

By Robert T. Napier

Kill the CRTs

In better times, charitable remainder trusts were popular income and estate planning tools. In trying economic times with low tax rates, many should be terminated early

In what kind of *Alice in Wonderland* world might clients be better off destroying good things like charitable remainder trusts (CRTs)?

Answer: in the down-the-rabbit-hole world where we find ourselves these days.

Here are three good reasons why we should be saying "off with their heads" to many CRTs now:

- **Terminating a CRT prematurely should make a charity happy.** You may think that charities would be quite content to wait until CRTs died a natural death. You would be mistaken. Call your favorite charity right now and ask the fundraiser who answers the phone which she'd prefer—the potential of receiving a possibly larger dollar amount in the future or the certainty of receiving funds immediately?

Of course, she's going to say she prefers the certain, immediate gift over the uncertain future gift.

Why is the future gift uncertain? Isn't death a certainty?

Most grantors retain the power to change the ultimate remainder beneficiary of their CRTs. If a charity is currently named as the remainder benefi-

ciary of a CRT, it typically has no assurance that it will still be named as a remainder beneficiary when the CRT terminates; another charity the grantor meets in the future may have overtaken the grantor's heartstrings.¹

Also, the CRT's payments to the grantor may make it unlikely that CRT funds will last until the time comes for distribution to the charity. Indeed, CRTs established with an annual payout to the grantor that is currently significantly greater than the projected future earnings of the CRT may not have any funds remaining to distribute to the charity.

You also have to think that the fundraiser on the other end of the phone has a quota to meet for revenue to the charity employing her. That fundraiser likes job retention as much as the next person and would be delighted to receive funds immediately.

Rare is the charity that cannot currently put funds to work. From an economic perspective, receiving the present value of funds is at least as appealing as receiving the future value of those funds later. It may be even more appealing in this economic environment, because the charity may feel as poor as the grantor currently does.²

Immediate extra cash would be embraced by many charities because many are hurting right now. Investments have taken a hit. Donations are down. Endowments have dropped.



Robert T. Napier is a partner at Robert T. Napier & Associates, P.C., in Chicago

In an early CRT termination, the charity eliminates the investment risk that it is exposed to while the CRT is alive and kicking. A dollar in a CRT one year ago may be worth a fraction of that today. Given the material diminution in asset values, the charity may be understandably disenchanted with the trusteeship of many CRTs.

But suppose the grantor is an introvert who's reticent to call his favorite charity and ask about receptivity to an early termination. What's a grantor like that do? If the CRT document allows it, he can transfer his remainder interest to a supporting organization (SO). But beware, since the Pension Protection Act became law, most SOs (particularly Type IIIs) have become the redheaded stepchildren of charitable planning.¹ (See "Not SO Bad: The proposed regulations for Type III supporting organizations could have been worse. Still, one new requirement may be disastrous," by Gerald B. Treacy, Jr., p. 54).

Previously, the Internal Revenue Service allowed CRTs to be prematurely terminated and the remainder interest transferred to the grantor's private foundation. But Private Letter Ruling 200614032 put an end to that practice.⁴ As an alternative, grantors might consider funding a donor-advised fund with their CRT's remainder interest.⁵ This alternative keeps investment advisors happy, because they continue managing nearly the same amount of assets before and after the termination.

• **Killing a CRT should make its creator happy.** What? The creator is now the destroyer? Yes. Chances are the CRT was built in better times. The grantor may have been feeling flush and generous when the CRT was created. The grantor may have created his CRT when capital gains rates were in the neighborhood of 28 percent. The grantor may have formerly lived in a high tax state or municipality.

So where is the grantor today? Chances are he's poorer and would like to have some of the CRT funds back.⁶ The grantor may have retired to warmer climates, places like Florida, Texas or Nevada. Those locations, and others, have low or no state

and local income taxes.

Chances are that the grantor is no fool; he had the wherewithal to amass significant wealth and the sophistication to build a CRT. This grantor, then, can sense one or more imminent tax increases coming his way. President Obama has promised⁷ a federal capital gains tax of at least 20 percent. Illinois residents have the prospect of an income tax increase of perhaps 50 percent.

If that's the case, why not kill the CRT now, before these tax increases land in the grantor's lap like a wet St. Bernard? Terminating the CRT now will cause the present value⁸ of the unitrust or annuity interest⁹ to be treated as taxable income for state and federal tax purposes. Also, because CRT asset values have likely plummeted, incurring the tax currently makes even more economic sense.

