

**Introduction:** The U.S. Agriculture Economy - The United States agriculture and food industry supported over 34 million domestic jobs and contributed \$1.53 trillion to the economy in 2023. In addition, American farmers annually produce agricultural products for export worldwide, reaching \$175 billion in 2023.

Most farmers in America operate on a cash basis, meaning income and expenses are recorded when received and paid, respectively. Farmers usually plant crops in the spring, cultivate, fertilize and spray crops as needed during the summer and harvest in the fall. The revenue from the crops, after expenses, represents the profit or net income from the farming operation.

When farm production is good, the farmer will recover all costs for machinery, seed, fuel, fertilizer, pesticide and other items. The remaining crop represents the surplus or the profit potential. After the farmer has sold a sufficient portion of the crop to cover expenses, there is generally a zero cost basis in the remaining crop. Once it has been severed from the land, the crop becomes tangible personal property (TPP) and frequently held in storage for a period of time. The stored crop is readily portable and may be sold within a day or two in the usual market for that commodity. Once sold the entire proceeds will be taxed as ordinary income for the farmer. Farmers may also raise livestock for market consumption, which would generally be considered inventory for the farmer.

**Farm Inventory to Fund a Charitable Remainder Unitrust** - Livestock and crops are types of tangible personal property that may be used to fund a charitable remainder unitrust (CRUT). Livestock or crops are generally inventory for the farmer or rancher and will produce ordinary income when sold, with very low or potentially no cost basis. Similarly, assets like farming equipment, vehicles, aircraft and other items subject to depreciation may result in gain that is recaptured as ordinary income upon sale. All these assets may be appropriate candidates for a tangible personal property-funded unitrust. By transferring farm inventory to a charitable remainder trust, the ordinary income is bypassed in the year of the gift, making crops an excellent candidate for funding unitrust.

**Charitable Remainder Unitrust Basics** - A CRUT is an irrevocable tax-exempt trust that can be funded with farm inventory. The donor funds the trust with farm inventory, such as crops, livestock or equipment and the beneficiaries receive income for the duration of the CRUT. Upon the expiration of the trust term, the charity receives the remainder interest. **The deduction for a CRUT funded with TPP is limited to cost basis times the applicable unitrust factor.** The unitrust deduction factor for a remainder interest will be based on the payout percentage and the expected duration of the trust.

CRUTs can be created for a life, lives, a term up to 20 years or a combination of a life or lives plus a term of years, with a vested remainder interest in one or more qualified charities. A CRUT pays a fixed percentage of the trust principal, which is revalued each year. For example, a CRUT with a 5% payment funded with \$300,000 will pay out \$15,000 the first year and then 5% of the trust's value, as revalued annually. When funding a trust with farm inventory, CRUTs are favorable due to the ability to create more flexible payment structures.

Charitable remainder unitrusts are subject to the 10% minimum deduction interest test to qualify as a charitable remainder trust. Under this test, the charity's remainder interest must be at least 10% of the initial value of the trust. Additionally, the trust must make payments of at least 5%, but no more than 50% to qualify as a charitable remainder trust. CRUTs are revalued each year to determine the unitrust payment amount and donors may contribute additional assets or funds to the trust.

The trust payments from CRUTs can be structured four different ways: (1) standard unitrust, which pays the unitrust percentage stated in the trust document; (2) net income charitable remainder unitrust (NICRUT), which pays the lesser of the net income or the stated unitrust percentage; (3) net income plus makeup charitable remainder unitrust (NIMCRUT), which operates in a similar way as a NICRUT but includes an additional provision allowing the trustee to pay make up payments in years when the trust earns more than the stated unitrust percentage, provided there were deficits in previous years due to the net income limitation on payments; and (4) FLIP charitable remainder unitrust, which first operates as a NIMCRUT and then "flips" to a standard unitrust upon the occurrence of a trigger event or date. When drafting a charitable remainder trust, the donor and his or her attorney should be knowledgeable about the similarities and differences of each type. **With farm inventory, a FLIP structure may be preferred as the CRUT will lack liquidity until the assets are sold.**

**Structuring the CRUT for Farm Inventory** - Donors can choose to self-trustee a CRT, but this option may not be advisable when funding a CRT with farm inventory due to the increased risk of a transaction being **deemed self-dealing**. It may be more favorable to have an independent trustee negotiate the sale of the inventory, with the donor named as the successor trustee. While a donor can retain an aspect of control by serving in the role of initial trustee, it is important not to run afoul of the self-dealing prohibitions in Sec. 4941. Under Sec. 4941 self-dealing rules, excise taxes are imposed upon direct or indirect transactions between the trust and disqualified persons. Some examples of disqualified transactions involving trust assets are the sale, exchange or leasing of property with disqualified persons. Disqualified persons include the donor, trustee, beneficiaries, as well as lineal descendants, including children, grandchildren and spouses of disqualified persons. The excise taxes imposed can be severe and donors should consult with an attorney when administering the trust.

Because crops and livestock are generally considered inventory for the farmer, they produce ordinary income when sold. In order to bypass this ordinary income, the farmer could transfer the crops or livestock into a charitable remainder unitrust prior to any sale. The CRUT trustee would then subsequently sell the assets tax free and make payments according to the trust terms.

Trustees often use auction houses, agents or elevators to complete the sale of crops, livestock and other farming equipment. The trustee must be under no legally binding obligation to sell the assets that are being donated to the CRUT. If such an obligation exists, the donor would be involved in a pre-arranged sale which would prevent the donor from bypassing the recognition of ordinary income. In addition, the bill of sale for the assets must show that the assets were sold by the trustee of the CRUT.

