

#12: Income Shifting Charitable Remainder Trust

An income shifting charitable remainder trust (CRT) or standard CRT for the donor’s children is the same as the CRT discussed in an earlier CRT topic in this series, except that the donor’s children or grandchildren are the income beneficiaries of the lead interest, not the donor. An income shifting CRT uses a CRT to eliminate or reduce the donor’s taxes by shifting ordinary income and capital gains to the donor’s children or grandchildren while also benefiting charity. As shown by the examples below, by shifting income, the donor can avoid the net investment income tax (NIIT), the higher ordinary income tax brackets, and the higher capital gains brackets.

Capital Gains Rates

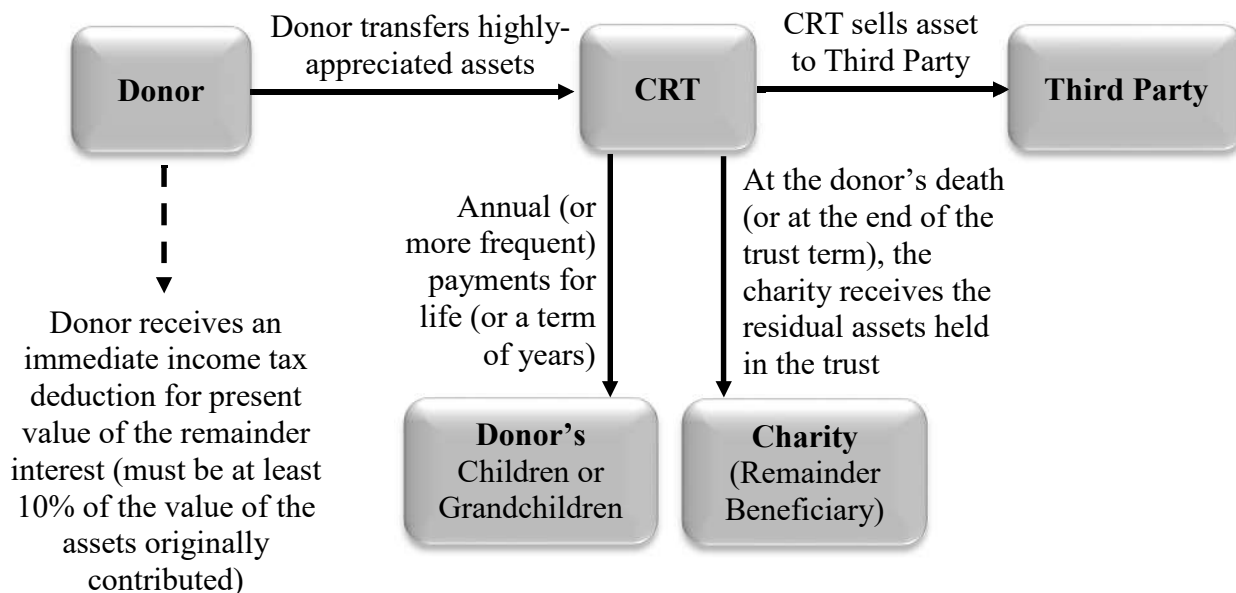
The capital gains rates in 2024 are as follows:

	Single	MFJ
0%	up to \$47,025	up to \$94,050
15%	\$47,026- \$518,900	\$94,051- \$583,750
20%	>\$518,900	>\$583,850

If the capital asset sold is not an asset from a business in which the taxpayer actively participates, it will be treated as net investment income (NII) for purposes of the 3.8% NIIT. This could raise the federal tax rate on the gain to as high as 23.8%, and perhaps even higher with state taxes. Thus, shifting capital gains to the children or grandchildren by using a CRT could reduce the capital gains rate from 23.8% to 15% or even to the 0% capital gains rate.

How the Strategy Works

The diagram below shows the basic mechanics of an income shifting CRT for the benefit of the donor’s children or grandchildren.



Tax Savings

The tax benefits are illustrated in the following examples:

Example 1. Assume that Donor and Spouse are married taxpayers filing jointly with \$600,000 of taxable income from salaries. They have two children in their 20's. Child A is a married taxpayer filing jointly with taxable income of \$20,000 and Child B is a married taxpayer filing jointly with \$90,000 of taxable income. Donor owns Blackacre, non-business property with a basis of \$100,000 and fair market value of \$400,000.

If Donor and Spouse sell the land they will recognize a gain of \$300,000, which will be taxed at 23.8%. The total tax payable will be \$71,400 (.238 x \$300,000).

	Donor	Child A
Taxable Amt. @ 15% Cap. Gains Tax	\$ 0	\$ 0
Taxable Amt. @ 20% Cap. Gains Tax	\$ 300,000	\$ 0
Taxable Amt. @ 3.8% NIIT	\$ 300,000	\$ 0
Total Tax	\$ 71,400	\$ 0
Total Tax Savings	\$ 71,400	

Suppose instead, that the parents transfer the land to an eight-year CRAT for the benefit of Child A in December 2023. The CRAT sells Blackacre and recognizes no gain because it is a tax-exempt entity. When distributions are made, Child A will pay no tax because the income from the trust distribution (\$56,150.84/year) will keep him in the 0% capital gain tax bracket, which ends at \$89,250.

