Bill Laskin - Thu, 9/20/2012 - 00:00

Charitable remainder trusts, as we know them today, are a creation of the Tax Reform Act of 1969. Their popularity grew steadily for the first 20 years or so of their existence, and then exploded in the 1990s. According to IRS statistics, from 1999 to 2002 the number of charitable remainder annuity trusts (CRATs) grew 14% and the number of charitable remainder unitrusts (CRUTs) grew 38%. Since then, however, interest in CRTs has cooled: the number of charitable remainder unitrusts in force in 2010 was just 4.4% greater than it was in 2002, and the number of active charitable remainder annuity trusts declined 26.2% over the same period.

Although the popularity of CRTs today is not what it once was, they remain an excellent solution in a variety of donor situations. Also, there may be changes afoot that will restore some of their former luster.

Why the Ebb and Flow in CRT Popularity?

Several factors converged to make CRTs, and especially CRUTs, popular in the 1990s and early 2000s. Stocks appreciated strongly without significant interruption throughout this period (the S&P 500 nearly quintupled from 330 to 1,500 from 1991 to 1999). Consequently, as the 1990s wore on many donors found themselves holding highly appreciated assets. Meanwhile, from 1991 to mid-1997, the federal tax rate on most realized long-term capital gains was 28%, nearly twice what it is today. It then continued at 20% until May 2003, after which it dropped to the current 15%.

A donor can fund a CRT with long-term capital gain property and receive a deduction based on the full fair market value of the property. Being a tax-exempt trust, the CRT can then sell the donated property without incurring any capital gains tax, allowing it to reinvest the entire proceeds. The combination in the 1990s of many donors holding highly appreciated assets and relatively high capital gains tax and income tax rates made CRTs very attractive vehicles for unlocking the cash flow from these assets while reducing income taxes. These advantages were not lost on the many financial planners who actively promoted CRTs, especially the more flexible CRUTs, to their clients. Gift planners for non-profits also put substantial effort into marketing CRTs.

In the early 2000s, the conditions that had made CRTs so appealing during the previous decade quickly evaporated. The internet bubble burst in March 2000. Over the next two years the S&P 500 lost 40% of its value. Then, in May 2003 the federal tax rate on long-term capital gain dropped from 20% to 15%. During the same period, the top federal income tax rate declined from 39.6% to 35%. The loss of asset value not only erased the possibility of avoiding capital gains tax on gains that no longer existed, but created donor nervousness about the nation's economy that had been largely absent for years. Nervous donors were less likely to fund an irrevocable charitable trust, such as a CRT. The reduction in tax rates further dampened enthusiasm for CRTs by reducing the amount of taxes donors could save by funding one. CRTs became a "harder sell." Financial planners for whom the philanthropic component of a CRT was never the main attraction stopped suggesting CRTs to their clients.

Tax rates have remained the same since 2003, but the Great Recession of 2008-2009 dealt another major blow to the portfolios of donors. Once again, large amounts of long-term gains disappeared with declining stock values and, perhaps more importantly, the anxiety of donors about their financial future made many of them cautious about making irrevocable commitments to charity. What's more, some charities became reluctant to suggest CRTs to donors after seeing the value of some existing CRATs shrink toward $0 and writing letters to CRUT beneficiaries to explain why their checks had become so much smaller.

The Present Climate for CRTs

The climate for CRTs has improved since the S&P 500 reached its modern low on March 6, 2009. The S&P 500 is up 110% since then and is almost back to its high in March 2000. In other words, donors are holding far more appreciation in their portfolios than they were just a few years ago. Also, while hardly robust, the economy has stabilized and donors are less worried than in the recent past that they could be facing financial catastrophe.

The climate for CRUTs has improved more than for CRATs, as borne out by the IRS statistics quoted at the beginning of this article. This is primarily a consequence of the record low IRS discount rate (1.0%). The way the math works, the charitable deduction available for funding a CRUT is affected very little by changes in the IRS discount rate. In contrast, the charitable deduction available for funding a CRAT is affected significantly by changes in the IRS discount rate. In particular, the

deduction available for a CRAT declines as the IRS discount rate declines.

A record low IRS discount rate translates into record low deductions for funding a CRAT. It also increases the likelihood that a CRAT will fail the 5% probability-of-exhaustion test. Right now, a CRAT paying the minimum rate of 5% for life fails the 5% probability test with one beneficiary age 75 or younger or two beneficiaries ages 77 or younger. This means that the pool of eligible beneficiaries for a CRAT is currently very narrow. A solution that may be acceptable to some donors is to use a fixed term of not more than 20 years in lieu of or concurrent with a term measured by the lives of one or more beneficiaries.

The 5% probability-of-exhaustion test does not apply to CRUTs. They need to meet only the requirement that the charitable portion be at least 10% of the funding amount. Under today's 1.0% IRS discount rate, a CRUT can have two lifelong beneficiaries as young as 40 and still qualify.

