on the CRT assets, the NIMCRUT is currently enabling them to support their children when necessary and defer any taxable CRT income distributions their children do not need into the future.

By the end of Josh and Elaine's joint life expectancy, the value of the trust will be much greater than it is today. At that point, their children will be able to begin taking substantially larger income distributions than their parents ever received.

Case study #3. *NIMCRUT to standard CRUT.* Walter is the vice president of marketing of the North American division of a multinational bank; his wife, Rhonda, is a CPA at a mid-sized firm. The two met in the early-1990s while working for a technology startup outside of San Francisco. A couple of years later, they were married with two small children. As the tech bubble developed, the young family watched the shares of their company stock skyrocket. During one particularly frenetic week, their share prices soared by over 1,000%.

Ever the skeptic, Walter began to sense that the entire industry had become afflicted with a speculative mania. After the company announced some modest changes to its website and its stock price doubled (again), he decided to take action. He set up a CRT, added himself and his new wife as joint income beneficiaries, put the majority of their stock inside the trust, sold the shares (deferring a huge capital gain in the process), and reinvested the proceeds in marketable securities. Six months later, the bubble burst.

Walter and Ronda had not owned a huge piece of the company, but they cashed out at exactly the right time. They decided to take some time off and spent six months traveling with their young daughters around Europe, South Africa, and the Far East. Eventually, they relocated to the East Coast to be closer to their families and settled into more stable careers at established firms.

While the couple was on strong financial footing, they were not completely immune to financial pressures. In early 2015, Walter and Rhonda's elder daughter, Christina, got engaged, and their younger daughter, Vicki, was accepted to Harvard. Walter and Rhonda were proud of their children, but they were also facing the high costs of a wedding and four years of massive tuition payments. Walter had two objectives:

1. Free up cash to help pay for Christina's wedding.
2. Generate more income from the CRT to pay for four years of Vicki's Harvard tuition.

After speaking with their estate planner, Walter and Rhonda determined that the best strategy would be to roll their current CRT into a new CRT with a higher payout rate. First, Walter received a large tax deduction in connection with the rollover, which reduced the family's taxable income. Second, even though the starting value of the new CRT was 90% of the value of the original CRT, its higher payout rate is projected to generate more income for Walter and Rhonda over the next five to seven years. The tax deduction relieved a lot of the pressure of the cost of Christina's wedding, and the higher projected distributions should put Walter and Rhonda in a much better position to be able to afford Vicki's Harvard tuition.

Answers to frequently asked questions

Various myths are associated with the secondary market for CRT income interests. This section highlights (and debunks) nine of the most common.

Answer #1. *A seller of a CRT income interest pays long-term capital gains tax on the sale proceeds.* Rev. Rul. 72-243 confirms that an income interest in any trust is a private capital asset, and proceeds from the sale of that interest are capital gains property in the hands of the seller. A series of letter rulings that came out in the early 2000s,[3] which reference the original 1972 revenue ruling as their basis, confirm the salability and tax treatment of an income interest in a CRT specifically.

Answer #2. *A seller may have significant basis in his or her income interest, saving significant tax on a sale.* In January 2014, the IRS released proposed basis regulations involving sales of CRT interests. Those regulations, which were finalized without change in August 2015:

1. Are limited in scope to basis issues and application of Section 1001(e)(3) and do not in any way affect the ability of an income interest holder to sell his or her interest.
2. Reject a set zero-basis rule for the seller.
3. Adopt a rule that the seller's basis is his or her portion of the uniform basis of the underlying assets reduced (but not below zero) by undistributed ordinary income and net capital gain in the CRT.

Answer #3. *Selling or rolling a CRT income interest often makes sense for beneficiaries regardless of their age.* While younger people do have longer life expectancies, and therefore, the value of their income interest would be greater than an older person's interest (all else equal), anybody can sell or roll their interest for an amount that is (typically) greater than the after-tax present value of their income stream. In other words, selling a CRT income interest almost always makes financial sense, regardless of a client's age. By that same reasoning, if a client pursues a rollover, the starting value of the new CRT will typically be greater than the value of the interest in the former CRT.

Answer #4. *A CRT interest can usually be sold or rolled even if the CRT trust agreement contains a spendthrift clause.* A spendthrift clause is

[2] See, e.g., Ltr. Rul. 200739004.

[3] *Id.*

[4] See Blair, 300 U.S. 5, 18 AFTR 1132 (1937) and Lucas v. Earl, 281 U.S. 111, 8 AFTR 10287 (1930).

[5] 62 TC 684.

typically not a barrier to a sale or rollover. Many experts believe that a spendthrift clause in a self-settled trust is not enforceable. And in most cases, the risk (if any) associated with purchasing the income interest of a trust with a spendthrift provision can be handled contractually among the parties involved.

Answer #5. *A CRT rollover does not generate "assignment of income."* The irrevocable assignment of a CRT income interest is sufficient to shift the taxability of the income interest to the new CRT (the assignee).[4] Because the new CRT is exempt, no taxes are owed. As with all contributions of nonpublicly traded assets, advisors should be sensitive to *Palmer*[5]-type issues (i.e., gifts of stock to a charity that are subsequently redeemed pursuant to a prearranged plan).

Answer #6. *A client who wishes to sell or roll a CRT income interest generally does not need to be medically underwritten and insurable.* In general, the seller is not required to be medically underwritten. In addition, sellers who may not be insurable can often still sell their income interest in a CRT. In fact, a person's lack of insurability can be a reason for considering selling the income interest, because the client is uncomfortable bearing the financial risk of not receiving all of the expected payments.

Answer #7. *A grantor who sells or rolls an interest in a CRT gets to keep the entire original tax deduction received upon setting up the trust.* A CRT is a split-interest trust. When the trust is created, the life interest (typically, or term interest in the case of a term trust) at a stated rate (or dollar amount in the case of a CRAT) belongs to the grantor. This is the income interest that may be sold. The remainder interest is given irrevocably to charity when the trust is created. It is this gift which gives rise to the initial tax deduction. The sale of the lead interest does not change the fact the remainder is still assigned to charity.

Answer #8. *An arm's length transaction with an unrelated party with not give rise to an "excess benefit transaction."* The proceeds of a sale or rollover of a CRT income interest cannot be considered "excess benefit" as long as the buyer is an independent third party. Also, the price the buyer pays for the income interest is irrelevant because the assets inside the CRT—and therefore the future income stream and the amount eventually distributed to charity—are unaffected by the transaction.

Answer #9. *A sale or rollover is often possible even if the trust owns illiquid assets.* While illiquid assets need to be looked at on a case-by-case basis, they are not necessarily a barrier to a sale. Numerous transactions have been completed in the past in which illiquid assets were among the assets of the CRT.

Conclusion

Well-designed CRTs can fulfill a variety of planning objectives. Yet, a client's circumstances could subsequently change sufficiently that the CRT drafted for a prior stage of his or her life no longer fits the client's needs. In this situation, a sale or rollover of the CRT may assist in reallocating the client's assets to better meet current and future desires. Exhibit 1 lists sources of IRS guidance that should be consulted when structuring CRT transactions. ■

Charitable Remainder Trusts:

A New Look at an Old Planning Strategy

When does "irrevocable" mean "Yes, you can make a change"? New options for charitable remainder trusts can satisfy your philanthropic intent and give you more flexibility for changing life circumstances.

Philanthropy is an integral part of both estate planning and tax planning. In addition, making gifts to charities provides the opportunity to leave a legacy, make a generational connection or fulfill a personal objective. Of all the giving strategies available, the charitable remainder trust (CRT) stands out for its ability to pay donors an annual income stream for a set number of years *and* satisfy charitable desires because the trust's remainder passes to one or more charities at the trust's end. A CRT pays a fixed or variable income stream, with a minimum of 5% and a maximum of 50% of the trust's value, during the term of the trust.

"One of the most appealing features of a CRT has always been the income tax deduction you receive, an amount equal to the present value of the remainder interest," says H. Arthur Graper, CFP®, managing director and wealth strategist for Atlantic Trust. "CRTs were popular with clients interested in charitable giving in past higher interest rate environments. Now, even though we're in a low interest rate environment, income taxes are a bigger consideration, especially for people who live in high tax states. The tax deduction benefit has once again become very attractive for many people. In addition, CRTs should continue to get more attention as interest rates begin rising."

What About When a CRT No Longer "Fits"?

Sometimes, even with the initial best intentions for setting up a CRT, it makes good sense to re-examine the CRT's purpose and impact on the client's financial situation *today*, says Graper. "A CRT usually spans decades of clients' lives. Taking a fresh look is asking the question, 'If we could have a do-over on this CRT, what would we do differently?' A client's life can change dramatically in 10 years, for example, especially in regard to beneficiaries. So, you have an inflexible trust—remember that a CRT is irrevocable and its terms can't be changed—with naturally occurring changes in a client's life, resulting in a possible misalignment."

Until fairly recently, clients with CRTs had only two options: stay the course or exit the trust. Exiting, or terminating the trust, is typically a court-driven process in which the trust donor splits the assets in the trust with the remaindermen based on an IRS formula. This option involves attorney fees and court time, not particularly attractive to many clients, although the sale proceeds are taxed at capital gains rates rather than ordinary income rates.

Now, a relatively new technique—a CRT Rollover—offers new options to clients who might be better served by a different type of trust than what they originally established, primarily because of three drivers: fresh thinking in their later years on how loved ones will be taken care of financially, perhaps wishing to add children or a spouse as an income beneficiary; deferring taxable income, such as can be done by moving from a standard CRT to a type of trust called a Net Income Make-Up Charitable Remainder Unitrust (NIMCRUT); and fixing underperforming NIMCRUTs.

Comparison of CRT Options for a 6% CRUT, 21 Years of Life Expectancy

	NO ACTION[1]	SELL[2]	TERMINATE[3]
Gross Proceeds	$1,012,894	$1,200,000	$999,191
Fees	Unknown	($84,000)	Unknown
Taxes	($235,498)	($223,200)	($199,838)
Net, After-Tax Proceeds	**$777,396**	**$892,800**	**$799,353**

Loss From No Action: ($115,405) or -14.8%
Loss from Termination: ($93,447) or -11.7%

1 *Does not include trustee, administration or similar fees.*

2 *Includes all associated fees.*

3 *Does not include fees associated with termination. Calculated using Estate Planner module of ONESOURCE Trust & Estate Administration.*

Source: Sterling Foundation Management LLC.

In addition, says Evan Unzelman, president of Sterling Foundation Management LLC, "Clients today are demanding liquidity in *many* aspects of their financial lives. That ranges from daily trading of real estate investment trusts to mutual funds to retirement funds accessible through early withdrawals. In the world of trusts, most *living* trusts are revocable or changeable. But with an irrevocable CRT, it's always been viewed as 'for life,' primarily because a CRT's permanence is rooted in the fact that, to qualify for special tax treatment, a CRT must be irrevocable. However, that understanding of CRTs is beginning to change, as clients and advisors alike realize that illiquidity has been an institutional, rather than a fundamental, necessity. We're seeing more clients express an interest in getting beyond the CRT lifetime lockup."

Benefits of Two CRT "Do-Over" Options

A **rollover strategy** can be right for clients who wish to change the terms of a CRT. The rollover itself is "mechanically" always the same: Clients use ownership in a current CRT to form a new CRT that better aligns with their life situation *(see Case Study on next page)*. "It's not *changing* the existing CRT, but it is a blank slate and a fresh start with a new CRT," says Unzelman. "Perhaps the most important point about the rollover is that it should be done in the context of a review of the client's philanthropic intent and current life situation. The vast majority of clients with CRTs have little idea what they own. Clients' other capital assets—stocks, bonds, real estate holdings—typically get an annual, if not much more frequent, review to make sure the assets are still working for them. The CRT as a capital asset is often overlooked, in part because for many clients it was set up years ago."

A second option for a trust that no longer "fits" is **sale of the income stream**, which can be an attractive option in terms of maximizing the cash that the donor can receive. "In our experience,

Selling a CRT Income Interest: What You Need to Know

1. **What authority allows sale of a lead interest in a CRT?**
   An income interest in a trust is generally an asset under state law and is therefore salable under state law in the same manner as other such assets.

2. **Is there a recapture of the initial tax deduction taken by the grantor?**
   No. The seller of an income interest sells only his or her income interest—the portion of the trust value not given to charity. A qualified charity remains, whether named specifically or as to a class, as the remainder beneficiary.

3. **Are there age requirements or restrictions?**
   No. A person of any age can sell an interest. The younger the person, the longer the life expectancy and, therefore, everything else being equal, the greater the value of the income interest.

4. **What if the trust owns illiquid assets?**
   These assets need to be reviewed on a case-by-case basis. They're not necessarily a barrier to a sale.

5. **Who is an ideal buyer for an income interest?**
   The ideal buyers of a CRT income stream have the following characteristics, among others: They have large net worth with good liquidity, are able to tie up a significant sum for a potentially long time in an illiquid asset, may have various tax attributes such as NOLs and loss carry-forwards and are able to withstand the potential sudden drop in the value of their investment to zero in the event of a premature death of a measuring life. Perhaps most importantly, they have an understanding of and appreciation for philanthropy.

Source: Sterling Foundation Management LLC.

many times there is a buyer willing to pay a price that results in the seller receiving more than he or she would if the trust were simply terminated," says Unzelman. "There are several reasons for this, but the primary one is that the IRS formula is just that—a static formula, in which 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."

Sale of an income interest provides a donor with a lump sum over which he or she has complete control, giving greater flexibility to the grantor. "Having direct control over these funds may provide the grantor with a greater sense of financial security than simply having a right to annual but uncertain distributions from a CRT," says Unzelman. "Often, clients and advisors are 'doing the math' and discovering that it makes more economic sense to convert a long and uncertain stream of payments into an immediate and certain lump sum. And as for taxes, the taxation of the sale of a CRT income stream is surprisingly simple—the income stream is a capital asset and the sale is taxed at capital gains rates. In addition, the sale of a lead interest does not affect the deduction taken for the remainder interest. A qualified charity remains as the remainder beneficiary."

Flexibility as life changes is an important part of estate, tax and philanthropic planning, says Graper. "Very often, we and our clients have to look at trade-offs of complexity vs. simplicity, not just in their wealth strategies and management, but in their lives. The ability to offer options for more flexibility is always desired. With new options for CRTs, we have the ability to at least evaluate one more option for flexibility and responsiveness to changing situations."

Please talk with your advisor and your attorney for all of the options available on CRTs.

Case Study: The Rollover Option SCRUT to NIMCRUT - Adding Children as Beneficiaries

A Standard CRUT (often referred to as a "SCRUT") pays a fixed percentage of the trust's assets each year. The income beneficiaries do not have a choice as to whether or not they take the income. They must take it, and pay the related tax.

This structure can create problems for clients who have significant income outside of their SCRUTs and don't need or want the additional (taxable) income. If given the choice, many of these clients would rather have a NIMCRUT, which gives them the ability to defer the income to future years and allows the trust to grow the deferred distributions tax-free over that time. Using the CRT Rollover strategy to move these clients from their SCRUT to a NIMCRUT is often an effective planning technique.

In addition to the flexibility to take less income and compound it tax-deferred to take even more later, the rollover allows these clients to add beneficiaries, such as spouses and children, to their CRTs, extending the duration of the income stream to include loved ones who were not previously benefiting from their CRT. This can be a powerful way to build tax-free wealth for future generations.

SITUATION: A 63-year-old client was the sole lifetime beneficiary of a $2,185,000 SCRUT 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 that she would elect to defer if given the choice. She was even more dissatisfied about the related tax, which in some years approached 50%. She figured she'd 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 she would rather see benefit from the trust, but neither was a beneficiary of the CRT, so as it stood everything in the trust went to charity at her death. Her daughters would receive nothing.

SOLUTION: Sterling helped her advisors roll her SCRUT to a NIMCRUT and added her two daughters as contingent income beneficiaries. Her attorney added structure to the NIMCRUT that gave her complete discretion on whether or not she receives 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 for some reason she needs income, in any year she can elect to take the accrued gain the trust has built up. At her 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 of time, her daughters will be receiving distributions from a much larger trust—her financial advisors estimate that at between $3.5 and $4 million.

Source: Sterling Foundation Management LLC. Used with permission.

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Secondary Planning Options for CRT Clients

Charitable Remainder Trusts (CRTs) are usually a perfect fit for clients upon inception, but 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.

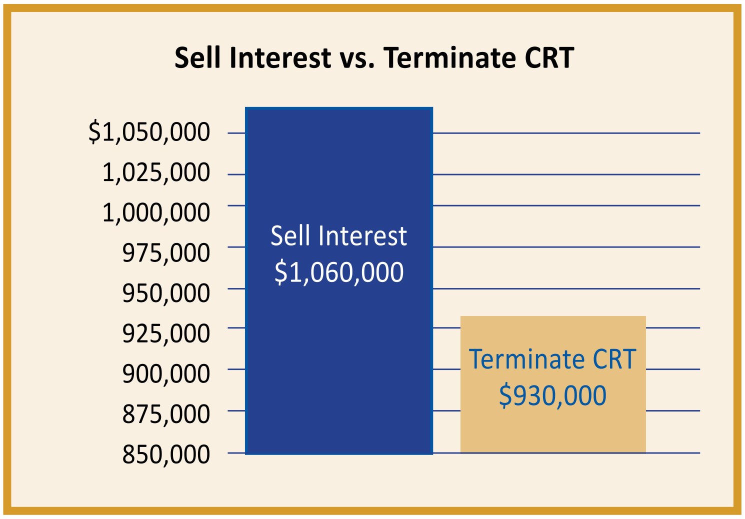
There are several reasons why clients tend to net more by selling their income interests than they would by terminating, but the primary reason is that the IRS uses a static formula to calculate the market value of a CRT interest. A buyer may anticipate higher future investment returns than a seller. 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 Foundation Management ("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) CRT Income 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 income 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, 1955-1C.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 (Febuary 13, 2003)
- PLR 200230004 (April 10, 2002)
- PLR 9611047 (December 15, 1995)
- PLR 8639046 (June 30, 1986)

Written by Evan Unzelman for the Atlanta Bar Association Estate Planning & Probate Section.

Sterling Research Series

New Frontiers in Charitable Remainder Trusts

Report #1501

New Frontiers in Charitable Remainder Trusts

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 determined 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 section 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.

■ ■ ■

About the Author. Roger D. Silk, Ph.D., CFA.

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).

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

There are two main reasons why people sell their lead interests in CRTs: value maximization and financial distress.

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,

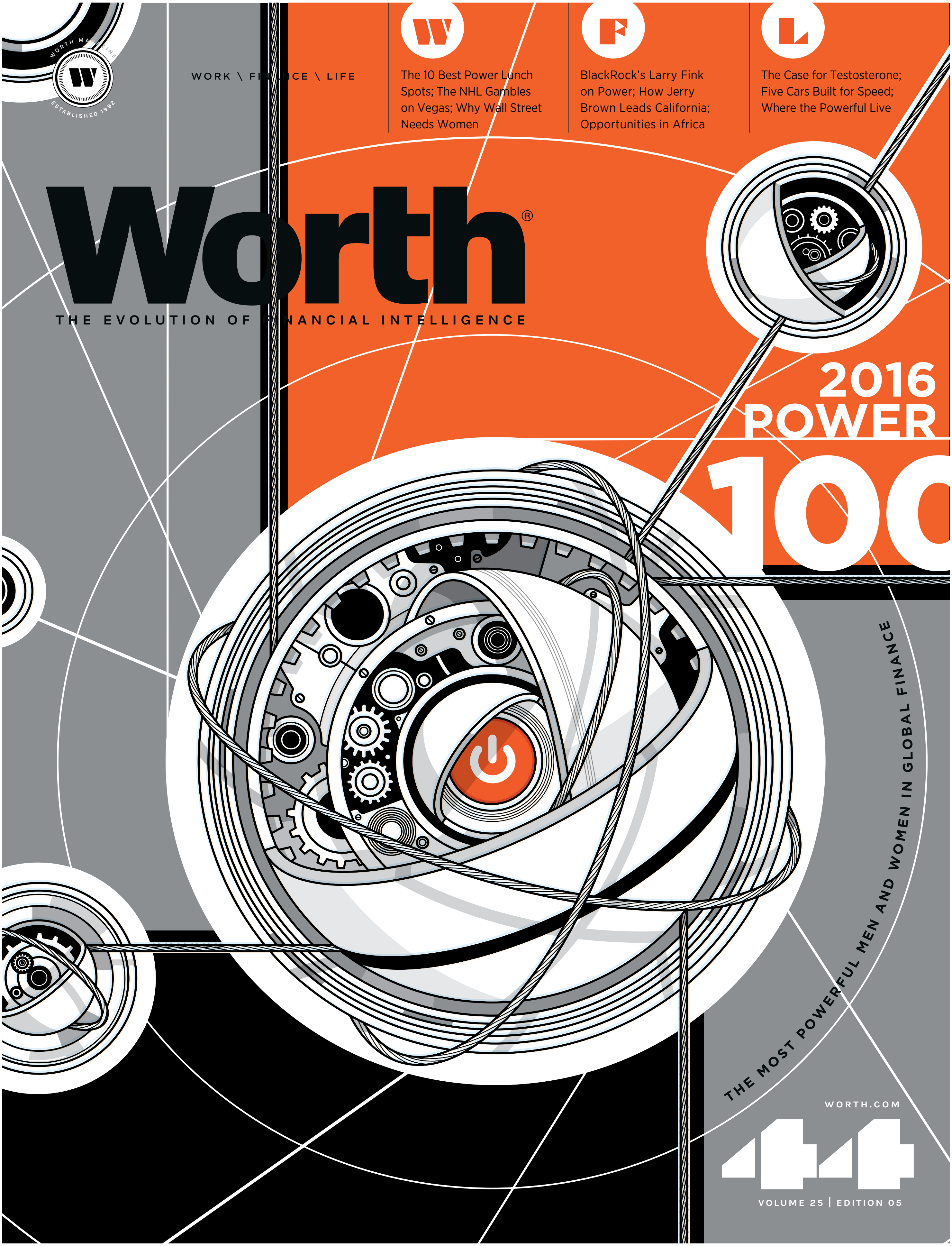
No. 1 (Nov.-Dec. 1999).

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.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Is your client's CRT still a good fit?

