Retirement From Farming

A law bulletin series on issues facing farmers considering retirement

Charitable Remainder Trusts as a Retirement Strategy for Farmers

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One of the primary challenges for a retiring farmer is the large tax burden that retirement may cause. Throughout their farming careers, farmers do a good job of managing income taxes, in part, by delaying sales and prepaying expenses. This strategy works well while the farm is operating but can cause significant tax liability upon retirement. The combination of a large increase in revenue from the sale of assets and little or no expenses to offset the revenue can cause a retiring farmer to be pushed into high tax brackets. It is not unusual for 40% or more of the sale proceeds from a retirement sale to go to taxes. One strategy to reduce income tax liability at retirement is a Charitable Remainder Trust (CRT). A CRT can be an effective way of managing income taxes at retirement, but it is not for everyone.

The CRT Strategy

A CRT is a charitable trust because at least some of the assets in the CRT must eventually pass to a qualified U.S. charitable organization such as a church or 501(c)(3) corporation. This charitable nature of the CRT is central to the CRT strategy. As a charitable trust, the CRT may sell assets without paying tax on the sale. So, instead of the retiring farmer selling assets in their own name, they donate the assets to the CRT and then the CRT sells the assets. The retiring farmer then receives an income stream from the CRT. After a period of time, the income stream stops and the remaining trust assets are contributed to the named charity. The following are the steps of the CRT strategy:

1. Assemble a team of advisors and develop a CRT strategy.
2. Donor establishes a CRT. The trust document declares the income beneficiaries and the charitable beneficiaries.
3. Donor determines the assets to be contributed to the CRT.
4. Donor contributes assets into the CRT, typically grain, machinery and/or livestock.
5. The CRT sells the assets but does not pay tax.
6. The Trustee of the CRT uses the sale proceeds to establish an annuity. The annuity must be designed to provide at least 10% of the sale proceeds to the charity.
7. The annuity pays out to the Donor over a number of years. The Donor pays income tax on the annuity distributions.
8. When the trust is terminated, the charity is paid the remaining assets.

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Consider the following example to help further explain how a CRT strategy works:

> *Farmer decides to retire at the end of the 2023 crop year. After harvesting the 2023 crop, Farmer owns $1 million of grain and $1.5 million of farm equipment. Farmer's accountant tells him that if he sells all the grain and machinery in one year, he will pay around $1 million in taxes. Farmer decides to implement the CRT strategy. He establishes a CRT and names himself and his spouse as the income beneficiaries and the local children's hospital as the charitable beneficiary. Farmer transfers his grain and machinery into the CRT. The CRT sells the grain and machinery and receives $2.5 million in sale proceeds.*
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> *The CRT establishes an annuity that will pay out $125,000 for the next 20 years. Farmer pays income tax on each $125,000 payment which results in $20,000 of annual income taxes. After 20 years, the trust is terminated, and the children's hospital receives the remaining funds in the CRT.*

As the example shows, the strategy avoids a large, up-front tax payment in the year of the asset sale. Farmer pays taxes on each annual $125,000 payment which allows him to stay in a lower tax bracket. In the example, instead of paying $1 million in taxes in 2023, Farmer spreads the payments out and ultimately pays $400,000 over 20 years.

Building the Team

The first step in the CRT strategy is to develop a team to assist in implementing the CRT. The CRT should be drafted by an attorney familiar with estate planning. Another key member of the team is an accountant. The accountant can assist with calculating potential tax savings of the CRT, address many other tax issues involving the CRT, and file the income tax return for the CRT. Lastly, but perhaps most importantly, a financial advisor should be included on the team. The financial advisor will help determine the type of annuity that should be used and calculate the annual payments to be sure the CRT accommodates the 10% required for the charity.

Establishing the Trust

After the team has met and the decision has been made to implement the CRT strategy, the trust document must be drafted. This document establishes the trust and includes all terms and provisions of the trust. The following are some of the key provisions included in a CRT document:

- The name of the CRT
- The Donor(s)
- The Trustee and any successor Trustees
- The income beneficiary(s)
- The charitable beneficiary(s)
- The legal and tax provisions required to qualify the trust as a CRT

The trust document is likely to be rather long, perhaps as many as 100 pages. The trust is lengthy because many standard boilerplate terms are included as well as many details and contingencies unique to each CRT plan. The trust document is signed by the Donor and the initial Trustee of the Trust.

