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Dusting Off the Old Charitable Remainder Trust

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During the 1990s, rapid appreciation of assets and a higher capital gain tax rate made the charitable remainder trust (CRT) a popular charitable, financial and tax planning tool. Flat or declining asset values in the 2000s, combined with lower tax rates, diminished interest in charitable remainder trusts. The stock market is back at its pre-crash levels, real estate markets are strengthening and tax rates are up. Once again planners are dusting off the old charitable remainder trust for the charitable, financial and tax benefits that it can provide to donors.

Drivers of Charitable Remainder Trust Planning

Although a charitable remainder trust can be used in a variety of contexts, most frequently a CRT is set up by a donor to provide income to the donor, or the donor and a spouse, for life, with the remainder passing to charity. Generally the donor is not in the financial position to give away the asset during lifetime because it is needed to generate income. One option for the donor would be to retain the asset for life and make a bequest to charity. The trust is potentially more tax advantageous because it provides an immediate income tax deduction for the remainder value that will pass to charity at the donor's death. This deduction, however, will represent only a fraction of the value of the assets, possibly as little as 10%. The donor needs to weigh the benefit of the deduction against the loss of access to the principal of the asset.

The donor's asset, however, may not be in the form that the donor desires. The asset may be undeveloped land that does not generate current income or may be a concentrated stock position that is creating an excessive risk in the donor's portfolio. In these circumstances, it would be advantageous for the donor to dispose of the asset. Here the case for the CRT for the donor becomes compelling. Using the trust allows the donor to preserve 30%-40% more of the value of the asset to reinvest to generate income than would be the case if the donor sold the asset outside of the trust. This means that the donor can enjoy significantly higher income from the

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sale's proceeds. Over time, the tax-exempt status of the CRT may be more beneficial to the donor than the original income tax deduction.

The extent of the advantage offered by the tax-exempt status of the CRT is a function of tax rates and the amount of taxable gain that would result from the sale of an asset that the donor contributes to the trust. In California, for example, prior to 2013, taxpayers selling long-term capital gain property paid a federal tax rate of 15% and a state tax of 9%. Because state taxes are deductible from federal taxable income, the effective tax rate was around 20%. For 2013, the federal tax rate on capital gain increased to 20% plus an additional 3.8% Medicare tax for high-income taxpayers. Under Proposition 30, the California tax rate increased to 13.5%. Even taking into account the deductibility of the state income taxes, the combined effective rate is still 30% or more. If the taxpayer was selling short-term capital gain property or ordinary income property, the combined rates would be 40% or 50%. These new higher tax rates mean the CRT preserves a significantly larger portion of an asset's value than was the case before the 2013 tax law changes.

The late 2000s saw a significant decline in asset values across most asset classes. The stock market, however, has recently reached its previous high values. Real estate values, particularly residential real estate, are recovering as well. This kind of appreciation of asset value is important for charitable remainder trust planning because the taxes that are avoided by the CRT apply only to the appreciation of the value of the asset over the donor's acquisition cost.

Maximizing Income with the Charitable Remainder Trust

If the donor has $1 million of long-term appreciated stock in a company and a basis of zero, the combined federal and California taxes on the sale of the asset would total approximately $300,000. Accordingly, the donor would be left with only $700,000 to reinvest for income. Assuming the donor was looking for an income of $50,000, the assets would need to generate the relatively high rate of return of 7.14% to achieve that income. Alternatively, if the assets generate a more likely rate of return of 5%, the donor would have an income of only $35,000.

If the stock was instead placed in a CRT, a payout rate of 5% would generate an income of $50,000 a year—$15,000 more than the direct investment example, above. Moreover, if the trust earned the same 7.14% rate of return, those excess returns above the $50,000 payment would be added to the trust principal, allowing for the possibility of growth in the payments in future years.

