Finseca Report
Marketplace

This Finseca Report Marketplace was prepared exclusively for Finseca Influencer members by Jonathan M. Forster, Partner & John F. DeStefano, Associate at **BakerHostetler.**

What comes around goes around – Charitable Remainder Trusts and wealth replacement life insurance return to the spotlight

Market trend

President Biden and Congressional Democrats have made clear that wealthy Americans should expect higher income taxes. In response, clients are looking to their advisors for creative planning options to manage their future income tax liability. Charitable remainder trusts ("**CRTs**") are moving up the list of advisor recommendations and becoming part of more client conversations. Such trusts are often complimented by life insurance as part of a more tax efficient wealth replacement plan.

Synopsis

The American Families Plan announced by President Biden, the "For the 99.5% Act" proposed by Senator Bernie Sanders, and the "STEP Act" set forth by Senator Chris Van Hollen all aim to raise more revenue from wealthy individuals through higher taxes on both ordinary and capital gain income, and by taxing unrealized capital gains on assets transferred at death. This potential sea change has shifted legacy planning to include more discussions around income tax planning.

In that light, a charitable remainder trust presents a unique value proposition to clients in the form of flexible retained cash flow, an immediate income tax charitable deduction, and a future gift to charity. Clients who are charitably inclined and who are sensitive to recently proposed tax increases may find CRTs particularly compelling. CRTs come in a variety of forms and choosing the right structure depends on each client's particular circumstances and asset mix.

This article highlights aspects of the leading proposals for future tax legislation, summarizes the different types of CRTs using examples, and provides a case study that demonstrates how a CRT may be utilized to achieve a client's charitable and income tax planning objectives.

Take-aways

As part of their comprehensive legacy plan, clients who are charitably inclined, hold significant highly appreciated assets, and wish to create a lifestyle "annuity" should consider a CRT, especially if they can benefit from an income tax charitable deduction. Selling an appreciated asset inside a CRT may provide an economically superior result compared to selling the same asset in a client's own hands, especially when done in conjunction with purchasing additional life insurance through an irrevocable life insurance trust ("**ILIT**").

Looking into the crystal ball – What could taxes look like in the future?

The American Families Plan

On April 28, 2021, President Biden announced the $1.8 trillion American Families Plan, which aims to enhance educational, health care, paid leave, and child care benefits for middle-class America. To finance the plan, the Fact Sheet released by the White House includes the following changes to individual income taxes and wealth transfer taxes:

- Increase the top marginal individual income tax rate from 37% to 39.6%.
- Increase the capital gains tax rate from 20% to 39.6% (plus the 3.8% net investment income tax for a total of 43.4%) for households making over $1 million.
- Eliminate the basis "step-up" at death, i.e., wealth transfers at passing become an income taxable event.
- Grant a $1 million gain exclusion per individual for wealth transfers at passing ($2.5 million per married couple, including the $500,000 gain exclusion for the sale of a primary residence).
- Taxing carried interest at ordinary income tax rates.
- Limit Section 1031 "like-kind exchanges" of real estate to $500,000 of gain.

The proposed gain recognition at passing does not apply to assets left to charity. Notably absent from the plan are an increase in the transfer tax rate and a reduction in the transfer tax exemption, both of which were often discussed as likelihoods. It is certainly possible that these may be added to the actual legislation, especially considering the proposals put forth by Senators Sanders and Van Hollen. Release of the so-called "Green Book" will add to the picture as well.

For the 99.5% Act

Senator Bernie Sanders's "For the 99.5% Act" goes further regarding transfer taxes. It proposes to:

- Increase the estate, gift, and generation-skipping transfer ("GST") tax rates from 40% to 45%, up to 65%.
- Reduce the estate and GST tax exemption from $11.7 million (as of 2021) to $3.5 million, and the gift tax exemption from $11.7 million (as of 2021) to $1 million.

