The CRT Stock Redemption Strategy for Philanthropic and Business Succession Planning

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When individuals own a closely-held business as part of their gross estate, particular challenges arise. For instance, since the business is an illiquid asset, how will they pay the estate taxes associated with such an asset? What will happen to the business when the founder passes? Is a child willing and able to step up and operate the business? What will the founder's surviving spouse live on? Of course, there are many other technical and practical issues involved in such a scenario.

Philanthropic planning may prove to be the catalyst that causes the founder of a closely-held business to consider these issues and become engaged in the planning process, because integrating philanthropy into an estate and financial plan produces many favorable and familiar results. The founder will leave a charitable legacy; deductions from taxation are available; and net after-tax cash flow is increased, while estate taxes are reduced, and so forth. In addition, integrating philanthropy into a business succession plan can help to solve some of the other issues raised above.

Although other philanthropic tools can be considered in structuring a business succession plan, this article will primarily address the CRT stock redemption plan. This may be the single best philanthropic tool to combine the power of charitable gift planning when closely-held C corporation stock is involved.

Fred considers his golden years

A case study illustrates this strategy, and generally outlines some of the benefits of consummating a CRT stock redemption. Here are the assumptions:

- Fred owns 51 percent and his daughter, Pebbles, owns 49 percent of the Bedrock Quarry Company, which constitutes a C Corporation for income tax purposes.
- Fair market value of Fred's Company stock is $5 million.
- Fred has a zero tax basis in his Company stock.
- Fred is subject to a 20 percent federal and state capital gains and a 45 percent income tax.
- 7 percent is the gross rate of return on investments.

Here are the steps for the CRT stock redemption:

- Fred creates and funds the CRT with the 51 percent stock interest in the Company.
- Company redeems the 51 percent stock interest from the CRT for cash.
- CRT reinvests the entire net proceeds from the sale into a diversified portfolio of marketable securities.
- Pebbles becomes the sole owner of the stock interest in the Company.
- CRT pays income to Fred and his wife, Wilma, for the rest of their lives.
- Upon the death of Fred and Wilma, the assets of the CRT will be distributed to the Bedrock Foundation.

Fred enjoys many benefits from contributing his Company stock to the CRT. First, Fred will get a significant income tax deduction, which can be used to offset other taxable income this year or can be carried over for five succeeding years. As an aside, Fred could also consider selling some of the Company stock directly to Pebbles (or to a valued employee), and use the charitable deduction in the year of the gift to offset that capital gain. Second, Fred and Wilma will receive an increased net after-tax cash flow, because the $5 million of cash proceeds to the CRT will not be reduced by income taxes. Third, Fred is converting (without an immediate income tax consequence) a single and significant appreciated asset into a diversified portfolio of marketable securities. Fourth, Fred and Wilma will avoid estate taxes on the value of the Company stock. Fifth, Fred and Wilma will leave a substantial charitable legacy. Sixth and finally, Pebbles can run the Bedrock Quarry Company as its sole owner for the potential benefit of generations to come. All of these benefits combine for a very powerful estate, financial, business succession and philanthropic plan.

Fred will probably want to compare the benefits of an outright sale of the Company stock vs. a contribution to the CRT:

	Fred sells stock outright	**Fred contributes to charitable remainder trust**
Tax	$1 million capital gains tax on sale, leaving $4 million to reinvest	Approximately $1.2 million income tax deduction, which saves in real dollars $540,000, and no immediate tax consequence on sale, leaving $5 million to reinvest
Income	$280,000 per year (before tax)	$350,000 per year (before tax)
Estate Taxes	Value of the investments are includible in his gross estate	CRT principal is effectively excluded from his gross estate, but the income not spent is includible in his gross estate
Benefit to Charity	None	CRT principal will benefit charity at CRT termination

As may be noted from the chart, if Fred contributes the stock to a CRT, he will be entitled to an income tax deduction in the year of the gift equal to approximately $1.2 million, which, in real dollars, saves approximately $540,000. Fred and Wilma also increase their income (before tax) to $350,000 per year. At death, the value of the tax savings and net income not spent will grow for the benefit of Pebbles, and may be subject to an estate tax; however, the value of the CRT assets, which is included in Fred's estate, is not effectively subject to tax, as his estate will be entitled to a charitable and a marital estate tax deduction. Of course, Pebbles will not receive any benefit from the principal of the trust, as the principal is irrevocably designated for the benefit of the charity chosen by Fred and Wilma to receive the trust remainder.