The Trustee

The CRT is managed by the Trustee. The Trustee can be almost anyone, including the Donor. In most situations, the Donor names themselves or one of the income beneficiaries to serve as Trustee. Contingent Trustees should be identified in the event the primary Trustee is unable to serve. The Trustee will sell the assets on behalf of the trust, establish the financial account for the annuity, distribute the income payments, distribute to the charity, and ensure that a tax return is filed for the CRT.

Contributing Assets to the CRT

After the CRT is established, the assets to be sold can be transferred/donated to the CRT. For untitled assets such as grain, livestock and machinery, the transfer should be documented with an assignment signed and dated by the Donor. For titled assets such as vehicles or real estate, the assets must be titled into the CRT before being sold.

Each asset should be valued at the time of the transfer into the CRT. Commodities such as grain and feeder livestock can use market prices while assets such as machinery and real estate should use appraisals. Establishing the value of the contributed asset is important because the Donor can receive a charitable deduction for the asset's contribution. The amount of the charitable deduction is based on asset value.

Analysis of Assets to Contribute

The Donor can donate nearly any asset to the CRT. Typical assets farmers donate to a CRT include crops, grain, inventory, livestock, and equipment. The best assets to contribute are those that have significant appreciation and/or a low tax basis. These high value, low tax basis assets, the sale of which would normally create significant, immediate tax liability for the owner, can be sold by the CRT without creating tax.

Assets that will not create much, if any, gain or recapture upon sale should probably not be contributed to a CRT. A primary purpose of the CRT is to avoid large tax liability upon the sale of assets. If there is little or no tax liability upon sale, the assets should be kept out of the CRT so that the retiring farmer retains full control over the sale proceeds. It is important to analyze each asset to determine if it is a good candidate for donation to the CRT.
Consider the following example:

> *Farmer owns a green tractor with a current value of $100,000. Farmer has fully depreciated the tractor so that the current tax basis is $0. If Farmer sells the tractor, it will create $100,000 of depreciation recapture taxed at ordinary income tax rates.*
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> *Farmer also owns a red tractor valued at $100,000. However, Farmer only recently purchased the tractor and it has $90,000 of tax basis. If Farmer sells the red tractor, it will create only $10,000 of depreciation recapture.*

In this example, the green tractor is an excellent asset to transfer to a CRT. If Farmer sells the green tractor, the $100,000 of depreciation recapture will create considerable tax liability, perhaps $40,000 or more. By donating the green tractor to the CRT then the CRT selling it, the CRT pays no tax on the sale of the tractor.

On the other hand, the red tractor will only create perhaps a few thousand dollars of taxes. Farmer may not want to donate this asset to the CRT. The small tax savings likely does not justify tying up the sale proceeds in the CRT for many years. A more prudent course of action is likely to sell the tractor outside of the CRT, pay the small amount of taxes owed upon the sale, and retain full control over the sale proceeds.

Donating Farmland to the CRT

While farmland may be donated to the CRT, it rarely is for the following reasons:

1. Farmland can provide a good source of rental income to the retiring farmer without creating much liability;
2. Farmland is relatively easy to manage;
3. Farmland is not a depreciable asset;
4. The farmland is often associated with family heritage so the owner usually desires the land to be passed on to future generations rather than being sold;
5. If held until death, the farmland will receive a stepped-up tax basis.

Consider the following example:

> *Farmer owns $750,000 of machinery which has been fully depreciated. Farmer also owns $2,000,000 of farmland. Farmer decides to donate the machinery to a CRT but retains ownership of the farmland. The farmland is leased to a local farmer for $200/acre.*

In this example, Farmer makes a good decision to donate the machinery to the CRT. The machinery has no tax basis and thus would create significant tax liability if sold by Farmer. Additionally, if Farmer retains the machinery, it will decrease in value over time and create liability exposure to Farmer. Unlike the machinery, Farmer can retain the farmland and earn rental income without the land creating much liability exposure. Also, it is important to Farmer that the farmland be passed along to his children and hopefully his grandchildren. Farmer has made a good decision by keeping ownership of the farmland and not donating it to the CRT.

Assets That Should Not be Contributed to a CRT

There are several types of assets that should not be donated to a CRT. One such asset is S-Corporation stock. While some types of trusts are eligible to own S-Corporation stock, a CRT is not. Transferring S-Corporation stock to a CRT will cause the corporation to be converted from an S-Corporation to a C-Corporation.