The Federal Reserve has just announced its intention to keep interest rates very low until 2015. It seems likely, therefore, that the IRS discount rate will remain very low for at least the next few years, largely stifling interest in CRATs. Nevertheless, there are potential tax changes on the horizon in 2013 that would add appeal to funding a CRUT, and the occasional CRAT, as well.

What Does the Future Hold for CRTs?

Starting on January 1, 2013, an additional .9% Medicare surtax on earned income and a new 3.8% Medicare surtax on net investment income will be applied to taxpayers with modified adjusted gross income above $250,000 for married couples and $200,000 for single persons. If investment income pushes a taxpayer over the threshold, only the excess over the threshold will be subject to the 3.8% surtax.

Charitable gifts will not be deductible for purposes of either Medicare surtax. Also, taxable income from charitable remainder trusts (as well as gift annuities and pooled income funds) may be subject to the 3.8% Medicare surtax as investment income. In sum, the Medicare surtaxes will increase the tax bill for high income donors without increasing the income tax savings they can enjoy from taking charitable deductions. At the margins, increased taxes without a matching increase in tax savings from charitable deductions may dissuade a few donors from funding a CRT or reduce the amount with which they fund it.

More importantly, if Congress allows the Bush-era tax cuts to expire at the end of the year, the federal capital gains tax rate on most long-term capital gains will return to 20% and the top federal income tax bracket will return to 39.6%. A higher long-term capital gains tax rate would increase in a meaningful way the tax benefit for every donor who funds a CRT with long-term appreciated property. Given that many of these donors are in the highest federal income tax bracket, an increase in that bracket from 35% to 39.6% would also increase the income tax savings from their charitable deduction.

These changes would likely attract the attention of some financial advisors, who would once again start suggesting CRUTs to some of their philanthropically-minded clients. They might even mention CRATs in certain limited situations. In addition, gift planners would be able to tout more generous tax benefits in their CRT marketing materials.
It is far from certain that we will return to the pre-Bush era tax rates in 2013, of course. Much will depend on the outcome of November's election. Here are some key features of the tax proposals from three of the main actors in the race for President .

Obama proposal: President Obama proposes reinstating the 36% and 39.6% income tax brackets for taxpayers with more than $200,000 of taxable income ($250,000 if married filing jointly). Tax rates for taxpayers with income below that level would not change. However, his plan also proposes capping at 28% the rate at which charitable deductions can be taken. Thus, while the top federal income tax brackets would increase for many (most?) potential CRUT donors, the income tax savings available from their charitable deductions would actually decrease from the current 35% level to 28%.

President Obama also proposes increasing the long-term capital gains tax rate from 15% to 20% for taxpayers with more than $200,000 of taxable income ($250,000 if married filing jointly). Such an increase would make CRUTs more attractive to high income donors with highly appreciated assets.

Romney proposal: In contrast to President Obama's proposal, presidential candidate Romney proposes reducing all federal income tax brackets by 20%. This would lower the top federal rate from 35% to 28%, for example. He also proposes eliminating the tax on long-term capital gain for taxpayers with less than $200,000

of taxable income ($250,000 if married filing jointly), and leaving it at 15% for taxpayers with earnings above these thresholds. All these changes would reduce the tax benefits of funding a CRUT from their current level.

Ryan proposal: Vice presidential candidate Ryan's tax proposal would reduce the top federal income tax bracket to 25% and eliminate the tax on long-term capital gain entirely. The latter change, in particular, would significantly reduce or eliminate the appeal of CRUTs for many donors.

It would be a fool's errand to predict which of the above proposals, or some compromise package, will actually become law. Too much depends on whether Obama or Romney is elected President and which party, if either, controls Congress. Even after those questions are settled, only time will reveal the details of the tax law that is actually passed. What does appear likely is that some measure of change in tax rates will take place, effective January 1, 2013. It's more a question of whether they will go up or down and for whom.

There's more to CRTs than just tax incentives

We've spent considerable virtual ink ruminating on the effects of tax incentives on CRT donations and the future direction of those incentives. Although IRS statistics indicate that tax incentives do affect the popularity of CRTs, they are not the only, or even the primary, reason many donors fund CRTs. The non-tax reasons remain as compelling as ever. A CRUT in particular, continues to be an excellent planning vehicle for a donor who wants to:

- Give illiquid assets, such as real estate (although cash or public-traded securities work well, too)
- Provide to himself, his spouse, and/or loved ones cash flow for life that has the potential to grow with inflation
- Retain control over who manages the trust's assets and/or administers the trust
- Leave a substantial gift to one or more charities

It is always wise fundraising to define a donor's financial and philanthropic goals first and then develop a gift plan for achieving those goals. The possibility of funding a charitable remainder unitrust should become part of the conversation when a donor's goals match well with the bullet points above. The situations where a charitable remainder annuity trust is desirable, on the other hand, will continue to be

uncommon as long as the IRS discount rate remains so low.

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