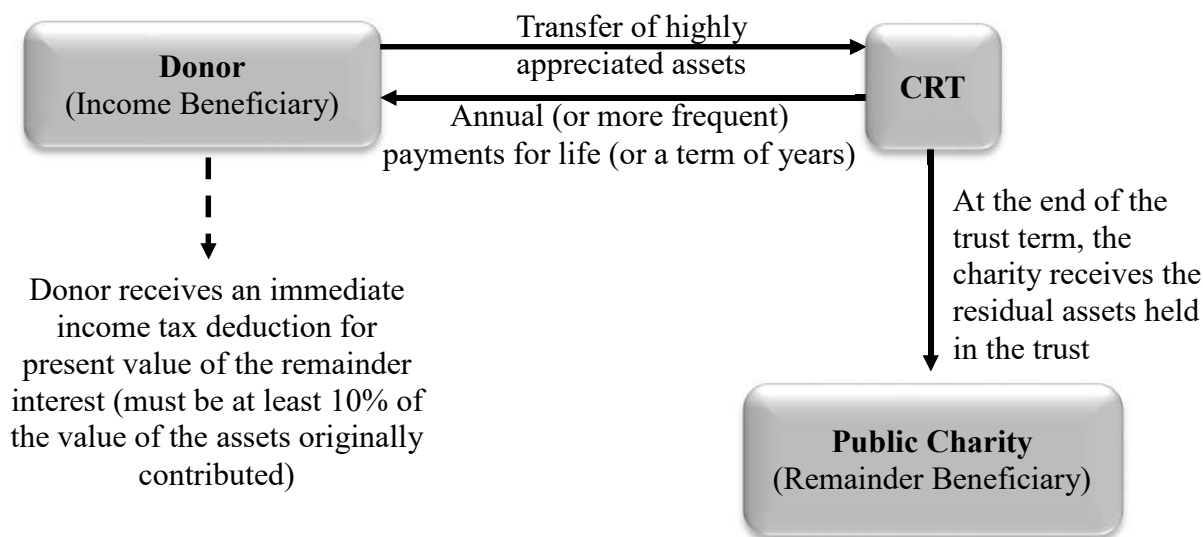


## #5: Substantial Sale Charitable Remainder Trust (CRT)

An inter vivos charitable remainder trust (CRT) is an irrevocable trust created by a donor during the donor's life with a lead annuity or unitrust interest and a charitable remainder interest. The lead interest can be for life or a term of years (not to exceed twenty). The donor generally retains the lead interest and any property left in the trust at the end of its term passes to charity. The donor receives gift tax and income tax charitable deductions for the present value of the remainder interest. Assuming that the donor retains the lead interest, it is not subject to gift tax because the donor still owns it. The present value of the remainder interest must be at least 10% of the value of the assets transferred to the trust.



CRTs can be extremely useful for a taxpayer who has a large capital gain that pushes income for a tax year up into higher tax brackets and/or subjects the taxpayer to the net investment income tax (NIIT). Because CRTs are tax-exempt entities, they can sell assets without recognizing gain. Instead, the gain realized by the trust is taxed to the grantor, but only as the annuity or unitrust payments are received, allowing the gain to be spread out over many years, possibly subjecting it to lower tax brackets.

The character of these payments is determined under the "tier" rules of IRC § 664. The payments are first treated as ordinary income, to the extent the trust has realized current or accumulated ordinary income, then as capital gains, to the extent the trust has current or accumulated capital gains, then as other income (e.g., tax-exempt income), and finally as tax-free return of trust corpus. This enables taxpayers to spread gain recognition over a number of years as shown in the following examples.

**Example 1.** Cindy, a single taxpayer age 51, has salary and interest income of \$150,000 net of deductions in 2024. Cindy sells Blackacre, vacant land with a basis of \$100,000, for \$800,000, recognizing a long-term capital gain of \$700,000. The gain is taxed as follows:

First \$50,000 @ 15% (15% rate, no NIIT)	\$7,500
Next \$318,900 @ 18.8% (15% rate, 3.8% NIIT)	\$59,953
Last \$331,100 @ 23.8% (20% rate, 3.8% NIIT)	<u>\$78,802</u>
Total Tax Paid on Gain	\$146,255

*This leaves Cindy with \$653,745 after tax.*

**Example 2.** Now suppose that instead of selling the land herself, Cindy contributes it to a 20-year CRAT in November 2023 when the Section 7520 rate is 5.6%. She sets the value of the charity's remainder interest at the minimum 10% value allowed under the Tax Code, \$80,000 (\$800,000 x 10%), and retains the right to receive an annuity of \$60,750 per year.

N	I	PV	PMT	FV
20 years	5.6% <sup>14</sup>	\$720,000 (800,000 - 80,000)	\$60,750 (TVM)	\$0

The CRAT subsequently sells the land and realizes a gain of \$700,000 but none of the gain is recognized because the trust is tax-exempt. Assume that the trust assets are all invested in tax-exempt bonds so that the capital gain from Blackacre is the only taxable income flowing out to Cindy. The annuity payments to Cindy are taxable to her until the last of the \$700,000 of capital gain realized on the sale of Blackacre has been distributed in Year 12. Because Cindy's income stays below her \$200,000 applicable threshold amount for the NIIT and the \$518,900 threshold amount for the 20% capital gains bracket, all payments are taxed at only 15%, making the total tax payable on the sale of Blackacre \$105,000 (.15 x \$700,000). Note that this is \$41,255 less than the tax paid in the previous example (\$146,255 - \$105,000). The tax is not only lower, but there is also substantial tax deferral.