BY JAMES W. LINTOTT

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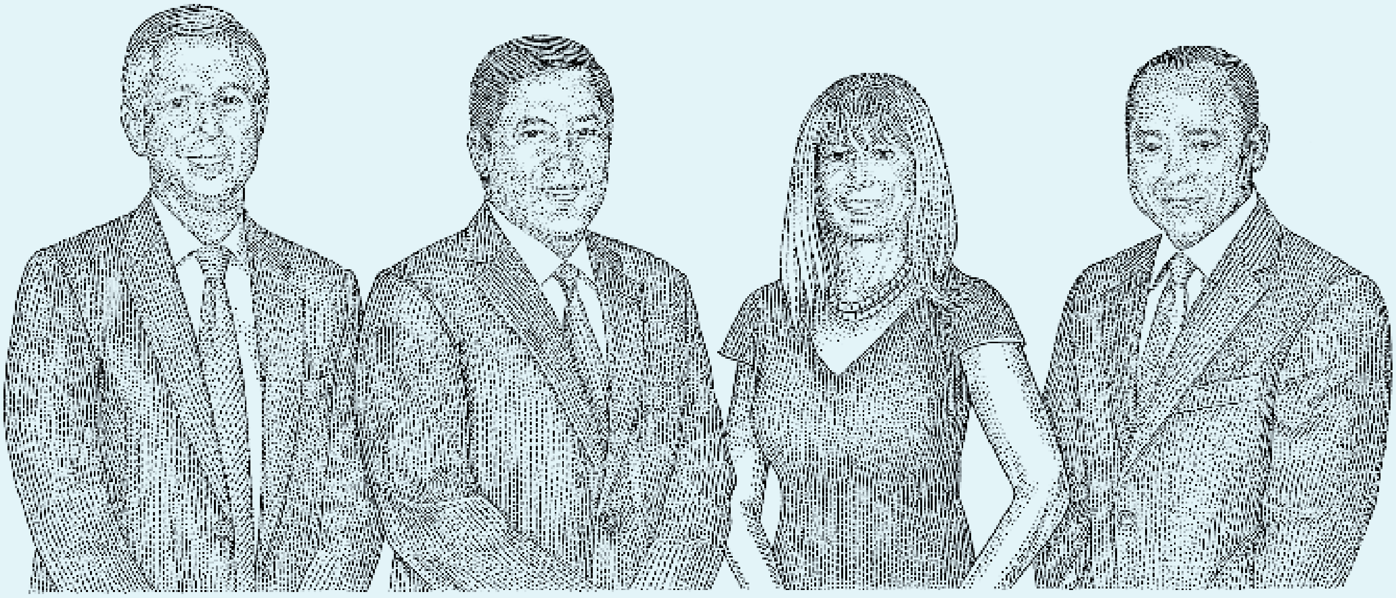

Left to right: *James W. Lintott, Peter F. Najera, Ellen K. Fishbein, Giovanni T. Kotoriy*

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ILLUSTRATION BY KEVIN SPROULS

Charitable remainder trusts (CRTs) offer a number of benefits: an immediate income tax deduction, the ability to convert an appreciated asset into a lifetime income stream, the deferral of capital gains tax, a potential reduction in estate tax and protection from creditors, among others. For many clients—particularly those who are charitably inclined—these benefits carry significant appeal.

WHEN THE SHOE NO LONGER FITS

The downside of CRTs is inflexibility. At its inception, a CRT is usually a perfect fit for a client's situation: It has the appropriate payout rate, trust structure and income beneficiaries. However, because CRTs are irrevocable trusts that can last for decades, they can become misaligned with a client's circumstances over time. Unfortunately, most clients with CRTs don't understand the full range of secondary planning options available to them. At Sterling, we've reviewed countless CRTs, and in our experience, the vast majority of clients with CRTs are under the erroneous impression that their trust is a lifetime lockup. Therefore, it is becoming increasingly important for advisors to inform their clients of the secondary options available, so that they are in a better position to make changes when the need arises.

> "Most clients with CRTs don't understand the full range of available secondary planning options."

SECONDARY PLANNING OPTIONS

Clients can exit a CRT in several ways. They can gift the income interest to charity, which results in an additional tax deduction to the donor, according to an Internal Revenue Service formula, the "7520 rules." They can also terminate their CRT by a complicated division of the assets between the income and remainder beneficiaries (again, based on the 7520 values of those respective interests).

However, if a client is seeking to get the most income possible out of a CRT, his or her best option is nearly always to sell the income interest on the secondary market. Because buyers of CRT-income interests are not bound by the 7520 rules, they are able—and generally *willing*—to pay more than a client would receive by terminating. Moreover, a termination can be a costly, time-consuming process that can take more than six months to complete; a sale, in contrast, can be completed in just two-to-four weeks.

WHY CLIENTS SELL

While the creation of CRTs tends to be driven by tax considerations, most sales occur because something has changed since the CRT was established. Common reasons for selling include: cash needed for an investment opportunity, simplification of financial affairs, divorce, tax considerations, a lack of cash for charitable needs, desire for increased flexibility and value maximization.

AUTHORITY AND TAX TREATMENT

A client's ability to sell an income interest in a trust is rooted in Rev. Rul. 72-243, 1972-1 C.B. 233. This ruling confirms that an income interest in a trust is a capital asset within the meaning of sections 1221 and 1222 of the Internal Revenue Code. In the early 2000s, a series of private letter rulings confirmed the tax treatment and salability of a CRT income interest, referencing the original 1972 Revenue Ruling as their basis.

Until last year, section 1001(e)(1) of the Internal Revenue Code indicated that a seller's basis in a CRT income interest was zero. Last August, however, the IRS issued final regulations, providing new rules for determining a taxable beneficiary's basis in a CRT income interest. These rules enable certain clients with CRTs to take basis, to the extent that that basis consists of a share of adjusted uniform basis.

CRT ROLLOVER

Don't miss our upcoming article on the CRT rollover, an innovative new strategy that enables clients with CRTs to, in effect, make changes to their trusts. Common rollover drivers include adding beneficiaries and deferring highly taxable income from a standard charitable remainder unitrust (CRUT).

ABOUT US

STERLING FOUNDATION MANAGEMENT, LLC IS THE OLDEST NATIONAL FOUNDATION MANAGEMENT FIRM IN THE COUNTRY AND THE NATION'S LEADING FACILITATOR OF SALES OF INCOME INTERESTS IN CHARITABLE REMAINDER TRUSTS. Sterling works with a broad range of clients and high net worth individuals to develop solutions that help them achieve their philanthropic, family and financial goals through the effective use of private foundations and other charitable-planning vehicles and financial services.

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Income Interest Sale Case Studies

"I am a financial advisor and just completed the sale of the income interest in my personal CRT. It was a new concept to me and I was amazed at the excellent communication and education I received, and the efficient service and expediency of the transaction. I have been very impressed with the Sterling team and I feel fortunate to have found a unique new resource for my clients."

Marlo L. Stil
Rancho Mirage, CA

Selling CRT Income Interests: Key Advantages Over Terminations

While a CRT is usually a perfect fit for a client 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 (CRTs are irrevocable, meaning that the primary beneficiaries, payout rate, or structure cannot be changed after a client sets one up).

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.
- Clients seeking to **simplify their affairs** by removing their CRT (and the administrative costs/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 is done according to an IRS formula, the so-called "7520 rules." The formula is the same one used to calculate the charitable deduction for a new CRT containing the same terms.

Don't let clients violate self-dealing rules.
When terminating a CRT, 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 not corrected within the taxable period, he will be subject to further penalties under 4941(b)(1). These penalties can be severe (excise taxes of more than 200% of the amount involved) and 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

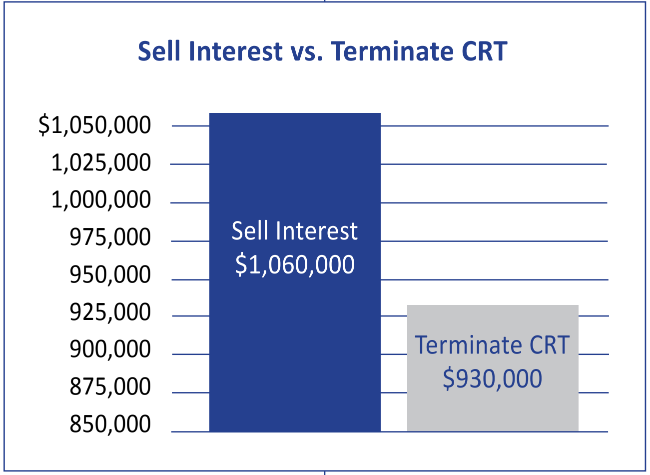
A simple, economically favorable option for clients considering terminations.

Continued on reverse side

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

Why a client can get more in a sale. There are several reasons why clients tend to net more by selling their interest than they would by terminating, but the primary one is that the IRS uses a static formula to calculate the value of a CRT interest. That formula yields a market value only by chance. A buyer may anticipate higher future investment returns than a seller, and 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 the CRT doesn't terminate when a client sells their interest – the income stream is simply redirected to a third party – there is no requirement for a court and/or Attorney General petition. Most CRT income interests can be sold in just two to four weeks, whereas a termination can take up to several months (or more) to complete.



Example

Problem: A husband and wife, both 75 years old, were joint beneficiaries of a 7% Standard CRUT that contained $1.5M. 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.

Solution: They approached their attorney, who told them that they had two options: 1) sell their interest, or 2) terminate the CRUT. Based on the IRS 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 $1.06M, 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 $1.06M, which was more than enough to cover the husband's medical costs.

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Case Study:
CRT Owning 99% of an LP

Summary

- Successfully concluded NIMCRUT with excellent results
- Retained up-front tax benefits
- Garnered long term capital gain treatment on what would have been ordinary income
- Eliminated exposure to rising tax rates

FINANCIAL RESULTS

- **Keep NIMCRUT: $3,700,000**
- **Terminate NIMCRUT: $956,000**
- **Sell NIMCRUT interest: $5,270,000**

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Case Study: CRT Owning 99% of an LP

Background

Mr. Wells established a charitable remainder unitrust in 2002 in order to defer capital gains tax on the sale of highly appreciated stock. He named himself and his wife co-income beneficiaries of the trust. After consulting with his advisors, he decided to structure the trust in a way that he believed would provide him with a desirable combination of upfront deductions, diversification, deferral, investment flexibility and a measure of effective control.

The resulting structure was a 10.875% Net Income with Make-Up Charitable Remainder Unitrust ("NIMCRUT") which owned a 99 percent interest in a Limited Partnership. The remaining 1% was owned by a corporation controlled in part by Mr. Wells. The NIMCRUT permitted Mr. and Mrs. Wells to receive the lesser of trust income or 10.875% (with an opportunity to receive more in future years by way of the 'make-up' provision), and the LP structure allowed them to defer their income into the future—letting the principal grow tax-free—and make withdrawals as they desired later in life.

The approximate value of the stock at the time of creation was $6 million.

Objective

By 2012, with 10 years remaining on the trust term, and an approximate underlying asset value of $8.5 million, Mr. Wells teamed up with his advisors to determine how best he could maximize the after-tax value of the entity to himself and his family.

They considered:

1. Maintain the status quo (since he didn't presently need the money). The rationale with this strategy was that the term had 10 years remaining and the underlying assets could further appreciate during that period. Then—in a few years time—he could turn on the "spigot" and withdraw funds as needed.
2. Terminate the trust early, thereby receiving the actuarial value of the income interest today. The problem with this strategy was that the actuarial value was very low—due to a historically low applicable federal interest rate used in the valuation—so he would only be entitled to a tiny portion of the trust's assets.
3. Liquidate the income interest today by selling it to a third party non-charitable buyer.

Due to Mr. Wells' perception of where tax rates were headed, he determined that he would like to take as much money as he possibly could today, at the current tax rates.

Because of the sizable make-up amount he had accrued, he had the ability to withdraw about $2.5 million from the trust today. After taking the withdrawal, he would either continue to maintain the trust for another few years, or terminate the trust. A downside of this approach was that much of the $2.5 million in distributable income would have been taxable as ordinary income (35% rate). The after-tax, present value of the income interest—assuming the best possible combination of immediate withdrawals and future withdrawals—was estimated to be about $3.7 million.

He then consulted with Sterling to assess the potential value of his interest in a sale. Sterling was able to find a buyer to pay him about $6.2 million (net of costs) for his income interest in the trust today. Because the income interest is considered a capital asset, the proceeds he would receive in a sale would be treated as long-term capital gain income (15%). Thus the net, after-tax value of this option was $5.27 million.

Solution

Given the clear financial benefit of selling his income interest today (>$1.5 million), coupled with the simple procedure handled by Sterling, he elected to proceed with the sale. Eight weeks after deciding to pursue the sale, the transaction was closed.

Mr. Wells received the $6.2 million in cash—wired to his personal account on the date of closing—affording him the flexibility to do whatever he pleased with the money.

His attorney and CPA—pleased by the transaction—have since referred two other clients to Sterling in hopes of achieving similar outcomes.

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Case Study:
CRT Owning 99% of an LP

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STERLING
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Case Study:
Divorce

Summary

- Divorced clients successfully decoupled from CRT
- Retained up-front tax benefits
- Maximized dollars to donors

FINANCIAL RESULTS

- **Sale of income interest netted clients $500,000 more than termination**

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Case Study: Divorce

Background

Mr. Jensen, a venture capitalist, and his then-wife, Mrs. Jensen, a patent attorney, set up a charitable remainder trust in 2007 to defer capital gains tax on the sale of stock in a biotech company. They named themselves co-income beneficiaries of the trust, which was set up to make standard 11% distributions from the trust annually, for a period of 20 years.

By 2011, Mr. and Mrs. Jensen were divorced.

The vast majority of their assets had been divided and disbursed, but the two were still connected financially in a way that neither liked: they co-owned the right to receive income from their CRUT for the remaining term.

Objective

The Jensen's advisors were looking to terminate the CRUT—thereby allowing the two to decouple from the jointly-owned asset—and split the proceeds equally. But a termination can be a long, expensive process which requires court involvement, so the Jensen's asked their advisors to look for alternatives.

The first alternative the advisors examined was the option to split the trust. This would result in two trusts in which the ex-spouses would own separate interests. But the Jensen's weren't thrilled with the idea of continuing to pay for compliance and administration on trusts they really wanted to get rid of. In addition, though they would own interests in separate trusts, the trusts would still serve as a constant reminder of their ex-spouse.

Their advisors then found Sterling and learned about the sale option. Similar to a termination, the sale would result in a lump sum of cash the Jensen's could split between each other. However, there were two distinct advantages of selling their income interest instead of terminating:

1. The sale would net the Jensen's $500,000 more than they'd receive in a termination.
2. The sale would take less than four weeks to complete and would not require court involvement, while the termination would take several months and would require court involvement.

Solution

Given the clear financial benefit of selling their income interest today, coupled with the simple procedure handled by Sterling, the Jensen's elected to proceed with the sale. Three weeks after deciding to pursue the sale, the transaction was closed.

Since this time, Sterling has become a valuable resource to divorce attorneys and divorce financial advisors around the country, helping them solve a problem that was previously considered almost too costly and time-consuming to pursue.

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Case Study:
Divorce

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Case Study:
Underwater NIMCRUT

Summary

- Successfully concluded NIMCRUT with excellent results
- Retained up-front tax benefits
- Provided valuable liquidity
- Maximized dollars to donors
- Garnered long term capital gain tax treatment on what would have been ordinary income

FINANCIAL RESULTS

- **CRT income interest sold for 4x more than termination value**

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Case Study: Underwater NIMCRUT

Background

In 2006, Mr. and Mrs. Walker, a young couple who had done very well, very quickly with an internet business, established a charitable remainder trust as a retirement-planning tool. Their advisors arranged it in a way—very common at the time—that would allow them to defer income for as long as they would like, and take withdrawals as needed later in life (hopefully).

The arrangement was a 10% Net Income with Make-Up Charitable Remainder Unitrust (NIMCRUT) which would own variable annuities. The idea was that the annuities would appreciate in value, but they wouldn't generate trust income unless they were specifically tapped to do so. This way they could grow and grow during the couple's career, creating a pot that could be tapped into later in life. This is a nice theory, but it relies on one, elusive ingredient: positive investment returns.

With the investment and interest rate environment of the last few years, many of the variable annuity contracts purchased during the bubble years are actually 'underwater' today (i.e., below cost basis).

In these cases, the income beneficiaries are actually unable to withdraw anything at all from the trust (because the annuity contract has to have a current value that is higher than cost basis in order to distribute money). (Another negative about this arrangement is that if the annuities do have gain and can distribute income, the withdrawals are treated as ordinary income.)

Objective

In 2012, the Walkers were still very well-off by most standards, but the NIMCRUT was simply underperforming and they were not interested in waiting and hoping for the annuities to come back up above water only to withdraw the income at a combined ordinary tax rate potentially above 50%.

So they had their advisors look for exit strategies.

They identified two.
1. Judicially terminate the trust and receive the actuarial value of the income interest.
2. Sell the income interest to a third-party, non-charitable buyer.

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Case Study:
Underwater NIMCRUT

Their advisors quickly learned that a judicial termination would not deliver a desirable financial outcome to the income interest holders given the currently low 7520 interest rate used to value income interests in CRTs. In addition, the sale could be completed in a much shorter time period and would not require court involvement.

Solution

Given the clear financial benefit of selling their income interest today, coupled with the simple procedure handled by Sterling, the Walker's decided to proceed with a sale.

As it turned out, the Walkers were able to exit the arrangement by selling their income interest in the trust for about 4x what they would have received if they terminated the trust. They were pleased with this outcome as it got them out of the NIMCRUT at a fair valuation, with long term capital gain tax treatment on the proceeds.

The annuities did not even have to be surrendered ahead of the transaction.

The Walkers were pleased and so were their advisors, who are now discussing this strategy with their other clients with NIMCRUTs holding variable annuities.

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CRT Rollover Case Studies

"The Rollover was a perfect fit for our client. It not only provided a new income source for her children, but it also reduced her own taxable income, which will save her hundreds of thousands in taxes. I would absolutely recommend Sterling for anything involving CRT planning. Had it not been for them, our client would be stuck with an asset (the income interest in her CRT) that no longer served its purpose."

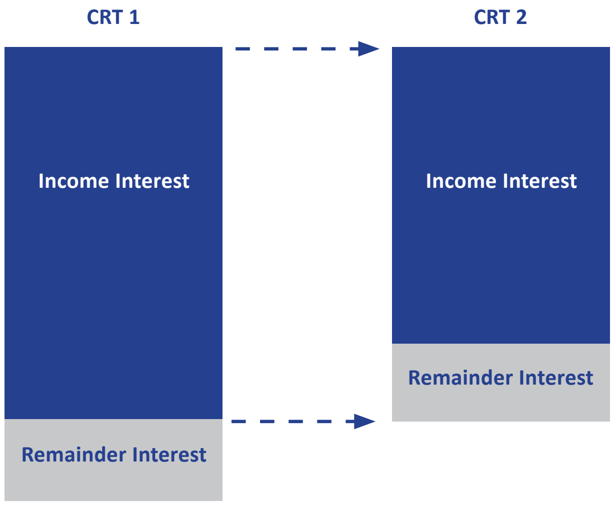
Barry B. Bondroff, Officer
Gorfine, Schiller & Gardyn
Owings Mills, MD

Clients Use CRT Rollover to Benefit Children: Two Case Studies

Charitable remainder trusts (CRTs) are irrevocable, split-interest trusts. The most common types of CRTs are standard CRUTs (SCRUTs) and net income with make-up CRUTs (NIMCRUTs).

SCRUTs force out a fixed percentage of the trust assets to a primary beneficiary (or beneficiaries) every year. Beneficiaries must take the income and pay the related taxes. NIMCRUTs, on the other hand, require that either a fixed percentage of the trust assets be credited to the primary beneficiaries, or if less, the net income the trust generates for that year. With NIMCRUTs, any deficiencies can be made up later, during years when the trust income exceeds the payout rate.

CRT Rollover



The CRT rollover gives clients the opportunity to hit the reset button on the terms and conditions of their trusts. Through a rollover, a client uses their income interest in their current CRT (or CRTs) to set up a new CRT. Clients can add children (or grandchildren or spouses) to their new CRTs, extending the income stream to include family members and loved ones who weren't previously benefitting from the trust.

Through a rollover, a client uses their income interest in their current CRT (or CRTs) to set up a new CRT.

Clients can switch from a SCRUT to a NIMCRUT, or from a NIMCRUT to a SCRUT. They also get a tax deduction in connection with the rollover. Many families have found the CRT rollover a compelling strategy for growing wealth tax-free for future generations.

Clients also get a tax deduction in connection with the rollover.

Example 1

Problem: A 76-year-old client was the sole surviving beneficiary of a 5% SCRUT that contained $5.43M. She had plenty of income sources outside the trust and did not like how it forced taxable income to her every year. She also had two daughters: a 54-year-old and a 56-year-old. When the client came to Sterling, she told us that she was interested in accomplishing two goals: 1) shutting off the highly taxable income stream from her SCRUT, and 2) using her SCRUT to transfer more wealth to her daughters.

Continued on reverse side

Solution: Sterling helped the client roll her SCRUT into a NIMCRUT and added her daughters to the trust as contingent lifetime beneficiaries. In connection with the rollover, the client received a tax deduction of approximately $600K. Her financial advisor invested the proceeds in a variable annuity that enables her to defer distributions from the NIMCRUT and grow them tax-free. Her plan is to defer all future distributions (again, she doesn't need the income). Over the remainder of her lifetime (11 years, according to IRS tables), the trust will grow tax-free. When she passes, her daughters will be able to flip on the income stream and receive distributions for the remainder of their lifetimes.

Result: an anticipated **$2.9M** income stream that the client didn't need and didn't like paying taxes on was converted into an anticipated **$6M** income stream for her two daughters. *

Clients who don't need income from their CRTs can roll to a NIMCRUT, defer future distributions, and grow the new trust tax-free for the benefit of their children.

Example 2

Problem: A 75-year-old husband and a 73-year-old wife were joint lifetime beneficiaries of two CRTs. One CRT was an 8.5% SCRUT with $1.9M in assets; the other was an 8.5% NIMCRUT with $2.9M in assets. While the couple relied on some of the income from their CRTs, they didn't need it all. They wanted to know if there was a way to use their interests in the trusts, which were set to expire upon their deaths, to benefit their four children aged 40, 45, 48, and 54.

Solution: Sterling helped the couple roll their SCRUT and NIMCRUT income interests into a new 5% Standard CRUT and added their four children as lifetime beneficiaries. The couple received a $340K tax deduction for setting up the new trust. The parents will continue to receive distributions from the new SCRUT until they pass. At the death of the last surviving parent, their four children will start receiving income from the SCRUT for the remainder of their lifetimes. While the total income paid to the two parents each year has declined slightly, the new 5% SCRUT still generates more than enough to maintain their standard of living. Most importantly, the new trust is expected to extend beyond the parents lifetimes, until the death of the last surviving child.

Result: an anticipated **$3.4M** income stream to the two parents was converted into an anticipated **$2.8M** income stream for the two parents and an anticipated **$6M** income stream to the four children—a total of **$8.8M** to the family overall. *

Clients who rely on the income from their CRTs can roll to a SCRUT and continue to take distributions until the end of their lifetimes. At that point, their children start receiving the income.

*Email contact@sterlingfoundations.com with "cash flows" as the subject to receive electronic copies of the projected cash flows for both case study examples.