Planning Situations

Donors with significant real estate wealth have the option of selling one piece of real property and acquiring another piece of real property without the payment of capital gain tax through use of a section 1031 exchange. Section 1031 allows a person to avoid payment of taxes on the gain from the sale if that person purchases similar real estate of equal or greater value to the property that was sold. If such a person wishes to acquire an asset other than real estate of a like kind, however, taxes must be paid on the gain. If the donor is holding property that was acquired at the end of a series of like-kind exchanges, the donor's basis may be little or nothing, particularly if the donor had deducted depreciation with respect to the property. Assuming that the property does not have debt on it or the donor can pay off the debt prior to contributing the property to the CRT, the trust may be an ideal way for the donor to sell the real property without having to acquire another piece of real property.

"Quick! I need some more charitable donations!"

Similarly, founders of companies often have little or no basis in their stock. Individuals who have acquired stock for investment may also have highly appreciated stock positions. Currently, early investors in Google and Apple would have significant appreciation in their positions. Should these donors wish to diversify out of the appreciated position, the charitable remainder trust is a way to do that and maximize the ability to reinvest the proceeds of the sale.

Planning Issues and Solutions

If the donor holds an appreciated asset that does not generate income and may be difficult to sell, such as unimproved real estate or closely held stock, a CRT may not have the cash flow necessary to make the required payments to the beneficiary. The CRT that changes from a net income unitrust to a standard unitrust, sometimes referred to as a "flip" trust, is designed specifically to address this situation. The flip trust can be funded with an illiquid asset and the required distributions would be limited to the cash flow of the trust until the asset is sold. Thereafter, when the trust can invest in liquid assets, it would make a unitrust payment equal to the fixed percentage of the value of its assets. The flip trust can be used in other circumstances such as designing a trust to start making larger payments when the donor reaches retirement age. It may be possible to structure a triggering event that the donor can influence so that the donor has flexibility to determine when to start receiving larger payments from the trust. The sale of an item of tangible personal property, for example, could be used as the triggering event.

Financial and Philanthropic Benefits

For donors with highly appreciated assets, even a small amount of philanthropic intent can be combined with substantial tax and financial benefits to make a charitable remainder trust attractive. For donors with large charitable intent, a charitable remainder trust and its benefits will allow a much larger gift than the donor might have thought possible. Planners may not have been talking about charitable remainder trusts as much in the past decade. Now is the time to bring charitable remainder trusts to the forefront of conversations about highly

Using CRTs to Plan for Retirement

Q: This all sounds good but right now I don't want or need any additional income that would be subject to high income tax rates. While I could use additional income when I retire in 15 years, I really need more tax deductions right now. What can a CRT do for me?

A: Your situation is similar to that of many successful persons in the prime of their careers. They have exhausted all traditional tax-advantaged retirement-savings options but are not sure that what they have set aside will be enough. Some unique features of CRTs make them particularly useful for retirement planning purposes.

First, you can add provisions to CRTs so that the annual distribution will be made only to the extent the trust has income (a net income charitable remainder unitrust). ***Note:*** "Income" as defined by state law generally means elements taxed as ordinary income (such as dividends, interest and net rents) or as tax-exempt income—and can include capital gain if the trust so specifies and state law permits. Planned properly, a CRT can be set up and invested so as to produce little or no current income.

This allows the trust to grow much more rapidly, increasing the distributions you will receive when the trust does start generating income. When income is needed in the future, the trust can change investments and sell appreciated assets to create capital gain that can be distributed to you.

A fairly recent development in the law allows you to create a trust that starts out as an "income only" trust and then converts, or "flips," to a trust that pays out the stated unitrust percentage at some point in the future, regardless of the actual investment results of the trust.

Note: This kind of "flip" trust may work even better than an "income only" trust: The trustee will not have to worry about being able to generate sufficient "income" when the time to start distributions arrives. In fact, the trustee will be able to invest in a balanced portfolio that is likely to generate a higher total return in the long run than one that is invested for high current income.

Avoid Capital Gain Tax: Create Income That Can Grow

Profile: Ted and Mary, both 67, have recently retired. They have a number of stock investments that have appreciated but pay no dividends. Now that they are retired, they would like to increase their annual cash flow.

Ted and Mary's Story: About five years ago we bought shares in a company we believed had a great future. It turns out that we were right, and now the stock is worth twice the $125,000 we paid for it. When we retired, we talked about selling it and reinvesting the proceeds to produce income because the stock pays no dividends. We were discouraged to find out that $18,750 of our $250,000 selling price would go to pay capital gain tax.

