WRMarketplace
An AALU Washington Report
Rose Street ADVISORS
BENEFITS | INSURANCE | INVESTMENTS

Thursday, September 4 2014 **WRM# 14-35**

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Tax-Smart Diversification: Charitable Remainder Trusts & Life Insurance.

MARKET TREND: Higher tax rates and longer life expectancies have increased the importance of efficient planning for asset diversification and retirement income generation, particularly for business owners and others with concentrated wealth positions.

SYNOPSIS: For clients with a highly appreciated asset or concentrated wealth position (particularly if nearing retirement), a lifetime charitable remainder trust ("CRT") may be an attractive option to defer the capital gains and net investment income ("NII") tax from diversification of the assets while generating a lifetime income stream. CRTs are tax-exempt trusts created and funded by a donor, which make regular payments to a non-charitable beneficiary (usually the donor and/or his spouse) for a set term and leave the remainder to a charity. Lifetime CRTs can provide: (1) diversification of highly appreciated assets and/or concentrated positions without immediate capital gains or NII tax; (2) income and NII tax-deferred asset growth within the CRT until distributed; (3) an income stream payable to the non-charitable beneficiaries for a desired term (e.g., life); (4) an immediate federal income and gift tax charitable deduction up to the present value of the charitable remainder interest; (5) exclusion of the CRT assets from the donor's estate for federal estate tax purposes; and (6) recognition of a gift to the donor's chosen charity during the donor's life.

TAKE AWAY: CRTs provide a unique opportunity for asset diversification and retirement planning due to their ability to defer tax exposure on the sale of appreciated assets, to provide an income stream to the non-charitable beneficiaries, and to offer flexibility in term selection and payment structure. Combining a CRT with life insurance purchased through an ILIT can help the donor replace the wealth transferred to the charity for his heirs, on an efficient basis. With proper attention on the economics, in certain cases, CRTs may provide planning benefits even for clients needing asset diversification who are less charitably inclined. To reach optimum performance, however, CRTs will need regular monitoring to review their investment strategy and the tax impact of that strategy and the CRT distributions on the non-charitable beneficiaries.

Higher income tax rates and the addition of the NII tax have significantly altered the landscape for asset diversification planning. For clients with highly appreciated assets or a concentrated wealth position (particularly if nearing retirement), a lifetime CRT may be an attractive option to defer income and NII tax from the diversification of the asset while generating a lifetime income stream. Combining the plan with life insurance can help ensure that the inheritance of the client's heir is not diminished by the gift, on an efficient basis.

LIFETIME CRTS – POTENTIAL OPPORTUNITIES

As detailed below, a CRT is a tax-exempt trust created and funded by a donor, which makes an annuity or unitrust payment to a non-charitable beneficiary (usually the donor and/or his spouse, the "**NC beneficiaries**") for a set term. The remaining assets pass to charity at the end of the term. As a tax and retirement planning tool, lifetime CRTs can provide several unique benefits:[1]

- Diversification of highly appreciated capital assets and/or concentrated position without an immediate capital gains or NII tax when sold by the CRT;[2]
- Income and NII tax-deferred asset growth within the CRT until distributed;
- An income stream payable to the NC beneficiaries for a desired term (such as for life);
- An immediate federal income and gift tax charitable deduction[3] up to the present value of the charitable remainder interest left to charity;
- Exclusion of the CRT assets from the donor's estate for federal estate tax purposes;[4] and
- Recognition of a gift to the donor's chosen charity during the donor's life.

HOW LIFETIME CRTS WORK

Generally. An individual ("**donor**") creates and funds an irrevocable trust during life. The CRT distributes a specified amount to one or more designated NC beneficiaries (*e.g.*, the donor and the donor's spouse). The distributions are paid at least annually for: (1) the lifetimes of the NC beneficiaries, (2) for a term of up to 20 years, or (3) the shorter or longer of the NC beneficiaries' lives or 20 years. At expiration of the CRT term, the remainder passes to one or more charities selected by the donor, which may include public charities, private foundations, donor advised funds, etc.

Two Types. CRTs come in two main forms: (1) charitable remainder annuity trusts ("**CRATs**") and (2) charitable remainder unitrusts ("**CRUTs**").[5] Key features of these CRTs include:

	CRATs	CRUTS
Payments to Income Beneficiary	**Fixed** annuity. Typically based on set percentage of fair market value (**FMV**) of initial contribution to trust.[6]	**Variable** unitrust amount. Based on set percentage of FMV of trust assets, determined **annually**.
Annuity/Unitrust Requirements	Must equal 5% but not more than 50% of initial FMV of trust assets and the annuity's length/value cannot create more than a 5% probability that no remainder will exist at the end of the CRT term.	Must equal 5% but not more than 50% of the annual FMV of the trust assets.
Additional Trust Contributions	**Prohibited**	**Allowed**
Present Value of Charitable Remainder	Must equal at least **10% of FMV of initial contribution** to trust.	Must equal at least **10% of FMV of each contribution** to the trust
§7520 Rate Sensivity	**May favor higher rates** (higher value for deductible charitable remainder).	**Neutral** (rate does not impact value of charitable remainder).
Trust Valuations	**Once** for initial contribution to trust.	**Annually** to determine unitrust amount.