CRT ROLLOVER CASE STUDY

NIMCRUT to Term SCRUT, Add Sons as Beneficiaries

A Net Income With Make-Up CRUT (or NIMCRUT) has a fixed percentage payout, but does not necessarily pay out that percentage every year. It only pays out the amount earned each year up to the stated payout (for example, if a 7% NIMCRUT earns 3%, it will only pay 3%), but if there are years that the NIMCRUT earns less than the stated distribution amount, those unpaid amounts can be accrued and distributed later (if they are eventually earned).

NIMCRUTs that underperform over time—that is, they earn less than their payout rates—create problems for clients who were counting on the trusts earning their payouts. If given the choice, many clients would rather have a Standard CRUT (or "SCRUT"), which pays the fixed percentage regardless of how much income the trust earns.

Using the CRT Rollover strategy to transfer clients from their NIMCRUT to a SCRUT is often an effective planning technique.

Not only can donors change to a SCRUT through a Rollover, they can also add beneficiaries (such as spouses and children) to their trusts. This technique enables donors to provide for family members who were not previously benefiting from the trust. In the case of adding children, it also extends the duration of the income stream.

Example

Problem: A husband and wife, both in their late 70s, were the lifetime beneficiaries of a $6,150,000 NIMCRUT with a 7% payout. The NIMCRUT earned about 3% per year, on average. While the couple was well-off when they set up the NIMCRUT, they had become extremely wealthy since. The husband's real estate business had boomed throughout the 1990s and 2000s; by the time his advisors contacted Sterling, the couple's estate was worth $80 million. The couple has three children, all in their 40s, who will be well taken care of after both parents pass away and the children inherit their estate. However, the parents wanted to find a way to get more income to their children (who have children of their own, several of whom are getting ready to enter college) while they are still alive. They also wanted to get more income out of the NIMCRUT, which the husband described as "one of the poorest investment decisions I've ever made."

Solution: Sterling helped the couple's advisors roll their 7% NIMCRUT to a 10%, 20-year term SCRUT with their three children as income beneficiaries. The parents are no longer on the trust, which is fine by them (they don't need the income). Instead, the distributions will go directly to their three children for the next 20 years, which is well beyond the couple's joint life expectancy. In the end, the three children expect to receive over $1,000,000 more from the SCRUT than their parents expected to receive from the old NIMCRUT.

CRT ROLLOVER CASE STUDY

SCRUT to NIMCRUT, Add Children as Beneficiaries

A Standard CRUTs (often referred to as a "SCRUT") pays a fixed percentage of the trust's assets each year. The income beneficiary does not have a choice as to whether or not they take the income. They must take it, and pay the related tax.

This structure can create problems for clients who have significant income outside of their SCRUTs and don't need/want the additional (taxable) income. If given the choice, many of these clients would rather have a NIMCRUT, which gives them the ability to defer the income to future years and allows the trust to grow the deferred distributions tax-free over that time.

Using the CRT Rollover strategy to move these clients from their SCRUT to a NIMCRUT is often an effective planning technique.

In addition to the flexibility to take less income and compound it tax-deferred to take even more later, the Rollover allows these clients to add beneficiaries (such as spouses and children) to their CRTs, extending the duration of the income stream to include loved ones who were not before benefiting from their CRT. This can be a powerful way to build tax-free wealth for future generations.

Example

Problem: A 63-year-old client was the sole lifetime beneficiary of a $2,185,000 SCRUT 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 she would elect to defer if given the choice. She was even more dissatisfied about the related tax, which in some years approached 50%. She figured she'd 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 she would rather see benefit from the trust, but neither was a beneficiary of the CRT, so as it stood everything in the trust went to charity at her death. Her daughters would receive nothing.

Solution: Sterling helped her advisors Roll her SCRUT to a NIMCRUT and added her two daughters as contingent income beneficiaries. Her attorney added structure to the NIMCRUT that gave her complete discretion on whether or not she receives 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 for some reason she needs income, in any year she can elect to take the accrued gain the trust has built up. At her 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 of time, her daughters will be receiving distributions from a much larger trust (her financial advisors estimate between $3.5 and $4 million).

SCRUT to SCRUT, Add Younger Wife as Beneficiary

A Standard CRUT (often referred to as a "SCRUT") pays a fixed percentage of the trust's assets each year. Like all charitable remainder trusts, a SCRUT is irrevocable by law—once it's set up, the terms of the trust (income beneficiaries, payout rate, etc.) cannot be changed.

The inflexible nature of SCRUTs (or any CRT for that matter) can create problems for grantors whose life circumstances change over time. If given the choice, many donors would prefer to adjust the terms and conditions of their trust to match their circumstances as they get older (for example, by adding beneficiaries to their trust or changing the trust type).

Using the CRT Rollover strategy to transfer clients from their current SCRUT to a new, optimized SCRUT is often an effective planning technique.

Not only can donors change their SCRUT payout rates through a Rollover, they can also add beneficiaries (such as spouses and children) to their CRTs. This technique enables donors to extend the duration of the income stream and provide for family members who were not previously benefitting from the CRT.

Example

Problem: A 75-year-old client was the sole beneficiary of a $5,000,000 SCRUT with a 5% payout. He set up the SCRUT shortly after divorcing his first wife, while he was still single. Several years later, he married a woman ten years his junior. The client and his new wife relied on the distributions from the SCRUT, which constituted a large percentage of their overall income.

As time passed, the client became increasingly concerned that his new wife would suffer a cut in living standards if he predeceases her, which is likely given their difference in age. As it stood, everything in the trust was set to be distributed to charity upon his death. The client needed to not only provide for himself during his lifetime, but also for his wife after he passed.

Solution: Sterling helped the client's advisors roll his 5% SCRUT to a new 10% SCRUT and add his wife as an income beneficiary. Because the payout rate on the new SCRUT is higher, the couple expects to receive more income up front, during the client's lifetime. By the time the client is expected to pass, the SCRUT will be distributing less income (unless the CRT can earn 10% each year). However, at that point, less income will be needed, since only his wife will be dependent on the SCRUT distributions.

Now the client can rest assured knowing that his wife will be taken care of after he passes.

For Advisors

"All advisors ought to know that this potential for liquidity exists. It creates important flexibility for the client, which may have significant economic value. If you make a client aware and they don't want to do anything, no one is out. But if you don't tell them, and they might have benefited, they could be hurt and that could be an actionable omission. 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."

Alan P. Dye, Partner
Webster, Chamberlain & Bean, Washington, DC
Chairman, Washington Non-Profit Legal and Tax Conference

Making Philanthropy Make A Difference.™

Advisor’s Guide to the Sale of CRT Income Interests.

"Over the past 25 years, CFO4Life has worked with a wide array of different people with different situations. In that time, we have reviewed countless strategies with one goal in mind: to help people achieve financial independence and the peace of mind that comes with it. One of the most exciting strategies we've come across is Sterling Foundation Management's liquidity option for CRTs. As is our usual practice, we carefully and thoroughly researched the area. We concluded that for a number of our clients, a sale of their CRT interest would offer them a significant benefit. We have worked with Sterling to complete sales for many of these clients, and continue to work with them where it makes sense for the client.

We are very pleased with Sterling's professionalism, responsiveness, and especially the results they have helped us achieve for our clients.

Today more than ever, clients need advisors who can help our clients achieve their financial goals. If you have clients who have CRTs, you need to know whether a sale of their CRT interest would help them."

Levi McMellian, CPA, Managing Director/CEO
CFO4Life/ LPL Financial, Inc., Dallas, TX

Selling a Charitable Remainder Trust (CRT) Income Interest

Why People Create CRTs

There are four main reasons people decide to create a CRT. These are:

- to diversify a highly appreciated asset, while deferring tax on the sale into the future
- to generate a stream of income for life (or a set term)
- to generate an up-front income tax deduction
- to benefit charity in the future, usually upon the death of the last grantor.

Reasons (1) and (2) are closely related, because almost everyone who creates a CRT does so because they expect that the value of the resulting cash flow stream (2) will be greater than the amount they could have realized from the sale of the asset (1). Whether or not this turns out to be the case depends on what happens after the CRT is set up. Primary factors include investment returns, tax rates, and how long the people live.

Reason (3), generating an immediate tax deduction, is also important. A person receives the tax deduction in the year they fund the CRT. Even if they subsequently sell their income interest, they keep the original tax deduction.

"I worked closely with Sterling to complete the sale of a Charitable Remainder Trust (CRT) income interest for valued clients. My clients and I were very happy with the result, which saw my clients receive lump-sum payments at a desirable premium to net present value. The process was very straightforward and all my dealings with Sterling were open, honest and highly professional. I would not hesitate to work with Sterling again on future CRT transactions and would recommend them to any advisor wanting to secure a similar desirable outcome for their client."

Karen Streisfeld-Leitner, Counsel
McLaughlin & Stern, LLP, New York, NY

While charity is a motive in all CRTs, it is often relatively low on the list. The main reason for this low relative position is that people who have very high charitable motivation will typically opt for a more direct means of giving to charity. For example, a person with highly appreciated stock and a strong desire to help charity can simply donate the appreciated stock directly to charity, generating a deduction and also completely avoiding tax on the sale of the asset. But in this case they don't get cash flow (reason 2).

Why People Sell Their CRT Income Interests

The list of reasons that people sell their CRT income interests is much longer than the list of reasons they set them up in the first place. Most CRT creations are driven, in one form or another, by tax considerations. Most sales of CRT interests occur because something has changed since the CRT was created. A partial list of things that can change follows.

- Stock market losses
- Need for liquidity
- Divorce
- Disappointment with investment performance
- Desire for increased flexibility
- Cash needed for a business
- Concern over potential future tax rate increases
- Desire for simplification
- Desire to reduce administrative costs
- Desire to maximize the value of CRT interest
- Lack of cash for charitable needs
- Cash needed for an investment opportunity
- Death of a spouse
- Tired of waiting for CRT tax returns

Who Can Sell

We have found that most CRT income interests can, in theory, be sold. From the point of view of the seller, the most important items determining whether an interest can be sold are the health of the seller, the terms of the trust, and the identities of the people whose consent is needed.

In terms of health, the seller cannot be terminally ill. Other illness, if it affects life expectancy, may affect the value of their interest, but not necessarily its salability.

Each trust is different, and in each case the terms of the trust must be reviewed, along with applicable state law. In our experience, there is no legal barrier to sale in the great majority of cases.

If an income beneficiary wishes to sell their interest, he or she will need the consent of the trustee(s). In addition, it is usually necessary as a practical matter that if there are multiple income beneficiaries, all the income beneficiaries (e.g. both husband and wife) agree in their desire to sell their interests.

Age is an important factor in determining valuation, but not usually in determining salability. Most sellers are older, but that is likely because most people who have CRTs are older. We have completed sales for income beneficiaries as young as their thirties.

Who Can Buy

The buyer of an income interest essentially steps into the shoes of the seller with respect to the income stream. That means that the buyer must understand and be willing to accept an income stream of indeterminate duration (in the case of lifetime trusts), uncertain dollar amount (in the case of unitrusts), over which he has limited or no control, and which is illiquid.

It might be thought that a charity would be a natural buyer for an income interest. However, there are a number of issues that arise to the potential detriment of both the income interest holder and the charity which make it preferable to find a non-charitable buyer. We always seek a non-charitable buyer for these reasons.

Valuing a CRT Income Interest

The value of a CRT income interest depends upon a number of factors. Primary among these are:

- the current value of the trust's assets
- the indicated payout rate of the trust
- the expected remaining number of payments from the trust
- the investment return the trust is expected to earn over its remaining life
- the discount rate applied to future expected payments
- the tax rate expected to be applicable to future payments.

These factors are generally sufficient to permit a traditional discounted cash flow model of valuation. In addition, given the limited marketability of a trust interest and the possibility of limited control and flexibility imposed by the requirements of the CRT, an interest holder may deem it appropriate to apply some additional discount to the valuation yielded by the cash flow analysis.

The Process of Selling

Not every CRT client should sell their CRT income interest. We have found that many advisors prefer to approach the issue with a review of the client's CRT. We have developed a five point review process and a set of presentation materials.

Step 1 – Initial Discussion

Often, advisors will know of client situations in which it makes sense to consider the possibility of sale of the CRT income interest. In such situations, the advisor will usually have an initial discussion of a case with Sterling. It is not even necessary to disclose a client's name at this stage. Advisors will often initiate discussion about a case by sending an Evaluation Request Form to Sterling.

Step 2 – Preliminary Evaluation

Following the initial discussion, at the advisor's request and based on information provided by the advisor about a specific client situation (still without the necessity for names), Sterling will prepare a preliminary estimate of the value of the client's

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> "Sterling Foundation Management arranged the sale of my client's income interest in a term CRT. The transaction was financially fulfilling to my client, as the sales price exceeded the values of other options they had with respect to the CRT. Both our firm and the client found the process straightforward and Sterling easy to work with. We won't hesitate to turn to Sterling again when the client facts fit."

Benjamin T. White, Partner
Alston & Bird, Atlanta, GA

income interest. Sterling will then share this analysis, in summary or in detail or in both at the advisor's option, with the advisor.

Step 3 – Discussion of Analysis

When the analysis is completed, Sterling shares it with the advisor and reviews and answers questions. Once the advisor is comfortable with their understanding of the analysis, the process can proceed in the direction indicated by the advisor. Generally this will be one or more of the following:

- a request for additional or different analysis
- a discussion with the client
- a request for additional information from Sterling, (e.g. Sterling's view of the amount which the client might reasonably expect to net from a sale of the income interest).

Step 4 – Presentation to Client

If the advisor believes it makes sense to present options to the client, at the advisor's request Sterling will prepare a set of presentation materials for the advisor. These materials typically include an analysis of the value to the client of keeping the CRT income interest, an estimate of the potential net value to the client in a sale, a comparison of the two, and appropriate disclosures.

Step 5 – Terms Letter

If the client and advisor agree that a sale makes sense at the terms which Sterling believes are attainable, Sterling will provide a terms letter for the client's signature. Sterling will complete any open items of due diligence at this stage.

Step 6 – Find Buyer and Get Commitment

Once the client has indicated the desire to sell, Sterling will attempt to locate a buyer willing and able to complete a purchase on the terms indicated in the terms letter. While there can be no assurances that we will continue to enjoy the same degree of success as we have in the past, Sterling has been able to complete the great majority of sales transactions at terms the same as or comparable to those described in the terms letter.

Step 7 – Contract

When buyer and seller have agreed to terms, Sterling will have a purchase/sale agreement drafted and presented to the parties for signature.

Step 8 – Closing

Although the specifics may vary from trust to trust, the typical closing occurs via an escrow, in which the trustee is changed from the seller's trustee to the buyer's trustee simultaneous with the buyer delivering the sales price, in cash, to the seller. Once the agreements are signed, the closing typically takes place within a matter of days.

The overall timing for the process, of course, depends largely on the speed with which the seller moves. A typical case can be completed in a matter of weeks from the initial discussion.

"Sterling worked diligently with me and my client's counsel to educate us on the CRT income interest sales transaction. In the end, they made the entire process simple and painless for my client, and were always responsive, thorough, and sensitive to our needs.

Because of my client's advanced age, I was skeptical that Sterling could find a buyer willing to pay a premium in line with those typically garnered through their program. But Sterling spent the time necessary to locate a buyer willing to pay such a premium, enabling my client to benefit tremendously.

I am now working on another CRT transaction with Sterling and expect to them to deliver comparable value. I would highly recommend that any advisor with CRT clients leverage this unique and value-added service."

Mark D. Arlen, MBA, CFP
Lincoln Financial Advisors, Denver, CO

Case Study 2011-10

Background: The following analysis was for a client who had established a charitable remainder trust (CRT) in 2001 to defer capital gains tax on the sale of appreciated real estate. The CRT also created an income stream for the client and his wife for their joint lives.

Problem: While the client and his wife had collected income from the CRT each year since its inception, their distributions had decreased from $75,000 during the first year to less than $50,000 in 2010 (most of which was then coming from principal, not income). In addition, the clients wanted liquidity, so a large lump sum of cash was desirable.

Solutions: The clients and their advisor looked at three potential sources of cash to meet their liquidity needs: 1) monetizing their CRT income interest, 2) redeeming a hedge fund holding, and 3) selling an investment in a private REIT. If they liquidated the hedge fund position, the clients would have been forced to pay a significant redemption fee. The private REIT was redeeming at $8/share, while they'd acquired it at $10/share. So, in both scenarios, the clients would have been forced to exit the investment at a significant discount. Only by monetizing the income interest in their CRT were the clients not forced to take a discount in exchange for up-front liquidity.

Result: The clients used the following analysis to assess the value of a sale of their CRT interest. Because their objective was to liquidate an asset without taking a discount, this was an easy decision. The transaction was closed about three weeks after the review of this analysis.

If you have clients with a CRT, please contact us. We'll figure out if the income interest is salable and, if so, we'll run the numbers to help you determine whether a sale makes sense for your client.

Sterling Foundation Management, LLC
12030 Sunrise Valley Dr., Suite 450
Reston, VA 20191
Phone: (703) 437-9720
E-mail: CRT@SterlingFoundations.com

Charitable Remainder Trust

Analysis of Client Options

Prepared for: REDACTED

Private and Confidential
Sterling Foundation Management LLC

Facts & Assumptions

Facts

Nearest Client Age(s)	71/69
Years of Life Expectancy	18
Value of Trust Assets	$705,000
Distribution Rate	6%

Assumptions

Investment Return	6%
Tax Rate on CRT Distributions	N/A*

*Pre-tax analysis

Present Value Analysis

Present Value of Income Interest	$458,009
Net Proceeds from Sale	$529,245

Analysis of Alternatives

	Present Value[1]	Sale Value[2]
Gross Proceeds	$458,008	$570,000
Transaction Fees	N/A	($40,755)
Net Proceeds	**$458,009**	**$529,245**

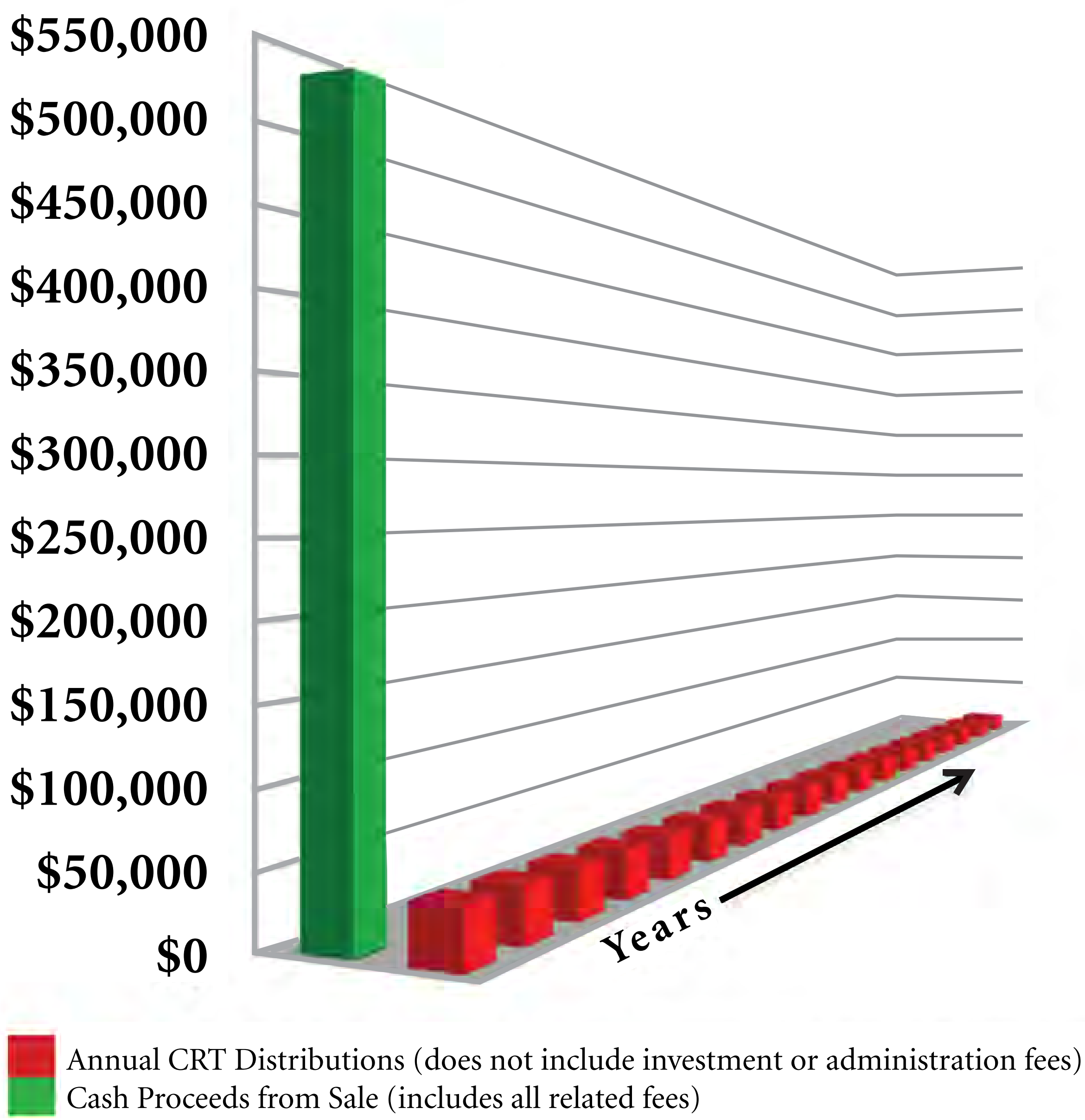
Taxed according to IRC Section 664. (Most often some combination of ordinary and capital gain.)

Subject to capital gains tax. (See Rev. Rul. 72-243, 1972-1 C.B. 233.)

[1] Does not include investment or administration fees.

[2] Includes all related fees.

Illustration of CRT Value: No Action vs. Sale



These materials are not intended to be investment, financial planning, insurance consulting, legal or tax advice. You should consult with your own tax, legal and investment advisors before determining what choice you make with your interest in the Charitable Remainder Trust ("CRT"). The presentations herein do not itemize all commissions, fees and charges that may be incurred in any decision to sell a CRT interest. Please carefully review the Written Disclosure for important information concerning assumptions and other considerations. Any sale of a CRT lead interest shall be subject to the terms of a written Agreement for Sale/Purchase of CRT Lead Interest.

APPENDIX I - WRITTEN DISCLOSURE RELATED TO THE SALE OF A CRT LEAD INTEREST

This written disclosure highlights certain of the issues raised by any sale/purchase of a charitable remainder trust ("CRT") lead interest. Sterling Foundation Management, LLC ("Sterling") is providing this disclosure only for your convenience, and the convenience of your legal, tax and investment advisors in considering the sale of the CRT lead interest. Any such sale would ultimately take place pursuant to the terms of a written "Agreement for Sale/Purchase of CRT Lead Interest."

