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Using Charitable Remainder Trusts to Defer Reporting the Gain Realized From the Sale of Marketable Securities for Cash

By Jerome M. Hesch and Stephen M. Breitstone[*]

For appreciated marketable securities owners who do not want to wait until the income tax-free step-up in basis at death or cannot take advantage of it at death because the appreciated stock is owned by an irrevocable grantor trust[1] that is not exposed to the estate tax, a limited approach obtaining liquidity is to use a margin loan. That may not be satisfactory, as the built-in gain still exists when pledging an appreciated asset as collateral for a loan. However, one can use a charitable remainder trust (CRT) to defer the reporting of the realized gain if one desires to sell the marketable securities while living.

The first part of this article provides a brief overview of how CRTs are treated for federal income tax purposes. The second part will demonstrate how the CRT can obtain income tax deferral of a taxable gain on a cash sale of an asset, with a caution about its limitations and its risks.

I. CHARITABLE REMAINDER TRUSTS IN GENERAL

A. What Is a Charitable Remainder Trust?

A CRT allows transfer of an asset to a trust, retaining a right to receive a distribution of a predetermined amount that can consist of both trust income and trust principal for a period measured by a life or a fixed term not to exceed 20 years. At the end of the CRT term, whatever assets are left in the trust (trust principal) are distributed to charity. In the year of the CRT's creation, the settlor is entitled to a current charitable income tax and gift tax deduction in an amount equal to the present value of the assumed trust's assets that will pass to charity at the end of the CRT term.[2]

What is important is that the annual amount distributed to the non-charitable holder of the lead interest is determined independently from the income earned by the trust. Instead, the formula for determining the annual distributions fixes the required distribution upon creation of the trust. There are two kinds of CRTs, the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT). In the case of the CRAT, the lead interest is an annuity for a predetermined dollar amount that must be distributed each year regardless of the value of the trust principal. In the case of a CRUT, the lead interest is a fixed percentage of the value of trust corpus where the value of the principal is measured annually. In either case, the lead interest is determined by formula without regard to the income earned by the CRT. Distributions during the CRT term can be a combination of income

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[1] As discussed below in the text under "Who Can Create a CRT?" a non-grantor trust cannot create a charitable remainder trust. *See* Reg. §1.664-1(a)(1)(iii)*(a)*. All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[2] In general, if a marketable security is contributed to a charitable remainder trust, the charitable income tax deduction is based on value. If the charitable beneficiary for a charitable remainder trust is a private foundation, and other types of long-term capital gain property is contributed, the charitable income tax deduction is based on the income tax basis for the contributed asset. For our purpose, the asset contributed is a marketable security so that its value can be used in determining the charitable income tax deduction.

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and principal or, if income is greater than the fixed amount, the distribution can be only income.

B. How Are Charitable Remainder Trusts Taxed?

1. A CRT's Income Is Tax Exempt

The CRT does not pay income taxes on the income it reports. However, if that income is distributed, the non-charitable holder of the lead interest is taxable on the distributed income under the ordering regime set forth in §664(a). The income earned by the CRT is reported on the CRT income tax return even though the CRT does not pay income taxes.[3] If that income is not distributed, it is not subject to income tax currently. If income accumulated in the CRT is later distributed to the non-charitable holder of the lead interest, the income is taxable to the non-charitable beneficiary, and the character of the trust's income passes to the holder of the lead interest. In effect, the CRT is a pass-through entity only when a distribution is made.

2. The Settlor Contributes an Appreciated Asset to the CRT

If the CRT sells an appreciated asset that was contributed to it, the CRT realizes a gain. The built-in gain (the appreciation in value at the time of the transfer in trust) realized by the CRT is treated as trust principal and is reported as a gain on the trust's income tax return even though the realized gain is not taxable to the CRT. However, under the §664(a) ordering rules, if trust principal is later distributed to the non-charitable beneficiary, the gain realized by the CRT from the sale of the contributed asset is reported incrementally as the trust principal is distributed to the non-charitable recipient.[4]

