# THE CHARITABLE REMAINDER TRUST AFTER THE TAX CUTS AND JOBS ACT

One of the most common forms of charitable tax planning is the Charitable Remainder Trust (the "CRT"). By establishing a CRT, the donor can convert a highly appreciated asset (such as real estate or stocks) into lifetime income (with possibly a significant higher return) without paying capital gains tax on the sale. The donor, as income beneficiary of the trust, will receive an income tax charitable deduction. The donated asset is removed from the donor's estate without use of the donor's gift tax exemption. The charity benefits not only because it will receive the funds but also because it knows that the funds will be available in the future and can plan future projects in reliance on those funds The benefits appear to be even greater under the new federal tax reform legislation.

## WHO BENEFITS FROM A CRT?

A CRT is generally an appropriate estate planning vehicle for a person age 50 or older who owns a highly appreciated asset and (1) wants to enjoy the profits from the sale of this asset now while avoiding capital gains tax; and/or (2) wants to reduce his or her estate taxes; and/or (3) wants to make a charitable gift.

A CRT is not for everyone. First and foremost, if a person is not ready to transfer control of the asset or to manage it within an irrevocable trust, he or she may want to consider other options. Only the income set forth in the CRT can be distributed so the donor must be absolutely certain that the entire corpus of the funds will not be needed at a later date. Second, as with any provision in the tax code that appears too good to be true, there are a number of limitations and steps which must be followed. Failure to comply with these requirements may cause denial of the charitable deduction, realization of the capital gains tax to the donor, or full inclusion of the value of the CRT corpus in the donor's estate.

## HOW DOES A CRT WORK?

The CRT is structured like any other trust except it is irrevocable and its provisions are strictly dictated by the IRS. The donor establishes the trust (the donor is the "settlor" of the trust) and transfers the appreciated asset to the trustee of the trust who manages the asset subject to the terms of the CRT. The donor is generally the income beneficiary of the CRT. There are gift tax consequences if the income beneficiary is not the donor or the donor's spouse. There will need to be a qualified appraisal of the donated asset.

The trustee then sells the asset at full market value. There are no capital gains tax due on the sale because a CRT is not subject to income tax. Thus, the full amount of the sales proceeds can earn income for the donor. There must not be any agreement to sell the asset to a third party prior to establishment of the CRT.

The trustee then invests the full amount of the sales proceeds in income-producing assets, which will grow tax-free. As the current income beneficiary, the donor will receive the designated income distributions from the CRT. Although income received by the CRT is not taxable, the

income distributions are taxable to the donor as the same type of income as received by the CRT (so if ordinary income is received by the CRT and then distributed to the donor, it is ordinary income to the donor). The donor receives an immediate charitable income tax deduction when the property is transferred to the CRT – reducing current income taxes.

Upon the donor's death or a term certain, the trust assets are distributed to one or more charities.

## COMPARISON OF CRT TO OUTRIGHT SALE OF PROPERTY

As an example of how a CRT can benefit a client, let's look at Gary and Nita Farmer. They own 160 acres of table grape vineyard. Gary is age 65 and Nita is age 63. They bought the farmland many years ago. The vineyard could now be very valuable land if planted to almonds. Gary and Nita want to retire and do not want to continue to farm or develop it to almonds. They are shocked that the value of the land has increased so much and that neighboring farmers have made inquiries to purchase the property for $25,000 per acre. Gary and Nita feel that they would be selling at the top of the market now and it's a good time to get out of farming. Their net income from farming has vastly fluctuated and they would like a stable retirement income. They have received an average annual income of $160,000 from the farm.

Their income tax basis in the farm is $1,000,000 and based on $25,000 per acre it now has a fair market value of $4,000,000. Unfortunately, if they sold the farm outright, they would pay capital gains tax on the appreciation of the property. Under the current tax structure, they would pay approximately $843,000 in state and federal capital gains tax. This would leave them with $3,157,000 of the net sale proceeds for reinvestment. If they invested the sales proceeds at a 4% rate of return, they would receive an annual income of $126,280 per year.

Now if Gary and Nita establish a CRT and transfer the farm to the CRT, the trustee would then sell the farm. No capital gains tax would be payable so all $4,000,000 could be invested. If we assume that they established unitrust CRT (I'll explain the difference between an annuity CRT and a unitrust CRT later), the trustee could then invest the entire sales proceeds. Based on the current IRS factors and interest rates, assuming a 5% minimum payout requirement, the Farmers could receive $200,000 per year for their joint lifetimes – replacing their farming income. At their deaths, the remainder would be distributed to their designated charity or charities.

Based on the above factors, the Farmers would receive an income tax deduction of $1,265,040 which is the charitable deduction for the value of the remainder interest which passes to the charity and the value of the farm has been removed from their estates.

## WHAT IS THE AMOUNT OF INCOME THAT CAN BE RECEIVED FROM A CRT?

The amount of income received from a CRT is flexible, subject to the requirements of a CRAT or a CRUT, as discussed below. The amount of income will depend on the amount of income desired by the donor, the value of the property, whether income is paid monthly, quarterly or annually, and the age of the donor.