CONSIDERATIONS

There are a number of considerations related to the sale of the CRT lead interest that you should discuss with your advisors. The value of your financial interest in the CRT is affected by a number of factors, including but not limited to: your age; your health; the payout rate under your CRT; and the tax treatment of your CRT payouts (ordinary income, capital gains, state taxes) and the expected tax rates thereon. We note the following as a way for you to begin to consider the suitability of any sale of your CRT lead interest with your team of advisors.

Life Expectancy. The ultimate financial value of the sale of the CRT lead interest is subject to mortality risk. Since the CRT provides you with lifetime income, the longer you live, the more economically valuable your CRT lead interest would be.

Investment Rates of Return. By selling your lead interest in the CRT, you will be liquidating the debt and equity positions held by the CRT. You understand that in doing so, you will be "cashing out" the investment positions held in the CRT, thus foregoing any future investment gains, or losses, that would result from those positions.

Taxation. The impact of a sale of your lead interest in a CRT on your tax situation may vary. You should consult with qualified tax advisors.

EXPENSES, FEES AND OTHER CHARGES

If you choose to sell your CRT lead interest, you should understand that there are certain expenses, fees and charges associated with that transaction. First, the liquidation of the assets in the CRT may generate certain transaction costs (e.g., brokerage commissions) that will reduce the overall value of the assets held by the CRT. Second, as part of the costs incurred for entering into the CRT sale/purchase, there will be a Fee of six percent charged, and, in addition, there will be a charge for Closing Costs of one and fifteen hundredths percent. The Fee and Closing Costs will reduce the amount paid to you as the seller of the lead interest of the CRT.

STERLING IS NOT PROVIDING YOU WITH TAX, LEGAL OR INVESTMENT ADVICE

You understand and acknowledge that Sterling is not providing you any tax, legal or investment advice in connection with any aspects of any proposed sale/purchase of a lead interest in any CRT. You acknowledge that you have had an opportunity to consult with your own tax, legal and investment advisory team in connection with the proposed sale/purchase of a CRT interest, and that they have deemed the sale of the CRT interest to be suitable for you. You are not relying on Sterling in making your decision to sell your CRT interest.

APPENDIX II - PRESENT VALUE CALCULATIONS

ASSUMPTIONS

Value of Assets at Year 1. . .$705,000
Distribution Rate 6.0%
Growth Rate. 6.0%

CRT VALUE	YEAR 1	YEAR 2	YEAR 3 . . . YEAR 17	YEAR 18
Value at Start of Year	705,000	705,000	705,000 . . . 705,000	705,000
Assumed Growth	42,300	42,300	42,300 . . . 42,300	42,300
Distribution	(42,300)	(42,300)	(42,300) . . . (42,300)	(42,300)
Value at End of Year	705,000	705,000	705,000 . . . 705,000	705,000

DISTRIBUTIONS

Gross Distribution	42,300	42,300	42,300 . . . 42,300	42,300

PRESENT VALUE ANALYSIS

Year-End Present Values at 6.0%	39,906	37,647	35,516 . . . 15,709	14,820
Cumulative Year-End Present Values		77,553	113,069 . . . 443,189	458,009

Years of Life Expectancy 18
PV at Life Expectancy $458,009

CRT Evaluation Request Form

Please return completed form by e-mail to CRT@SterlingFoundations.com
or by fax to (703) 935-4883

Name: ____

Phone: __________________ E-Mail: ______________________

Trust Facts & Assumptions

Type of Trust (circle one): CRUT NIMCRUT CRAT

Payout Rate (annuity amount if CRAT): __________

Current Value of Trust: $ ____________________

Income Beneficiary Facts

Date of Birth (Client 1): _____/______/______

Date of Birth (Client 2): _____/______/______

Present Value Comparison

For an analysis comparing the value of selling the CRT income interest to that of keeping the CRT, please provide the following*:

Expected Return on Trust Assets: __________

State of Residency: _______________

Tax Bracket: __________

* There is no charge for this analysis.

"Sterling provided a valuable service to me and my family by facilitating the successful liquidation of our CRT income interest. They were attentive, professional, easy to work with, and able to find a buyer within a tight timeframe, allowing us to close the transaction by year's end. We are extremely thankful to Sterling and would certainly recommend them to others considering their CRT Liquidity Program."

Winter K. Mead
San Francisco, CA

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Completing Charitable Remainder Trust Reviews: An Advisor's Guide

by Roger D. Silk, PhD, CFA

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.

This issue of the Journal went to press in April 2011.

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. ■

Roger D. Silk, PhD, CFA, is CEO of Sterling Foundation Management, a provider of back office administration for private foundations. Dr. Silk is widely recognized as a leading expert in the field of charitable planning. He is coauthor of the bestselling book *Creating a Private Foundation* and a member of the *Trusts & Estates* editorial advisory board for philanthropic matters. Dr. Silk earned a PhD and an MA in applied economics from Stanford University, as well as a BA in economics (with distinction). He may be reached at RSilk@SterlingFoundations.com.

(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.

CASE STUDY:

CRT Rollover Benefits Clients, Their Children and Their Advisor

While CRT rollovers can accomplish a wide range of client objectives, probably the most common rollover fact pattern involves a client who:

- Does not want or need the income the CRT is forcing them to take
- Would prefer their children or grandchildren to benefit from the CRT

Clients in this situation are good rollover prospects.

Beyond the immediate client benefits of reducing taxable income and creating income for heirs, a rollover can also—in a very unique way—establish or deepen advisors' working relationships with their clients' children and grandchildren.

Example

Scenario: A Denver-based advisor learned about the CRT rollover technique at the Heckerling Institute on Estate Planning in Orlando.[1] He had previously used Sterling's CRT program to help clients sell their income interests—and that option worked well for his clients who preferred cash today to waiting for future CRT income—but the rollover fixed an entirely different client need.

The advisor routinely had clients complain about the taxable income their CRT forced them to take, to the point that he often structured CRTs as NIMCRUTs in the first place to allow for more control over the timing and amount of CRT distributions.

The rollover addresses these client frustrations about unneeded (yet highly-taxable) income, but what really grabbed his attention was when he learned that **the rollover could also benefit the client's children**.

The rollover was a new option he would be able to propose as an alternative to giving the income interest to charity (thus terminating the CRT), which was the only option he had in the past for clients who no longer needed their CRT income.

"With the rollover, I can give clients the opportunity to reduce or eliminate the taxable income they're being forced to take from their CRT, while also effectively transferring that forgone income to their children," the advisor reflected. "It's a great solution for clients—often with larger CRTs and who are tax-adverse—who are interested in new ways to get additional assets to their children or grandchildren."

The advisor knew that a current client, John—who had a $4,800,000 CRUT forcing more than $300,000 in unneeded income per year—would be interested in learning about how best to redirect his CRT distributions.

Solution: Being tax-adverse and having plenty of other sources of income, John liked the idea of removing the CRT income stream from his tax picture. But what most moved him to take action was the way in which the rollover would benefit his three children and their families. John immediately green-lighted the rollover, and set out to make sure his family played a role in how the benefits would be distributed by inviting them to a meeting with his advisor.

This meeting gave the advisor an opportunity to interact professionally with John's children, who each stood to inherit several million dollars through John's estate. The advisor continued to work with John's children throughout the rollover process, during which time his relationship with each child and their family continued to grow. **Today, the advisor is fully involved in the planning for all of the families.**

"Prior to utilizing the rollover option, if a client didn't need CRT income, gifting the income interest to charity was the most common course of action," the advisor commented. "While that worked in accomplishing the single goal of stopping unwanted CRT income, it's not as good as a rollover, which also brings future generations into the equation. Not surprisingly, most clients are choosing the rollover [instead of just giving everything to charity], and for me, that continues to bring the clients' children and grandchildren into the relationship."

Outcome: In effect, the rollover enabled John and his wife to convert about $5,100,000 of projected CRT income into about $8,600,000 of income for their three children. John and his wife will also avoid paying taxes on the $5,100,000 of converted income, and garnered an immediate income tax deduction of about $400,000. Even using conservative assumptions, the advisor calculates that the total tax savings to John and his wife will be in excess of $2,200,000.[2]

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[1] If you're interest in receiving a copy of the presentation he attended, please email CRT@SterlingFoundations.com with "Heckerling presentation" as the subject).

[2] To see our full review of John's rollover and the related cash flow projections, email CRT@SterlingFoundations.com with "rollover cash flows" as the subject.

Partnering with a Trusted Provider

Surprisingly, many clients with CRTs are still unaware that there are options available outside of waiting for future distributions and paying the related tax. If you have clients who haven't had their CRTs reviewed, or if you are just interested in learning more about CRT secondary planning, Sterling offers valuable expertise and resources.

For more information, please contact our CRT Department.

Key Contact:
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(703) 997-4717
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Sterling Foundation Management does not provide tax or legal advice, and nothing in this document is to be construed as such. Any information or analysis provided is believed to be accurate but is not guaranteed or warranted.

TIPS FOR EVERY STAGE OF A CRT

David J. Murray, Vice President, CRT Department

As the industry leader in secondary planning for charitable remainder trusts (CRTs), the CRT Department at Sterling Foundation Management has reviewed nearly 6,000 CRTs over the last two decades. Drawing on this experience, we performed a meta-analysis of every stage of the CRT process, findings that we've reduced here to helpful tips.

For questions about this report, or to discuss a particular CRT, please contact us at (703) 677-8747 or CRT@SterlingFoundations.com.

INCEPTION

Tip: Make Sure the Client Understands a CRT Is Not Necessarily a Lifetime Lockup

While most CRTs will remain good fits for clients throughout their lifetimes, certain situations (often related to a major life event) can lead to misalignment between the client's current situation and the CRT they established many years before. At the CRT's inception, or even when discussing the CRT conceptually, practitioners should ensure clients understand that at any time they have the ability to:

- Sell their income interest for cash
- Terminate the CRT and accept the 7520 valuation for their income interest
- Give their income interest to the CRT's remainderman (thus terminating the CRT) and receive an additional tax deduction
- Use their income interest to create a new CRT with different terms ("CRT rollover")

This awareness is not only good practice, but in our experience, it ***also leads to more CRT creations***. Why? If a client understands that a CRT isn't necessarily a lifetime obligation, they are often more willing to pull the trigger on creating one in the first place.

DRAFTING

Tip: Give the Grantor Maximum Flexibility

Flexibility usually comes at no tax or economic cost to the client, so there's no reason not to give the client maximum flexibility with respect to the trust.[1] In our experience, lack of flexibility is often related to the charitable beneficiary designation and trusteeship. Be sure to:

- Include language permitting the grantor to change the charitable beneficiary[2]
- Include language permitting a change of situs and controlling law

[1] A possible exception is for CRTs that aren't self-settled (i.e., the grantor is creating the CRT to distribute income to someone else). In these cases, the grantor may wish to purposely restrict some of the flexibility afforded to the CRT's income beneficiaries.

[2] A possible exception is if the charitable beneficiary is paying for the CRT's creation. However, we'd encourage the grantor to weigh the related savings against the forgone flexibility. Most CRTs can be created for a few thousand dollars. To save that amount, is the client willing to irrevocably give up control over what charity ultimately receives the trust's assets? We routinely field inquiries from clients who regret giving up control over the charitable beneficiary to save a few thousand dollars in creation fees.

- Include clear language regarding successor trusteeship (in particular, resignation and power of removal/appointment for the grantor and/or recipients)

Tip: Maximize the Nuances of NIMCRUTs

Using the net income with make-up CRUT (NIMCRUT) structure can allow for flexibility over the timing/amount of CRT distributions. Additionally, in cases where the asset contributed to the trust is not immediately liquid, using the NIMCRUT structure is often a necessity. Be sure to:

- Include capital gain in the definition of trust accounting income
- In the case of NIMCRUTs holding a partnership interest or a variable annuity, ensure that the definition of trust accounting income is limited to distributions from the partnership or the annuity

Tip: Consider a Private Foundation as a Permissible Remainderman

Including a private foundation as a permissible remainderman of the CRT means the client's contribution is considered a gift to a private foundation (as opposed to a public charity).[3]

While this could negatively affect the up-front charitable deduction, many clients would accept that to ensure their private foundation is a permissible remainderman.

ONGOING TAX RETURNS

Tip: Watch the Calculations for Reporting Distributions to Beneficiaries

The most common problems we see with respect to the CRT's tax return (IRS Form 5227) relate to calculating the income distributions. Namely:

- Most trust documents state that the unitrust amount should be calculated using the beginning-of-year values, but it is often calculated based on the end-of-year values
- Once the unitrust distribution is calculated, the *timing* of the distributions is often incorrect
  - Many trust documents state that the distributions should be monthly or quarterly, but the distribution is made annually
  - Distributions are often made at the beginning of the following year. When determining the required distributions, this is sometimes forgotten and the beneficiaries have taken too much

Tip for CPAs: Watch Out for These Common Pitfalls

Listed below are other, more specific problems we commonly see.

- Undistributed income on the balance sheet in the net assets section doesn't tie to the accumulation schedule on page 7

[3]Most CRTs restrict the definition of a permissible remainderman to a charitable organization of a type described in Sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Internal Revenue Code. Requiring the charity to qualify under both 170(b)(1)(A) and 170(c) restricts the permissible charitable remainderman to be a charitable organization that qualifies as a public charity rather than a private foundation.

- The questions on Part V-B and/or Part VI-B are not all answered or answered incorrectly. In particular:
  - CRUT Information (most commonly, classifying a NIMCRUT as a Standard CRUT)
  - Self-dealing
- Having liabilities against the CRT (line 55 of Part IV) that may cause self-dealing or other excise taxes

ONGOING MANAGEMENT

Tip: Include Professional Advisors

Clients often make mistakes going it on their own: they don't have a financial advisor in place to properly manage the CRT's assets and/or a CPA or administrator in place to prepare the CRT's annual tax return and ensure the CRT remains in full compliance.

Here are some common mistakes we see clients make when going it on their own (and which most professional advisors would prevent):

- Trading on margin or otherwise using debt (e.g., CRT uses a mortgage to acquire real estate)
- Disqualified persons borrowing money from a CRT
- Disqualified persons lending money to a CRT[4]
- Not taking the required distribution (while clients might think this is okay because it benefits the remainderman, this could ultimately disqualify the CRT and jeopardize the tax benefits the grantor received when creating the CRT[5])

SECONDARY PLANNING

Tip: Give CRTs Periodic Reviews

For trust and estate attorneys, CPAs and financial advisors alike, evaluating the appropriateness of a CRT should be a routine part of any regular financial or trust and estate review. No matter how much a client has benefited over the years from having a CRT, does retaining their income interest in the trust still benefit the client? If not, what kind of secondary planning best serves the client's needs? Options include:

- Selling income interest
  - *Provides immediate, maximum liquidity*
- Gifting income interest
  - *Creates additional tax deduction*
  - *Eliminates CRT income stream*
- CRT termination
  - *Provides liquidity, though not as much as with sale option*
- CRT rollover
  - *Reduces taxable income for CRT clients who don't need/want the income*

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[4]Treas. Reg. § 53.4941(d)-2(c)(2) provides that an interest-free loan from a disqualified person to a private foundation (or an entity treated as a private foundation, such as a CRT) is not an act of self-dealing. However, an interest-free loan to the CRT likely creates adverse tax consequences to the lender because § 7872 generally treats such loans as if the borrower (e.g., the CRT) had paid a statutory rate of interest to the lender (i.e., the AFR). Although Treas. Reg. § 1.7872-5T(b)(9) provides that loans of up to $250,000 to a charity are exempt from these rules, the CRT is not technically a charitable organization (notwithstanding the fact that the CRT is subject to many of the tax rules that apply to private foundations).

[5]In *Estate of Atkinson*, the 11th Circuit affirmed the Tax Court's ruling that a CRAT was disqualified when the income beneficiary did not receive the required annual distributions. The Tax Court reasoned that the regulations governing CRTs provide that the CRT must meet the statutory requirements and operate strictly within those terms from its creation, and failure to do so disqualifies the CRT from its date of creation.

- *Creates income streams for children or grandchildren*
- *Generates additional tax deduction*

To quote the late Steve Jobs, *"A lot of times, people don't know what they want until you show it to them."* An easy way to show a client their alternatives is including the discussion in your normal reviews with the client.

Tip: Choose the Best Secondary Planning

The decision to engage in some form of secondary planning is an important first step. Given that there are several secondary planning options available, however, it's equally important that a client chooses the option that is best suited to their needs. Choosing the wrong option can be very costly for clients. The decision to terminate a CRT instead of sell the income interest, for example, can easily cost a client hundreds of thousands of dollars, or more. Below are common mistakes we see.

Terminating a CRT when a client wants maximum liquidity

In our experience, the real-world value for an income interest (i.e., what a third-party buyer would pay for the interest) usually exceeds the 7520 value of the same interest, which the income beneficiary is limited to in a termination. Clients who terminate their CRTs without checking to see what third-party buyers would pay are almost certainly worse off/harmed financially.

Taking taxable income from a CRT when it's not needed or desired

These clients should look at either gifting their income interest to the CRT's remainderman or completing a CRT rollover to reduce/eliminate the income stream and, in the case of a rollover, transfer its benefit to their children, grandchildren or other family members.

Giving an income interest to charity instead of rolling the interest for family

Some clients who no longer want their CRT income choose to give their income interest to charity to remove the income stream. If given the choice, however, many of these clients would have instead elected to roll the interest into a new CRT, usually with children or grandchildren as income beneficiaries.

PARTNERING WITH A TRUSTED PROVIDER

If you have clients who haven't had their CRTs reviewed, or if you are just interested in learning more about CRT secondary planning, Sterling offers valuable expertise and resources — anonymously, and at no cost or obligation.

In short, we support your service to your clients and stand ready to work with you.

For more information, please contact our CRT Department.

Key Contact:
David Murray, Vice President
(703) 997-4717
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Frequently Asked Questions

About the Sale of a CRT Income Interest

Are there tax advantages to selling a CRT income interest?

In most cases, yes. Distributions from a CRT are taxed according to Internal Revenue Code Section 664's "worst in, first out" four-tier accounting rules. The long and short of those rules is that they force the income beneficiaries to pay the maximum possible tax rate on their distributions (usually some combination of ordinary and capital gains rates). The proceeds from selling an income interest, on the other hand, are (at worst) taxable as long-term capital gain income.

What is the authority for the tax treatment of a CRT income interest sale?

Rev. Rul. 72-243, 1972-1 C.B. 233 provides that the sale of the life interest in a trust by the life tenant of a trust is treated as the sale of a capital asset.

Is there recapture of the initial charitable contribution?

No. A CRT is a split interest trust. When the trust is created, the life interest (typically, or term interest in the case of a term trust) at a stated rate (or dollar amount in the case of a CRAT) belongs to the grantor. This is the income interest that may be sold. The remainder interest is given irrevocably to charity when the trust is created. It is this gift which gives rise to the initial tax deduction. The sale of the income interest does not change the fact the remainder is still assigned to charity.

What are the legal issues of selling a CRT income interest?

In general, no unusual legal issues arise in connection with the sale of a CRT income interest. Each trust must be analyzed individually in accordance with its terms and the applicable state law.

How long does it take to complete the sale of a CRT income interest?

In most cases, an income interest sale can be completed in 2–4 weeks from a seller's decision to proceed with the transaction.

Where does closing occur?

Closing takes place at Wells Fargo Bank under the supervision of an escrow agent. Neither buyer nor seller needs to be physically present at the closing, however.

What is the closing process?

1. Buyer places the purchase price in escrow.
2. Escrow agent provides seller with confirmation of buyer's funded escrow account.
3. CRT's trustee places the trust assets in escrow.
4. Escrow agent performs final purchase price calculation and arranges seller's payment (usually by wire) from buyer's escrow account.

Who are the buyers?

Buyers are generally individuals, families, or other *taxable* entities.

Who is an ideal buyer?

The ideal buyer of a CRT income stream has the following characteristics, among others. They have large net worth with good liquidity. They are able to tie up a significant sum for a potentially long time in an illiquid asset. They may have various tax attributes such as NOLs and loss carryforwards. They are able to withstand, without undue distress, the potential sudden drop in the value of their investment to zero in the event of a premature death of a measuring life. They have an understanding of, and preferably an appreciation of, philanthropy. (In other words, they would never say "But why would someone want to give away that kind of money?").

Does the existence of a spendthrift clause in the trust agreement preclude a sale?

In the case of a self-settled trust (i.e., the income beneficiary is the trust's grantor), no. If the trust is not self-settled, the salability of the income interest will depend on the specific language of the spendthrift clause, the identity of the parties affected, and state law.

Does the sale of the income interest change any of the CRT's terms?

No. A CRT income interest is a capital asset and salable, but the CRT itself is irrevocable. As such, its key terms (measuring lives, payout rate, type of trust, payout to charity upon last of income beneficiaries to die, etc.) cannot be changed.

What is the ideal size for a trust?

There is no fixed minimum size for a trust for the income interest to be a candidate for sale.

Can CLAT interests be sold?

Yes. A CLAT is a charitable lead annuity trust. It is very similar to a CRAT, except the lead and remainder beneficiaries are reversed. The analysis is similar to the analysis for a CRAT.

What age people can sell their interests?

Any age person can sell their interest. Sterling has completed transactions for people in their thirties all the way up to people well into their nineties.

How do you calculate life expectancy?

Life expectancy is determined by reference to IRS tables (the same tables used to calculate the charitable deduction when creating a CRT). Sterling, as is standard practice, relies upon software from third-party vendors to obtain life expectancies.

Does it matter how the trust assets are invested?

Not usually. If the trust assets are invested in marketable securities, such as stocks, bonds, mutual funds, money market instruments and the like, there is generally no issue.

What if the trust owns illiquid assets?

Illiquid assets need to be looked at on a case-by-case basis. This is not necessarily a barrier to a sale. Sterling has successfully completed transactions in which illiquid assets were among the assets of the CRT.

Does the seller need to be medically underwritten?

No. In general, the seller is not required to be medically underwritten. However, if the potential seller is very ill, to the point of being terminal, this may likely preclude a sale.

Can a person sell an interest even if they are not insurable?

Yes, provided that they are not too seriously ill. In general, as people get quite old, insurability becomes more difficult. Sometimes a person's lack of insurability is even a reason for them to consider selling their income interest, because they are uncomfortable bearing the financial risk that they might not receive all the expected payments. Sterling has successfully completed a number of transactions in which the seller was not insurable.

Does the seller receive cash?

Yes. In the great majority of cases, the seller receives their full sales proceeds in cash immediately upon closing.

When does the seller receive payment?

The seller receives full payment in cash immediately upon closing.

How and when is Sterling paid?

Sterling is paid by seller upon closing. Sterling charges a fee that is tied to the purchase price. Depending on the size of the trust, Sterling's fee generally ranges from 3%-6%. In very large or very small transactions, the fee is a fixed dollar amount rather than a percentage.