Example 1: Senior contributes an asset with a basis of $1,000,000 and a value of $10,000,000 to the CRT. Trust principal is $10,000,000. The CRT sells the asset and reports a $9,000,000 capital gain on the CRT's income tax return. The $9,000,000 gain is not taxable to the CRT. The trust invests the $10,000,000 of sale proceeds in other assets that earn $500,000 of interest and dividend income on the $10,000,000 of trust principal. At the end of the first year, the trust is required to distribute to the non-charitable holder of the lead interest $650,000, an amount fixed in the trust instrument. The first $500,000 received is treated as interest and dividend income (fiduciary accounting income). The remaining $150,000 is a distribution of principal, where 90% is treated as capital gain and 10% is treated as a return of basis.[5]

C. The Conduit Rules Under §664(a)

1. The income earned by the trust is not subject to income tax when it is retained in the trust. However, trust income is taxable if, and to the extent, it is distributed to the non-charitable holder of the lead interest (the noncharitable beneficiary). Unlike the DNI rules of Subchapter J that apply to private trusts, a special ordering rule is found in §664(a) which consists of four tiers. The first three tiers are determined by the character of the income (fiduciary accounting income) earned from the investment of the trust principal. The first dollar distributed comes out of Tier 1, which consists of interest, dividends, royalties and other forms of ordinary income. Tier 2 consists of capital gains generated from the investment of the trust principal. Tier 3 is tax-exempt income. Tier 4 is trust principal.

Example 2: The $10,000,000 of sale proceeds from the sale of the contributed asset are invested in an asset that has a $10,000,000 cost basis. That asset is later sold for $10,100,000. The $100,000 of capital gain realized by the CRT can be treated as Tier 2 trust accounting income, depending upon if state law allows capital gains earned by investment of trust principal to be treated as fiduciary accounting income. The $9,000,000 of gain from the sale of the trust principal is Tier 4 income if it is distributed.

All CRATs and certain CRUTs permit the trust to distribute trust principal. Certain CRUTs do not allow the trust to distribute trust principal.[6]

Example 3: Going back to Example 1, where $650,000 was distributed and fiduciary accounting income was only $500,000, the remaining $150,000 is a Tier 4 distribution of trust principal which passes out the basis and the capital gain inherent in the $10,000,000 of initial trust principal.

D. Assignment of Income Exposure Upon the Contribution of Appreciated Property to a Charitable Remainder Trust

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[3] A charitable remainder trust cannot be a grantor trust and files a separate income tax return using its own taxpayer identification number.

[4] Prop. Reg. §1.1014-5; adopting the position first announced in Notice 2008-99, 2008-2 C.B. 1194. The built-in gain cannot be eliminated when the CRT invests the sale proceeds in another asset that has a basis equal to its cost.

[5] Prop. Reg. §1.1014-5.

[6] This limitation applies to net income make-up charitable remainder unitrusts (NIMCRUTs) and net income charitable remainder unitrusts (NICRUTs).

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1. In general, the law that has evolved and the approach taken by the IRS is that as long as there is no *legally binding obligation* imposed on the donor or on a CRT to sell the property when contributed by a donor, the assignment of income doctrine will *not* be applicable, notwithstanding any prearranged or contemplated plan to have the CRT sell the property. This principle has been applied *even where there is a prearranged plan* for the CRT to sell the property shortly after the contribution.

2. A court decision demonstrating this principle is *Palmer v. Commissioner,*[7] where the donor — a controlling shareholder of a corporation — transferred the stock to a private foundation, which the donor also controlled. Subsequent to the transfer and pursuant to a prearranged plan, the shareholder caused the corporation to redeem the transferred shares from the foundation the very next day. The Tax Court respected the form of the transaction and did not recharacterize the transaction as a redemption of the stock by the donor shareholder followed by a gift of the redemption proceeds to the private foundation. This conclusion was based on a finding that the gift of stock had in fact been made to the foundation and *that the corporation was not legally obligated to redeem the stock at the time the foundation received title to the shares*. The Tax Court reasoned that

> there were two paths which the [donor shareholder] could have taken—he could have had the stock redeemed and then made a contribution of the [proceeds], or he could have contributed the stock and let the donee arrange for the redemption. The tax consequences to the donor turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way.

See also Rev. Rul. 78-197, where the IRS concluded that it will treat the proceeds of a redemption of stock under facts similar to *Palmer* as income to the donor under the assignment of income doctrine only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. Compare *Blake v. Commissioner*[8] where the assignment of income doctrine applied. In *Blake*, the taxpayer contributed publicly traded stock to a charity, with the understanding that the charity would sell the stock and use the cash proceeds to purchase his yacht. Under these facts, the New York law of promissory estoppel applied because the charity was under a legal obligation under state law to sell the contributed stock and use the proceeds to purchase the donor's yacht.