There are two types of CRTs – a charitable remainder annuity trust ("CRAT") or a charitable remainder unitrust ("CRUT"). For both types, there of course must be a remainder beneficiary that is a charity. This charity must be a charity that has received tax-exempt status from the IRS. The income payments from the CRT to the donor must be made at least annually and must continue for the donor(s) lives or for a term certain (not to exceed 20 years).

A CRAT functions similar to a fixed annuity. The donor specifies in the CRT document the sum certain that the trustee is to pay to the donor. The sum certain may be an absolute dollar amount, or a fraction or percentage of the initial net fair market value of the property placed in trust. This amount must be not less than 5% (but not more than 50%) of the initial net fair market value of the property placed in trust. Therefore, the property will need to be appraised when it is placed into the trust. This type of CRT provides the donor with security as to the amount of annual income that will be received. Once the CRAT is established, no other property can be transferred to the CRAT.

A CRUT functions similar to a variable annuity. The donor specifies in the CRT document the percentage of the net value of the CRT that the donor is to receive. The CRUT therefore gives a hedge against inflation. The net value of the trust assets must be redetermined (reappraised) annually. The donor must receive at least 5% (but not more than 50%) of the net value as determined annually. Any income that is not distributed is retained by the CRT and will grow tax-free, thus increasing the value of the CRT. A variation on a CRUT is where the donor receives the net income of the trust (rather than a percentage amount). This prevents the trustee from having to use the principal of the trust to meet a percentage requirement. A "make-up" provision may also be included in a CRUT so if the trust doesn't earn the specified percentage that year, it will make up the difference in later years when there are sufficient earnings. The donor may contribute additional properties to the CRUT at a later time.

For either a CRAT or a CRUT, the present value of the remainder interest that will pass to charity at the time the trust is established must be at least 10% of the initial net fair market value of the assets contributed.

## HOW MUCH IS THE INCOME TAX DEDUCTION?

The charitable income tax deduction is based on the amount of income the donor receives, the value of the property transferred, and the donor's age. Basically, the more the donor receives in income, the less the deduction will be. The deduction is limited to either 30% or 60% of the donor's adjusted gross income – depending on how the IRS defines the charity and the type of asset involved. If the entire deduction is not used the first year, then the donor can carry it forward for up to five additional years.

The new tax reform legislation favors formation of CRTs. First, by increasing the standard deduction and capping the state and local tax deduction, the number of taxpayers who benefit from itemizing deductions, including charitable deductions, has been drastically reduced. Also, the provision that limited various deductions for high income taxpayers has been eliminated. So there is a greater incentive for donors to make a large one-time gift to a CRT in order to maximize the charitable deduction.

Also, prior to the tax reform legislation, the charitable deduction was limited to 30% or 50% depending on the type or charity and type of asset. The 50% deduction was increased to 60%, thus allowing a greater charitable deduction.

## WHAT TYPES OF ASSETS ARE SUITABLE FOR A CRT?

Assets that have greatly appreciated in value since they were purchased or inherited by the donor are the best assets for a CRT. These assets can be real property, publicly traded stock or stock in a closely-held corporation. The asset must be free from debt though so there cannot be any loans against it or the donor must pay off the loan prior to transferring it to the CRT. Furthermore, the donor must transfer the donor's entire interest in that asset to the CRT.

## PROVIDING FOR WEALTH REPLACEMENT

One of the benefits of a CRT is that it removes the donated asset from the donor's estate without using the donor's gift tax exemption. That also means that the donor's non-charitable beneficiaries may receive less from the donor's estate.

A CRT can be combined with an irrevocable life insurance trust or a "wealth-replacement trust." Let's assume Gary and Nita only need the $160,000 annual income they were receiving from the farm but don't need the additional $40,000 annual income they will receive from the CRT (or they only want a portion of it). Because the property was removed from their estate, Gary and Nita's children will no longer inherit the farm.

The solution is to establish a Wealth Replacement Trust (a fancy word for an irrevocable life insurance trust) to replace this lost asset. Gary and Nita could use a portion of the $40,000 in increased income and gift it to the Wealth Replacement Trust every year. The trust would then purchase a second to die policy life insurance policy using the gift to pay the premiums. **The amount of the insurance available will depend on Gary and Nita's relative health and respective ages at the time the insurance policy is contracted for.** Gary and Nita's children are the beneficiaries of the Wealth Replacement Trust. Upon Gary and Nita's death, the insurance proceeds would be distributed to the children.

By using the income tax savings and part of the increased income received from the CRT, the Farmers are able to fund an irrevocable life insurance trust to replace the value of the asset placed in the CRT. Thus, the children are still inheriting the life insurance proceeds, but there will be no estate taxes paid on that. Gary and Nita will receive a higher income and will have an immediate income tax charitable deduction. Finally, the charity will receive a large distribution that will allow it to continue its charitable projects.

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