The Charitable Remainder Trust

Having your cake and eating it too!

By Michael King

Key Takeaways:

- Recent tax rate increases will lead to a resurgence in the popularity of charitable remainder trusts.
- CRTs are an ideal strategy when selling highly appreciated assets such as marketable securities, real estate and certain closely held businesses.
- A myriad of benefits can be secured with a CRT—an immediate charitable deduction, avoided tax upon sale of the asset, a lifetime stream of income and a meaningful charitable gift at death.

In recent years, tax legislation has dramatically increased tax rates on high-income earners. These rate increases have impacted a plethora of income types, including ordinary income (wage income, interest, and rental income), dividends, and capital gains.

The American Taxpayer Relief Act of 2012 increased the highest marginal tax rates on ordinary income from 35 percent to 39.6 percent, and on capital gains and qualified dividends from 15 percent to 20 percent. In addition, the Health Care and Education Reconciliation Act of 2010 imposed a 3.8 percent Medicare tax, for the first time, on non-wage income. This tax applies to investment income, including interest, capital gains, dividends, and rental income.

As a result, these tax rate increases will most assuredly cause a resurgence in the popularity of charitable remainder trusts (CRTs), particularly when taxpayers plan to sell appreciated assets such as marketable securities, real estate and certain closely held businesses. Many taxpayers selling such assets will incur a federal tax of 20 percent on their capital gains, plus an additional 3.8 percent Medicare tax. This combined tax rate of 23.8 percent represents an increase of over 58 percent from the 15 percent tax rate imposed prior to January 2013. For many taxpayers, the 23.8 percent federal tax rate will increase further due to the imposition of state income taxes that, on average, could add an additional 5 percent to 10 percent tax. Adding insult to injury, no sooner had these tax rate increases gone into effect, the current administration announced proposals to increase some of these rates even higher, including the capital gains tax rate to 28 percent—almost double the 15 percent rate that applied prior to January 2013. One presidential candidate in the 2016 race has vowed to increase the capital gains tax rate so it’s equal to the ordinary income tax rate of 39.6 percent.

The power of CRTs: Real-world example

A CRT is an extremely effective financial planning technique for taxpayers planning a sale of highly appreciated assets. In this context, a CRT allows taxpayers to reduce their current (and often future) income tax liability, increase their charitable contributions and deductions, and secure an annual income stream for the rest of their lives.

The following example illustrates the power of a CRT and the benefits it provides to both the taxpayer and charity**:**

Barry is a recently retired executive from a Fortune 500 company. He and his wife, Linda, have accumulated significant assets, consisting primarily of qualified retirement plan assets, a diversified taxable investment portfolio and a rental real estate property they've owned for over 20 years. Upon reaching their current ages of 65 and 64, respectively, they decided to sell their investment real estate and relieve themselves of the significant management and maintenance responsibilities that such rental properties often require.

The six-unit apartment building is valued at $750,000. With an adjusted income tax basis of $200,000 (purchase price, adjusted for capital improvements and depreciation over time), Barry and Linda will recognize a capital gain of $550,000 at the time of sale. This will create a capital gain tax liability of $143,000 (at 20 percent federal and 6 percent state tax rates), plus $20,900 from the 3.8 percent Medicare tax on capital gains.

Instead of selling the rental real estate outright, Barry and Linda contribute the real estate to a CRT while retaining a 5 percent unitrust interest. This entitles them to a distribution from the trust of 5 percent of the trust assets each year for the balance of their lifetimes. Upon sale of the real estate, the $163,900 of combined capital gain and Medicare investment taxes are avoided, thereby preserving the entire $750,000 of sale proceeds for reinvestment by the CRT. As a result, the 5 percent unitrust will produce an initial distribution to Barry and Linda of $37,500, and assuming the underlying CRT assets grow at a rate in excess of the 5 percent unitrust amount, Barry and Linda's unitrust payments will increase over time, providing a hedge against inflation.

In addition, Barry and Linda receive a charitable income tax deduction that's equal to the present value of the charitable remainder interest that will pass to charity after both pass away. Based on their joint life expectancy, as well as on the IRS-provided rate on the projected return over time on the CRT assets and the 5 percent unitrust payment, Barry and Linda will receive a charitable deduction of $248,100, immediately saving them $113,134 in taxes (based on 39.6 percent federal and 6 percent state tax rates).

The unitrust payments Barry and Linda receive each year will be subject to tax according to a four-tier system carrying out ordinary income first, followed by capital gains, tax-exempt income and finally a return of principal. As a result, their actual tax liability on the unitrust payments they receive will ultimately depend on how the underlying sale proceeds are invested and on the specific types of income the assets generate over time.

Finally, upon the second spouse's death, the assets remaining in the CRT will pass to one or more charitable beneficiaries. If the CRT assets earned the same percentage return as the 5 percent unitrust payout to Barry and Linda, $750,000 would pass to charity at that time. To the extent the assets produce a higher total rate of return, more assets will be available to charity. For example, if the CRT earned an 8 percent total return over the term of the trust, at Barry and Linda's joint life expectancy of 23 years, $1,480,000 would pass to charity.

Conclusion

The use of CRTs by astute advisors and their clients will increase dramatically in the years to come. The benefits of CRTs are significant:

- Avoidance of capital gain and Medicare tax on investment income upon the sale of appreciated assets
- Securing an immediate charitable income tax deduction

- Providing an additional source of lifetime income in the form of an annual unitrust payment
- Providing a meaningful charitable gift upon death

The family wins, charity wins and the IRS loses—that's a win-win-win scenario, and about as close as you can get to having your cake and eating it too!

About the Author

Michael King *is an attorney serving generous families, charitable organizations, and professional advisors, helping them to maximize the amount and impact of charitable giving through creative strategies that minimize taxes and maximize giving potential. He has served in this capacity for over twenty years with an international tax and accounting firm, a multi-family office, and a national charitable foundation. Michael can be reached at mking@legacypointe.us.*