[7] 62 T.C. 684 (1974).

[8] 697 F.2d 473 (2d Cir. 1982).

See generally, the *Ferguson v. Commissioner,*[9] *Marc Chrem v. Commissioner*,[10] and *Rauenhourst v. Commissioner*[11] court decisions that applied the "*anticipatory assignment of income*" principle to tax the settlor of the trust on the gain realized from the sale even though the gain was realized after the appreciated asset was contributed to the trust. If all the business terms for the sale of an asset have been agreed upon so that neither the seller nor the buyer can back out of the sale without being liable for damages, what you are assigning to the charitable remainder trust is not an appreciated asset, but the right to the collection of the sale proceeds at closing. This approach is similar to whether an appreciated asset owned by the decedent at the date of death is eligible for a basis step-up on death under §1014 or is income-in-respect-of-a-decedent (IRD) under §691.[12] Compare *Court Holding*[13] (last-minute distribution from a corporation of property subject to a fully negotiated contract was disregarded under substance-over-form principles). One word of caution. The ability to shift taxable income to a CRT is not available for income from services.[14]

E. Why a Charitable Remainder Unitrust Instead of an Annuity Trust?

1. What Is a Unitrust?

Unlike with a CRAT, the annual payment is not a fixed amount determined at the time a CRUT is created. Instead, it is a fixed percentage of the value of the trust principal for the year the distribution to the holder of the lead interest is made.

> **Example 4:** Senior created a CRAT, required to distribute to Senior an amount equal to 5% of the trust principal, using the value of the asset transferred in trust at the time the trust is created. Senior contributed $1,000,000 of cash to the trust. The trust is required to distribute $50,000 (5% × $1,000,000) to Senior each year regardless of the trust's annual income. During the first year, the trust principal generated $60,000 of taxable in-

[9] 108 T.C. 244 (1997), *aff'd,* 174 F.3d 997 (9th Cir. 1999).

[10] T.C.M. 2018-164.

[11] 119 T.C. 157, 166 (2002).

[12] In *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981), the actual closing took place after the decedent's death. The determination depended upon whether the parties could be liable for damages if they did not go through with the sale.

[13] 324 U.S. 331 (1945).

[14] *Lucas v. Earl*, 324 U.S. 331 (1945) (assignment of income from services to another taxpayer remains taxable to the service provider).

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come. Senior received a $50,000 distribution, and the excess $10,000 was added to trust principal. During the second year, the trust generated only $45,000 of taxable income. Senior received a distribution of $50,000, thereby reducing trust principal by $5,000.

Example 5: Senior created a CRUT, required to distribute to Senior an amount equal to 5% of the trust principal, using the value of the trust principal at the beginning of each year that a distribution is made. Senior contributed $1,000,000 cash in trust. At the end of the first year, Senior is entitled to an amount equal to 5% of the value of trust principal at the start of each year. During the first year, the trust generated $60,000 of taxable income. Senior received a distribution of only $50,000, and the $10,000 excess is added to trust principal increasing trust principal for the start of the second year to $1,010,000. For the second year, Senior is entitled to receive a distribution of $50,500 (5% × $1,010,000) regardless of the trust's income for the year.

Given the 5% minimum distribution requirement (the minimum amount both the unitrust and the annuity trust must distribute), trust principal can be distributed if the trust's income (fiduciary accounting income) is less than 5%. As the above examples illustrate, both the unitrust and the annuity trust allow for depletion of trust principal over time. As we will illustrate later, that distribution of trust principal is what passes out the deferred gain realized from the sale of the property contributed to the CRT.

2. When It Is More Advantageous to Create a Unitrust Instead of an Annuity Trust

A charitable remainder unitrust provides a larger immediate income tax charitable deduction than a charitable remainder annuity trust when the §7520 rate is less than 5%. If the §7520 rate is greater than 5%, the annuity trust will produce a larger charitable income tax deduction than the unitrust.

Example 6: An individual contributes $10,000,000 to a CRT for a 20-year fixed term and retains a 5% interest. The trust qualifies as a CRT because the present value of the remainder interest passing to charity is not less than 10%. For a CRAT the retained interest is fixed in advance at 5% of the value of trust principal at the time the trust was created. For a CRUT, the individual retains the same minimum unitrust percentage allowed by the statute (5% of the value of the existing trust principal each year).

