

Sales Strategy

Monthly publication describing timely and useful sales ideas and concepts.

THE CHARITABLE REMAINDER TRUST

INTRODUCTION

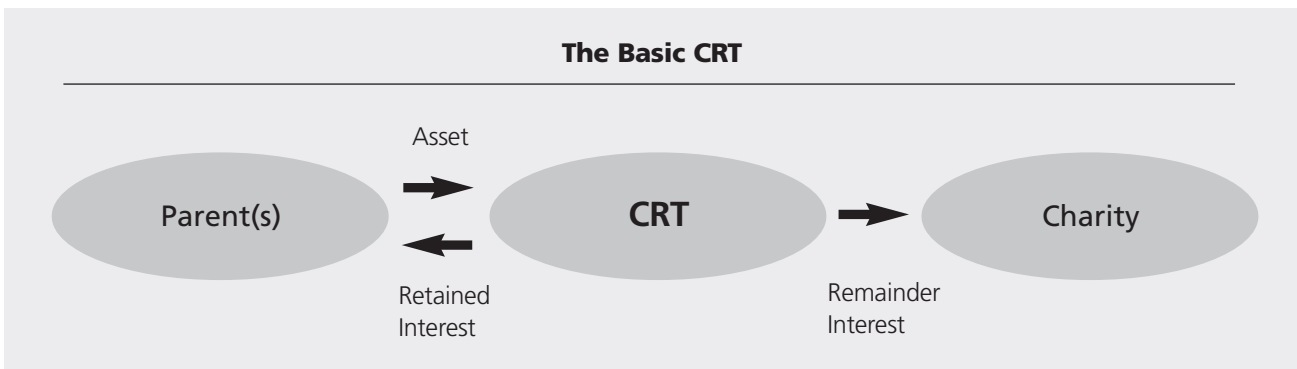
Understanding the Basics – Charitable Remainder Trust (CRT) Defined

A CRT is an irrevocable trust¹ established for the benefit of a named (or to be named in the future) charitable beneficiary. The trust is tax-exempt and can be established to last for one or more lifetimes or for a term not to exceed 20 years. Operationally, a CRT includes three key components: (1) an Asset; (2) a Retained Interest; and (3) a Remainder Interest.

The Asset. The asset is irrevocably transferred to the CRT. What kind of asset? A highly appreciated, low basis, low yield asset such as stock or real estate is the optimum asset for the CRT transaction. However, other types of assets may also provide substantial benefits.

The Retained Interest. Even though the asset is irrevocably transferred away to the CRT, the donor retains an income interest in the CRT. In short, the CRT is required to provide an income-stream back to the donor, usually over the donor's lifetime (and often over his or her spouse's lifetime also). In many instances, the retained interest will dramatically increase the donor's cash flow.

The Remainder Interest. Whatever is left in the CRT at its termination is distributed to the charitable beneficiary.



BENEFITS OF THE CRT

The donor enjoys a number of tax and non-tax benefits from the CRT transaction

Capital Gains Tax Avoidance. The CRT is a tax-exempt entity. The perfect asset for the CRT is a highly appreciated asset (e.g., A mother and father purchased a building for \$100,000 which is currently worth \$600,000). By transferring a highly appreciated asset to a CRT, the CRT trustee can sell the asset, pay no capital gains tax, and thereby preserve the entire principal to fund the donor's retained interest and provide a future gift to charity.

Charitable Income Tax Deduction. The government has provided taxpayers with tables to calculate what should be left for charity at the termination of the CRT. The calculated value of the future gift is based on the donor age(s), the value of the retained interest, and the government's current interest rate assumption. If a donor is 55 years old, and retains a 10% income

interest in the CRT, the government tables (based on current interest rate assumptions) calculate what should be left for charity at the donor's death. The donor receives an immediate income tax deduction equal to what "should" be left based on the government tables. This deduction has some Adjusted Gross Income (AGI) limitations, but can be carried forward for five years.

Taxable Estate Reduced. Because the asset has been irrevocably transferred, the asset no longer will be part of the donor's taxable estate. Of course, the retained interest payments will increase the donor's estate over time, unless they are consumed or given away by the donor.

Increase Yield on Assets. The donor can often retain a greater income stream from the CRT than the asset was providing prior to the CRT transaction (e.g., the asset yielded 7% prior to the transfer and the donor retains a 9% income-interest from the CRT). The CRT trustee can either dip into principal to fund the difference, or can sell the asset transferred to the CRT and reinvest the proceeds in higher yielding assets without triggering capital gains tax. Additionally, in the early years of the CRT the donor often enjoys increased cash flow due to the charitable income tax deduction.