If however, Fred sells the Company stock outside of the CRT, he will incur a $1 million capital gains tax, leaving him and Wilma with $4 million to reinvest. Thus, they will accrue $280,000 of income (before tax) for the rest of their lives. At death, their estates will be subject to estate tax depending upon the value of the investments at that time and the applicable exclusion amount, and the Bedrock Foundation will not receive any benefit from an outright sale.

What type of CRT might interest the founder of a successful closely-held enterprise?

"It's not what you own, but what you control."
Nelson Rockefeller

"If everything seems under control, you're just not going fast enough."
Mario Andretti

Many professional disciplines intersect when attempting to integrate a philanthropic structure with a business succession plan, including legal, tax, accounting and financial and investment planning, as well as planning for the use of the charitable dollars by the ultimate charitable recipient—but psychiatry would likely be the most valued. One of the biggest practical impediments in implementing any business succession plan is the desire of the founder to maintain absolute control (among other personal and emotional impediments). The founder has built a successful and vibrant business, to which he or she has devoted long hours and made many other personal and financial investments and sacrifices. How do you move such an individual to plan?

The founder must, at a minimum, be willing to actually consider the economic, tax, financial and/or estate planning issues involved with taking no action. If you have the founder's ear, then you have a chance to explain that, with a philanthropic plan, the founder is merely moving tax dollars from the government to a charity or charities that he or she cares about, as well as obtaining all of the same types of benefits that Fred achieved in the case study above.

Another possible catalyst for a planning discussion may be the type of charitable vehicle that is chosen. For instance, the founder may find the net income with makeup charitable remainder unitrust (NIMCRUT) of particular interest. A NIMCRUT pays the unitrust amount from the lesser of (1) the net fiduciary income earned by the trust's assets, or (2) a percentage of the net fair market value of the trust's assets (determined annually). In the event that, in any year, the amount described in condition (2) does not get distributed as the unitrust amount, a deficiency account may accrue. The deficiency may be "made up" in subsequent years, when and if the net fiduciary income of the trust for that year exceeds the stated percentage payout rate.

The NIMCRUT can be a flexible tool to meet some very special needs. Would it be appealing to be able to build value in a NIMCRUT on a tax-deferred basis, and get distributions at a later date as needed? To oversimplify the analysis, a spigot can be turned on and distributions of the unitrust amount made to the income beneficiaries at times when they may need the funds; otherwise, if no fiduciary income is generated, the assets will grow in value on a tax-deferred basis within the NIMCRUT, for the benefit of both the income and remainder beneficiaries.

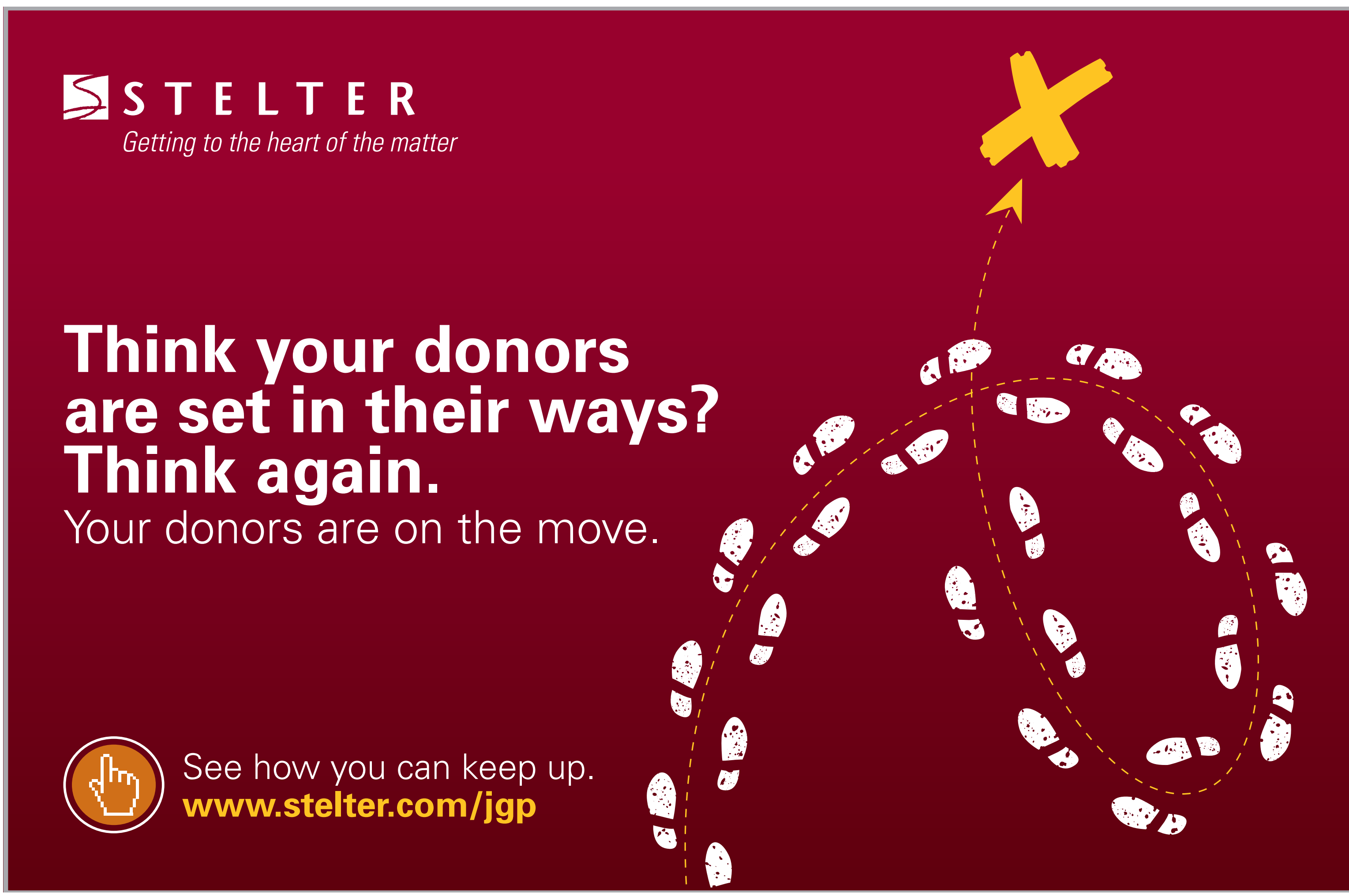
If the founder desires to use a NIMCRUT as a supplement to his or her retirement planning, special consideration must be given prior to the execution of the trust. For instance, the definition of fiduciary income and the mix of investments will dictate the ability to control the timing of receipt of fiduciary income, and therefore, the timing of receipt of the unitrust amount. State law relating to principal and income and the specific terms of the trust agreement will determine the definition of fiduciary income, as further described in Code Section 643(b). In addition, it is prudent to consider including language in the trust instrument authorizing the appointment of an Independent Special Trustee to make any decision regarding the production of fiduciary income that will cause a distribution of the unitrust amount.