If the §7520 rate is 3.2%, the CRUT will yield a $3,704,210 charitable income tax deduction while a CRAT with the same asset will yield a $2,696,950 charitable income tax deduction.[15]

If the §7520 rate is 5.8%, with a 5% retained interest, the CRUT will yield a $3,798,160 charitable income tax deduction while the CRAT will yield a $4,170,750 income tax deduction.[16]

3. The Advantage of Doing a CRT for Life

Because §7520 requires the use of the 2000CM mortality tables, the present value of the remainder interest passing to charity is assumed to pass to the charity when the individual reaches their life expectancy under the 2000CM mortality tables. Under the 2000CM mortality tables, an individual age 70 has a life expectancy of 14.2 years. Therefore, it is assumed the charity will receive the trust principal in 14.2 years when computing the present value of the charity's remainder interest. Because the 2000CM mortality tables are 19 years out of date — based upon the 2000 census data for the entire U.S. population — it is probable an individual creating a CRT for life will live far beyond this mortality assumption, especially because clients who create charitable remainder trusts have access to far better healthcare and nutrition than the U.S. population as a whole. Because the actual life expectancy of a wealthy individual age 70 is more like 20 years, the value of charitable deduction for creation of the CRT is inflated because the required use of the 2000CM mortality tables assumes the charity will receive a distribution of the trust principal far sooner. The Treasury was required to issue new mortality assumptions based on the 2010 census data on May 1, 2019, but it has been unable to do so because the Centers for Disease Control has not provided the needed data to Treasury. Even with the adoption of the 2010 mortality assumptions, these discrepancies will still exist. The adoption of the 2010 tables will still be nine years outdated. Moreover, it does not consider the fact that clients who create CRTs tend to be healthier and live longer than expected based on the 2010 mortality tables.

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[15] For the CRAT you start with the value of trust principal less the present value of the annuity payments. With a discount rate of 3.2%, the present value of the retained $50,000 annual annuity is $7,303,050. Because the CRAT is sensitive to the §7520 discount rate, a larger discount rate lowers the value of the retained annuity. When dealing with a CRUT you determine the present value of the remainder interest. The factor used for the CRUT is based solely on the CRUT's payout percentage rate, not the §7520 rate then in effect. Thus, the calculation of the present value of a remainder interest in a CRUT will essentially be the same for a charitable remainder unitrust that has a 5% annual payout regardless of the §7520 rate being 1%, 5%, or even 10%.

[16] At a discount rate of 5.8%, the present value of the retained $50,000 annual annuity is $5,829,250.

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F. Requirements to Qualify for CRT Treatment

1. 10% Remainder Interest Requirement

In order to qualify as a CRT, the present value of the remainder interest passing to the charity must be at least 10% of the value of the initial trust principal. The 10% minimum value of the charitable remainder interest limits the annual distributions that can be made to the lead interest holder. The 10% is only a minimum. If one desires to maximize the immediate charitable income tax deduction, one can reduce the annuity amount or unitrust amount to the 5% minimum for the lead interest. Retaining a right to receive less than the maximum lead interest increases the amount passing to charity, thereby increasing the present value of the remainder interest.

2. 5% Minimum Distribution Requirement

Another requirement is that the noncharitable lead interest for a charitable remainder trust cannot be less than 5%. For a unitrust, the minimum annual distribution cannot be less than 5% of the value of the trust principal, measured each year. For an annuity trust, the minimum annual distribution fixed at creation of the trust must be an amount equal to 5.0% of the trust principal at the time of contribution.

Example 7: If an individual age 70 desires to retain the maximum unitrust interest and still have a remainder interest passing to charity with a present value of 10% of trust principal, the unitrust percentage would be 26.077%. If the retained unitrust interest is the 5.0% minimum, the present value of the charity's remainder interest is 52.882%.

3. Maximum Trust Term

The lead interest for the CRT term can be for one life or a combination of any number of lives. If the lead interest for the trust is a fixed term, that term cannot exceed 20 years. If an entity creates a CRT, the trust term cannot be for life because the entity does not have a life expectancy. Accordingly, when an entity creates a CRT, it must be for a fixed term.