Choosing a CRT. CRUTs are generally more popular than CRATs, as they provide more flexibility, allow additional contributions, and can provide annual distributions that better pace inflation (since distributions will increase as the CRT's value increases). CRATs, however, may

be preferred in higher interest rate environments or where fixed (known) payments are desired (such as if clients fear a reduction in payments due to an economic downturn).

CRT INCOME AND NII TAXATION

No Tax to CRT. As tax-exempt charitable trusts, CRTs are exempt from income, capital gains, and NII tax. Accordingly, a CRT's sale of a highly appreciated asset will not result in the CRT's recognition of taxable gain or NII.

Tax Deduction to Donor. The donor can take a charitable income tax and gift tax deduction for the present value of the CRT's charitable remainder interest. The available income tax deduction will depend on the assets the donor gives to the CRT (*e.g.*, appreciated capital gain property, cash) and the designated charity (public or private).[7] The donor can carry forward any unused deduction for up to five years.

Tax on NC Beneficiaries. NC beneficiaries, however, will incur income and NII tax on the CRT distributions, which will retain the income and NII characterization they had in the CRT, as described below.

Income Tax "Tiers." Income taxation of CRT distributions relies on the categorization of CRT income into four "Tiers:" (1) ordinary income; (2) capital gain; (3) other income; and (4) principal. In each of the first three Tiers, there is a hierarchy of income "classes," arranged by the highest federal income tax rate applicable to that income (e.g., 39.6%, 20%). Generally, distributions come first from the highest-taxed class in the highest-taxed Tier until the Tier is exhausted -- e.g., interest income (39.6%) is distributed before qualified dividends (20%) from Tier 1, and both are fully distributed before any short-term capital gain (39.6%) from Tier 2.

NII Tax Follows Tiers. For CRT distributions, NII taxation ties into the Tier system by creating an additional class within each Tier – income that is NII (income received **before 2013 and income otherwise excluded as NII is not NII**). For distribution ordering purposes, the tax rate for each class of income that is NII increases by 3.8% (39.6% to 43.4%; 20% to 23.8%). So, generally, Tier 1 distributions will come first from ordinary income that is NII (43.4%), then ordinary income that is not NII (39.6%), then qualified dividends that are NII (23.8%), etc.

PUTTING IT ALL TOGETHER

Diversification and Tax Management. Although CRT distributions carry out taxable income and NII to the NC beneficiaries, the CRT effectively can level out taxable amounts received by such beneficiaries annually during the CRT term. This "leveling out" may prevent or limit the crossing of certain income tax and NII thresholds in a given year, depending upon the NC beneficiaries respective NII and adjusted gross income ("**AGI**"). Thus, a CRT may defer both the income and NII tax ultimately recognized on the CRT assets.

> *Example*: Donor, age 65 contributes $5 million of appreciated stock with $4,000,000 of built-in gain to a lifetime CRUT for the benefit of Donor and his spouse (age 60) for the longer of their joint lives or 20 years. Assuming a §7520 rate of 2.2%, a 6% annual return on the CRT assets, and optimization of the unitrust distributions to maximize the payout to the NC beneficiaries (while still meeting the 10% charitable remainder requirement):

- The CRUT generates a $500,100 federal income and gift tax charitable deduction.
- The CRUT's subsequent sale of the stock avoids immediate recognition of up to $952,000 in combined federal income and NII tax (based on a 23.8% rate).

- The NC beneficiaries receive unitrust payments totaling almost $7.7 million over their estimated 25 year joint life expectancy ("**LE**").

- The charity receives an estimated remainder of over $2.2 million.

Managing the Economics. A CRT's success as a retirement, tax and charitable planning technique relies heavily "on the numbers." Specifically, compliance with mandated distribution and remainder requirements, as well as selection of the CRT's payout rate and frequency (*e.g.*, monthly, quarterly, annually), term, and asset values, will directly affect the CRT's investment strategies, asset allocations and overall performance. CRT economics also have been impacted by (1) the recent rise in overall tax rates, which increases the benefit of the tax-free investment environment offered within the CRT and (2) the fact that IRS mortality tables typically underestimate joint LE, which, in turn, overstates the cost of establishing a CRT.

With proper management of these economics, in certain cases, some commentators assert that CRTs may provide planning benefits for clients needing asset diversification who are less charitably inclined, placing them in roughly the same, or possibly better, position, tax and income-wise, than a direct sale of the asset and subsequent reinvestment in a taxable portfolio.[8] Of course, these results are dependent on numerous tax, LE and financial assumptions, which must be carefully analyzed and modeled.