- Limit the GST tax exemption benefit to 50 years.
- Limit aggregate annual gift tax exclusion transfers in trust (including to irrevocable life insurance trusts) to $30,000 per year.
- Eliminate valuation discounts for non-active businesses transferred to family members if the family holds at least 50% of the vote or value.
- Include "grantor trusts" in the grantor's gross estate for estate tax purposes.

STEP Act

On March 29, 2021, Senator Chris Van Hollen, a member of the Senate Budget Committee, announced the Sensible Taxation and Equity Promotion (STEP) Act of 2021, which aims to:

- Treat non-charitable gifts, transfers to non-grantor trusts, and transfers at passing as income taxable events.
- Grant every individual a $1 million gain exclusion, plus a $500,000 exclusion for the transfer of a personal residence.
- Allow income taxes paid under the proposal to be deductible against future estate taxes.
- Maintain that charitable gifts do generally not trigger gain.
- Curb transfer tax planning benefits from GRATs and grantor trusts through various changes.

Charitable Remainder Trusts

What is a charitable remainder trust?

A CRT is an irrevocable trust designed to provide income to its creator, then its remainder to charity. The appeal is the CRT is in effect tax-exempt, allowing for highly appreciated assets to be sold by the trustee and reinvested tax-free. This allows for tax-free portfolio diversification while ensuring that the income to the trust creator is maximized. The creator receives an upfront income tax charitable deduction upon funding the CRT. The CRT assets are outside of the client's estate for estate tax purposes. These are compelling benefits, making CRTs a very popular tool during times of high income tax rates.

Which clients should consider a charitable remainder trust?

A CRT may be an appropriate planning tool if the advisor answers "yes," to the following questions:

- Is the client charitably inclined?
- Can the client utilize an income tax charitable deduction?
- Does the client have an appreciated asset that is expected to be sold?
- Does the client want to retain cash flow after the asset is sold?

CRTs come in a variety of forms and there is no one-size-fits-all solution. Choosing the right structure depends on the client's particular needs and goals. A brief review of the CRT variations follows.

CRAT – Charitable Remainder Annuity Trust

A CRAT pays a fixed annuity amount back to the grantor. The annual annuity payment must be between 5% and 50% of the fair market value of the assets initially contributed to the trust. A CRAT works well when a client is able to fund the trust with marketable securities and wants predictable, stable cash flow returned in the form of an annuity.

For example, if a client contributes $5 million to a CRAT with a stated annuity amount of 5%, then the client would receive an annual annuity of $250,000 for the entire term of the trust. At the end of the term, any remaining assets in the trust pass to the designated charitable beneficiaries.

CRUT – Charitable Remainder Unitrust

A CRUT pays the grantor a fixed percentage of the fair market value of the trust's assets *valued on an annual basis*. Unlike a CRAT, the amount distributed back to the grantor varies from year to year, which can work as an inflation hedge (and may in fact, be needed in today's market).

For example, if a client contributes $5 million to a CRUT with a payout percentage of 5%, and the assets appreciate in value to $6 million in year 2, the trust would distribute $300,000 to the client in year 2 (5% x $6 million). If in year 3 the trust assets appreciate to $7 million, the trust would distribute $350,000 to the client. If in year 4 the trust assets decrease in value back to $6 million, the trust would distribute $300,000.

NICRUT – Net Income Charitable Remainder Unitrust

A NICRUT pays the grantor the lesser of the trust's net income or the stated payout percentage. Note that a standard CRUT's payout is based on the fair market value of the entire trust, not the trust's income, so satisfying the payout presents a challenge if the trust assets are illiquid or do not produce sufficient income to cover the distribution amount. A NICRUT solves that problem by limiting the trust's distribution to net income in a particular year, if less than the payout percentage, making NICRUTs attractive for clients who want to fund a CRT with business interests.

For example, if a NICRUT with a payout percentage of 5% holds an asset worth $5 million, and the asset does not generate any income in a particular year, the trust would distribute $0 back to the grantor for that year (not $250,000).

