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Avoid Capital Gain Tax and Disinherit the Government

Appreciated capital assets can be a mixed blessing. When we purchase stocks, equity mutual funds or real estate, our goal is to have these assets rise in value over time. However, the more these assets increase in value, the more tax inertia can set in and discourage a sale to better diversify the assets.

We have a solution to this problem that may work under the right set of circumstances.

We were approached by clients who recently retired. They owned several rental properties and were unhappy with the cash flows generated by the rentals.

"Too bad we can't sell them and invest for greater cash flows," they lamented. "The income tax bill on the gains will absolutely kill this idea." Let's look at their situation.

In all, they owned eight houses each valued at $500,000 — a total value of $4 million — that had been originally purchased for $800,000. They had claimed $400,000 in depreciation deductions over time, so the adjusted basis of the properties was down to only $400,000. The mortgages were fully paid off, so the properties were owned free and clear of debt. However, their annual cash flows were netting only $80,000 per year, an annual return of only 2% based on the current property values. The clients wanted higher cash flows, but the thought of paying tax on a $3.6 million capital gain was unacceptable to them.

I explained that a Charitable Remainder Unitrust (CRUT) could solve their problem. First they would list three houses for sale. When they receive an offer on two of the houses, these houses would be deeded to a CRUT and the offer to sell will be accepted by the CRUT. The third property will simply be sold.

Upon donating to the CRUT, a donation deduction will be earned by our clients. The deduction is equal to the present value of the remaining asset going to charity when both our clients pass away. We calculated for our clients that they would receive a $200,000 charitable deduction from the $1 million initial CRUT assets. The sale of the third property will generate a $450,000 capital gain, but the donation deduction will help reduce their tax significantly.

After the sales are completed, the CRUT will invest the $1,000,000 sale proceeds from the two houses into a diversified portfolio. The CRUT calls for an annual payout rate of 7%, so in year one our clients will receive $70,000 from the CRUT. They will also get $50,000 from the remaining five houses and approximately $16,000 from a $400,000 bond portfolio purchased with the after-tax proceeds of the house sold. Their projected annual income is now increased to $136,000 from $80,000 previously.

Our clients also will benefit from the increased liquidity offered by the $400,000 bond portfolio. The income from the CRUT will continue for their joint lifetimes, although the amount will fluctuate each year based on the performance of their investment portfolio. Our clients also liked the fact that they could serve as the CRUT trustees, enabling them to maintain control over investing the funds.

At the death of the second spouse, the remaining assets held in the CRUT will be disbursed to the charities named by our clients. While they viewed this as a disadvantage for their children, it will insure that none of these assets remain to be taxed as part of their estate. They will still leave the other five rental houses, the bond portfolio and all their other assets to their children. The government will lose out on some of the income taxes and estate taxes that they might have claimed, and several charities that our clients support will also become benefactors of their plan.

Our clients decided that the increased liquidity, increased cash flows and tax reductions gained outweighed the downside of the remainder assets going to charity rather than their children. We accompanied them to see their estate planning attorney to complete the design and drafting of the trust. Within a few months they sold three of the rental houses that they had previously been unwilling to sell. The increased annual income will enable them to better enjoy their retirement without having to watch their cash flows as strictly as they would have otherwise been required to do.

If you feel hopelessly tied to an appreciated stock or property because the tax specter is too daunting, we would be glad to illustrate the potential benefits of a CRUT to liberate you from this situation.