So, yes, the grantor should be happy to end his CRT because he'll obtain the CRT assets now. He'll avoid the coming federal income tax increase;¹⁰ he'll avoid the coming Illinois tax increase (or avoid any state income tax entirely if he has fled a high tax state).¹¹ After killing the CRT, chances are the grantor will feel better about his balance sheet.¹²

• **Ending the CRT won't upset the IRS.** On numerous occasions, the IRS has issued PLRs approving of early terminations.¹³ The IRS has not generally concluded that the early termination of a CRT is an act of self-dealing nor does it mean a termination tax is due. Of course, the IRS could and should challenge any CRT termination that was conceived as a step-transaction in an effort to arbitrage tax rates or otherwise exploit the rules. And remember that while grantors and charities are feeling poor and favorably disposed to current liquidity, the government is in the same position—if not more so.¹⁴

The U.S. Treasury is delighted to receive more tax revenue now. Just as charities enjoy receiving the assets immediately (and eliminating the investment risk, the risk of unforeseen longevity, and the risk of being replaced by a younger or better-looking charity of the future), early CRT termination allows

the IRS to collect currently and to eliminate the risk of the grantor dying prematurely. In that regrettable situation, the IRS would helplessly watch the CRT terminate without the government even getting its beak wet.¹⁵

It should be noted that if you're terminating a CRT established for the lifetime of one or more individuals, the written opinion of each individual's normal life expectancy from a medical doctor is required.¹⁶ Termination of CRTs with infirmed or older measuring lives is generally impractical. Note that early termination of a CRT still can make sense if there are multiple lifetime beneficiaries and one of them is materially younger than the rest.

The IRS generally doesn't see a CRT's early termination as an act of self-dealing nor has it found that a termination tax is due.

Start Running

Time is not on the side of the CRT grantor. The grantor will not know that he has the CRT early termination option¹⁷ unless his charity or his advisors tell him. Failure to immediately terminate a CRT may effectively be tantamount to the grantor affirmatively choosing to pay higher taxes on the future distributions to him.

Rather than accelerating income in a low tax rate environment and benefiting a charity now, failure to terminate a CRT may be choosing to defer income to a higher tax rate environment and completely depriving a charity.

It may seem illogical to chop off the heads of CRTs that once upon a time were so lovingly crafted. But, in this economic environment, it makes the same kind of sense as the Red Queen's race. As the Queen of Hearts explains to Alice in *Through the Looking Glass*: "Now, here, you see, it takes all the running you can do, to

keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!" □

Endnotes

1. See Katrina, *burial case*.
2. The Giving USA Foundation recently reported that charitable gifts in 2005 decreased by 2 percent. The last decline in giving was 1987. See *Giving USA 2006: The Annual Report on Philanthropy for the Year 2006*. <www.givingusainstitute.org/gusa/give_foundation.cfm>.
3. The author apologizes to all rehearsed stepchildren but admits to having four reneaded children of his own.
4. Private Letter Ruling 200614032 revoked PLR 200625014 regarding concerns of self-dealing. Note that some charitable remainder trusts (CRTs) have language prohibiting distributions to private foundations anyway, so that the initial funding of the CRT would have afforded greater income tax benefits to the grantor.
5. Some donor advised fund managers are hesitant to play a part in CRT terminations, but many are willing and knowledgeable.
6. Academics have observed that the emotional pain of a financial loss is at least twice as great as the emotional pleasure of an equivalent gain. This phenomenon is called loss aversion and at least partly explains morose planning attitudes.
7. Or threatened, depending on your point of view.
8. The Internal Revenue Code Section 7520 rate for the month of termination, as opposed to the month of creation, is the relevant figure to use in making this calculation.
9. If the CRT is a net income make-up charitable remainder trust (NIMCRUT), the annual payout for future years is unknown. Accordingly, the present value of the retained undistributed interest is determined using a "reasonable method." Several PLRs (200809044, 200816033, 200817039, 200827009, 200833012 and 200912036) have stated that a reasonable method is pegging the annual payout in a NIMCRUT termination at the lesser of (a) the annual payout percentage stated in the NIMCRUT agreement, and (b) the IRC Section 7520 rate for the month of the NIMCRUT termination. Thus, if the NIMCRUT uses an 8 percent annual payout but the Section 7520 rate for the month of termination is 5.6 percent, the present value of the retained interest is calculated using the 5.6 percent.
10. Note that the grantor will be treated as having no basis in the assets he receives from the CRT. The distribution to the donor is governed by IRC Sections 1001 and 1015, which treat the distribution as the sale of a term interest by the donor in which the donor's basis is disregarded.
11. IRC Section 1001(e) seemingly suggests that a simultaneous sale of a trust or annuity interest and the remainder interest to a third party will be a tax-free transaction. In Notice 2008-99, 2008-47 IRB (Nov. 24, 2008), the Internal Revenue Service listed as a "transaction of interest" a transaction involving the sale of interests in a CRT used to avoid capital gains taxes on assets transferred to a CRT. The grantor and remainder beneficiary then sell

their interests in the CRT, and the grantor claims that no gain is recognized on the sale. Persons entering into this transaction on or after Nov. 2, 2006, must disclose the transaction as described in Treasury Regulations Section 1.6011-4. Advisers who make a tax statement on or after Nov. 2, 2009, regarding transactions entered into on or after that date have disclosure and tax maintenance obligations under IRC Sections 671 and 672.