NIMCRUT – Net Income Make-up Charitable Remainder Unitrust

A NIMCRUT functions similarly to a NICRUT but includes an additional provision that allows net income above the percentage payout to be distributed to the extent of shortfalls in prior years. Compared to NICRUT, a NIMCRUT increases the overall amount of income that can be distributed to the grantor, making NIMCRUTs attractive to clients who want to maximize a CRT's income benefit or defer income until retirement years.

For example, if a NIMCRUT has a value of $5 million and a payout percentage of 5%, and the trust's net income is $100,000, the trust would distribute $100,000 back to the grantor and accumulate a "make-up" of $150,000. If the trust's value stays the same the following year but the trust generates $350,000 of income, the trust would distribute the full $250,000 payout percentage plus an additional $100,000 of the accumulated make-up, leaving $50,000 of accumulated make-up to be applied if net income exceeds the percentage payout in future years.

Depending on the trust agreement and default state law, trustees may have discretion to allocate receipts between trust income and trust principal, which provides additional flexibility to increase or decrease distributions back to the client year to year.

FLIPCRUT – NICRUT or NIMCRUT that "Flips" to a Standard CRUT

Finally, a FLIPCRUT is a NICRUT or NIMCRUT for an initial period, which then "flips" to a standard CRUT after a designated term of years or specified triggering event, such as the sale of a particular asset. In effect, the client can defer receiving payments until a future date. This structure provides a client with the ability to retain an illiquid or non-income producing asset in a CRT, then begin receiving regular unitrust payments after the asset is sold or begins to generate income.

Case Study

Assuming the American Families Plan becomes law as of January 1, 2022, the following case study compares results under two scenarios: selling an appreciated asset in the client's hands versus selling the asset inside a FLIPCRUT.

Facts

Husband and wife are both 62 years (with a 25-year joint survivor life expectancy). They own a business interest currently valued at $5 million which they expect to sell at the end of next year for $10 million. Their legacy planning goals include charitable giving and maintaining cash flow after the business is sold.

Straight Asset Sale

Assuming the clients retain the asset and sell it next year for $10 million, they will incur a $4.34 million income tax (43.4% total rate x $10 million gain, assuming $0 basis) and net $5.66 million from the sale. If they reinvest the net sales proceeds in the form of an ordinary annuity earning a 5.5% annual return for 25 years (their life expectancy), they would receive approximately $439,000 each year, for a total of approximately $10.1 million.

Utilizing a FLIPCRUT

Assume the clients gift the $5 million asset in May 2021 to a joint-survivor FLIPCRUT structured to "flip" the year after the asset is sold into a CRUT with an 8% percentage payout. They would receive an immediate income tax charitable deduction of approximately $742,000, and when the asset is sold in year 2, no taxable gain would be recognized because the sale occurs inside the tax-exempt CRT. From years 3 through life expectancy (year 25) the CRUT will distribute 8% of its annual value, which, assuming the $10 million net sales proceeds are reinvested at a 5.5% annual return, will be approximately $800,000 in year 3, $777,000 in year 4, and so on to $421,000 in year 25, for a total of $13.6 million. The CRT remainder projected to pass to charity at the end of the clients' lifetime is approximately $5.1 million.

To replace the wealth passing to charity, the clients create an ILIT and use the "found savings" from the income tax charitable deduction to purchase a survivorship life insurance policy.

Comparing the Results

Utilizing this approach produced an additional $3.5 million of cash flow to the clients - and created a $5.1 million benefit to charity without reducing the total legacy passing to the clients' descendants thanks to wealth replacement life insurance purchased by through the ILIT (see Table 1 below).

Table 1. Results comparison assuming American Families Plan becomes law

	Sale by Clients	Sale Inside FLIPCRUT
Income Tax on Sale of $10 million Asset	$4.34 million	$0
Total Receipts on Reinvested Net Sales Proceeds (5.5%; 25 yrs)	$10.1 million	$13.6 million
Charitable Deduction	$0	$742,000
Amount Passing to Charity	$0	$5.1 million
Wealth Replaced through ILIT	$0	$5.1 million

Take-aways

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