Transferring assets subject to debt to a CRT can trigger tax liability. An explanation of the implications of donated debt is complicated and technical and beyond the scope of this bulletin. Before donating any assets with debt to a CRT, be sure to discuss the tax implications with the team's accountant.

Lastly, assets that are already contracted to be sold should probably not be donated to the CRT. The IRS will likely consider these assets already effectively sold and take the position that the only purpose for contributing the asset to the CRT is to avoid tax. The IRS could choose to not consider the transfer of the asset to the CRT a charitable donation and may expect taxes to be paid as if it were sold.

Sale of the Donated Assets

The CRT Trustee may sell the assets at public auction, private sale, or consignment. It is in the best interest of the income beneficiaries to sell the assets for as much money as possible. The sale of the assets may only be done by the Trustee but the Donor can obviously provide ideas and suggestions to the Trustee.

The donated assets can be sold to anyone except family members. Selling to family members violates the charitable requirement of the CRT. Because family members cannot buy the assets, the CRT strategy is generally not used when transitioning a farming operation to the next generation. The CRT strategy is best used when the retiring farmer has no heirs to take over the farming operation.

The Charitable Donation

When an individual donates assets to a CRT, they may be eligible for an immediate tax deduction for the charitable portion of the gift. The amount of the tax deduction is based on the present value of the remainder interest that will ultimately pass to the named charitable organization at the end of the trust's term. The calculation of the tax deduction takes into account several factors such as the value of the assets donated, the donor's age, the payout rate to the beneficiaries, and the applicable federal interest rate (AFR) at the time of the donation.

The charitable deduction is only available for the amount of tax basis still in ordinary income property such as machinery and livestock. The deduction of long-term capital gain property is based on the fair market value. The tax deduction for donating assets to a CRT is subject to certain income limitations and other rules and regulations. The charitable tax deduction is one of the primary reasons that the Donor’s team should include a knowledgeable accountant who can calculate and apply the charitable deduction.

The Income Stream

As stated previously, the sale proceeds from the donated assets are used to establish an income stream. The Donor’s financial advisor calculates the amount of money that can be distributed to the Donor while fulfilling the CRT’s obligation to the named charitable beneficiaries. The money is then invested in financial instruments that will provide the required income and charitable donation. The income stream is paid out to the income beneficiary for a stated period of time which cannot exceed 20 years or the life of one or more of the beneficiaries. IRS rules require at least 5% of the trust principal to be paid out each year but limits annual payments to no more than 50% of the trust principal. These rules effectively cause most CRTs to be in effect between two and twenty years.

This step in the CRT process requires a financial advisor familiar with CRTs. The financial advisor determines the best financial product to hold the funds and the amount of funds that can be distributed each year to meet the charitable donation requirement and the designated income payment period. The IRS requires the Donor to be able to show that the type of financial instrument used and the income stream calculations were done in good faith to provide 10% to the identified charitable beneficiaries. Market fluctuations can cause the actual distribution to be more or less than 10% when the CRT terminates. The CRT is not required to actually provide 10% to the charitable beneficiary, what is required is to show that a good faith forecast was made to provide at least 10% to the beneficiary.

Consider the following example:

> *Farmer establishes a CRT for a term of 10 years with initial assets of $1,000,000. Based on current values and projected return on investment, Farmer's financial advisor establishes an annuity that will pay annual income of $91,000 to Farmer with $100,000 remaining to be transferred to the charity at the end of the 10-year term. The return on investment does not do as well as expected and at the end of the 10-year term only $90,000 remains for the charity. If Farmer can show that a good faith effort was made to leave the charity $100,000, the CRT will keep its charitable designation.*

Beneficiaries

As stated previously, the trust document identifies the income beneficiaries and the charitable beneficiaries. There can be multiple income beneficiaries concurrently; spouses often are joint beneficiaries. Once established, income beneficiaries may not be changed but the charitable beneficiaries can be changed.

A CRT can include contingent beneficiaries for the income stream. Including a contingent beneficiary helps alleviate the risk of the primary beneficiary dying shortly after the CRT is established, causing almost all of the assets to go to the charity. For example, the Donor may designate themself as the primary beneficiary and their child as the contingent beneficiary. Upon the Donor's death, the income stream will pass to the designated contingent beneficiary for the remainder of the trust term or for the remainder of the contingent beneficiary's life, depending on the terms of the trust.