Substantial Benefit to Charity. Not only does the CRT provide the donor with a number of substantial tax benefits, it can also provide a substantial benefit to the charitable beneficiary.

In short, the CRT is a "win-win" for all parties involved:

- The donor receives tax benefits and the satisfaction that comes with making a charitable gift.
- The government enjoys the benefit of an increase in private sector giving, reducing its burden.
- The charity receives a generous gift of support.

Wealth Replacement Through the Irrevocable Life Insurance Trust (ILIT). In addition to the tax and non-tax benefits outlined above, a CRT transaction can often be structured in a way that ultimately unites the family, despite the substantial charitable gift. Family wealth replacement is often accomplished by creating a wealth replacement ILIT. Parents can replace the value of the asset by funding life insurance in an ILIT for the benefit of family members.

CRUTS VS CRATS

There are two primary types of CRTs:

- the Charitable Remainder Unitrust (CRUT) and
- the Charitable Remainder Annuity Trust (CRAT).

When a CRUT is used, the retained interest equals a stated percentage of the trust value each year (e.g., donor retains a 6% income interest from the CRUT each year). The CRUT assets need to be re-valued each year to determine what the donor will receive. This is not a big problem where the assets are easy to value (e.g., marketable securities), but it can become costly where the assets are difficult to value (e.g., closely held stock). The CRUT protects the donor from inflation and can provide the donor with what has been called "positive arbitrage" where the CRT earns a return greater than the IRC Section 7520 rates (i.e., the government's current interest rate assumption). This makes the CRUT perfect for highly appreciating trust assets. The downside of the CRUT is that the donor is exposed to negative fluctuations in the value of the trust assets. If predictable CRT income is critical to the donor, a CRAT may be a better choice.

When a CRAT is used, the donor receives a fixed amount each year (e.g., \$100,000). No matter how the trust assets perform, the donor receives his or her annuity interest, even if the CRT trustee has to use trust principal. The CRAT protects the donor from negative fluctuations in the value of trust assets, but eliminates the possibility of positive arbitrage and does not provide a hedge against inflation.

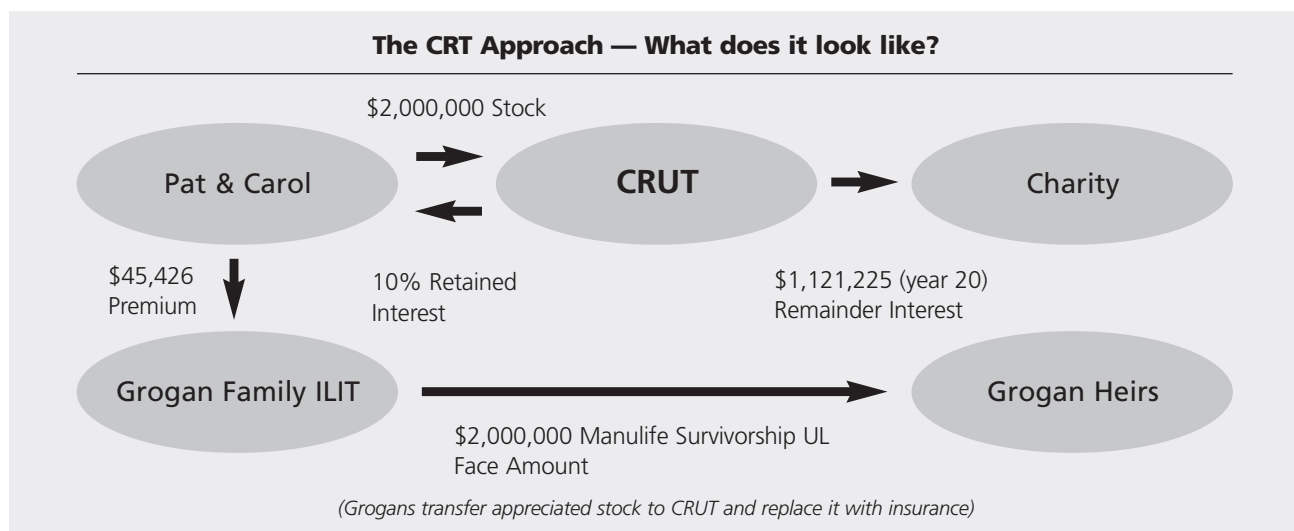
PERCENTAGE PAYOUT TESTS FOR CRTS

As a part of the 1997 tax act, the government adopted new requirements on the payouts that can be made from charitable remainder trusts. The changes came in response to the fact that under the prior rules, it was possible to create a CRT in which the charity's remainder interest was negligible.