4. Who Can Create a CRT?

An entity or an individual can create a charitable remainder trust. If an entity creates a CRT and retains the non-charitable lead interest, the CRT term cannot be for life and therefore must be for a fixed term, subject to the 20-year maximum. However, an irrevocable, non-grantor trust cannot create a CRT. Treas. Reg. §1.664-1(a)(1)(iii)*(a)* requires that the settlor of a CRT must be entitled to a charitable income tax deduction under §170. A complex trust is not entitled to a charitable deduction under §170, but instead is entitled to one under §642(c). However, it appears that a grantor trust can create a CRT because the individual grantor is deemed to be the owner of the grantor trust's assets.

Example 8: A partnership owns an appreciated asset it would like to sell. The partnership is a tax person and a tax person can create a CRT. Therefore, this partnership can create a CRT and name itself as the noncharitable holder of the lead interest.

5. The Exhaustion Test

Pursuant to Rev. Rul. 77-374,[17] an additional requirement is imposed on charitable remainder annuity trusts.[18] The revenue ruling requires that there cannot be more than a 5% probability that the distributions to the annuitant will exhaust the CRAT. The IRS has not applied this same rule to CRUTs because, in theory, a charitable remainder unitrust cannot be exhausted prior to the termination of the unitrust interest. For example, if a CRAT is established for a single individual's life and there is a greater than 5% probability that the funds of the charitable remainder trust will be exhausted before the individual is expected to die, then the CRAT will fail the exhaustion test and not qualify for a charitable deduction.

In order to determine the probability of failing the exhaustion test, most practitioners use commercial programs that automatically provide the calculations after inputting the age of the measuring life and the §7520 rate. It can be manually computed by following two basic steps. First, calculate how many years it will take to exhaust the CRAT assuming growth at the §7520 rate and the selected annual payout rate. Second, determine the probability the beneficiary will still be living when the charitable remainder trust is exhausted. If that probability is greater than 5%, then the CRAT will fail the exhaustion test.

In the current low-interest-rate environment, the exhaustion test makes it very difficult to establish a CRAT that is entitled to a charitable deduction. Why? In determining the probability the CRAT will be exhausted, its principal is assumed to grow annually at the §7520 rate. The lower the §7520 rate, the smaller the CRAT is expected to grow. Furthermore, the other rules for all CRTs require the annual payout to be at least 5%.[19] This means that in our current interest rate environment, a CRAT will be eroding principal every year it is in existence if the §7520 rate is less than

[17] 1977-2 C.B. 329.

[18] Practitioners generally believe that this requirement does not apply to CRUTs, but the IRS has not directly addressed the issue.

[19] §664(d)(1)(A), §664(d)(2)(A).

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5.0%.[20] The longer its term, the more likely the CRAT will fail the exhaustion test. Many individuals will use a CRUT for life or a CRAT for a fixed term because neither has to satisfy the exhaustion test.

The exhaustion test has severely hampered charitable giving by essentially making CRATs obsolete in our low-interest-rate environment. Since December 2007, the §7520 rate has not exceeded the minimum 5% annuity payout rate required of all charitable remainder trusts. This makes it difficult to pass the exhaustion test. The IRS, realizing the negative impact the exhaustion test has been having on CRATs, issued Rev. Proc. 2016-42[21] as a reprieve. The revenue procedure applies to all CRATs created on or after August 8, 2016.[5] It allows for CRATs to now be terminated by virtue of a qualified contingency if at some later time the remaining trust value, as discounted from the date of creation, is about to be reduced to 10% of its initial fair market value by the next annuity payment.[22] This tool to circumvent the impact of the exhaustion test may not be used that often because of the administrative complexity it adds to CRATs. And, it will lead most practitioners to use the unitrust, especially with §7520 rates below 5%.

G. Compare Alternative Choices for the CRT

1. Advantage of a Fixed Trust Term Over a Term for Life

As a result of the exhaustion test, the CRAT may not work for a younger measuring life. Therefore, you may have to use a fixed term up to 20 years. However, you will not get the benefit of the life expectancy distortion in the mortality tables when using a fixed term.

With a CRT for life, if one dies prematurely, the annual payments cease and all trust principal at the date of death passes to the charitable remainder beneficiary. As will be illustrated later in this article for a CRUT designed to deplete trust principal, a larger amount will pass to charity than if the measuring life died later. If one does not want to take the risk of a premature death, one should consider a CRT for a fixed term of up to 20 years. As the right to an annuity or unitrust amount is retained for a fixed term, the decedent's retained interest does not terminate at death and can be passed on to the successor-in-interest.

