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Business Succession Planning Using a Charitable Remainder Trust

Using a charitable remainder trust¹ (“CRT”) as part of a business succession plan is a viable option for many business owners. This strategy allows the transfer of a business with minimum tax exposure, contributes to the business owner’s retirement income, and creates a permanent charitable legacy.

Sales Idea: While most business owners will like the idea of both maximizing their retirement income and benefiting charities, they may have reservations about reducing their children’s inheritance. A universal life insurance policy on the business owner naming his or her children as beneficiaries can provide them with something they would probably like even better than mom or dad’s stock - cash. This concept is discussed in more detail below as part of the Wealth Replacement Trust strategy.

Target Audience. Combining a CRT with a business succession plan may be a good option where a business owner:

- Owns stock in a C corporation
- Is at or near retirement (and considering leaving the business)
- Wants to help others through charitable gifts
- Wants to sell his or her stock with more favorable tax treatment

How it Works. The following is a step-by-step example of how this strategy might be implemented:

1. **Establish a CRT.** Business owner establishes a CRT naming him or herself as income beneficiary, and a favorite charity (or charities) as remainder beneficiary.
2. **Gift Corporate Stock.** Business owner gifts all of his or her business interest to the CRT. This gift would generate a personal tax deduction for the owner, determined using factors such as the value of the transferred business interest, the business owner’s life expectancy (or designated term of years), the applicable federal rate, and the amount of retained income interest.



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3. **Sale of Stock by CRT.** After obtaining the stock, the trustee of the CRT sells it at fair market value.² Under the right circumstances³, the buyer could be the company, which would then retire the stock.⁴ In that situation, the remaining stockholders would have control of the business, since their interests would have changed from a minority position to a majority position when the stock was retired. If the company is not in a position to buy back the stock, the trustee would seek a qualified outside buyer, possibly the individual stockholders.
4. **Payment of Income.** Once the stock is sold, the trustee invests the entire sale proceeds (paying no tax on the gain).
5. **Fund Wealth Replacement Trust.** An irrevocable wealth replacement trust is established, a trustee named, and a universal life insurance policy acquired on the business owner naming the trust as owner and beneficiary. The business owner uses the after-tax CRT income to make annual gifts to the trust to ensure that the trust is adequately funded.⁵ At the business owner's death, the life insurance proceeds flow tax-free through the trust to its beneficiaries.
Life Insurance Sale: Business owner, a widower, has donated \$1 million in business interests to a CRT and wants to ensure that his 2 children (they are not involved in the business) will not lose their inheritance because of the donation. To accomplish this, the trustee purchases a \$1 million Lifetime Protector 50+^{SM6} universal life insurance policy on the business owner using donor gifts to pay an annual premium of \$21,180.⁷ At the business owner's death, his 2 children will receive the death benefits tax-free. Had he passed his business interests to them instead, they may have faced not only tax consequences but also possible difficulty in liquidating the interests.
6. **Gift of Remaining Assets.** When the CRT income payout period is over, the trustee of the CRT then transfers the remaining assets to the designated charity or charities.

What has been Accomplished. Let's look at what the business owner in the above example has accomplished:

- Transferred his or her stock without paying capital gains on the transfer⁸
- Provided a retirement income stream for the owner (dependent on the performance of the trust assets)
- Received a income tax deduction which he or she can spread over 6 years⁹
- Left a sizable charitable gift as a way of giving back to the community

Possible Concerns:

- Transfer of stock interest is irrevocable
- If family members are stockholders, possible issues exist involving attribution rules
- If the CRT does not find a ready buyer, it may have trouble generating income to pay the donor
- Care must be taken in implementing this strategy. If the IRS decides that the charitable trust is being used for the sole purpose of generating tax benefits that the transaction would not produce otherwise, it may disallow those tax benefits. The key is that the donor have a true charitable motivation for entering into the arrangement.

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¹ A CRT is an irrevocable trust into which a donor transfers assets, such as closely held corporate stock. The donor receives an income tax deduction for the gift. The stock is sold by the trust without incurring capital gains tax liability, and the owner is paid an income interest for life or some other predetermined period. At the end of this period, the underlying assets pass to the designated charity.

² The IRS may apply the step transaction rule if the parties to a sale have had discussions about it before the business interest is transferred to a charitable trust.

³ Notes of caution: An independent trustee may be required in order to avoid self-dealing problems. In addition, a transfer of stock to a charitable remainder trust by an owner of more than 35 percent of the voting stock of the corporation followed by a corporate redemption is a prohibited act of self-dealing. IRC §4941(d)(2)(F) does create a way to avoid this problem, but it requires that the corporation make a bona fide offer on a uniform basis to the trust foundation and to every other person who holds stock. The exception also appears to require an all cash payment -- no loans. Finally, Reg. §1.664-1(a)(7) provides new rules for valuing unmarketable assets that are transferred to or held by a charitable remainder trust. A CRT holding unmarketable assets will be disqualified under IRC §664 (and no corresponding charitable deduction will be allowed) unless any required valuations of the unmarketable assets owned by the trust are (i) performed exclusively by an independent trustee; or (ii) determined by a current qualified appraisal by a qualified appraiser.

⁴ The CRT is a tax-exempt entity.

⁵ The trust will need “Crummey” withdrawal powers to allow the gift to qualify for the annual gift tax exclusion (\$12,000 per year, per beneficiary in 2006).

⁶ Illustrated using Lifetime Protector 50+SM, underwritten by First Colony Life Insurance Company, Lynchburg, VA. Illustration based on 60-year old male, Preferred No Nicotine Use, with guaranteed death benefit as long as premiums are paid. Actual results may vary.

⁷ Assuming that the trust has “Crummey” withdrawal powers, these gifts qualify for the gift tax annual exclusion (\$12,000 per year, per beneficiary in 2006), meaning that they may escape gift tax consequences.

⁸ When a CRT sells appreciated stock, a capital gain is generated on the sale. The CRT is a tax-exempt entity, so it pays no capital gains tax (and never will). But the capital gain does not simply disappear. There may come a time when an annual distribution is made where the trust has no ordinary income or dividends to distribute. At that point it may have to distribute from principal, and the tax character of that distribution would be capital gains until the capital gain had been used up.

⁹ The tax deduction is available in the year of transfer, and, if not completely used, then a carry-forward for up to five more years is available.