If instead, the parents transfer the land to an eight-year CRAT for the benefit of Child B when the distributions are made, Child B will pay tax because the income (\$56,150.84 per year) will be in the 22% income tax bracket, and thus, the 15% capital gains rate will apply.³⁹ However, the NIIT will not apply because Child B's MAGI (\$146,150) is below the applicable threshold amount of \$250,000. The chart below compares the tax that will be paid over the entire term of the CRT for the \$300,000 in capital gains with the tax that would have been paid if the parents had sold the property.

³⁹ The distributions will be subject to capital gains tax for Child B until the full \$300,000 of gain has been received. Thus, the total capital gains tax payable will be \$.15 x \$300,000 = \$45,000.

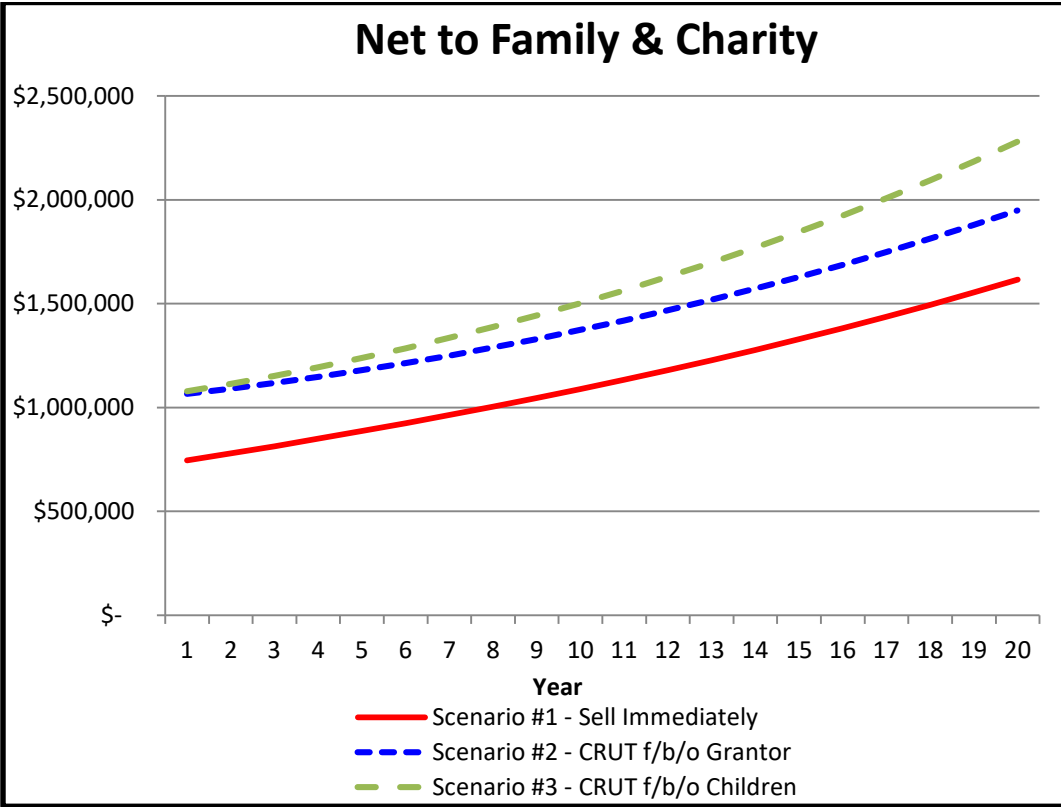
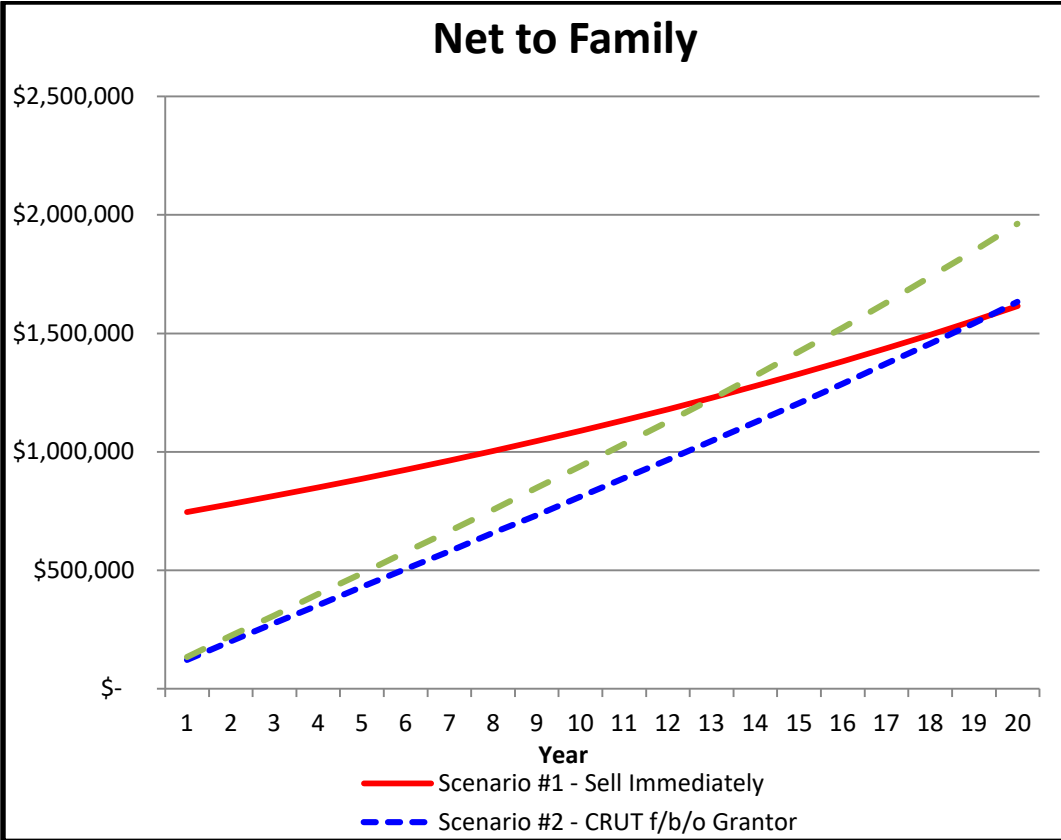
	Donor	Child B
Taxable Amt. @ 15% Cap. Gains Tax	\$ 0	\$ 300,000
Taxable Amt. @ 20% Cap. Gains Tax	\$ 300,000	\$ 0
Taxable Amt. @ 3.8% NIIT	<u>\$ 300,000</u>	<u>\$ 0</u>
Total Tax	<u>\$ 71,400</u>	<u>\$ 45,000</u>
Total Tax Savings	\$ 26,400	