Consider the following examples:

> *Farmer establishes a CRT for a term of 20 years with himself as the income beneficiary. He names Daughter as the contingent beneficiary. Farmer dies in year 10 of the trust term. Daughter will receive the income for the remaining 10 years of the trust term.*
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> *Farmer establishes a CRT that will pay out income to him for the remainder of his life. He names Daughter as the contingent beneficiary. Farmer dies after 10 years. Daughter will receive the remaining payments. The 5% minimum payout requirement will likely mean that Daughter will receive payments for another 10 years, not necessarily for the remainder of her life.*

The charitable beneficiary may be any organization qualified under section 170(c) of the Internal Revenue Code. Charitable beneficiaries can include non-profit organizations, churches, veteran's organizations, fire departments and community foundations. Multiple charitable beneficiaries may be named.

Two Types of CRT

There are two types of CRTs – charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). The primary differences between the two types are how the income distribution to beneficiaries is determined and if additional contributions can be made. In a CRAT, the income is distributed each year as a fixed amount, and the donor cannot make additional contributions to the CRAT. The fixed income distribution must adhere to the 5% minimum/ 50% maximum distribution rule. The assets are not re-valued each year.

With a CRUT, the income is distributed each year as a fixed percentage, and the donor can make additional contributions to the CRUT. The fixed percentage distribution must be at least 5% and no more than 50% of the fair market value of the assets, valued annually. Because the assets are re-valued each year, the income will likely vary from year to year.

A CRAT tends to be used more when all the assets are sold at one time and the Donor wants to provide a pre-determined income stream to the beneficiaries. A CRUT is used more often when the Donor may want to donate additional assets in the future and may be more inclined to accept the risks and rewards of asset value changes and financial market fluctuations. Deciding upon a CRAT or CRUT must be done prior to establishing the CRT and is an important early discussion for the CRT team.

Irrevocability

A CRT is an irrevocable trust, which means it generally cannot be amended or changed without the consent of the beneficiaries and a court. State law often requires a court's permission to make material changes to irrevocable trusts. The irrevocable nature of the CRT is its primary disadvantage. Once the CRT is established and funded with assets, the plan is set and cannot be undone except in extraordinary circumstances. For people who wish to keep control of their assets and keep flexibility, a CRT may not be the best strategy.

The irrevocable nature of the CRT does have an advantage. Once the assets are transferred into the CRT, the assets are protected from creditors of the donor. Because the Donor has given up ownership and control of the assets, the Donor's creditors are not entitled to access the trust principal[1]. However, the income payments from the trust to the beneficiaries are not protected and are subject to creditors.

Taxes

The CRT must file both a 1041 Tax Return (Trusts) and an IRS Form 5227 (Split-Interest Trust) annually. Payments from a charitable remainder trust are taxable to the non-charitable beneficiaries and must be reported to them on a Schedule K-1 "Beneficiary's Share of Income, Deductions and Credits." The payments to a non-charitable beneficiary are taxed as distributions of the CRT's income and gains in the following order[2]:

1. <u>Ordinary income</u>: Payments are considered ordinary income first to the extent the trust had ordinary income for the year and undistributed ordinary income from prior years. If the trust has enough ordinary income to cover all payments, the entire payments are taxed as ordinary income. Beneficiaries must report payments as ordinary income as reported to them on Schedule K-1.

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[1] Assets are protected provided they were not donated as part of scheme to avoid creditors. Donation of assets to a CRT can cause disqualification for Medicaid which could subject the donated assets to risk of being spent for long-term care costs.

[2] Internal Revenue Service, https://www.irs.gov/charities-non-profits/charitable-remainder-trusts

2. Capital gains: Once the trust's ordinary income is exhausted, payments are taxed as capital gains based on the sale or disposition of the trust's capital assets. These payments are taxed as capital gain to the extent of the capital gain of the trust for the current year and any undistributed capital gain income from prior years.
3. Other income: Once all ordinary income and capital gains in the trust are fully distributed, payments are characterized as other income to the extent of the trust's current year and accumulated other income. This includes tax-exempt income.
4. Corpus: After all current-year and accumulated income and gains are fully distributed, payments would lastly be considered corpus or "principal" of the trust not subject to tax.

Illegal Uses

Charitable remainder trusts must not be misused to evade taxes or illegally benefit their beneficiaries. By law, a charitable remainder trust may not:[3]

- Inflate the basis of an asset to its market value when the asset was transferred into the trust, instead of recording the asset at carryover basis, or the basis in the hands of the donor, to illegally minimize or eliminate capital gains or ordinary income.
- Omit or fail to account for the sale of any assets of the trust.
- Mischaracterize distributions of ordinary or capital gain income as distributions of corpus.
- Give non-charitable beneficiaries any payment beyond the prescribed annual income payments, called "self-dealing."
- Transfer the charitable remainder interest of the trust to an organization that isn't a qualified tax-exempt organization.
- Make an upfront cash payment to a charitable beneficiary in lieu of the remainder interest .