Is legal counsel required for all parties?

Yes. All parties represent and warrant to have had the opportunity to obtain the advice of independent tax, legal, and other counsel with respect to the income tax or other consequences of the sale/purchase of the CRT income interest.

Who is Sterling's legal counsel?

Sterling is represented by Venable LLP. The partner in charge of Sterling's account is Douglas L. Siegler in the firm's Washington office.

Are references available?

Yes. Sterling has completed transactions for clients and a wide range of advisors. References are available upon request.

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:

Charitable Deduction: Conditions under which contribution of a CRT lead interest can qualify for the income tax charitable deduction under IRC §170 and the gift tax charitable deduction under IRC §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)
But see 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)

Other Press

"Two of our clients sold their CRT income interests in transactions facilitated by Sterling. A key benefit of working with Sterling was the simplicity and smoothness of the process. We were very impressed with the expertise and professionalism of Sterling, including their technical competence, excellent communication and quick response time. We look forward to working with Sterling again in the future."

Joel Baker, Founder
The J R Baker Group
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Does a CRT rollover make sense for your client?

BY JAMES W. LINTOTT

WHAT MAKES A GOOD CLIENT?

A donor who's interested in his or her philanthropy making a difference and who appreciates the value of professional charitable consulting experience and expertise.

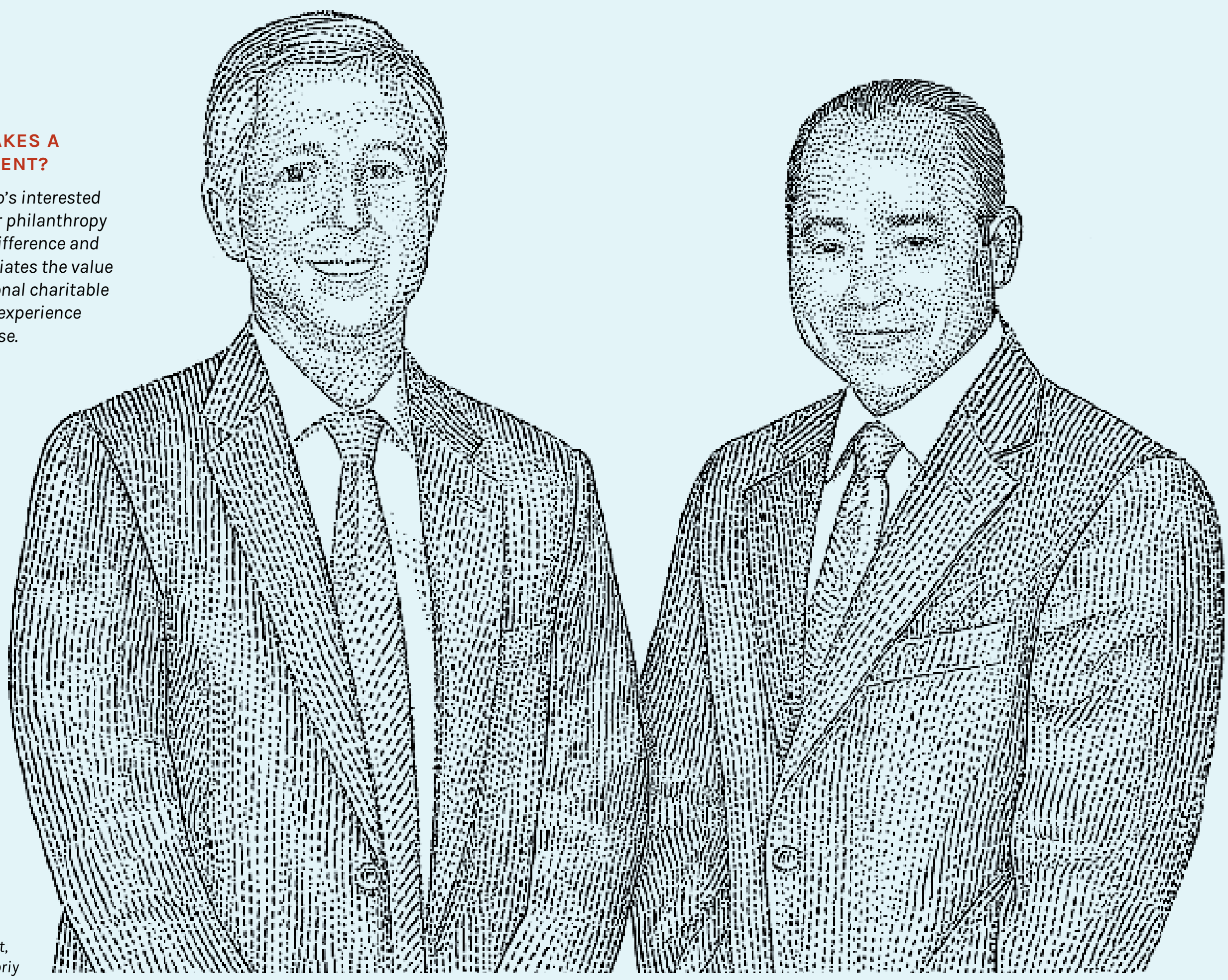

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ILLUSTRATION BY KEVIN SPROULS

Charitable remainder trusts (CRTs) enable clients to convert appreciated assets into lifetime income streams, defer capital gains taxes, reduce estate taxes, protect assets from creditors and distribute funds to charities they're favorable to.

However, because CRTs are irrevocable, many clients get frustrated when a trust they established in the past becomes misaligned with their current needs and goals. In a previous article, we discussed how clients with CRTs can sell their interest to third-party buyers; this article focuses on an alternative secondary planning strategy: the CRT rollover.

FIXING MISALIGNMENTS WITH A CRT ROLLOVER

Consider a scenario in which joint beneficiaries of a CRT established years ago want to use their trust to benefit their children, who are now old enough to be added as lifetime beneficiaries. Or maybe an individual who remarried late in life wants to add the new spouse to his or her CRT.

At some point, joint beneficiaries of a standard charitable remainder unitrust (CRUT) might benefit from shutting off (and growing, tax-deferred) an income stream they don't need and don't like paying taxes on. What about a client with an underperforming net income with makeup charitable remainder unitrust (NIMCRUT), who would prefer a higher, more consistent payout rate?

The rollover is a technique for clients with CRTs to fix these (and other) misalignments. As this strategy gains widespread acceptance among the estate-planning community, more advisors are informing their clients with CRTs that they can use rollovers to (in effect) make changes to their trusts.

> "Most clients with CRTs don't understand the full range of available secondary planning options."

NO, IT'S NOT DECANTING

While clients with CRTs pursue rollovers for different reasons, the underlying process and technique are always the same: Income beneficiaries use the interest in their CRT to form a new CRT that's more aligned to their current circumstances.

Because the initial CRT is unchanged, the rollover process is not decanting, which of course isn't possible with CRTs. Instead, the net result of a rollover is two CRTs, each with its own set of income and charitable beneficiaries. However, because the income beneficiaries are effectively removed from the original trust, clients don't have to deal with the hassles of an additional tax return or the administrative costs of managing a second CRT.

CASE STUDY: SCRUT TO NIMCRUT: ADDING DAUGHTERS AS BENEFICIARIES

Problem: A 76-year-old client we knew was the sole beneficiary of a $5.3 million standard charitable remainder unitrust with a 5 percent payout. This woman had plenty of wealth and income sources and did not like how the CRT was forcing taxable income upon her (so much so that in some years, her tax rate on the distributions approached 45 percent).

In addition, she had two daughters, ages 56 and 54. Neither was listed as a beneficiary of her CRT, so everything in the trust was set to be distributed to charity when the client passed away.

Solution: The client's advisors rolled her standard CRUT income interest into a NIMCRUT. The advisors also added her two daughters as contingent beneficiaries.

The NIMCRUT structure enabled the client to defer her income distributions in full year after year, growing the trust assets tax-free over the remainder of her life expectancy (11 more years, according to IRS life expectancy tables).

At her death, her daughters will split the future distributions (an estimated total of $5 million) from the trust for their joint lifetimes.

IN CASE YOU MISSED IT

A previous article in volume 25, edition 5 of *Worth* magazine explained how clients who sell their income interest to third-party buyers typically get more than they would by keeping their interest or terminating their CRT. Common sale drivers include cash needed for an investment opportunity, simplification of financial affairs, divorce, tax arbitrage, a lack of cash for charitable needs, desire for increased flexibility and value maximization.

Advisors should inform clients with CRTs of the sale and rollover options so that they're informed to make changes, should the need arise in the future. ●

ABOUT US

STERLING FOUNDATION MANAGEMENT, LLC IS THE OLDEST NATIONAL FOUNDATION-MANAGEMENT FIRM IN THE COUNTRY AND THE NATION'S LEADING FACILITATOR OF SALES OF INCOME INTERESTS IN CHARITABLE REMAINDER TRUSTS. Sterling works with a broad range of clients and high net worth individuals to develop solutions that help them achieve their philanthropic, family and financial goals through the effective use of private foundations and other charitable-planning vehicles and financial services. ●

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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

By Roger D. Silk, Ph.D., CFA, Chief Executive Officer of Sterling Foundation Management, LLC, based in Reston, VA.

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.

trustsandestates.com/wealth_watch/charitable-remainder-trust-termination-1222/

FROM ***JOURNAL OF FINANCIAL PLANNING***, 2012

Tax Deferral: When Does It Make Sense and When Does It Cost Cents (or Dollars)?

by Roger D. Silk, Ph.D., CFA

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Executive Summary

- Most of us have absorbed the belief that tax deferral is always better than paying current taxes
- That can be true if certain assumptions are met: tax rates are uniform across income types (no difference between capital gain and other income) and constant over time (future tax rates will not be higher than current tax rates), and the client's personal discount rate is lower than the expected rate of return on the assets
- Given current tax rates, the compounding benefit of deferral is largely, but not totally, offset by the shifting of long-term gain to ordinary income
- This paper explores various client tax situations involving different asset classes and vehicles (IRAs, deferred variable annuities, taxable bonds, tax-exempt bonds, charitable remainder trusts), and provides guidelines based on analyses of multiple scenarios to determine when tax deferral makes financial sense and when it doesn't

In 1974, Congress enacted the Employee Retirement Income Security Act (ERISA). Among the myriad provisions of ERISA was the creation of a new type of tax-deferred investment account: the individual retirement account (IRA). From a market point of view, the IRA has been a tremendous success. As of 2011, according to the Investment Company Institute, IRA assets totaled nearly $5 trillion.[1]

The vast majority of those IRA assets represent income on which taxes have not yet been paid. In other words, they represent nearly $5 trillion of untaxed income.[2] Most of us have absorbed, perhaps without even being explicitly aware that we were absorbing it, the lesson that we should defer taxes whenever possible. We have probably made the argument to our clients, and prospective clients, more times than we can remember. We have probably made our own decisions on the basis of the belief that deferral is always better than paying current taxes.

A review of the academic literature suggests that most academicians writing on the subject have also absorbed the idea that deferral is always a good thing. For example, here are a couple of abstracts of papers that look at how an investor should approach the taxable/tax-deferred decision:

> We show a strong preference for holding taxable bonds in the tax-deferred account and equity in the taxable account, reflecting the higher tax burden on taxable bonds relative to equity. For most investors, the optimal asset location policy is robust to the introduction of tax-exempt bonds and liquidity shocks. Numerical results illustrate optimal portfolio decisions as a function of age and tax-deferred wealth. Interestingly, the proportion of total wealth allocated to equity is inversely related to the fraction of total wealth in tax-deferred accounts.[3]

Or this from the Gregory Singer article "Best Use of Tax-Deferred Accounts" in the September 2009 *CPA Journal*:

> Tax-deferred accounts often play a central role in accumulating wealth for retirement. For investors who own both personal and tax-deferred assets, implementing a retirement strategy requires the prudent use of both types of accounts.

The prevailing assumption, that tax deferral is good, seems to go largely unexamined.[4]

When Does Tax Deferral Make Sense?

Let us begin by looking at the case of an IRA, and asking the question: when does it make sense to use an IRA to defer taxes?

As previously mentioned, most practitioners have learned that deferral always makes sense. That can be true if certain assumptions are met. Among these are the assumption that tax rates are uniform across income types (no difference between capital gain and other income) and constant over time (future tax rates will not be higher than current tax rates), and the assumption that the client's personal discount rate is lower than the expected rate of return on the assets.

Today's IRAs violate at least one of these major assumptions. Under current law, any increase in the value of an IRA, regardless of source, will be taxed at ordinary income rates when the money is withdrawn from the IRA. Today, with the top ordinary rate at 35 percent (federal) and the top capital gains and dividend tax rate at 15 percent, it is far from obvious that deferral makes sense, if deferral converts long-term capital gain or dividend income into ordinary income.

Given current tax rates, the compounding benefit of deferral is largely, but not totally, offset by the shifting of long-term gain to ordinary income.

For example, consider a lump sum of $100,000, on which a taxpayer has two alternatives. First, call it Scenario A, he can pay tax today, at 35 percent, and invest the net proceeds in a portfolio of growth stocks that will grow at 5 percent a year compounded, and eventually produce long-term capital gain when sold. Second, call it Scenario B, he can put the entire pretax sum in a tax-deferred retirement plan, such as an IRA.[5] Let's also assume an average return of 5 percent a year. If tax rates don't change, after 30 years, when he sells his stocks under Scenario A, he will net, after paying long-term capital gain tax at 15 percent, $237,000. Under Scenario B, when he withdraws the entire balance from his IRA and pays ordinary tax at 35 percent, he will net $267,000.

Under this scenario, as we all expect, deferral is better. With the IRA, he ends up with 12 percent more.

The IRA is indeed better, but not by very much. Probably not by nearly so much as we might have expected.

Effect of Costs. In the real world, IRAs tend to be quite inexpensive to administer. A typical annual administration fee with a brokerage or mutual fund company might be only $25 or so. A small fee like that can be ignored.

But other types of plans, particularly some Keogh plans and small corporate plans, which allow higher contribution limits, may have significant administrative costs. Even a relatively small plan can easily incur annual expenses of a few thousand dollars. That doesn't sound like much, but it can add up and make a real difference over time.

For example, if we take the same facts as our first example, except that we say that the pension plan incurs just a $500 administrative expense each year, that completely wipes out the advantage of the tax deferral.[6]

The same would be the case for a $500,000 plan (today's value) that incurs an average annual administrative expense of $2,500.[7]

Potential for Changed Tax Rates in the Future. Deferral when rates are very high makes sense, almost no matter what, provided that rates don't go any higher.

If you think tax rates are likely to be higher in the future, new deferrals into retirement or similar plans are probably hard to justify purely on the basis of maximizing ultimate net after-tax dollars. For example, consider a current income of $100,000 that offers the choice of tax now at ordinary rates, or tax-deferred growth with ordinary tax in the future. This is, in fact, the decision that faces anyone with $100,000 in an existing IRA, if they are able to withdraw it penalty-free.

There are two scenarios. Scenario C is take the $100,000 now, pay tax at the current 35 percent ordinary tax rate, and invest the remaining $65,000 into a portfolio of non-dividend-paying growth stocks. Upon sale, the capital gain will be taxed at the assumed then-current rate of 23.8 percent.[8] Scenario D is to leave the $100,000 in a tax-deferred account to grow at the same rate. When the funds are withdrawn from the tax-deferred account, they will be taxed at the assumed then-current ordinary income tax rate of 43.8 percent.[9] Under these particular assumptions of increasing tax rates in the future (which are based on existing law), deferral is worse than paying taxes now for 18 years. Deferral finally noses ahead in the 19th year.

Non-Tax Considerations. Taxes are not the only consideration facing a client or an adviser pondering deferral. There are also non-tax considerations that may be quite important. These non-tax factors tend to be hard or impossible to model. However, understanding the tax consequences may be useful for a client struggling with a decision involving non-tax factors.

For example, retirement plans may have important non-tax benefits such as forced saving, creditor protection, feeling virtuous, or peace of mind.

There may also be non-tax costs. Among these might be limited access to funds, limited or no ability to borrow against the funds or use them in a business, and in some types of plans potential ERISA liability.

Guidelines

The above analysis allows us to develop some guidelines or rules.

RULE 1. If the client has the opportunity to defer ordinary income, deferral probably makes sense if the client is comfortable that tax rates will not rise significantly in the future, or if the client expects to be in a tax bracket in the future not significantly higher than the current bracket.[10]

RULE 2. If a taxpayer is in a high-income-tax state, such as New York or California, deferral probably makes sense if there is any reasonable possibility that the eventual withdrawals will be made when he is no longer a resident of the high-tax state. State income taxes are a major factor in the ongoing exodus of high earners from high-tax states like New

York and California to lower-tax states like Florida and Nevada.

RULE 3. If the taxpayer expects ordinary income tax rates to rise as much as or more than they would under current law, deferral might be a poor strategy, unless his expected holding period is very long.

RULE 4. If a taxpayer expects ordinary income tax rates to rise as much as or more than they would under current law, it might make sense to withdraw from a regular IRA, pay the tax, and roll the proceeds into a Roth IRA.[11]

These rules apply generally to ERISA plans, such as IRAs, 401(k)s, and most corporate pension plans. These plans provide deferral and turn all income ultimately into ordinary income. We will now look at some non-ERISA deferral vehicles, and see whether the same analysis applies.

Non-ERISA Deferrals

Among non-ERISA deferrals, probably the two largest categories are deferred variable annuities (DVA) and unrealized capital gains. Variable annuity assets reached $1.5 trillion in 2010[12], and unrealized gains, although hard to measure, are probably significantly larger.[13]

Tax treatment of variable annuities is on the surface quite similar to that of qualified plans. However, a major difference is the requirement (applicable in most instances) that variable annuities be funded with after-tax dollars.[14]

Most lump-sum distributions from deferred variable annuities will be taxable at ordinary rates on the growth. So, like qualified plans, variable annuities convert any kind of income into ordinary income. Like qualified plans, there may be penalties on withdrawals prior to age 59½. Unlike qualified plans, variable annuities permit deferral well past age 70½.

The difference with the biggest tax implications in most cases is the requirement to fund with after-tax dollars. This requirement means that it is harder for variable annuities to overcome the conversion of capital gain to ordinary income.

For an ordinary, taxable account, the most efficient strategy is to invest in non-income producing growth stocks, and hold them "forever." In our examples above, we assumed the most favorable possible deferral—complete deferral until sale after 30 years. Against a tax-deferred qualified plan, even this most favorable assumption toward taxable accounts does not make the taxable account superior.[15]

RULE 5. Given constant tax rates and ordinary rates higher than capital gain rates, a variable annuity, because it is funded with after-tax dollars, cannot make up the difference when compared against fully deferred capital gains.[16]

But what about when the taxable account has turnover during the deferral period? If the turnover is taxable at ordinary rates, then, in the absence of fees, the DVA will be superior. The proof is very similar to the previous proof, and we leave it to the reader.

However, there are two more interesting questions: (1) what if there is turnover in the taxable account at long-term capital gain rates, and (2) how high can DVA fees be and not wipe out the benefit of deferral against annually realized short-term gains?

Taxable Turnover at Long-Term Gain Rates. We again compare two scenarios. The first scenario, call it E, consists of a fully taxable account invested in growth stocks, but which realizes 100 percent of its return each year in long-term capital gains. The second scenario, call it F, consists of a DVA earning the same rate of return, except that it charges annual fees at the rate of X basis points per year. The holding period is 30 years. The return is 5 percent.

With DVA fees at zero, there is almost no difference between these two strategies. If fees are 50 basis points per year, there is about a 12 percent (total, not annual) benefit from the taxable, long-term-gain strategy.

RULE 6. A deferred variable annuity will not beat a taxable all-long-term-gain portfolio, even if the taxable portfolio realizes all its gains every year.

Taxable Turnover at Ordinary Income Rates. Turnover in a taxable account defeats the goal of tax deferral. Note, however, that the average mutual fund turnover rate is somewhere in the vicinity of 100 percent a year.[17] If this turnover were all short-term gain, then the taxable strategy is also the tax-maximizing strategy. Let's call this Scenario G. Now we compare it with the DVA with deferral and ultimate tax at ordinary rates (Scenario F). Over 30 years, the deferral of the DVA really shines. At zero DVA fees[18] (not realistic), the DVA outperforms by 51 percent over the 30-year period.[19]

At 100 basis points in fees, the DVA still results in about 19 percent more net wealth available at the end of the period.[20]

RULE 7. A variable annuity over time will significantly outperform a high-turnover taxable portfolio generating income.[21]

Non-Tax DVA Considerations. Deferred variable annuities are complex contracts and may have many features in addition to the tax benefits of deferral. Among these features may be guaranteed minimum rates of return, guaranteed minimum death benefits, and "high-water marks"[22] to name a few.

Some of these features may have considerable value. Depending on the contract, features may be included, or may be available as riders. The valuation of these features, ex-ante, can be challenging. Discussion of the approaches to valuation are beyond the scope of this article.

Highly Appreciated Long-Term Bonds—Special Case

Highly appreciated long-term bonds present a special case of deferral and transformation of the tax character of income. We consider taxable bonds and tax-exempt bonds separately, for reasons that will become apparent.

Taxable Bonds. Bond interest is usually considered ordinary income, except in the case of tax-exempt bonds. When interest rates fall after a bond has been issued, the price of the outstanding bond will rise, unless there is a deterioration of credit quality. Such an appreciated bond is said to trade at a premium.

Sometimes these premiums can be big. For example, recently, the 6.25 percent U.S. Treasury bonds maturing 5/15/2030, 19 years from now, were trading at a price of $126.35, for a yield-to-maturity of 4.22 percent.[23]

Assume an owner purchased the bonds at par. If she holds the bonds to maturity, she will earn the yield-to-maturity. Alternatively, she can sell the bonds today, pay long-term capital gain tax on the gain, and reinvest the proceeds at par at 4.22 percent (assuming such a bond is available).

Which is better? You will recognize this is a similar problem as before. Is deferral of gain but ultimate payment of ordinary income tax rate better, or is a sooner payment but at a lower rate optimal?

In this case, you would be better off selling the bonds, paying the long-term capital gain, and reinvesting the after-tax proceeds. The difference over the remaining 19-year life of the bond is about 2.3 percent, total, or about 12 basis points a year, non-compounded. That doesn't sound like a very big number, but it is significant in the world of Treasury bonds, and especially in a world like today's, in which it is a large fraction of the yield on short-term fixed income instruments.

RULE 8. Take a good, hard look at harvesting long-term capital gains on taxable bonds and reinvesting the after-tax proceeds.

Tax-Exempt Bonds. Here, for once, the analysis is simple. If you have a gain in tax-exempt bonds and sell the bonds, you pay capital gains tax on the gain when you sell. If you hold the bonds to maturity, you can collect the coupons tax-free. Hold the bonds. The converse is true for tax-exempt bonds on which you have a capital loss. Sell the bonds, recognize the loss, reinvest in similar bonds or wait the 31 days and buy back the bonds.