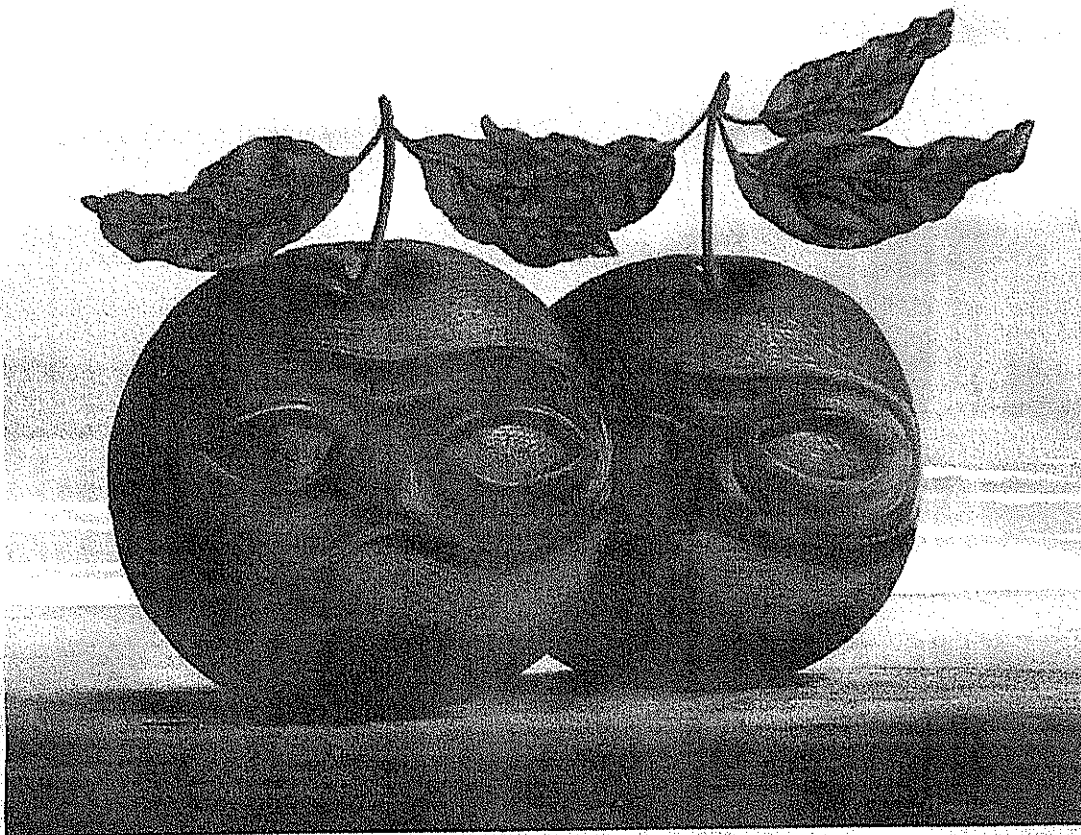
12. Chances are the federal and local governments will still feel broke.
13. PLRs 200846037; 200841041; 200935012; 200920009; 200807059, and 200916033. But in Revenue Procedure 2009-3, the IRA has decided to stop issuing PLRs on the topic. This is presumably in response to the issues raised in endnote 11, *supra*.

14. The Illinois attorney general is a helpful resource in early CRT termination. The AG seems to acknowledge the immediate benefits to charity and perhaps the concept that local charities are likely to benefit, as opposed to the possibility of charities located in the grantor's future state of domicile.

15. The author apologizes to the readers of *The Spectrum*.

16. See Regs. Secs. 1.642-2(c) and 1.642-4¹ addressing the use of new actuarial tables for transactions on or after May 1, 2009.

17. The procedure for early termination of CRTs is described in Robert T. Napper and Rita F. Lane, "Charitable Trusts and Charitable Remainder Trusts—Built to Be Broken Too?" *Exempt Securities* (October 2005) at pp. 81-86.



SPOT LIGHT

Playtime! René Magritte's gouache on paper "La Valse Hésitation," about 26 centimeters by 35 centimeters and painted in 1955, sold for \$962,500 at Sotheby's auction on Nov. 4, 2009 in New York.