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## Gift It Or Lose It

eping assets out of Uncle Sam's hands can be a taxing experience for some executives. The estate-planning strategy—a charitable remainder trust—sidesteps taxes and guarantees retirement income.

trust department often advises a CEO to establish a CRT, which allows him to convert an asset to a favorite charity or institution, secure a tax deduction, avoid capital gains and receive an income stream for life—or after retirement. A CRT pays no tax, so assets placed into it are removed from the CEO's estate, avoiding estate taxes. The CRT also offers executives great flexibility. Appreciated assets used to fund a CRT can be sold without incurring any capital gains liability; likewise, poor-performing assets can be converted to better-yielding investments.

As grantor, the CEO receives a charitable income tax deduction based on the value and type of donated asset, the age of the income beneficiary or beneficiaries, and the class of charity. Up to 30 percent of an executive's adjusted gross income may be deducted annually, and unused charitable deductions can be carried forward five years. The older the executive and the less income taken from the CRT, the greater the deduction. A CRT is judgment proof; neither creditors nor plaintiffs can threaten it. Assets, including cash, can be added each year. These contributions can be alternatives to other, maximized retirement plans. The gifted assets pass to the charity only after the death of all named CRT beneficiaries, including spouse and heirs, if desired.

A chief executive often has much of his wealth tied up in company stock acquired through his employment. If he has held the stock for a long time, it may be highly appreciated, but it also could be a low-dividend issue that provides little current yield. Such was the case of a CEO who contacted our trust department for help in converting stock he held in his company

into an asset that would generate an income stream of at least \$150,000 annually for his retirement. The stock, representing 80 percent of his total net worth, was paying an annual dividend of just 1 percent. We recommended he establish a CRT with \$3 million of his shares. We then sold the shares, using the cash to fund a diversified portfolio of 40 percent fixed income and 60 percent equities (based on the executive's risk tolerance and investment objectives). A 6 percent annual payout from the CRT provided the executive with \$180,000 of annual income, compared with \$30,000 in dividends he had been receiving on his company stock. That met his retirement needs and also provided funds to purchase an insurance policy in an irrevocable trust for his heirs to replace the value of the stock gifted to the CRT. When he dies, the policy will distribute tax-free to his heirs. But besides providing a stream of retirement income, the CRT also diversified the CEO's income sources. In addition, the executive removed a major portion of assets from his estate,

avoided a capital gains tax hit on the sale of the highly appreciated stock, and ensured a substantial inheritance for his heirs.

### INVESTMENT CONSIDERATIONS

When short-term government yields were flying high in the 1980s, acceptable investment returns from CRT assets were easily captured. Assets placed into a CRT, however, must provide adequate earnings on a consistent basis without disturbing the principal. This requirement and recent uncertainties in the financial market point out the importance of choosing an experienced investment manager. Of course, management fees should be one criterion in making a choice, but saving on fees for bad advice is false economy.

The philosophy of the fiduciary should mesh with that of the CEO/grantor. If a pitched battle ensues each time the investment manager makes a decision, the relationship will quickly deteriorate. This can usually be avoided if the grantor lays out specific investment objectives. At Wells Fargo, we routinely assign separate

trust and investment professionals to each CRT account. The trust expert has the legal and tax experience to provide a solid foundation for the CRT and to define retirement and investment objectives. The investment manager executes the strategy and provides knowledge of the financial markets and asset allocation.

For CEOs with assets heavily concentrated in company stock, frequently on a low-cost basis, placing some or all of the stock in a CRT, where it can be

converted into a more diverse asset base, will mitigate unfavorable tax consequences. Liquidating the appreciated stock triggers 28 percent capital gains taxes. At death, the remainder may be subject to estate taxes of up to 55 percent. The combined tax hit, often occurring within a period of a few years, could diminish the value of an estate.

Timing is another critical factor in determining when to establish a CRT with an asset—such as stock—that is to be sold once in the trust. A CEO with 200,000 shares of stock worth \$3 million may choose to gift 50,000 shares to the CRT. Obviously, he would prefer to liquidate the stock at the highest possible price, to provide the largest gift possible to the charity or university, and the biggest asset base for income generation. On the other hand, the same CEO might elect to gift a specific amount, such as \$1 million. This means: The higher the market price at liquidation, the fewer shares needed to equal the designated amount. Either way, it might be wise to have the trust documentation prepared, so the trust officer can enter the market at any time.