RULE 9. Hold appreciated tax-exempt bonds. Sell depreciated tax-exempt bonds.

Charitable Remainder Trusts

Charitable remainder trusts (CRTs) function in many ways like qualified retirement plans. CRTs are usually funded with pre-tax dollars and are tax-deferral vehicles. Unlike qualified plans, CRTs do not change the nature of the income earned within them.

Instead, CRTs distribute income under the rules in section 664, the so-called "worst in, first out" rules. These rules require that distributions are deemed to come only from the type of income subject to the highest rate of tax, until that type is exhausted; then distributions are deemed to come only from the remaining type of income subject to the highest rate of tax, and so on.

A consequence of these rules is that many CRTs must deem all of their distributions as income in the form of highly taxed ordinary income or short-term capital gains. From the point of view of the client who owns a CRT, the CRT may thus be viewed as a stream of taxable cash flows. The client, like the client with appreciated bonds, faces the opportunity of selling, effectively causing all his future payments to be taxed currently. Also like the bond holder, the gain the CRT client receives is taxed as long-term capital gain.

In the past decade, a niche market for CRT income interests has developed. To understand the market, it is useful to review the history of the CRT and the uses of CRTs over the years since they were created by an act of Congress.

In 1969, Congress decided to overhaul certain sections of the tax code related to charitable contributions. One such area was charitable deductions generated by gifts of remainder interests to charity. It was argued that the value of the remainder interests was often inflated to save the taxpayer money by overstating the income tax deduction. Congress reacted to the perceived abuse by eliminating all deductions for partial interests in trusts, unless such trusts qualified under the newly enacted section 664. It is such trusts that we now recognize as CRTs.

There are several categories of CRTs that qualify under section 664 and which are in common use by practitioners today. CRTs can be categorized according to the method by which their lead distributions are calculated and made. All CRTs are either CRATs (charitable remainder annuity trusts) or CRUTs (charitable remainder unitrusts).

A CRAT is a CRT in which the annual payment amount to the lead interest holder is defined as a fixed number of dollars per year, although the payment may be more frequent, depending on the specific terms of the trust.[24]

A CRUT is a CRT in which the annual payment amount to the lead interest holder is defined as a fixed annual percentage of the trust's value on January 1 of that year. Again, the payment may be quarterly or monthly, provided that appropriate adjustments are made.

CRUTs may be further divided into two main types: standard CRUTs, or SCRUTs, and net income CRUTs. A SCRUT is the simplest type, with a fixed annual percentage being paid out each year, whether the trust earns it or not.

Net income CRUTs come in three main varieties: Net income without makeup (NICRUT), net income with makeup (NIMCRUT), and flip CRUTs. A NICRUT pays out its stated rate of income only if the trust earns the stated amount as income in the given year. If the trust earns less than the stated amount, there is no making it up in future years.

The NIMCRUT overcomes this limitation of the NICRUT by adding a makeup provision. For example, if a NIMCRUT calls for a 6 percent annual distribution, and the trust earns only 5 percent in that year, 5 percent will be paid out and the 1 percent not paid will be carried forward to the next year. In the next year, if the trust earns 7 percent, the trust can distribute the entire 7 percent (the current year's 6 percent plus the 1 percent in the makeup account).

A flip CRUT is a combination of a NIMCRUT and a SCRUT, in which the trust starts out as a NIMCRUT and "flips" to a SCRUT at a pre-specified date or upon the occurrence of some specified event. The event could be the sale of a business interest held by the trust, or the death of a beneficiary, or a divorce, etc. The IRS issued final regulations on December 9, 1998, which define in detail the permitted triggers.

Value of a Trust Interest

IRS Valuation Method. As part of Congress's drive to eliminate the perceived abuse of deductions of charitable remainders, the 1969 law that created CRTs also described a methodology for determining the value of the charitable interest for purposes of computing the tax deduction to which the grantor is entitled. The procedure is described in the Treasury regulations, Subchapter A, Sec. 1.664-4.[25] One variable that goes into the calculations is the applicable federal rate, or AFR, which is also known as a "7520" rate because it is calculated according to the rules in Sec. 7520 of the Internal Revenue Code.

The procedure, if followed correctly, will yield a correct valuation for purposes of the income tax deduction. But these values will only correspond roughly with actual fair market values.

Actual Market Value. The actual fair market value of a CRT income interest may vary considerably from the calculated 7520 value, because many other factors enter the equation. These factors may include, but are not limited to, specific terms of the trust, individual actuarial information on a life beneficiary, variability of market returns, and, of course, supply and demand.

Trust Terms. The trust terms that most affect the market value of an interest are the specifics of the payout rate and the method for determining the trust's term. These are also the main determinants of the 7520 value. Obviously, the higher the payout rate, the more valuable the lead interest, and the longer the expected term, the more valuable the lead interest.

Beyond payout and term, provisions concerning the identity and nature of the trustee, the presence or absence of a spendthrift clause, and clarity with which a trust is written can all affect the market value of a trust interest. Generally, the rule is that more flexibility is better. For example, an interest in a trust the terms of which appoint a specific corporate trustee and do not permit that trustee to be changed will be less marketable (and hence probably less valuable) than if it permitted changing the trustee. A trust that allows individual trustees will behave similarly.[26] A spendthrift clause in a trust is usually a negative. Spendthrift clauses come in many varieties and may or may not affect the marketability and hence the value of a trust interest. Spendthrift clauses must be looked at on an individual basis. All CRTs must have basic language and terms defined by the IRS. However, some CRTs may be written with important issues—for example, how to change a trustee—unclear, ambiguous, or contradictory. Such problems with the trust can affect marketability of interests in the trust.

Actuarial Information on Life Beneficiaries. The 7520 valuation is based in part on a life expectancy drawn from a table.[27] The table is developed from information gathered by the decennial census. The census is designed (and required by the U.S. Constitution, Article 1) to count the entire population of the United States. As such, life expectancy tables generated from this data might not yield the best possible predictor for the life expectancy of an individual about whom additional information, beyond age, can be known.

Additional actuarial information about a specific individual, such as health status, health history, and residence ZIP code, may provide further valuable information not captured in the general census data. Such information, if it tends to suggest a longer life expectancy than the census data, would tend toward a market value higher than the 7520 valuation for a lead interest, and if it suggests a shorter life expectancy, then the market value would tend to be lower.

Variability of Market Returns. Actual realized market returns will tend to have different types of effects on CRATs than on CRUTs, and accordingly, we will examine them separately.

The key distinction, again, is that annual payments from CRATs are fixed, while annual payments from CRUTs are variable.[28] Because the lead payment from a CRAT is fixed, the returns realized do not affect the value of the CRAT lead payment stream, unless the returns are low and threaten to extinguish the CRAT.[29]

The value of the remainder interest in a CRAT is therefore often very sensitive to the actual realized returns on the trust assets. For example, we recently examined a CRAT originated as a $5 million, 5 percent CRAT, paying out $250,000 annually. Having experienced good market performance for many years, its worth had risen to over $15 million when we examined it, which will in all likelihood create a large and unanticipated (at the time of creation) windfall for the charitable beneficiary. It is this same remainder sensitivity that makes charitable lead annuity trusts (CLATs) and grantor retained annuity trusts (GRATs) potentially powerful estate tax planning tools.

In contrast to CRATs, the effect of actual market returns, and even the timing of those periodic returns, on CRUTs falls much more heavily on the lead interest holder.

Variable Returns, Risk Aversion, CAPM, and CRUTs

Expected variability of future returns, and the specific pattern of returns, can affect the number of dollars paid to the lead beneficiary, and hence affect the value of that stream of payments. Even the same average return over a given period of years can result in significantly different dollar payouts depending on the timing of the gains and losses. An example illustrates this point.

Consider a $1 million SCRUT with a payout rate of 5 percent. Suppose that over two years the average annual return is 5 percent per year, with one year returning 15 percent and the other year returning negative 5 percent.

If the trust earns 15 percent in year one, the trust value, pre-payout, at the end of year one will be $1.15 million. After the 5 percent payout (based on the year's beginning value of $1 million) of $50,000 is paid to the lead holder, the trust has $1.1 million. The second year's payout is based on this amount, and is therefore $55,000. If the trust then loses 5 percent of the $1.1 million with which it began the year, it will finish the year with a pre-payout balance of $1.045 million. It then pays the lead interest holder $55,000, and ends year two with $990,000. The lead holder has received a total of $105,000 in lead payments over the two years.

Now consider the losing year occurring first. The trust begins with $1 million, loses 5 percent ($50,000), and ends the year, pre-payout, with $950,000. The trust then distributes the $50,000 first-year payment to the lead holder, so the trust assets at the end of year one are $900,000. This $900,000 value is used to calculate the second year's lead payment, which will be $45,000 payable at the end of the year. During year two, the trust gains 15 percent, enabling the trust assets to grow to $1.035 million by the end of year two, prior to the payment to the lead interest holder. The trust pays the $45,000 to the lead holder, and ends the year with $990,000. The lead interest holder has received a total of $95,000 over the two years.

As this example demonstrates, there is an important risk arising from the timing of returns, even given the same average return over time. We call this the "return-timing" risk. This risk falls on the lead interest holder.

Risk Aversion. Risk aversion, first described in the technical literature way back in 1738 by the mathematician Daniel Bernoulli,[30] occurs when an individual's utility function is concave; that is, when the individual's expected utility from a lottery[31] is less than the expected value of the lottery. Consider, for example, a fair coin toss with payoffs of $100,000 for heads and $0 for tails. Because the probability of heads equals the probability of tails (one-half), the expected value of this lottery is $50,000. A risk-averse person would be unwilling to pay $50,000 to play this lottery. A risk-neutral person would be indifferent between an offer of $50,000 or playing this lottery, and a risk-loving person would prefer the lottery to receiving a payment of $50,000.

For decades, much of the theory of finance has rested on the assumption that, on average, investors are risk averse.[32] This widely held belief is supported by empirical evidence, and indeed more recent evidence has supported the view that risk aversion declines with wealth.[33] And it is commonly believed, and supported by evidence, that risk aversion tends to increase with age.[34]

For the present purposes, we are concerned with predictable changes in risk aversion in a given individual over time, and in differences in risk aversion among different wealth categories of individuals.

Return-Timing Risk and the Value of a CRUT Lead Interest. Return-timing risk represents a lottery in the classic sense of the risk-aversion literature. As such, given that the average investor is risk averse, return-timing risk will tend to affect the value of a CRUT lead interest (but not that of a CRAT).

The individual who creates a CRUT, funds it, and holds it will tend, merely by the fact of aging, to experience increasing risk aversion. This increased risk aversion will tend to reduce the value of the CRUT lead interest to the holder, but not necessarily to a buyer. This is purely a function of the lead interest holder's utility function becoming more concave as the interest holder ages. The expected value of the lead interest does not change, but its perceived value to the holder does. Such differences are not, and cannot be, captured in the 7520 valuation approach.

Different Risk-Aversion Profiles. As seen above, the return-timing risk inherent in a CRUT lead interest means that a given stream of lead payments might have different value to different market participants, even if they share the same expectations regarding future returns and the variability of those returns.

Changing risk aversion over time can lead a previously happy CRT lead interest holder to be no longer happy with the same asset with the same risk profile.

Transaction volume has increased steadily, and in recent years most CRT interests that have sought a buyer have been able to find buyers at prices that make sense for both buyer and seller.

The nature of the CRT lead interest makes it, for tax purposes, like bonds, in which the holder has a huge unrealized gain.[35] Like the long-term bond, a sale generates a long-term capital gain, taxable at favored long-term capital gains tax rates. Holding on to a CRT, like holding on to a taxable bond, will result in some or all of this capital gain being taxed at higher ordinary rates.

Because of the zero basis, in the majority of cases, a CRT income interest holder of a seasoned CRT will be better off, net of all taxes and fees, selling and reinvesting the proceeds than he would be holding until maturity.

RULE 10. Take a good, hard look at selling seasoned CRTs, effectively paying tax at capital gains rates on all future income, and reinvesting the after-tax proceeds.

Conclusion

Adviser attitudes toward deferral of income taxes formed in the period of very high taxes that prevailed a generation ago have served very well. However, where there is a spread between capital gains and ordinary rates, and where conversion of capital gains to ordinary income is the price of deferral, the wisdom of that deferral must be tested against a specific set of facts.

Second, where there is an opportunity

to avoid higher taxes that are expected in the future, deferral may be the opposite of the best strategy.

Lastly, where there are assets, such as appreciated taxable bonds or CRT income interests, that can be sold and the gain taxed at long-term gain rates, deferral is again likely to be the worst strategy and immediate payment of tax the best strategy.

JFP

Endnotes

1. Investment Company Institute. 2011. *The U.S. Retirement Market Second Quarter 2011* (September).
2. It is sobering and shocking to realize that even if 100 percent of IRA assets were taxed immediately at the maximum federal rate of 35 percent, the resulting tax revenue would fund the federal deficit for barely a year.
3. Dammon, Robert M., Chester S. Spatt, and Harold H. Zhang. 2004. "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing." *Journal of Finance* (June).
4. There are some papers that do examine the question, such as Lawrence Kotlikoff's 2009 NBER Working Paper 13763 "To Roth or Not to Roth." Kotlikoff's analysis leads him to the conclusion that the choice of whether to pay tax now or in the future depends to an important extent on expected future tax rates and the shape of the future tax regime.
5. Under current law it is generally not possible to put a lump sum of $100,000, pre-tax, into an IRA. However, over several years it is possible for high earners to contribute hundreds of thousands of pre-tax dollars to similar tax-deferred retirement accounts. For example, the limit for defined contribution plans under Section 415(c)(1)(A) is $50,000. We use the example here of a single year to simplify the analysis, while not sacrificing generality.
6. Adjusted for assumed inflation of 3 percent a year.
7. Actual plan administration expenses may vary depending on the specifics of a plan. The point here is not to state that certain kinds of plans are not useful because of their expenses, but only to point out that certain plans, because of their complexity, may have higher expenses than other plans, and that those higher expenses should be considered in an analysis.
8. This rate was chosen because it would be the effective ordinary income tax rate on January 1, 2013, unless Congress acts to change the law.
9. Ibid.
10. This follows from the standard result of deferral of tax under conditions of positive interest rates and tax rates. See the Mathematical Appendix.
11. Some advisers have cautioned that this strategy depends on the belief that Congress will not decide in the future to tax Roth IRAs, despite the many fairness and other arguments against such taxation. If you think Roth IRAs may be taxed in the future, you naturally would not want to pay tax now, only to be taxed again on the same money.
12. *FA* magazine staff. 2011. "Variable Annuity Assets Reach Record Levels in 2010." *Financial Advisor*, as reposted on NASDAQ.com (March 7).
13. The total value of the U.S. stock markets as of April 1, 2011, was approximately $14 trillion. Unrealized gains likely constitute more than 10 percent of that number, although a significant percentage would be owned by pension funds, making it difficult to estimate the amount of unrealized gain held by taxable accounts.
14. A variable annuity owned by a non-natural person may not enjoy the tax-deferred inside buildup characteristic of variable annuities under consideration here. Thus, although there may be situations (such as within an IRA or a CRT) in which a variable annuity is funded with pre-tax dollars, it is likely not the variable annuity that is providing tax deferral in those situations.
15. One obvious and non-trivial issue with this strategy is the difficulty of predicting which stocks will in fact prove to be both non-dividend paying and growth stocks for the next three decades.
16. Unlike many of our other rules of thumb, this one is easily provable with equations. Let B = net after-tax lump sum invested in either a taxable account or a VA; let R = growth rate for either account; let n = number of years of growth/compounding/deferral; let T_L = long-term capital gains tax rate and T_O = ordinary income tax rate. The ending balance after-tax for the taxable account is then $B(1 + R)^n(1 - T_L)$, and the after-tax ending balance for the VA account, $B(1 + R)^n(1 - T_O)$. Under what conditions is the taxable account superior? It is superior for all $T_L < T_O$. This is exactly the condition that the long-term capital gains tax rate is lower than the ordinary income tax rate.
17. Reed, Brian. 2004. Investment Company Institute *Research Commentary* (November 17).
18. An astute reader of a draft of this article raised the question of whether it is reasonable to compare a professionally managed DVA investment, which must pay fees, to a comparably managed taxable account, and as we do in our analysis, not charge any fees against the taxable account. Of course a managed taxable account will incur fees, and we can assume that competitive markets will result in the portfolio management portion of the costs to be approximately equal for both the DVA and the taxable account. However, the DVA also incurs additional costs above and beyond the portfolio management fees. These additional fees are often referred to as M&E expense. In our comparisons, we assume that the only difference in fees between a DVA and an equivalent taxable portfolio are these DVA-specific fees.
19. We illustrate this unrealistic scenario for two reasons. First, to enable the reader to see the potential for a no- or low-fee deferral vehicle, and second, to enable the reader to observe how the presence of fees can offset the advantages of deferral. This result will vary with the specific rates of return and tax rates used. For this example, we used a 35 percent total tax rate and an expected return of 7.5 percent. Plugging these rates into equations (1) and (2) yield the result here. See the Mathematical Appendix.
20. Annual fees in the deferral vehicle equate to lower pre-tax returns in the deferral vehicle. If we let the annual fee in percent be f, then in the model (see the Mathematical Appendix) they can be represented by using r_f instead of r, where $r_f = r - f$.
21. This and all these comparisons assume identical pre-tax, pre-fee rates of return in each of the scenarios being compared.
22. A high-water mark is the highest total value (adjusted for contributions and withdrawals) reached by an account at some specified measuring time, such as month end, quarter end, or year end. For example, if a portfolio starts at $1 million, rises 25 percent to $1.25 million, then declines to $1.02 million, the high-water mark up to that time would be $1.25 million. The value versus the cost of each of these "riders" needs to be evaluated on an individual basis, and is beyond the scope of this article.
23. Note that there is an arcane science known as

Mathematical Appendix

The net after-tax future value of an investment with deferral and payment of tax at the end of the holding period, where *t* = tax rate, *r* = rate of return, *n* = number of periods, *P* = the beginning principle balance, is given by:

(1) $(1 - t)[Pe^{rn} - P] + P$

The formula for the future value of an investment at the end of the holding period, with tax paid annually, is given by:

(2) $Pe^{r(1 - t)n}$

The standard result, that deferral maximizes net after-tax future value, can be derived by showing that (1) is greater than (2). The proof follows.

We expand expression (1) to obtain:

(3) $Pe^{rn} - P - tPe^{rn} + tP + P$

Gathering terms gives:

(4) $Pe^{rn} - tPe^{rn} + tP$

Factoring yields:

(5) $P[e^{rn}(1 - t) + t]$

Which equals:

(6) $[P[rn(\ln(e)](1 - t)] + t$

Simplfying:

(7) $P[rn(1 - t) + t]$

Expanding the term in the exponent in (2):

(8) $Pe^{rn - rtn}$

Equals:

(9) $P(rn - rtn)[\ln(e)]$

Which simplifies to:

(10) $P(rn - rtn)$

Our task is to show that (7) > (10)

$Prn(1 - t) + t > Prn - Prtn$

$rn - rnt + t > rn - rtn$

$t > 0$

We thus have shown the condition under which after-tax future value is maximized, namely when the tax rate is greater than zero, which is what we set out to demonstrate.

We then build upon expressions (1) and (2) to develop further analytic models. For example, suppose that tax rates are expected to change in the future. For simplicity, we consider the tax rate now, t_1, and the tax rate in the future, t_2. For a given r, t_1, and t_2, we can calculate the elapsed time n at which both expressions will be equal. This will give us the "breakeven" time for a given return and tax rate differential.

Expression (1) becomes:

(11) $(1 - t_2)[Pe^{rn} - P] + P$

and expression (2) becomes:

(12) $Pe^{r(1 - t_1)n}$

The indifference condition is found when (11) equals (12), which occurs when the following equation holds:

(13) $t_2 (nr - 1) = nr\, t_1$

The reader will note that these are not the only possible patterns in which tax rates could change. Estimating the full range of possible future tax rates and the time sequence of the effectiveness of such combinations of possible future tax rates becomes an exercise in combinatoric analysis. For example, if we limit our analysis to a single effective tax rate per calendar year, and assume that the tax rates themselves must take integer values between 0 and 99, over a planning horizon of just 10 years there exist theoretically one-hundred quintillion (10^{20}) possible rate paths. Restricting the possible effective tax rates further, by constraining the possible values of the tax rate to integer multiples of five between 0 and 95 inclusive, results in over 10 trillion possible paths. Unfortunately, we have no compelling theoretical basis to predict a path, nor do we have a basis upon which to forecast a stochastic model of future effective rates.

Note on Continuous Versus Discrete Analysis

The mathematically attentive reader will note that in our analysis we have used the continuous form of the expressions for computing the future value of an investment. The reader may also note that in actual practice, fees and taxes are not collected continuously but rather at discrete intervals. In the case of fees, such as mutual fund fees or variable annuity fees, this interval is likely to be daily, and in the case of taxes, it is likely to be quarterly. At reasonable rates of return, the difference in results between quarterly compounding and continuous compounding (which is the difference between using a discrete model that has taxes paid quarterly and a continuous model that has them paid continuously) is insignificant and would be extremely unlikely to change any results. For example, at 6 percent returns and 35 percent tax rates, the cumulative difference over 10 years between quarterly compounding and continuous compounding is less than two-tenths of 1 percent.

"bond math." A yield-to-maturity is a conventional number, understood and agreed on by the players. It is not actually a guarantee of the return that will be earned by holding the bond to maturity. It is usually a pretty good estimate, but be aware that if you are doing fine-pencil comparisons, the yield-to-maturity is only an approximation. A standard reference is Frank Fabozzi's *Fixed Income Mathematics*, 4th ed. (McGraw-Hill 2005).

24. The reader will see that given a fixed dollar annual payment, a long enough term, and low enough returns, it is possible for a CRAT to completely exhaust its principal before the end of the lead period, resulting in charity receiving nothing. To minimize the likelihood of this happening, all CRTs created after 1997 must be structured so that they have an expectation that at least 10 percent will go to charity (IRC Sec. 664 d(1)D and d(2)D).

25. Note that as of this writing some free online sources for the regulation, such as taxalmanac.org, show tables based on the mortality table 90CM. Since 2010, the correct mortality table has been table 2000CM. Most practitioners rely on commercial software packages, such as Leimberg's Numbercruncher, PGCalc, or Thompson-Onesource's zcalc. For one-off calculations, there are some free online tools that may be found by an Internet search. We suggest caution with this latter approach, as such free sources may not be accurate or up to date.

