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Unlocking the Value of Ag Land with Charitable Remainder Trusts

This article attempts to further readers' awareness and understanding of the benefits of Charitable Remainder Trusts (CRTs). We'll start by looking at a case study of how a Nebraska couple with charitable inclinations used a CRT to unlock the appreciated value in their farmland.

In 2012, a married couple in their early 80s decided it was time to simplify their lives and take advantage of the increased value of the quarter section of farmland they owned and rented out in Clay County.

After evaluating the tax, income and charitable benefits, the couple decided to deed an undivided 50 percent interest in the land (80 acres) to a CRT. The couple and the CRT then jointly sold the land. The couple's charitable contribution deduction for the gift to the CRT offset a substantial portion of the capital gains on the land interest they sold outright.

Based upon their income needs, the couple established a two-life Charitable Remainder Unitrust (CRUT) with a 7 percent annual income payout rate.

This 2012 CRUT formation resulted in tax and income benefits as follows:

Real Estate Value ($10,000/acre):	$800,000
Cost Basis ($1,850/acre):	$148,000
Capital Gains Tax Bypassed:	$97,800
Charitable Deduction (based on donor age):	$394,800
First-year CRUT Income at 7%:	$56,000

This couple decided to designate a portion of the charitable remainder to their local church. The other portion will be used to pass on their values of charitable giving to their family through a donor-advised fund with the Nebraska Community Foundation. They have named their adult children to make the grant recommendations from this fund. The Nebraska Community Foundation staff prepared a donor-advised fund agreement and will help the couple develop grant-making guidelines and principles to share with their children.

With the value of Nebraska's ag land at or near record levels, now is the time to explore the benefits of a CRT, if you are considering selling ag land but are hesitant because of capital gains taxes and the need for lifetime income. The following information describes some of the benefits and considerations for determining if a CRT is a good fit.

What is a CRT?

A CRT is a special tax-exempt, irrevocable trust arrangement written to comply with federal tax laws. The donor can transfer cash or assets (especially appreciated assets) to the trust and receive income for one or more lifetimes; or the donor may choose a term of years (not to exceed 20). For example, the income could be paid over the lifetimes of a husband and wife; then, the couple's children could be paid income for an additional 20-year term.

After the income beneficiaries' interests have ended, the charitable remainder beneficiary or beneficiaries will receive the remaining corpus of the trust. Note: IRC Section 664 lists the requirements a trust must meet in order to qualify as a CRT.

Overview of the Benefits of a CRT

The creation of a CRT typically provides the following benefits for the donor:

Avoid capital gains: No capital gains tax is due on the appreciation of the contributed property when the trustee sells and reinvests. The charitable contribution deduction is based on the fair market value of the property, not on the donor's basis in the property.

Increase income: The trustee can take appreciated, low-yield property, sell it and invest the proceeds in higher-yielding assets without paying capital gains taxes.

Provide an immediate charitable income tax deduction: The deduction is based on the present value of the remainder interest.

Types of CRTs

There are two basic types of CRTs: an annuity trust and a unitrust. The major difference between the two is how the payout to the income beneficiaries is determined. The annuity trust payout is a fixed annual dollar amount of not less than 5 percent of the initial value of the trust assets. The unitrust payout is a fixed percentage of not less than 5 percent of the beginning of the year value of the trust assets; as a result, the unitrust payout will vary from year to year.

Annuity Trust and Unitrust Considerations

- The payout rate may not exceed 50 percent of the initial value (annuity trust) or the annual value (unitrust).
- The present value of the charitable remainder must be at least 10 percent of the net fair market value of the

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assets transferred to the trust on the date of the gift.

- When the donor names anyone other than himself/herself or a spouse as an income beneficiary, he/she is making a gift to that person with gift tax consequences.
- The value of a CRT is included in the donor's estate. If the donor or donor's spouse are the only income beneficiaries of a CRT, the estate will receive a corresponding charitable estate deduction or marital deduction for the value of the CRT. If there are other successor income beneficiaries, there may be a taxable transfer of the present value of the non-charitable beneficiaries' income interest.
- The taxation to the beneficiary of the income payout depends upon the character of the income earned by the CRT. Distributions are taxed based on a "four-tier" system, in the following order:
  - **First**, current and accumulated ordinary income;
  - **Second**, capital gain (short-term gain is deemed distributed before long-term gain) determined on a cumulative net basis;
  - **Third**, tax-exempt income; and
  - **Fourth**, trust corpus.
- The trustee can be a commercial trustee, a charitable organization, an unrelated third person or the donor.
- A 1977 Revenue Ruling created the 5 Percent Probability Test for Annuity Trusts. Under this test, the trust is disqualified as a CRT if the chances are greater than 5 percent that the income beneficiaries will live long enough to exhaust the trust, leaving nothing for the charitable remainder.
- Unitrust Options:
  - **Standard**: The unitrust payout amount will vary year to year as the value of the trust assets rises or falls.
  - **Net income**: The trust agreement states that payment will be the lesser of the stated payout percentage or the net income earned.
  - **Net income with makeup provisions**: Allows the trustee to make up prior years' deficiencies in payouts to the extent current income of the trust exceeds the specified unitrust amount.
  - **Flip**: Allows a net income trust to flip to a standard trust upon the occurrence of a specific triggering event, which must be outside the control of the trustee or any other person. Examples of triggering events are a beneficiary attaining a specific age, marriage, divorce, death, birth and sale of an unmarketable asset.
- Additional contributions may be made to the same unitrust. However, additional contributions cannot be made to the same annuity trust.

Conclusion

In my work with many generous people across Nebraska, I've found that in almost every case there is a planned giving tool that fulfills a donor's charitable intentions, while maximizing tax benefits. CRTs are not widely understood by the general public. However, they may be very well-suited to people in Nebraska who hold much of their wealth in the appreciated value of their agricultural land. The people I have assisted in using a CRT held a strong attachment to their land and preferred making a gift to charitable causes close to their heart rather than paying significant taxes when it was time to sell. The flexibility of a CRT enables donors to choose from different options for lifetime income payments. For these reasons, I encourage readers to learn more about CRTs and how they may be right for a landowner.

Editor's Note: *This article is reprinted in part from The Nebraska Lawyer, May/June 2014. For more information, Gustafson can be reached at (402) 323-7341.* ■NC■