We have always wanted to make a significant gift to Pomona College, so we decided to talk with their planned giving representatives to see if they had any ideas that could help us.

When we found out that we could avoid the capital gain tax on the initial transfer of the stock to a charitable remainder unitrust, it sounded really good to us.

Because the unitrust is tax-exempt, it can sell the stock and not owe any tax. This means the entire $250,000 value of the stock will stay at work for us, producing another source of cash flow.

Further, our income will grow if the value of the trust increases. At 67, we plan to live a long time. We decided on a 6% unitrust payment. The first year the trust will pay us $15,000; but if the trust is able to obtain an average total return of 8%, our distribution will be almost $20,000 fifteen years from now. We also get to deduct more than $75,000, saving us over $25,000 in taxes.

Analysis: Ted and Mary found themselves in a classic "locked in" position in their investment. They wanted to convert the value of the investment to a source of income but faced heavy capital gain tax if they did so.

One of the most attractive features of the charitable remainder unitrust is the potential for income growth. If the value of trust assets goes up, so does your income. This is especially important to relatively young donors like Ted and Mary. Of course, in any given year trust assets could decline in value, resulting in a decline in income the following year.

appreciated assets or other assets that would be addressed by a trust.

These illustrations show the real financial benefit of a charitable remainder trust—the ability to reinvest and generate income from the pretax value of the property contributed to the trust. In the case of a zero basis asset, the present value of the tax savings from the charitable remainder trust and the larger income stream can exceed the present value of a taxable sale of the property. As the donor's basis increases, the financial benefit of the charitable remainder trust declines. But it must be kept in mind that the charitable remainder trust provides a substantial gift to charity.

"Do you have a minute to talk about your retirement years?"

A Plan That Will Make You Flip: Supplementing Future Retirement Income

Profile: Carol, 50, has a successful medical practice. She doesn't need or want any additional income now but would like to find a tax-advantaged way to create more retirement income.

Carol's Story: In addition to the rewards of helping others, Carol's profession has allowed her to earn a comfortable living. She tries to take advantage of all available opportunities to make tax-deductible contributions to retirement plans, but worries that may not be enough.

She wanted to do something that would eventually benefit Pomona College and help secure her retirement. She knew about life-income gifts but didn't want more income right now. She is pleased to be able to make contributions to a trust that will grow until she retires and then start making payments to her.

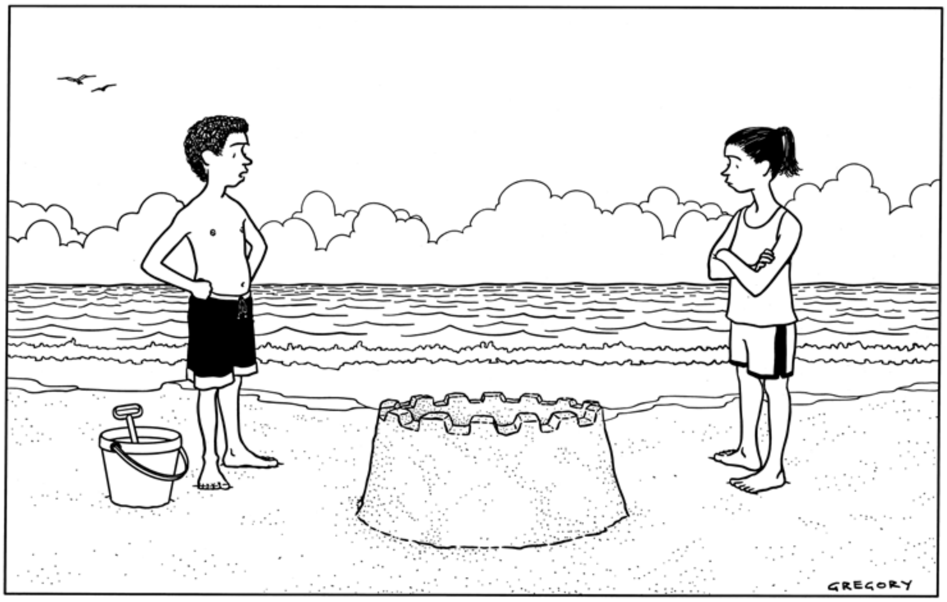
She plans to contribute $100,000 initially and then add $20,000 to the trust every year until her retirement. The contributions will be to a special kind of charitable remainder unitrust that will make payments to her only if it has income—basically meaning interest or dividends—until she retires. Then, the unitrust will convert, or "flip," to a unitrust that will pay her 5% of its value each year, regardless of the amount of income the trust earns.