Example 2. Taxpayer has a \$1 million stock position with a \$0 basis. The charts below compare the economic consequences of three different planning scenarios:

Scenario 1: Taxpayer sells the entire position, incurring a 20% capital gains tax, a 3.8% NIIT, and a 5% state tax.

Scenario 2: Taxpayer moves the entire position to a 20-year CRUT for his own benefit. The CRUT is assumed to distribute at an 11.093% rate per year after the first year. The tax savings from the charitable donation are reinvested. A 4% growth rate and 1.5% yield is assumed for the assets.

Scenario 3: Taxpayer moves the entire position to a 20-year CRUT for the benefit of his children. The CRUT is assumed to distribute at an 11.093% rate per year after the first year. The tax savings from the charitable donation are reinvested. The children will have a 15% capital gains tax rate on the Federal capital gains. A 4% growth rate and 1.5% yield is assumed for the assets.



As shown in the examples above, this is yet another great way to save money on taxes, provide for one's children, and contribute to charity. It must be noted, however, that the tax consequences are different when the donor's children are the lead beneficiaries instead of the donor. If the donor is the lead beneficiary, there is no taxable gift. The remainder interest isn't taxable because of the charitable deduction, while the lead interest is not taxable because the donor still owns it. When the donor's children are the lead beneficiaries, however, the amount of the taxable gift is equal to the present value of the annuity or unitrust interest (i.e., the amount transferred minus the present value of the remainder interest). Given the high applicable exclusion amount currently in effect, however (\$13,610,000 in 2024) and adjusted for inflation thereafter), most taxpayers can make contributions to CRTs without incurring any gift tax.

Whether the transfer qualifies for the \$18,000 annual exclusion in 2024 depends on the facts of the case. If there is only one lead beneficiary, the gift qualifies for the annual exclusion.⁴⁰ If there are multiple lead beneficiaries and their percentage interests are not fixed (e.g., the trustee has discretion as to how much each receives), no part of the gift qualifies for the annual exclusion.⁴¹ If there are multiple lead beneficiaries and their percentage interests are fixed, annual exclusions would evidently be available based on these percentages. If there are successive lead beneficiaries, only the gift to the first beneficiary qualifies for the annual exclusion.

An important caveat should be noted for this strategy. It only works if the children aren't subject to the Kiddie Tax. If they are, the distributions they receive from the CRT will be taxable at the rates applicable to trusts and estates. A child is subject to the Kiddie Tax if (1) the child is 18 or under, or (2) is 19-23 and a full-time student.

⁴⁰ Reg. § 25.2503-3(b); *Commissioner v. Sharp*, 153 F2d 163 (9th Cir. 1946); *Commissioner v. Lowden*, 131 F2d 127 (7th Cir. 1942).

⁴¹ Reg. § 25.2503-2.