Regardless of whether initially charitably-motivated, once implemented, achieving optimum CRT performance requires regular monitoring of the CRT to review the performance of the underlying assets, the ability of the investment strategy to support the distributions to the NC beneficiaries, (particularly for CRUTS, where payments vary with the annual trust value), the tax impact of the investment strategy and CRT distributions to the NC beneficiaries, and the corresponding need to make changes to the investments to address these issues. Although a donor may serve as trustee of the CRT,[9] the trust will still need an experienced trustee and/or investment advisor to provide this active management and review, as well as assistance with on-going administrative and reporting requirements.

Incorporating Life Insurance. As discussed below, with proper structure and management, NC beneficiaries may find that the annual payments provided by the CRT affords them sufficient funds to both satisfy their retirement income needs (possibly in combination with other income sources) and to re-invest a portion of the payments, thus generating assets for their heirs that can replace those passing to the CRT's charitable beneficiary. Without other planning, however, those reinvested assets will be subject to estate tax in the NC beneficiaries' estate.

A typical complementary planning technique for CRTs is the use of an irrevocable life insurance trust ("**ILIT**" also called a "**wealth replacement trust**"). The NC beneficiaries can use the excess CRT distributions to fund the ILIT acquisition of a life insurance policy. The policy can provide a guaranteed death benefit targeted to replace the anticipated charitable remainder, and the benefits will pass to the ILIT beneficiaries (i.e., heirs) estate tax-free.

TAKE-AWAYS

- CRTs provide a unique opportunity for asset diversification and retirement planning due to their ability to defer and/or reduce tax exposure on the sale of appreciated assets, to provide an income stream to the non-charitable beneficiaries, and to offer flexibility with regard to term selection and payment structure.

- Combining a CRT with life insurance purchased through an ILIT can complement the plan, by helping the donor to replace the wealth transferred to the charity for his heirs, on an estate tax-efficient basis.

- With proper managing of the economics, in certain cases, CRTs may provide planning benefits even for clients needing asset diversification who are less charitably inclined.
- To help ensure optimum performance, CRTs will need regular monitoring to review their investment performance, the ability of the investment strategy to support distributions to the NC beneficiaries, (particularly for CRUTS, where payments vary with the annual trust value), and the tax impact of the strategy and CRT distributions on the NC beneficiaries.

NOTES

[1] Note that the property should not be subject to a debt upon contribution, or the donor may recognize gain. Further, creating a CRT and achieving the intended results requires strict adherence to several formalities and on-going administrative requirements. For example, a CRT must have a written trust instrument meeting all statutory and regulatory requirements and a tax identification number. The trustee must file annual information returns. The CRT agreement must prohibit violation of the excise tax rules applicable to private foundations on self-dealing and taxable expenditures that are applicable to private foundations. Thus, planning with, and maintenance of, CRTs will require consultation with experienced advisor before, during, and after implementation.

[2] However, there should be no express or implied obligation for the CRT to sell the asset.

[3] Unless, with regard to the gift tax deduction, the donor reserves a testamentary power of appointment to change the remainder charitable beneficiary. The gift will be completed at the donor's death, when a federal estate tax charitable deduction should be available.

[4] Based on availability of a federal estate tax charitable deduction for the donor's estate. If both the donor and the donor's spouse are the only NC beneficiaries, the donor's estate should receive a marital deduction for the value of the surviving spouse's annuity/unitrust interest and a charitable deduction for the charitable remainder interest. The CRT property is not includible in the surviving spouse's gross estate, because he or she never has more than a lifetime interest in the CRT.

[5] CRUTs also may be structured as a "net income with makeup CRUT" ("**NIMCRUT**"), where the annual unitrust payout is based on the **lesser** of net income or the otherwise determined percentage distribution amount (at least 5%). The trust generally pays out any resulting deficit (the "makeup") in later years, to the extent its net income exceeds the percentage distribution amount (i.e., when the trust invests for more income). Another variation, a "Flip-CRUT," is a NIMCRUT that changes (flips) to a regular CRUT on January 1st of the year following occurrence of an event specified in the trust agreement (e.g., if the sale of a specified asset occurs). A client typically would consider a NIMCRUT or a Flip-CRUT if he wanted to defer income for himself or the other NC beneficiaries until, for example, other sources of income diminish or cease (e.g., at retirement).

[6] The annuity may also be expressed as a fixed dollar amount.

[7] The charitable deduction rules, particularly the percentage limitation rules, need to be considered by the client.

[8] *See* John C. Yeoman, "The Economics of Using a Charitable Remainder Trust to Fund a Retirement Portfolio," *The Journal of Wealth Management*, pp. 40-50, Summer 2014.

[9] As long as the trustee's powers, if held by the donor, do not create a grantor trust.

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