- **Ten Percent Minimum Charitable Remainder** – One of the requirements enacted in 1997 was that the present value of the charitable remainder interest must be at least 10% of the net fair market value of the contribution, at the time the contribution is made.² For CRATs, this test is applied only once, when the trust is funded. For CRUTs, the test is applied to the initial contribution to the trust and to any additional contributions that are made. This rule can prevent some younger donors from being able to establish a qualifying CRT.
- **Five Percent Minimum Payout** – A CRAT must pay a specified amount each year to a designated noncharitable beneficiary or beneficiaries. The minimum amount is 5% of the fair market value of the property contributed to the trust, as of the date of contribution. A CRUT must pay out annually at least 5% of the net fair market value of the trust, and the test is applied annually to the revalued assets. A percentage higher than 5% can be used for the income payout, as long as all of the other qualifications for CRTs are met.³
- **Fifty Percent Maximum Payout** – The maximum payout income percentage for CRATs and CRUTs is 50% of the initial fair market value of the trust principal in the case of a CRAT, and 50% of the annually revalued principal for a CRUT.⁴ This rule is designed to prevent acceleration of payments in a short-term CRT.

PUTTING THE CRT TRANSACTION TOGETHER – PAT AND CAROL GROGAN

The best way to clearly understand the true tax magic created by the CRT is by example. Pat and Carol Grogan are ages 71 and 69, respectively. They have a residence worth \$500,000, a block of stock worth \$2,000,000 (\$300,000 basis), and other assets worth \$3,000,000, for a total net worth of \$5,500,000. Pat and Carol have begun their estate planning process. They are interested in incorporating some charitable giving into their overall plan. Their lawyer, H. Joseph Price, Jr., has recommended that they consider creating a CRUT and fund it with the block of highly appreciated stock. The Grogans were intrigued by the suggestion, but wanted to make sure they understood all the possible options they had regarding the stock. They also wanted to make sure that the CRUT transaction in no way diminished the inheritance available to their children. What happens if they keep the stock until death? What if they sell it and reinvest the proceeds? What will they gain, if anything, by creating a CRUT? Mr. Price recommended that a wealth replacement ILIT be used to replace the value of the stock for their children. Mr. Price provided the Grogans with the following chart and table to highlight some of the key measures resulting from each approach:⁵



CRT and Wealth Replacement ILIT vs. Selling Stock

	Tax Due	Net to Family (Year 20)	Net to Charity (Year 20)
Sell Stock and Pay Tax	Capital Gains Tax = \$425,000 Estate Tax = \$1,379,580	Sale Proceeds = \$1,128,747 (after tax, with 7 % growth) After Tax Income = \$1,667,102	0
Charitable Remainder Unitrust and Life Insurance Trust	0	ILIT = \$2,416,218 CRUT Income = \$2,747,223 (after paying Income tax)	\$1,121,225

As the table indicates, the Grogans come out ahead by selecting the CRT alternative. By choosing the CRT, the Grogans were able to (1) generate an income tax deduction of \$297,460; (2) avoid paying \$425,000 in capital gains taxes; (3) reduce their taxable estate by the value of the stock (\$2,000,000); (4) provide a \$1,121,225 gift to charity; and (5) receive \$2,747,223 in income from the CRT, after income tax; (6) increase the amount of after-tax wealth passing to their children! The CRT is truly a “Win-Win” planning transaction for the Grogan family.

SUMMARY

For clients who have highly appreciated assets and are rich “on paper” as well as charitably inclined, a CRT can be the ideal solution. The donors will get a charitable deduction and an income stream from the trust, while the charity will receive the remainder interest from the CRT. Clients can also combine a CRT with a wealth replacement ILIT, and use some of the CRT income to fund an ILIT for the benefit of their family members.

- 1 Trust should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping tax). Failure to do so could result in adverse tax treatments of trust proceeds.
- 2 IRC Section 664(d)(1)(D), (2)(D). The ten percent test applies to all contributions made to charitable remainder trusts after July 28, 1997.
- 3 IRC Section 664(d)(1).
- 4 IRC Section 664(d)(1)(A), (2)(A).
- 5 This example assumes the following: The stock is sold this year and appreciated at 7%, Annual CRT income and appreciation of 7%, Section 7520 rate of 6.2%, No unified credits have been used, income tax rate of 40%, capital gains tax rate (state and federal) of 25%, annual life insurance premium of \$45,426 on a Manulife Survivorship UL life insurance policy with face amount of \$2 million, Pat is age 71 and Carol is age 69, both standard non-smoker, and they both die in year 20. Both the CRT and the stock proceeds have a 10 % payout to the Grogans. Manulife Survivorship UL is issued by The Manufacturers Life Insurance Company (USA), a stock company, which is a member of the Manulife Financial group of companies, wholly owned subsidiary of Manulife Financial Corporation.

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