She plans to invest her contributions primarily in stocks paying minimal dividends, so any distributions from the trust will be very small. Even better, she thinks these are the kinds of investments that have the best chance to grow, which will mean more income at retirement when she needs it.

If the trust appreciates in value at a rate of 7% per year, it will grow to more than $750,000 by the time she retires. This means her income that first year will be about $37,500 and will continue to grow as she gets older. Along the way, she will be able to take about $124,000 in deductions, saving her more than $40,000 in taxes assuming her tax rate remains at 33%. If she lives her normal life expectancy, and the rate of return continues, Pomona College could receive $1 million.

Analysis: Carol is dealing with a dilemma faced by many successful professionals who have made maximum allowable deductible contributions to traditional retirement plans—but still want to make additional tax-favored contributions that will produce income at retirement.

A "flip" unitrust may be the answer for many. It starts out with special "income only" provisions to last until some preselected point in the future—often the anticipated retirement date. Until that time, the trust will make only distributions of "income"—normally defined as interest and dividends. Once it "flips," the trust pays the stipulated unitrust percentage. This can be paid out of income, capital gain or principal.



"I hope we can flip it before the tide comes in."

FROM THE DIRECTOR:

Trusts: A Little Dusty? Perhaps, but Useful Too!

Pomona College is well known for being a leader among institutions of American higher education in the area of life-income gifts. We are perhaps best known for our gift annuity program because of the unique combination of higher rates and financial security that we offer to donors inclined to support Pomona's educational mission.

Over the past year, however, there has been a kind of "perfect storm" of factors that have led to a resurgence of a trusty old life-income friend, the charitable remainder trust (CRT). This past year, several younger donors (by which we mean under the age of 75) availed themselves of this opportunity. What gave rise to this? Three things in particular—the rising value of real estate, the new Medicare-related Net Investment Income Tax and other capital gain tax increases, and the impact of the low IRS discount rate on annuity rates. This has lead to interest in a particular variant of the CRT known as a flip unitrust that allows us to accept an illiquid asset, such as a home, and hold it temporarily while it is being sold to fund what will become a standard unitrust after the sale.

With this increased interest, we thought it would be good to publish a more extensive review of the CRT. To help us, we have turned to a good friend of the *Pomona Plan*, attorney Reynolds Cafferata. Reynolds is a partner at Rodriguez, Horii, Choi & Cafferata LLP in Los Angeles. The firm focuses on tax-exempt organizations and California taxes and Reynolds' practice is concentrated in the area of charitable tax, trust and corporate law. He also represents charities and fiduciaries in contested probates and judicial reformation of trusts and provides guidance for managing charitable trusts, so he is quite expert in the area of CRTs.

I will offer a little more background on our guest author. Reynolds received his B.A., *summa cum laude*, from The George Washington University and his J.D., Order of the Coif, from USC Law. He is a member of the USC Tax Institute Planning Committee. He has been named a "Super Lawyer" by *Los Angeles Lawyer* and a "Best Lawyer" in nonprofit/charities law by *The Best Lawyers in America* and the 2011 Lawyer of the Year, Trust and Estates, Los Angeles. He is a fellow of the American College of Trust and Estate Counsel and has been involved in many other business and community organizations, including the Los Angeles County Bar Association and the Altadena Historical Society.

I hope that you will enjoy and learn from Reynolds as he "dusts off" the CRT. When the dust settles, perhaps you will find that it offers some opportunities for you, too.

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