This structure is very technical, and great care must be taken to assure that the charity is not hurt in any way (see TAM 9825001). It *is* possible that the charity may get a windfall in the event the income beneficiaries should die without being paid the full unitrust amount to which they were legally entitled under the terms of the NIMCRUT document and federal law. However, as has been painfully experienced in recent memory, marketable securities or mutual funds do not always increase in value. If the CRT assets do not appreciate, the payment of the unitrust amount is directly and adversely affected.

Finally, it should be noted that the IRS will not ordinarily issue a private letter ruling to determine whether a CRT is qualified when a partnership or deferred annuity contract is used to defer the receipt of fiduciary income (see Revenue Procedure 2009-3, Section 4.01(37); but also see TAM 9825001, in which a NIMCRUT acquired a deferred annuity contract for the purpose of deferring fiduciary income, and the IRS ruled that no self-dealing occurred and the CRT was not disqualified due to such acquisition). Planners can also consider the use of a single member LLC as the vehicle owned by the NIMCRUT to hold the investments and defer the receipt of fiduciary income.

Another excellent option for a founder's consideration is the use of a FlipCRUT. The Final Regulations adopted in 1997 permit a "one-time flip" of the character of the unitrust amount to be received by the income beneficiary, from a NIMCRUT interest to a standard CRT interest. A standard CRT must pay out to the income beneficiaries a fixed percentage of the fair market value of the CRT's assets as re-determined each year, whether from fiduciary income or principal. The "triggering event" that causes the change in unitrust method must (1) be stated in the governing instrument, and (2) arise *either* on a specific date, *or* by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other person. However, the initial unitrust method can only be an income exception method (like a NIMCRUT), which flips into a standard unitrust interest, and the flip to the standard interest must take effect at the beginning of the taxable year following the year in which the triggering event occurs. As a consequence of the flip, any NIMCRUT make-up account will be forfeited.

The hope is to choose a date for the "flip" as close as possible to the time when the founder and his or her spouse expect they will need the unitrust payouts. It is also possible to plan on the character of the investments in the FlipCRUT to potentially increase in value on a tax-deferred basis during the NIMCRUT period, thus increasing the standard unitrust payouts once the flip occurs.