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26. The reason is both fees and flexibility. Usually, trust companies charge higher trustee fees than individual trustees (who often don't charge at all). Furthermore, some trust companies are perceived as poorer than average investment managers, or as favoring investments that charge higher-than-average fees, resulting over the long run in lower performance.
27. Technically, table 2000CM, the table indicated by IRS reg. 1.664-4, is the mortality table. Life expectancies can be computed from a mortality table.
28. The analysis is quite similar to the analysis of a grantor retained annuity trust (GRAT) compared to a grantor retained unitrust (GRUT).
29. In this respect the analysis of the value of a CRAT lead payment stream is similar to a bond credit analysis. If the CRAT has obviously sufficient resources to pay the lead interest, the lead interest will be valued similar to any other low- or no-risk annuity. If the CRAT resources are not obviously ample, the value of the lead payment stream may have to be discounted by some risk factor designed to quantify the risk that not all the payments will be received in full on a timely basis.
30. Bernoulli, Daniel. Reprinted 1954. "Exposition of a New Theory on the Measurement of Risk." *Econometrica* (January).
31. "Lottery" here has a technical meaning of a specified set of outcomes with specified probabilities. For example, a bet on the flip of a coin with payoffs of $10,000 for heads and $0 for tails would be a lottery.
32. Sharpe, William. 1965. "Risk Aversion in the Stock Market: Some Empirical Evidence." *Journal of Finance* (September).
33. Hartog, Joop, et al. 2000. "On a Simple Survey Measure of Individual Risk Aversion." Working paper, University of Amsterdam.
34. Halek, Martin, and Joseph Eisenhauer. 2001. "Demography of Risk Aversion." *Journal of Risk and Insurance* 68, 1.
35. The IRS has taken the position that a CRT lead beneficiary has no basis in the income interest. See Notice 2008-99 and comments thereto.

Selling A CRT Interest

By Roger D. Silk, Ph.D., CFA and Evan D. Unzelman

An advisor recently approached us with a dilemma. His client, we'll call him John, set up a CRT several years prior. Since then, John's circumstances had changed, and he found himself in a situation where immediate liquidity was much more valuable than his CRT income interest (i.e., receiving annual payments for the rest of his life).

We suggested that John might be able to sell his income interest in the CRT, a transaction with which the advisor was unfamiliar. In the end, John not only sold his income interest, but he was also able to do so at a premium to the net present value (NPV) of holding the CRT, and for cash. Needless to say, John was thrilled, and the advisor felt good about helping his client and adding a value-added service to his offering in the process.

Charitable Remainder Trusts - Pros and Cons

A charitable remainder trust (CRT) is a split-interest trust to which a client donates money or property and keeps the right to a specified cash flow each year, usually for the rest of his or her life (or joint life with a spouse). The series of cash flows from the trust is commonly referred to as the "income" or "lead" interest, and the grantor as the "income beneficiary."

There are two types of CRTs, the primary distinction being how the payout is calculated. In the case of a charitable remainder *annuity* trust (CRAT), the payment to the income beneficiary is a specified dollar amount. If the trust is a charitable remainder *unit* trust (CRUT), the payment is a percentage of the value of the trust, as valued each year.

At the end of the life of the last income beneficiary (or at the end of the specified term), the remaining assets in the trust go to charity. This amount is called the "charitable" or "remainder" interest.

The Pros

The primary reason for creating a CRT is tax savings. A CRT allows the grantor to avoid any capital gains tax on the donated assets, to receive an income tax deduction for the amount projected to go to the charitable beneficiary, and to remove an asset from his or her estate.

A second, less common reason for creating a CRT is to benefit charity.

The Cons

A careful analysis shows that for most clients the primary objectives are achieved very early in the life of the CRT, usually in the first year. That is when the grantor gets the charitable deduction, and when the assets are diversified. These clients then have the CRT, which produces income for them, but in most cases no other benefit. In short, to get the tax benefits, they have to keep the CRT for the rest of their lives. The result is a large, valuable, but illiquid asset.

Further, the income which comes out of a CRT is usually all or mostly taxable income. At an average tax rate of 30%, for example, a CRT holder gets to keep 70 cents of each dollar that comes out of the CRT.

Liquidity Opportunity – Keep the Pros, Eliminate the Cons

Recently, a niche market has developed for buyers of CRT income interests. What's notable about this market is that buyers are paying attractive premiums, which is uncommon given the nature of the transaction (uncertain number of payments; no secondary market; and in the case of CRUTs, unknown payment amounts).

Because of our firm's unique position at the crossroads of financial and philanthropic planning, we've seen this market develop first-hand and play an integral role in facilitating transactions.

Why Buyers Are Paying Premiums

Perhaps the most common question we are asked is how a buyer can afford to pay a premium for a CRT income interest. After all, most sales of cash flows involve the seller taking a discount. As it turns out, the answer is rooted in something with which most advisors are intimately familiar.

To an income beneficiary in the 30% tax bracket, each dollar from the CRT is worth 70 cents. To a buyer in a lower tax bracket, each dollar is worth some amount closer to 100 cents (in many cases this number *is* 100 cents). This tax rate differential allows for a potential spread of 30 cents on each dollar and drives the opportunity for the income beneficiary to sell at a premium to NPV.

Why are buyers in lower tax brackets? Beyond the obvious (exempt organizations), we've seen an array of tax attributes (net operating losses (NOLs) and capital loss carryforwards, for example) lead to situations where the income interest from a CRT is worth much more to a buyer than the same interest is to an income beneficiary.

As most of us know, there is nothing unusual about tax rate differential. Different potential owners of assets, distinguished by their tax status, is the same principle that makes the municipal bond market possible, for example. 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.

Why Clients are Selling

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 payment at a price representing a premium to the client's NPV of holding the CRT. This reason – we'll call it value maximization – is the by far the most common reason we are seeing for selling a CRT income interest.

Lock in current, low capital gains rates

Because the sale of a CRT income interest is a capital transaction (see "Tax/Legal Concerns" below), it is generally taxed at capital gains rates, which are now some of the most favorable rates out there. In fact, capital gains rates have never been lower over the past 70 years, as is evidenced by the following table.

Historical Capital Gains Tax Rates

Period	Capital Gains Tax Rate
1922 -1933	12.50%
1934 -1935	17.7%
1936 -1937	22.5%
1938 -1941	15.00%
1942 -1951	25.00%
1952 -1953	26.00%
1954	25.00%
1955 -1967	25.00%
1968	26.90%
1969	27.50%
1970	30.20%
1971	32.50%
1972 -1974	35.00%
1975 -1977	35.00%
1978	33.80%
1979	35.00%
1980 -1981	28.00%
1981 (June 20)	23.70%
1982 -1986	20.00%
1987-1992	28.00%
1993 to 1997 (May 6)	28.00%
1997 (after May 6) - 2003 (May 5)	20.00%
2003 (after May 5)	15.00%
Average	**26.05%**

Many advisors are skeptical as to how long these rates will remain low, however, and are encouraging their clients to sell now to take advantage of the currently low rates.

Distress

Distress can take a variety of forms. Common sources include divorce, unforeseen reversals in business, investment losses, “upside down” nimcrut, fear of Medicaid/nursing home assistance ineligibility, and threatened litigation between one or more of the parties associated with the trust. There is nothing like available cash to help with these kinds of distress, and we have seen these difficult situations solved to the satisfaction of all involved by cash generated from the sale of an income interest.

Liquidity concerns (or lack thereof)

Because CRTs are usually created for high net worth individuals, many advisors fall victim to the logic that, “since my client has substantial assets and doesn’t need liquidity, selling their CRT income interest doesn’t make sense.” We’ve seen this logic nearly hurt advisors on several occasions for the sole reason that the sale of a CRT income interest is *not* driven by a need for liquidity but instead by value maximization.

On one such occasion, we were working with an advisor on a $7.5 million CRT. We had located a buyer for the income interest willing to pay a 33% premium ($6 million) to the client’s NPV of holding the income stream ($4.5 million).

The advisor presented the opportunity to his client, but cautioned the buyer and us that liquidity was immaterial to this particular client (worth well in excess of $75 million) and that a sale was unlikely.

As it turns out, the advisor was half right. Liquidity was not important to his client. However, a 33% premium for the interest and a chance to put the money to work elsewhere (still under the advisor’s watch, we might add) proved to be a no-brainer for his client. From the client’s standpoint, the tax advantages had already been secured (and wouldn't be compromised because of the sale), he was taxed at a lower rate on the sale than he would have been on distributions from the CRT, and he liked the idea of having the advisor invest the money in several investments that having the money in the CRT would not have permitted.

Finding a Buyer

Buying a CRT income stream is a bit like buying a bond that has no principal repayment at the end, an uncertain number of payments (because they go on as long as the life of the donor), payments of uncertain amount (in the case of CRUTs, which most CRTs are) and no secondary market.

Because of these features, the universe of potential buyers is limited. A buyer must be able to deal with the long holding period, as well as the dual uncertainties of how many payments they will get and how large those payments will be.

Needless to say, unless one knows where to look, trying to find a buyer can be very frustrating. So it is probably best to enlist the assistance of someone familiar with this market.

Valuing Your Client's CRT Income Interest

The first step in evaluating the potential sale of a client's CRT income interest is to assign a value to your client of holding the CRT.

The value of an income interest to a client is the after-tax net present value of the cash flows which s/he expects to receive. So to value an interest, it is first necessary to estimate these cash flows. The cash flows will last until the end of the trust, which is either the end of the last lead beneficiary's life (life trust), or the stated term of the trust (term 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.

Once the expected number of payments has been determined, the next step is to estimate the amount of each one. This 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.

We now have a known number of known payments. Next, we apply the usual discount analysis to bring each payment to a present value. Then we add up each payment to get a pre-tax NPV. Finally, we apply the appropriate income tax rate to get an after-tax value.

Consider this example: We begin with the assumptions that the trust has a curren value of $1,000,000, a 7% payout, that there are two lifetime income beneficiaries who are both 70 years old, and that their effective tax rate on trust income is about 35%. Based on these assumptions, and assuming that the trust earns an average return of 6% per year going forward, we calculate that the after-tax NPV to the clients of the expected trust income is in the range of $400,000 to $460,000. (See the middle column highlighted below.) The calculations are shown below for differing effective tax rates and discount rates. (Please see our comments at the end of the article for a fuller discussion of an appropriate discount rate. Also, note that the NPV is not very sensitive to the rate of return going forward.)

Calculation of Value of Annuity Holder's Interest in a CRT

Life Expectancy (given age)	18
Age1	70
Age2	70
Beginning Balance	1,000,000
Payout percentage	7.00%
Return	6.00%

After-Tax Net Present Value Given Tax and Discount Rates

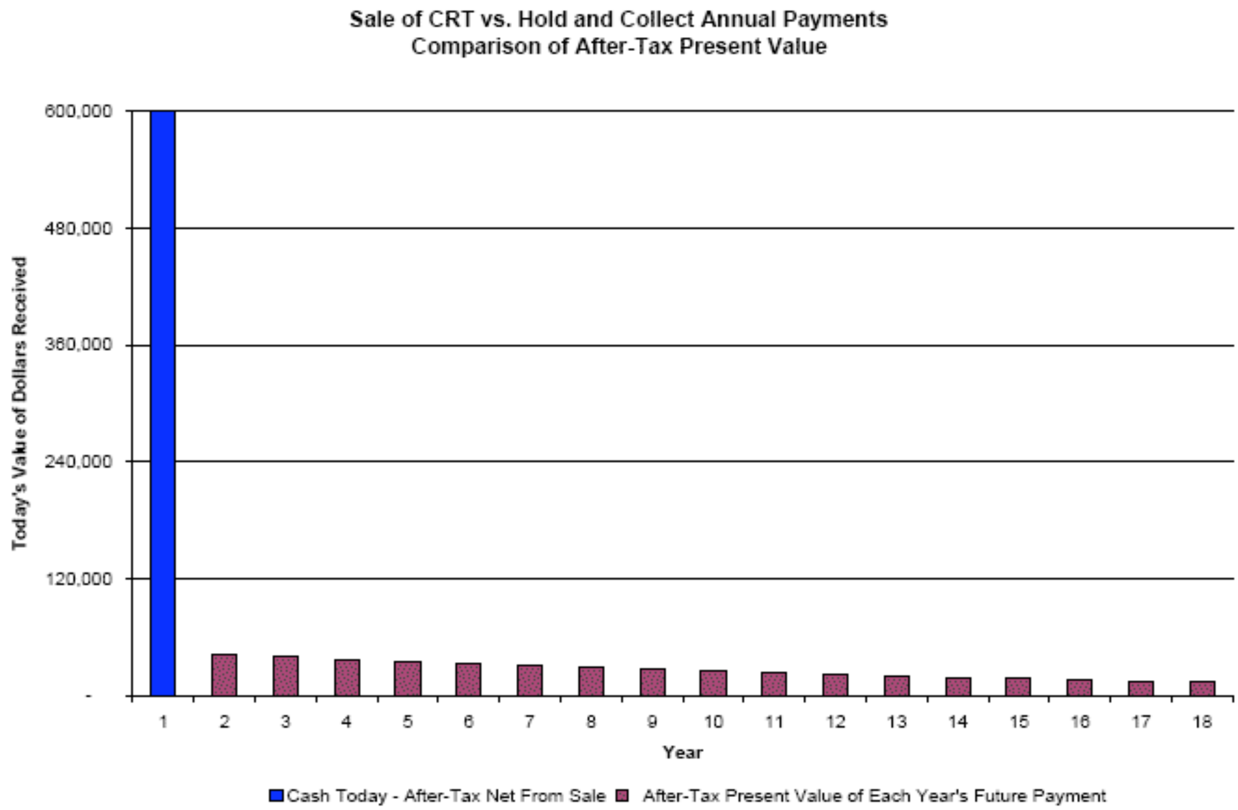
	Effective Tax Rate		
Discount Rate	30%	35%	40%
6%	$495,343	$459,962	$424,580
7%	$461,272	$428,324	$395,376
8%	$430,745	$399,977	$369,210

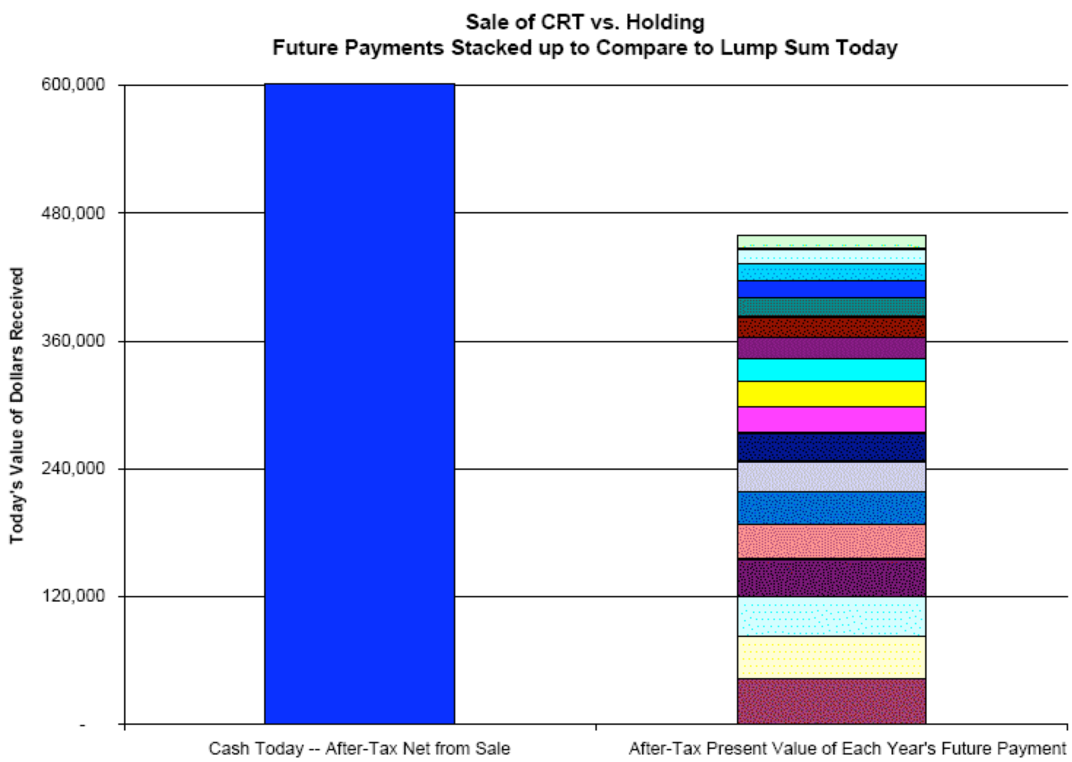
If the client is willing to let the buyer select the ultimate charitable beneficiary (and assuming there are no other barriers in the trust), this interest may command a price of $800,000 pre-tax. After commission, usually 6%, the client would get $752,000. The sale of the interest is a capital gains type transaction. Even if the client has zero basis, after paying capital gains taxes at an assumed rate of 20% (reflecting the federal capital gains rate at 15% plus an assumed additional 5% for net state tax) the client would net $601,600.

This is a terrific price. It represents a premium over NPV of between 30% and 50%, depending on which discount rate used to calculate NPV. In dollars, it represents an immediate, cash, net after-tax gain of between about $140,000 and $200,000, again depending on the discount rate used to calculate it.

These values are illustrated in the graphs below. The first graph, "Sale of CRT vs. Hold and Collect Annual Payments," shows in graphical format the value today of the lump sum, after-tax, payment versus the value of each future year's payment, after-tax and discounted to a present value. It shows graphically that a payment fifteen years or so from now is not worth very much today.

The second graph, "Sale of CRT vs. Holding," stacks up all these future payments, at today's value, and again illustrates that all together they are worth significantly less than the amount the clients would net today by selling. In addition, of course, as clients age, there is a significant risk that they will not collect some or all of the anticipated payments.


Sale of CRT vs. Hold and Collect Annual Payments
Comparison of After-Tax Present Value
600,000
480,000
360,000
240,000
120,000
-
Today's Value of Dollars Received
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
Year
Cash Today - After-Tax Net From Sale
After-Tax Present Value of Each Year's Future Payment


Sale of CRT vs. Holding
Future Payments Stacked up to Compare to Lump Sum Today
600,000
480,000
360,000
240,000
120,000
-
Today's Value of Dollars Received
Cash Today -- After-Tax Net from Sale
After-Tax Present Value of Each Year's Future Payment

Tax/Legal Considerations

Our firm retains the counsel of a nationally-recognized law firm to advise us on CRT law. After a period of intense study, they have determined that there are no legal barriers to the sale of CRT income interests, although each case must be looked at individually because each trust is different.

In addition, although each taxpayer must evaluate his or her own situation, the sale of a CRT lead interest is generally considered a capital transaction. The IRS has issued several private letter rulings on this matter. We usually direct advisors to PLR 200127023, which 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 of Rev. Rul. 72-243, 1972-1 C.B. 233.

PLR 200127023 goes on to say that 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. In other words, if a seller has held his interest for more than a year, the sale may be a long-term capital gain, which is taxed at one of the most favorable rates available.

These letters are the source of the determination that the sale of a CRT lead interest may be a capital transaction.

Benefits for the Advisor

From an advisor’s standpoint, the benefits of providing a client with liquidity for CRT interests are multi-faceted. Initiating this kind of transaction provides a valuable and needed service to the client, and ultimately keeps him or her happy. It also prevents your client from going to a competitor with a problem you couldn’t solve.

In addition, a number of advisors will find that merely being able to discuss the possibility of this type of transaction will heighten their esteem in clients’ eyes.

Discount Rate Cannot Be Lower Than the Expected Rate of Return

This is an assumption based on a logical analysis, which follows. 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: an investor's discount rate cannot be lower than the expected rate of return he believes he can earn on investable funds. To demonstrate this, let's suppose that it is NOT true. Suppose my discount rate is 10% and I can invest risk-free and 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.

Now let's put this 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. Again, let's proceed by assuming the opposite of what we want to demonstrate. To clarify and simplify, 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 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 (i.e. 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.

Unlocking Hidden Value in Existing CRTs

Roger Silk | 10-23-03 |

Clients pay you to create value for them. If you can turn a $1.00 into $1.10 in a year, you're doing a decent job. If you can do it overnight, you're a hero.

For your clients with existing charitable remainder trusts, here's how you can do it. And get paid, too.

As you read this, keep in mind that every CRT is unique, because every one is a trust with its own particular set of facts. So what we say here should be taken as generally accurate, but may or may not apply to any given CRT.

What Is Your Client's CRT Interest Worth Today?

A CRT is a split interest trust in which a donor retains an interest in specified cash flows, and charity owns the remainder interest. These cash flows are usually set as a given percentage, say 7%, of the value of the trust each year. The cash flows typically last until the donor dies. Then charity gets whatever is left; i.e. the remainder.

Economically, the donor's interest is worth the present value of these cash flows. The remainder, economically, is also worth the present value of a future number discounted back. Curiously, these present values added together, are often much less than the current total value of the assets in trust. That seems paradoxical, but it's not, because, as we all know, a bird in the hand is worth two (or more) in the bush. The future CRT cash flows are "birds in the bush" until they are received, when they become birds in the hand.

To estimate the value of a donor's interest, we must know the donor's age, the current value of the CRT, and the payout rate. Then, we must estimate the following four numbers: the rate of return on the assets, the donor's remaining life, the appropriate discount rate to use, and the applicable income tax rate. For example, let's consider the case of George.

First the facts. George is 65, the payout rate is 5%, and the current value in the trust is $1 million (rounded to make the numbers easier to follow). George's life expectancy (taken from a table; he has no special medical issues) is 17.2 years and his expected applicable income tax rate is 33% (roughly half capital gain and half ordinary income, with some state income tax also).

Once we have the facts, we have to make assumptions about future rates of return and discount rates. In today's environment, George's advisor, David, felt a conservative, reasonable rate would be 6% and that the discount rate to use for George should be 8.5%.

Given these facts and assumptions, George's after-tax net present value in the income stream calculates out to about $300,000. To the extent that George can sell it to net more than that, it makes economic sense for him to sell. An offer for $350,000 was all it took.

Due Diligence

If the economics work for both the buyer and seller, a buyer's due diligence will usually focus on legal issues relating to trust law and specific peculiarities relating to the terms of the trust itself. It is difficult to generalize about these, because there are 50 sets of state laws, and virtually every trust has its own unique features, clauses, and language. In addition, there may be income tax issues that must be addressed.

Who Is a Potential Buyer?

Buying a CRT income stream is a bit like buying a bond that has no principal repayment at the end, an uncertain number of payments (because they go on as long as the life of the donor), payments of uncertain amount (in the case of charitable remainder unit trusts, or CRUTs, which most CRTs are), and no secondary market. Because of these features, the universe of potential buyers is limited. A buyer must be able to deal with the long holding period, and the dual uncertainties of how many payments they'll get and how large those payments will be.

Why a Buyer Will Offer a Premium

A buyer values an income stream. A seller does the same thing. Most sales of cash flows involve the seller taking a discount. CRT lead interests may be sold at a premium. Why?

Because the same cash flows are worth more to a buyer who doesn't have to pay taxes on them.