By law, charitable trust donors and beneficiaries may not:

- Pay personal expenses with trust funds.
- Borrow from the trust.
- Change the character of payments from the trust from ordinary income or capital gains.
- Use loans, forward sales of assets or other financial schemes to hide capital gains or income in the trust.[4]

Early Termination

There are two scenarios in which the Donor or beneficiary may want to terminate the CRT early. The first is the Donor may wish to discontinue receiving income from the CRT. Perhaps the Donor has adequate income from other sources and does not wish to pay tax on the CRT income. In this situation, the beneficiary can transfer their interest in the income stream to the charitable organization. When this occurs, the transfer is considered a gift of a capital asset. Typically, the trust is then terminated under the merger doctrine due to the charity having both the current income stream and future remainder interest.

[3] Internal Revenue Service, https://www.irs.gov/charities-non-profits/charitable-remainder-trusts
[4] Internal Revenue Service, https://www.irs.gov/charities-non-profits/charitable-remainder-trusts

The second scenario may result if the Donor requires more immediate funds than the stream of income will provide. If the trust document allows, the trust assets may be distributed to the income beneficiary and the charity on a pro rata basis. When this occurs, the transfer is considered a sale of a capital asset, and gain is recognized on the entire proceeds of the sale. This strategy should only be used in rare occasions as the early termination would result in significant tax liability for the Donor.

Scheduled Termination

The CRT will terminate based upon the terms in the trust. Most CRTs terminate in one of two ways. If the term is measured by the life of the beneficiary, the trust will terminate upon the death of the beneficiary. The remaining trust assets at the time of death are distributed to the charity, a final tax return is filed and the trust is terminated.

If the term of the CRT is a specific number of years, the trust will terminate at the end of the term. All assets remaining at the end of the term are distributed to the charity, a final tax return is filed and the trust is terminated.

Estate Tax Implications

If the Donor establishes a charitable remainder trust for his or her life only, the trust assets will be included in his or her gross estate under IRC section 2036. The amount included, however, will "wash out" as an estate tax charitable deduction under IRC section 2055. A surviving spouse's interest in a qualified charitable remainder trust qualifies for the estate tax marital deduction. Note that the marital deduction is lost if there is any non-charitable beneficiary of the trust other than the donor and the donor's spouse.

If the donor names someone other than himself and spouse as the income beneficiary, the trust assets will not be included in the donor's estate. The donor has given up ownership and control of the trust assets and has not retained an interest in the assets. The donation of the assets to the CRT is essentially a completed gift.

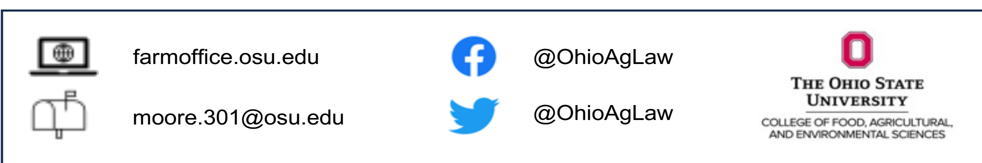
Timeline

Planning for the CRT should be started well in advance of retirement. It takes significant time to analyze the tax savings, calculate the term and payouts, establish the trust, transfer the assets to the trust, sell the assets, and establish the annuity. Preferably, planning should start at least one year prior to the retirement date. This will allow the team time to analyze, implement and manage the CRT. The CRT strategy can be implemented in a few months if necessary, but decisions and actions must be made quickly and deliberately.

The CRT strategy can be initiated after retirement. However, any assets that will be donated to the CRT must be held until the trust is established. During the time from retirement to implementing the CRT plan, the value of the assets can decrease, and the beneficiaries miss out on lost interest.

Conclusion

CRTs can be an excellent tool to reduce income taxes for the retiring farmer. A CRT can provide a steady income stream while providing a charitable benefit. However, once the CRT strategy is implemented, it generally cannot be changed. For those farmers who wish to retain control of assets or who may have heirs taking over the farming operation, a CRT is probably not the best option. When considering a CRT strategy, be sure to consult an attorney, tax advisor and financial advisor.



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