Issues—we always have issues

There are assuredly technical and practical hurdles to overcome in these planning strategies. One of the biggest initial and obvious technical tax hurdles relates to the question of self-dealing. This issue is implicated in the case study above, because Fred is a substantial contributor to the CRT, and thus, a Disqualified Person. Pebbles is a Disqualified Person, because she is a member of Fred's family. The Company will then constitute a Disqualified Person, because Pebbles owns more than a 35 percent interest in the Company.

Ordinarily, a sale between a CRT and a Disqualified Person, such as the Company, will constitute self-dealing and be subject to the self-dealing excise tax. For example, an act of self-dealing will occur if Pebbles purchases the Company stock directly from the CRT. However, in this case study, Fred won't have a problem with self-dealing if the transfer qualifies under an exception contained in Code Section 4941(d)(2)(f), which provides as follows: the Company must redeem the 51 percent stock interest from Fred pursuant to a plan of redemption in which the same offer for redemption is made to all shareholders for cash at a purchase price no less than fair market value of the Company stock. So, the self-dealing issue may not present an impediment in consummating the CRT Stock Redemption.

There are many more issues to consider in each founder's particular situation than can be addressed in this article. A few of these include:

- Each dollar of unrelated business taxable income is subject to an excise tax of 100 percent—yes, *every* dollar of UBI in the CRT will be lost to tax. Needless to say, the CRT can incur *no* UBI in the CRT stock redemption transaction. Thus, the character of all payments to be made to the CRT on sale must be fully analyzed prior to closure.
- The purchase of the Company stock in the redemption transaction cannot impair the capital of the Company, or Pebbles runs the risk of finding out that the business cannot sustain the debt or cash reserve reduction in order to consummate this transaction. For instance, the self-dealing exception mentioned above requires a cash deal. Thus, the exception is lost if the Company issues a promissory note to the CRT in purchasing Fred's stock, and the payments thereunder would constitute a continuing act of self-dealing.
- Care must be exercised to assure that the private foundation excise taxes will either not be implicated in the transaction, or won't apply (see Code Sections 4941, 4943, 4944, and 4945 and Code Section 4947(b)(3)).
- Consideration should be given to retaining an independent special trustee for the purpose of consummating the CRT stock redemption transaction.
- The founder may want to appoint his or her private foundation as the remainder beneficiary of the CRT, which raises certain other issues.
- A Subchapter S corporation cannot maintain its status while owned by a CRT, because the CRT is not a qualified shareholder (see Code Section 1361(c)(2)). However, with proper tax analysis

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in advance, the S election could be terminated and the CRT stock redemption consummated. In addition, if such termination is undesirable, the use of a charitable lead trust could be considered as a possible charitable alternative.

- Certain contracts (such as a buy-sell agreement or existing loan or lease agreements) may require consent to transfer the Company stock, or otherwise impact the ability to consummate the CRT stock redemption.
- Make sure that the consummation of the transaction does not cause an imputation of the capital gain incurred by the CRT to the founder.
- A qualified appraisal of the Company stock must be obtained.
- Fred may want to create an irrevocable life insurance trust to replace the present or future value of his interest in the Company stock, especially if Pebbles marries Bamm-Bamm and has kids of her own.

Conclusion

If the CRT stock redemption plan is to be accomplished, all Is must be dotted and Ts must be crossed—the transaction must be viewed and handled as an arm's length business deal. Toward that end, professional counsel must thoroughly analyze all potential practical and technical issues in advance. This process should bring together the founder's various professional advisors, working together in a cooperative fashion. Each piece of the puzzle is critical to the successful implementation of such a sophisticated plan.

Including the charity's perspective in this planning process is very important. Founders will have the opportunity to delve into their own charitable vision, will be more aware of the charity's present and future needs, and will ideally engage the next generation in evaluating its own philanthropic vision. The entire planning process will be enhanced, creating the best possible outcome for the founder, the founder's family, the charity, and thus, the community at large. It is exciting to think that our role as charitable gift planners could become the catalyst that causes the founder of a closely-held business to begin the planning process, and to ultimately implement a favorable estate, financial, business and philanthropic plan.

Jonathan Ackerman, Esq., has developed considerable experience in the areas of charitable gift planning, tax-exempt organizations, charitable solicitations laws and estate planning and probate. His advice is often sought by charitable and other tax-exempt organizations in their creation and governance, especially with respect to contributions and other funding opportunities for charities, as well as by families who desire to integrate philanthropy into their financial and estate plan. He is a frequent speaker on the topics of charitable gift planning and tax-exempt organizations and has published a number of articles in a variety of publications. Ackerman is a past chair of NCPG's Board of Directors, a past chair of its Conference Committee and a past president of the Chesapeake Planned Giving Council. He earned his JD from the University of Baltimore School of Law and his Masters of Laws in Taxation from the Georgetown University Law Center.