### Caveat

Notwithstanding the significant income tax savings, a CRAT may or may not give the taxpayer more after tax value than an outright sale of the property. There are two reasons for this. First, the taxpayer must give at least 10% of the amount transferred to a CRT to charity. In other words, the present value of the charitable remainder interest must be at least 10% of the value of the assets transferred to the trust. Second, if the IRC § 7520 rate might be too low to produce an adequate annual payout.. In the following example we compare the total wealth taxpayers would have after twenty years if they simply reinvested the after-tax sale proceeds with the total wealth they would have if they used the CRAT strategy given the 5.6% IRC Section 7520 rate for November 2023.

**Example 3.** Assume the same general fact pattern as in Examples 1 and 2. If Cindy reinvested the after-tax sale proceeds, she would have \$2,092,383 after 20 years

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<sup>14</sup> Example Section 7520 Rate.

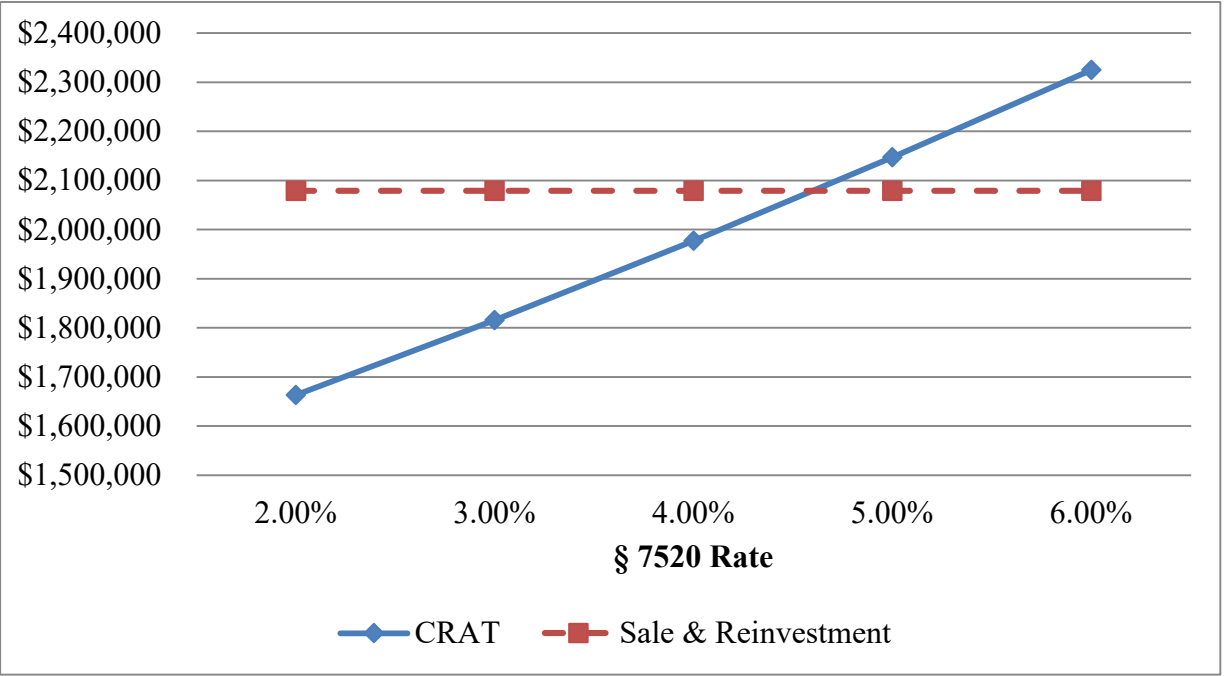
(\$652,415 appreciated @ 6% for 20 years). By contrast, if Cindy transferred Blackacre to the November 2023 CRAT she would receive the following payments after tax—

	<b>Calculation</b>	<b>After Tax</b>
<b>Years 1-11</b>	\$60,750 x 0.85	\$51,638
<b>Year 12</b>	(\$31,750 x. 0.85) +\$29,000	\$55,988
<b>Years 13-20:</b>		<u>\$60,750</u>
<b>FV of payment stream:</b>	TVM @ 6%	\$1,996,653
<b>FV of charitable deduction:</b>	TVM: \$80,000 @ 6%, 20 years	<u>\$256,571</u>
<b>Total wealth accumulation:</b>		<u><u>\$2,253,224</u></u>

Under these facts, Cindy ends up with \$156,575 more after 20 years with the CRAT than with an outright sale (\$2,253,224 – 2,096,649.<sup>15</sup> Note, however, that whether the strategy will work and how well it will work depend on the current 7520 rate. The higher the 7529 rate, the larger the annuity payouts will be. With a low Section 7520 rate, the strategy will only make sense if the taxpayer has strong charitable intent. If the Section 7520 rate continues to rise, the strategy will become even more favorable. The following chart compares the total wealth after twenty years from a sale and reinvestment with the total wealth from a CRAT after twenty years using various IRC § 7520 rates.

<b>§ 7520 Rate</b>	<b>Annual Annuity</b>	<b>FV of Annuity after 20 years</b>	<b>Plus \$256,571 from Charitable Deduction</b>	<b>Compared With Sale &amp; Reinvestment</b>
2.0%	\$44,033	\$1,414,953	\$1,671,524	\$2,096,649
3.0%	\$48,395	\$1,559,339	\$1,815,910	\$2,096,649
4.0%	\$52,979	\$1,720,835	\$1,977,406	\$2,096,649
5.6%	\$60,750	\$1,996,653	\$2,253,224	\$2,096,649
6.0%	\$62,773	\$2,068,698	\$2,325,269	\$2,096,649

<sup>15</sup> \$2,096,649 is the \$653,745 after tax proceeds of the sale appreciated at 6% for 20 years.



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