It's simple. To a seller in the 30% tax bracket, each dollar is worth 70 cents. To a buyer who doesn't have to worry about taxes, the same dollar is worth 100 cents. So the buyer can afford to pay the seller a premium to the seller's value and still have a decent investment.

Added Business for You--Commission

It's not all the time that you can show a client how to sell something for more than it's worth to him or her. With the market down from its levels of a few years ago, many, perhaps a majority, of CRTs are now worth more to the right buyer than to the existing holder. For a limited time, we are offering to evaluate your clients CRTs for potential sale at no charge. If you have client CRTs you'd like us to take a no obligation look at, send us an e-mail to mstarCRT@SterlingFoundations.com. For each one, here's the basic info we'll need: current value of trust assets, payout rate, and the age(s) of the income beneficiaries.

If a transaction is feasible, like David, you may be able to add a unique and valuable arrow to your quiver and bring important new benefits to your clients. Note that for advisors who accept commissions, there is usually a commission payable on sales. Advisors who don't accept commissions can pass that value along to their clients by forgoing the commission.

Roger Silk, PhD, CFA, and CEO of Sterling Foundation Management. Sterling works with investment and financial planners in sophisticated tax and charitable planning for wealthy individuals and families. Sterling provides turnkey foundation administration and management services, but does not manage investments or custody assets. Sterling may be able to locate potential buyers of CRT interests. For more information, or to request a free CRT valuation table, e-mail your request to mstarCRT@SterlingFoundations.com.

Questions and comments about this article should be directed to site manager Jerry Kerns.

Develop Business/Financial Planning

How to Sell a Client's Interest in a CRT

By Roger D. Silk, PhD, CFA
CEO of Sterling Foundation Management
May 19, 2003 12:00 am ET

Have a client who's looking for additional liquidity? He may be able to sell the income interest in his charitable remainder trust. Here's how.

Bob, an advisor, wanted to help out a client who had more than half of his net worth tied up in a charitable remainder trust (CRT). The client set up the CRT several years ago, and his circumstances have changed. After three years of an unrelenting bear market, Bob's client has lots of company.

I suggested to Bob that his client might be able to sell his income interest in the CRT. While not everyone can sell—each trust has its own particular set of facts—the following should prove generally accurate if you have clients who are in a similar situation.

Related Articles

Clients Receive Income, Cut Taxes With Charitable Remainder Trusts
A CRT enables clients to give property to favorite charities and still enjoy property benefits—in short, to donate the cake and eat it too.

Consider Charitable Remainder Trusts for Entrepreneurial Clients
Talk with your entrepreneurial client to determine if a charitable remainder trust is right for him.

What is a CRT worth today?

A CRT is a split interest trust in which a donor retains an interest in specified cash flows and the charity owns the remainder interest. These cash flows are usually set as a given percentage, say 7%, of the value of the trust each year. The cash flows typically last until the donor dies. Then, the charity gets whatever is left, i.e. the remainder.

Economically, the donor's interest is worth the present value of these cash flows. The remainder, economically, is also worth the present value of a future number discounted back. Curiously, these present values added together are often much less than the current total value of the assets in trust. That seems paradoxical, but it's not, because, as we know, a bird in the hand is worth two (or more) in the bush. The future CRT cash flows are birds in the bush until they are received, when they become birds in the hand.

To estimate the value of a donor's interest, you must know the donor's age, the current value of the CRT, and the payout rate. Then, estimate the following four numbers: the rate of return on the assets, the donor's remaining life, the appropriate discount rate to use, and the applicable income tax rate. Let's consider Bob's case as an example.

First, the facts. Bob's client, Hamilton, is 65; the payout rate on the charitable remainder unitrust (CRUT)—which most CRTs are—is 5%; and the current value in the trust is $1 million dollars (rounded to make the numbers easier to follow). Hamilton's life expectancy (taken from a table—he has no special medical issues) is 17.2 years, and his expected applicable income tax rate is 33% (roughly half capital gain and half ordinary income, with some state income tax also).

Now we can make assumptions about future rates of return and discount rates. In today's environment, Bob felt that a conservative, reasonable rate would be 6%, and that the discount rate to use for Hamilton should be 8.5%.

Given these facts and assumptions, Hamilton's after-tax net present value of the income stream calculates out to approximately $300,000. To the extent that Hamilton can sell it to net more than that, it makes economic sense for him to do so.

The mechanics of the transaction

Selling a CRT interest is like selling a house. There is no central exchange, each CRT is unique, and transaction costs can be significant. Also, as with houses, it can take weeks or months to find a buyer, and several more weeks or months to close. And if a seller has an unrealistic view of the value of what he is selling, it may never sell.

On the other hand, buying a CRT income stream is a bit like buying a bond with no principal repayment at the end, an uncertain number of payments (because they go on as long as the life of the donor), payments of uncertain amount (in the case of CRUTs, because the payments are a fixed percentage of a changing number), and no secondary market. Because of these features, the universe of potential buyers is limited. A buyer must be able to deal with the long holding period and the dual uncertainties of how many payments they'll get and how large those payments will be.

After factoring in these issues, a potential buyer may come up with a higher valuation than the seller (so that a transaction is economically possible) if his tolerance for illiquidity is higher than the seller's, or if his tax bracket is lower (and therefore a given stream of taxable payments is worth more to the lower bracket buyer). For example, private foundations may invest in CRT streams, as they have perpetual lives, need little liquidity, and are exempt from income taxes.

In Hamilton's case, we helped Bob find a foundation that offered $350,000, contingent on the buyer's due diligence. Due diligence will usually focus on legal issues relating to trust law and specific peculiarities relating to the terms of the trust itself. It is difficult to generalize about these, because there are 50 sets of state laws and virtually every trust has its own unique features, clauses, and language. In addition, there may be income tax issues that need to be addressed. Consequently, the sale of a CRT interest can involve transaction costs that can mount to thousands or tens of thousands of dollars.

Added business for you

If you have a client with a CRT who is interested in selling, the first step is to find out if your client has a realistic idea of what his CRT is worth if he keeps it. As a starting point, check this valuation table (free registration required). If a transaction is economically and legally feasible, you may be able to offer a unique and valuable service to your practice—helping high-net-worth clients attain some added liquidity when circumstances warrant.

Roger Silk, PhD, CFA, and CEO of Sterling Foundation Management, works with investment and financial planners in sophisticated tax and charitable planning for wealthy individuals and families. Sterling provides turnkey foundation administration and management services, but does not manage investments or custody assets. For more information, request the free publication, "What Every Investment Professional Needs to Know About Private Foundations" by e-mailing InvPro@SterlingFoundations.com.

About Sterling

"I've been practicing in the trusts and estates area for thirty years, and I've seen quite a few private foundations in that time. In the past, every time we created one, we carefully explained the administrative and compliance requirements to our clients. Yet we still worried about whether, over time, the client would dot every i and cross every t. If we send them to Sterling, we know the administration and compliance will be done, and done right."

Tim Baetz, Former Head of Estate Planning
McDermott, Will & Emery
Chicago, IL

STERLING FOUNDATION MANAGEMENT

Sterling Foundation Management is the oldest national foundation management firm in the United States and a leading provider of charitable advisory services to some of the country's largest and most active philanthropists and their advisors.

Since 1998, Sterling has worked with thousands of charities, donors, financial advisors, attorneys, CPAs and other professional advisors to help individuals and families achieve their philanthropic goals.

For some clients, Sterling oversees all aspects of their private foundation—from the mission statement and program development, to grant-making and board meetings, to administrative tasks and succession planning. For others, Sterling's team of experienced professionals provides strategic advice and consulting services. We develop and implement flexible programs individually designed to meet each client's specific needs.

Since we do not manage assets or provide tax, legal or investment advice, our services are complementary to those of financial advisors, attorneys and CPAs. We work closely with each client's team of professionals as a trusted philanthropic advisor.

FOUNDATION ADMINISTRATION

The administration and compliance tasks of a private foundation can be burdensome. Sterling has deep knowledge and experience in this area. Some of the activities we undertake for our clients include:

- Grant administration
- Compliance with private foundation rules
- Budget and cash management
- Governance
- Coordination of foundation meetings
- Overseeing federal and state tax returns
- Assistance with public inspection

- Scholarship program administration
- Expenditure responsibility
- Director compensation

Sterling does not:
- Manage assets or provide investment advice
- Provide legal or tax advice
- Prepare tax returns

CHARITABLE ADVISORY SERVICES

Some donors establish private foundations knowing exactly what they want to accomplish with their charitable giving. Others begin with much less specific plans. Sterling's knowledgeable and experienced advisors help clients define their mission and create a pathway to achieve their goals. Some of Sterling's Charitable Advisory Services include:

- Strategic planning to refine the foundation's vision and mission
- Programming to advance the mission
- Impact evaluation to measure effectiveness
- Succession planning to maintain donor intent and direction

OTHER SERVICES

Because of our extensive experience working with private foundations, Sterling's service offering has expanded to encompass a range of additional services. Central among these are the administration of other charitable entities and sales of non-charitable interests in charitable trusts.

Administration of Other Charitable Entities
- Private operating foundations
- Supporting organizations
- Public charities
- Donor advised funds

Sales of Non-Charitable Interests in Charitable Trusts
- Income interests in charitable remainder trusts (CRTs)
- Remainder interests in Charitable Lead Trusts (CLTs)

Executive Management

James W. Lintott, Esq.
Founder and Chairman

James W. Lintott founded and leads Sterling Foundation Management, which manages private foundations and provides charitable advisory services to philanthropists and their advisors. As the former head of one of the nation's largest private foundations, Mr. Lintott brings to Sterling extensive experience managing all aspects of foundations.

Mr. Lintott's expertise on charitable giving is wide-ranging. He has developed successful philanthropic projects for clients that include such diverse areas as symposia on destigmatizing certain medical conditions, programs to gauge the effectiveness of scholarships, the development of local cancer screening programs, and the creation of educational curricula for college and graduate students. He is the author, along with Roger Silk, of *Creating a Private Foundation* (2003) and *Managing Foundations and Charitable Trusts* (2011).

Mr. Lintott developed Sterling's Vision, Values, and Family, a program to help donors share their philanthropic vision with children, grandchildren, and other youth. The systematic approach provides a framework to impart philanthropic values, encourage charitable behavior and develop a tradition of philanthropy.

Prior to turning his full focus to private foundation management, Mr. Lintott was chief financial officer of a division of one of the nation's largest privately held company, where he played a critical role advising the company's leaders and guiding their philanthropic endeavors.

Mr. Lintott received his J.D. (with distinction) from Stanford Law School, as well as an M.A. in applied economics and B.A. degrees (Phi Beta Kappa) in economics and political science from Stanford University. He was a senior editor of the *Stanford Law Review*.

Mr. Lintott serves on the boards of nationally known charities, including Children's National Medical Center and Best Buddies International. Mr. Lintott is a board member of the United States-Japan Foundation. He is a founder and director, along with his wife, of their family foundation.

Roger D. Silk, Ph.D., CFA
Founder and Chief Executive Officer
Roger Silk founded and leads Sterling Foundation Management and is a leading expert in the field of private foundations and charitable trusts.

He is a founder and board member of several non-profit educational organizations. Dr. Silk is also a former bond trader at the World Bank, as well as a Stanford-trained Ph.D. economist. This mix of experience, practical knowledge, and theoretical insight enabled Dr. Silk to help build Sterling into the market leader that it is today.

Dr. Silk has guided multi-million-dollar non-profits in rethinking their operations, and led the complete restructuring of several charitable organizations. He has developed a wide range of successful philanthropic projects for clients, including such diverse areas as the development of scientific research laboratories, design of measurement programs to gauge the effectiveness of scholarships, preservation of environmentally sensitive areas through scenic easements, and development of curriculum for use in high schools nationwide.

Dr. Silk's articles have appeared in magazines such as *Estate Planning*, *Philanthropy*, *The Journal of Financial Planning*, and *Trusts & Estates*. He is the author of two important studies relating to the optimal use of charitable vehicles. He has spoken to audiences around the country on the types and uses of charitable entities, and has worked closely with one of the world's five largest banks to demonstrate the role private foundations can play for high net worth clients. Dr. Silk is a member of the *Trusts and Estates* editorial advisory board for philanthropic matters.

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 W. Lintott, of *Creating a Private Foundation* (2003) and *Managing Foundations and Charitable Trusts* (2011).

Paul Beckner
Principal

Paul Beckner joined Sterling Foundation Management in 2004. He has built a career managing and solving complex problems, building effective management teams, and creating value. At Sterling, he oversees various aspects of Sterling's business and advises clients on how best to achieve their charitable planning goals.

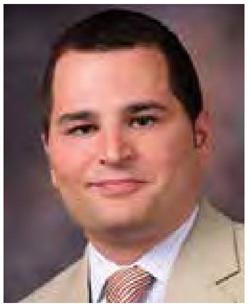
Mr. Beckner brings to Sterling deep knowledge and expertise from a 17-year career at a non-profit, public policy organization, where he quickly rose through the ranks to become Chief Executive Officer—a title he held for 14 years.

During his tenure as CEO, Mr. Beckner more than doubled the organization's revenues to create a national powerhouse. Mr. Beckner earned a reputation for integrity, accomplishment, sound judgment, and managerial acumen and was sought out to address some of the nation's most difficult political and policy problems by top leaders, including Fortune 50 CEOs, Forbes 400 families, Congressional leaders, and top White House staff.

Mr. Beckner has experience in all aspects of leadership, management and entrepreneurship. He has created and launched successful organizations, grew existing ones to new levels of success and effectiveness, spearheaded mergers and acquisitions, managed high-stakes litigation, and built world-class management teams.

Mr. Beckner began his career in the executive offices of a grocery store chain in Texas, before moving to work in New York publishing.

Mr. Beckner earned his M.B.A. from the Wharton School at the University of Pennsylvania, as well as a B.A. in history from Northwestern University. In 2001, he was appointed by the President of the United States to serve on the President's Advisory Committee for Trade Policy and Negotiations in the Office of the United States Trade Representative. He currently is Chairman of the Board of FreedomWorks Foundation and is on the Board of FreedomWorks.



Evan D. Unzelman
President

With fifteen years of specialized experience in the fields of private foundations and charitable remainder trusts (CRTs), Evan Unzelman has risen quickly through the ranks of charitable and tax planning.

Mr. Unzelman began his career at a multifamily office, where he provided comprehensive solutions to the unique challenges faced by affluent families. In 2006, he joined Sterling, where he oversaw the administration of all of the firms' charitable clients. In 2008, he was tasked with expanding Sterling's CRT secondary planning service offering.

Mr. Unzelman was elevated to Chief Operating Officer in 2010 to expand and sharpen Sterling's service offering for charitable donors and their advisors. In 2015, he was promoted to President, expanding his responsibilities to include the supervision of all aspects of Sterling's business.

Mr. Unzelman is a recognized expert and sought-after speaker in the field of charitable planning, and CRTs in particular. He speaks to a variety of audiences including attorneys, accountants and financial advisors, primarily on CRT secondary planning, tax implications of CRTs, and the role CRTs play in the estate and wealth planning of affluent clients.

Mr. Unzelman's articles have appeared in publications such as *Estate Planning*, *NAEPC's Journal of Tax & Estate Planning*, Atlanta Bar Association's *The Mortmain*, *Wealth Strategies Journal* and Atlantic Trust's *Trusted Advisor*. He was also the lead editor of *Managing Foundations and Charitable Trusts* (Bloomberg Press), which is largely regarded as the definitive guide to managing charitable entities.

He received his finance and economics degrees (summa cum laude) from Pacific Lutheran University in Tacoma, Washington. At Pacific Lutheran, he was President of the Student Investment Fund, member of the Beta Gamma Sigma Business Honors Society, and winner of the Academic Excellence Award as the top finance student.

Foundation Consulting and Management

Giovanni (Gio) Kotoriy

Vice President, Foundation Consulting & Management

Giovanni Kotoriy leverages his experience in leadership, management and charitable planning to ensure that the foundations managed by Sterling achieve the goals of their donors.

In past positions Mr. Kotoriy has won several awards for earning the highest client satisfaction scores. At Sterling, he strives to uncover client needs, develop solutions, and achieve goals that ensure each client receives customized attention and services.

Prior to joining Sterling, Mr. Kotoriy was a leader in PricewaterhouseCoooper's (PwC) Public Sector Practice, where he led multiple projects that provided project and portfolio management, strategic planning, financial management, change management, and business process improvement support and services to public sector organizations.

Mr. Kotoriy is a former U.S. Army officer and combat veteran. His 20 years of service includes tours of duty in Haiti and border surveillance of the former East-West German border, as well as combat deployments in Iraq and Afghanistan. Mr. Kotoriy was awarded two Bronze Stars, a Legion of Merit, and a Valorous Unit Award.

Mr. Kotoriy's community service and philanthropic contributions include building homes with Habitat for Humanity, teaching financial literacy with Junior Achievement, and leading community service projects with the Knights of Columbus.

He helps service members and their families with the USO, supports wounded veterans at Fischer Houses, and assists veterans in Veterans Administration hospitals. Mr. Kotoriy is a supporter of the National Children's Health System, Best Buddies International, the Wounded Warrior Project, and the Tragedy Assistance Program for Survivors.

Mr. Kotoriy earned an undergraduate degree from the University of Notre Dame and an M.A. from George Washington University, where he was inducted into the Omicron Delta Kappa National Leadership Honor Society.

J.C. Chang
Director, Foundation Consulting & Management
Ms. Chang helps Sterling clients drive transformational change related to finances, operations, and organizational structures.

She draws on more than seventeen years of experience in helping private and non-profit organizations manage large, complex programs. Ms. Chang has directly managed multi-million-dollar business enterprises, as well as provided portfolio management services for a $900 million government program.

Prior to Sterling, Ms. Chang was an advisory consultant with PriceWaterhouse-Coopers (PwC), where she excelled in program/project management, portfolio management, strategic planning, organizational change, performance measurement, and process improvement with a focus in nonprofit and pharmaceutical industries.

During her tenure at PwC, Ms. Chang often worked closely with senior executives including executive directors and C-suite leadership to ensure client needs were understood, expectations were met, and value was delivered. Ms. Chang also successfully led business pursuits that culminated in multi-year projects generating tens of millions of dollars in revenue.

Ms. Chang is dedicated to giving back to her community by serving as a leader of a youth and college group at her church, taking several mission trips to foreign countries, and volunteering her time at local charities. Ms. Chang earned her undergraduate degree from the University of Virginia and is a Project Management Professional member.

CRT Secondary Planning

David Murray

Vice President, CRT Secondary Planning

David Murray joined Sterling Foundation Management in 2008 and manages all aspects of Sterling's secondary planning services for charitable remainder trusts (CRTs). He has a deep understanding of the important and unique role CRTs play in estate and wealth planning.

Mr. Murray works extensively with trust and estate attorneys, CPAs, and financial advisors on the tax, legal and financial implications of creating and managing CRTs. He is also a leading expert on the secondary planning options available to clients with existing CRTs. He frequently speaks at industry conferences and writes for industry publications.

CRT clients also rely heavily on Mr. Murray's expertise as he works directly with them through every stage of the CRT Secondary Planning process. He helps them determine their CRT planning goals, coordinates the advice of attorneys, accountants, and financial advisors, prepares in-depth analyses of options, and works closely with them through the final closing process.

Mr. Murray is a sought-after speaker for professional and lay audiences on philanthropy and charitable planning. He speaks frequently about various charitable planning vehicles to a wide range of audiences, including trust and estate attorneys, CPAs, financial advisors, income beneficiaries, among others.

Mr. Murray received an undergraduate degree in Civil Engineering and an M.B.A from Queen's University in Kingston, Ontario, and a master's degree in Civil Engineering from the University of Alberta. He is a registered Professional Engineer (non-practicing).

Tyler True
Director, CRT Secondary Planning
Tyler True is a Director at Sterling Foundation Management and specializes in charitable remainder trust (CRT) secondary planning services.

Mr. True, who started with Sterling in 2013 as a Data Analyst in Sterling's Marketing Department, was quickly promoted to Associate Director in 2014. He was promoted to his current role in 2017.

As a Director in Sterling's CRT Department, Mr. True works with attorneys, CPAs and financial advisors on the range of secondary planning options available to their clients with CRTs. Mr. True also spends considerable time traveling the country speaking to CRT income beneficiaries, their families and advisors.

As a Data Analyst in Sterling's Marketing Department, Mr. True managed a ten-person team charged with overhauling Sterling's large and extensive database of clients and professionals. Upon completion of the database overhaul and promotion to Associate Director, Mr. True developed and implemented a comprehensive educational program on CRT secondary planning services for income beneficiaries and their financial advisors.

Mr. True began his career in the oil and gas industry. He earned his undergraduate degree in Biology at Radford University and completed additional coursework in Petroleum Engineering at West Virginia University.

LEGAL COUNSEL

Douglas L. Siegler

Venable LLP, Partner in Charge of Sterling's Engagement

Doug Siegler is a partner in Venable's Tax and Wealth Planning practice. An American College of Trust and Estate Counsel Fellow with more than 30 years of experience, Mr. Siegler advises individuals and families on estate planning and administration, as well as the multigenerational transfer of wealth, especially in regard to income, estate, gift, and generation-skipping transfer tax planning.

Mr. Siegler advises clients on wills, trust agreements, insurance, and charitable giving programs, and provides tax and business succession planning advice to owners of closely held businesses. He also handles transfer tax planning for clients married to non-U.S. citizens and people living outside the U.S.

For ten years straight, Mr. Siegler was named to The Best Lawyers in America in the area of trusts and estates. He earned his B.A., cum laude, at Princeton University and his J.D., with honors, at the Duke University Law School.

About Venable:

Venable is an American Lawyer 100 law firm. With more than 600 attorneys in nine offices across the country, it is strategically positioned to advance its clients' business objectives in the U.S. and abroad. Its clients rely on Venable's proven capabilities in all areas of corporate and business law, tax and wealth planning, complex litigation, intellectual property, and regulatory and government affairs.

Venable has more that than 60 attorneys focused on tax issues, including a former chair of the American Bar Association Tax Section, former staff of the IRS Office of Chief Counsel, former staff of the Joint Committee on Taxation, and authors of leading tax treatises and numerous articles in premier tax publications.

Sterling Foundation Management is the oldest national private foundation management firm in the United States and serves many of the country's most active philanthropists and their advisors. The firm provides highly personalized management services to private foundations (non-operating and operating), supporting organizations, public charities and other charitable entities.

In addition to management services, Sterling offers thought leadership and sophisticated advice to help donors define, focus and maximize the impact of their philanthropy.

Sterling is the nation's leading provider of secondary planning services for clients with Charitable Remainder Trusts (CRTs). The firm has been active in the market since 2003 and reviewed thousands of CRTs for clients and their advisors.

Sterling does *not*:

- Manage or custody assets
- Provide tax, legal or investment advice
- Prepare tax returns

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