To fund a charitable trust with crops, there must be **documents of transfer**. To transfer the crops into the trust and then sell tax-free through the trust, three documents should be created.

The first document, prepared by the donor's attorney, is a deed of gift. The deed of gift is similar to a deed of real property. A sample for a deed of gift is the following:

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**Deed of Gift**

I, [Donor's name], owner of [Farm's name] and the following agricultural products, hereby irrevocably give and transfer the products described by type, quantity and location, to [Trustee's name] as Trustee of a Charitable Remainder Unitrust dated [DATE], for the initial benefit of [Donor/Income Beneficiary].

Description of Property, Quantity and Property Location

[Description of the asset, quantity and location, for example: 50,000 Bushels of corn currently stored in Bin #104 on E-I-E-I-O Farm, County, State.]

Affirmation

I, [Donor's name], state that the above crops are unencumbered and are the products of [Farm's name]. I have full authority to irrevocably transfer these items to [Trustee's name] as trustee. [Trustee's name] shall have full and complete rights to hold, move, sell or otherwise manage the above property.

In Witness Whereof, I have signed this Deed of Gift on \_\_\_\_\_, \_\_\_\_\_.

\_\_\_\_\_  
[Donor's name]

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The **second document** is a receipt that will be signed by the transportation company. It acknowledges the ownership by the unitrust and confirms that the transfer is under the control of the trustee. Finally, the **third document** is confirmation of the sale by the elevator operator or other purchaser. Once again, the purchasing party states that the sale has been completed by the trustee on behalf of the trust.

**Charitable Tax Deductions**

When a charitable remainder trust is funded, the donor will usually receive an income tax deduction equal to the present value of the remainder interest to charity. The present value is calculated using the factors published by the IRS and the applicable federal rate (AFR) for the current month or one of the two prior months. When tangible personal property, such as livestock or crops, is transferred into a unitrust, additional rules impact the charitable deduction.

First, the transfer of assets into a unitrust creates an "intervening interest" under Sec. 170(a)(3). This section was created to preclude deductions for claimed "gifts" in which the donor retained possession and use of the donated asset. With a charitable remainder trust, Sec. 170(a)(3) causes the deduction to be delayed until the asset is sold. At that time, there is no longer an "intervening interest," since the asset has been converted to cash. During an "intervening interest" period, the donor must follow the Sec. 4941 rules regarding self-dealing.

Second, when a trust is funded with tangible personal property, the charitable deduction will be **limited to the cost basis of the asset**. With farm inventory, the farmer may receive a charitable deduction that is equal to zero, because the cost basis is typically zero. CRUTs do not qualify for a "related use" exception because a CRUT does not have a charitable purpose, instead it has a vested charitable remainder. As a result, when tangible personal property is transferred to a charitable remainder unitrust, the asset is always considered to be for an unrelated use.

### **Bypassing Ordinary Income**

The principal benefit of funding a unitrust with tangible personal property is the ability to defer the recognition of ordinary income. Even though there may be a modest or no charitable deduction, the avoidance of ordinary income tax at the point of sale of the asset could be a substantial income tax saving for the donor.

However, while CRTs are tax-exempt trusts, the payments to beneficiaries are subject to the four-tier accounting rules from Sec. 664 when distributed. Under this structure, the first tier is ordinary income, followed by capital gain, then tax-free income and finally the trust principal. Ordinary income must be paid out in its entirety before moving to the next tier with more favorable tax treatment and so on for each tier. The taxation of payments from charitable remainder trusts can be complex, donors should consult with a financial advisor or tax professional. When the unitrust is funded with farm inventory, it will pay out fully taxable ordinary income over the duration of the trust.

**Example – Corn Unitrust** - John and Mary's farm has an excellent corn crop this year. They sold most of the crop, recovered all expenses and have a current profit. In addition, John and Mary have 50,000 bushels of corn in a storage bin. Because their costs have been recovered, there is zero basis on the 50,000 bushels. Since the corn is inventory, they would pay a combined federal and state income tax rate of 41% if the corn were sold.

John and Mary use a Deed of Gift to transfer the corn into a CRUT that will make payments to them jointly for life. To minimize any potential risk with respect to prearranged sale, the financial advisor serves as initial trustee. The financial advisor immediately had the corn transported to the market and sold. Under Sec. 170(a)(3), the charitable income tax deduction is delayed until the corn is sold. All the corn sold for \$250,000.

Since this is a gift of tangible personal property for an unrelated use, the deduction is limited to John and Mary's cost basis. **Because the cost basis is zero, there is no charitable income tax deduction.** However, John and Mary saved approximately 41% tax on the sale, and effectively "banked" the \$250,000 tax-free. John and Mary will now receive income for their lives from the

trust, with each payment taxed as ordinary income. Because the value of their income over their lives may exceed the after-tax value from an outright sale, the corn unitrust is an excellent solution for John and Mary.

### Conclusion

For **donors looking to defer the recognition of ordinary income**, a charitable remainder unitrust can be an ideal financial planning method. A CRUT offers flexibility to enhance personal financial security and provides a beneficial way to donate crops or other farm inventory to charity. The trust's payments can be structured in several ways to best fit the donor's needs. A charitable remainder trust enables a donor and his or her advisor to tailor the trust to align with the charitable and financial goals of the donor.



#### ABOUT JAMES E. CONNELL

James E. Connell FAHP, CSA of Connell & Associates, Pinehurst, North Carolina, is a respected gift planning consultation firm with over four decades of experience offering a broad range of charitable estate and gift planning services to non-profits throughout the country. He heads CONNELL & ASSOCIATES, Charitable Estate & Gift Planning Specialists in Pinehurst, North Carolina. Contact him to help your organization analyze the value CGAs may provide.

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