### PROFESSIONAL ADVICE

Talking to a trust professional is usually the first step when setting up a CRT. A favorite charity or institution may also be a good source of information.

It's essential to involve tax and legal experts when establishing a CRT. The trust is not just a financial arrangement; it is a legal document with state and federal requirements. IRS regulations are complicated, and errors can trigger expensive repercussions. Since the CRT is irrevocable, miscalculations cannot be undone.

For example, the CEO of a large consulting firm, while negotiating the sale of his home, decided instead to gift the property to a charity via a CRT. The house had appreciated over \$700,000, and the primary lure of gifting it was avoiding approximately \$200,000 in capital gains taxes. Unfortunately, the lawyer who drafted the CRT was unaware of pertinent regulations. Therefore, the IRS challenged the charitable intent of the CRT, forcing

the CEO and his wife to liquidate other assets to pay taxes on the improper deduction. The home could not be withdrawn from the CRT, and the IRS compelled the couple to accept reduced prices for the assets.

In another case, the president of a manufacturing company established a CRT with the advice of his accountant and an attorney not versed in CRT law, using several hundred patents and copyrights. The understanding at the time the trust was set up: The patents and copyrights would be sold to a company in which the executive had a 51 percent interest. A Wells Fargo trust officer recognized that a conflict of interest existed and recommended that an attorney specializing in this area be consulted. The attorney confirmed the charitable deduction wasn't allowed, and it was necessary to unwind the transaction at considerable cost.

Another avoidable CRT imbroglio occurred when the head of a recording studio used a trust to donate a music studio to his alma mater. All went well until the university, as trustee, sold the studio to convert the equity into income-yielding assets. The executive was furious when he learned the selling price was well below what he believed to be the value of the property. He was also disturbed that the buyer was a former business competitor. The transaction is now in litigation, with the executive suing the university to revoke the trust. Legal fees to date are about half the selling price of the property.

This situation reveals the need for grantor, charity, and professional advisors to understand the objectives of a CRT before the papers are signed. Many times, successful, dynamic executives who gift assets to a CRT find it difficult to relinquish control of those assets. A game plan skirts these potential problems.

Of course, not all charitable trusts are plagued with difficulties. If properly planned, in conjunction with trust professionals, a CRT can provide a win-win situation for grantor, beneficiaries and charity. For example, a CEO and his wife established a CRT with her business, worth approximately \$2 million. The business was then sold out of the

trust, and the cash was invested in a diversified portfolio. The couple has realized an 8 percent average annual yield on the portfolio. And, because their business basis was virtually zero, they received handsome income without paying any capital gains tax. Upon the second death, a California university will receive the remaining trust principal.

Another successful CRT investment involved a corporate director who placed in trust a condominium on which he paid very low taxes. The property was a management nightmare, and the tax consequences of selling it outside a trust would have been egregious. Upon receiving the property, the trustee sold to an outside buyer and put the proceeds to work under a managed investment program. The CRT allowed the director to convert a problem rental into a sizable charitable gift while realizing a tax deduction and interest income for himself.

### NO NEED TO DENY HEIRS

One last question about CRTs: Will heirs lose out if assets are gifted to charity? This problem can be solved by combining the CRT with a second trust, funded with an insurance policy. Using funds from capital gains and income tax savings—or partially from CRT income—a policy can be purchased with heirs named as beneficiaries. When the surviving spouse dies, policy proceeds are paid to the beneficiaries through the trust, free from income and estate taxes. The policy value could replicate that of the original gifted asset, ensuring that heirs receive an undiminished inheritance.

Like death, taxes are inescapable, but the CRT provides an opportunity to shelter money from the IRS, minimize taxes, cushion retirement, provide for heirs, and leave a meaningful charitable legacy. When properly set up, this investment can pay big dividends. ■

**Carl Reichardt is chairman and chief executive officer of San Francisco-based Wells Fargo & Company and its principal subsidiary, Wells Fargo Bank. The bank, eighth largest in the U.S. at year-end 1991, manages approximately \$20 billion in personal and charitable assets through the Asset Management Division of its Private Banking Group.**