2. Advantages of a Unitrust Over an Annuity Trust

If the goal is to minimize what ends up going to charity, the unitrust allows the corpus to be depleted more predictably for the lead interest holder who lives beyond the life expectancy used in the mortality tables. And, as discussed above, the unitrust avoids the application of the exhaustion test, which limits the usefulness of an annuity trust.

II. CONTRIBUTION OF MARKETABLE SECURITIES TO A CRUT

The illustrative examples that follow assume the charitable income tax deduction is based upon the value of the asset contributed to the trust (*i.e.* initial trust principal). For both public charities and private foundations, the computation of the charitable income tax deduction uses the value of marketable securities. If the contributed asset is not a marketable security, the Internal Revenue Code provides that for certain types of assets the charitable income tax deduction will be based upon the basis of the appreciated asset contributed to the trust, not its value. Because the charitable income tax deduction can be limited to the basis of the property with a private foundation, a public charity should be the designated remainder beneficiary. A donor advised fund is a public charity.

A. How the CRT Defers Reporting Gain Realized From the Sale of the Contributed Asset

When the distribution required under the CRT is an amount that will exceed the income generated by the trust's assets, the excess of the distribution over the trust's income will be a tier 4 distribution of trust principal. Accordingly, the distribution of trust principal will pass out each year a portion of the gain realized when the trustee sold the appreciated asset that was contributed to the trust.[23]

> **Example 9:** Senior, age 59, owns public company stock valued at $10,000,000 with a zero basis. She contributes the appreciated stock to a CRUT, re-

[20] Using the 2.2% §7520 rate for September 2019, a CRAT with an annuity equal to 5.0% of trust principal, the exhaustion test will be failed if the measuring life is less than age 71. When using an annuity equal to the minimum of 5.0% of trust principal, at a 3.0% §7520 rate, the cut off age is 66. And, at a 4.0% §7520 rate, the cutoff age is 55. If the annuity is computed at a rate greater than 5.0% of trust principal, the cutoff age will be even younger.

[21] 2016-2 C.B. 269.

[22] §664(f).

[23] If the trust sells an appreciated asset and invests the sale proceeds in an asset with a basis equal to its cost (the amount of the sale proceeds), a distribution of trust principal will carry out the gain previously realized upon the sale of the appreciated asset contributed to the trust. Prop. Reg. §1.1014-5; adopting the position first announced in Notice 2008-99, 2008-2 C.B. 1194. The built-in gain cannot be eliminated even though the CRT invests the sale proceeds in another asset that has a basis equal to its cost.

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taining a 14.691% unitrust interest for her life. Although the §7520 rate was 3.4%, the unitrust calculations are not dependent upon the §7520 rate. The 14.691% unitrust rate is the maximum percentage that still satisfies the 10% value of trust principal that passes to the charitable remainder beneficiary. Therefore, Senior is entitled to an immediate $1,000,000 charitable income tax deduction.

Immediately after the CRUT received the stock, the trustee sold the stock for $10,000,000 cash and realized a $10,000,000 long-term capital gain. During the first year, the investment of the $10,000,000 of the sale proceeds earns 5%, or $500,000, consisting of interest and dividends. At the end of the first year, the trustee distributes $1,469,100 to Senior. Applying the four-tier allocation rule under §664(a) subjects Senior to income tax on the entire distribution amount. After the $500,000 of trust accounting income is allocated (a tier 1 distribution), the remaining $969,100 is a tier 4 distribution of trust principal and the entire $969,100 is reported as a long-term capital gain because there was no basis in the contributed asset that was sold by the trust.

The $1,000,000 charitable income tax deduction provides an income tax benefit as it can be used to offset taxable income for the year the CRUT is created and for the next five years.

After the payment of the income taxes on the $1,491,000 of income, Senior has $860,000 of cash remaining. She can invest the after-tax cash in any asset without any restrictions. For example, assume Senior purchases $4,000,000 of real estate with the $869,000 as a down payment and finances the remainder of the purchase price. That portion of the purchase price allocated to the building can be depreciated.

As mentioned above, if the §7520 rate is less than 5.0%, the CRUT will generate a larger charitable income tax deduction than the CRAT. Because the §7520 rate has not exceeded 5.0% since November 2007 and is not expected to be greater than 5.0% for now, the following illustrations will use a CRUT.

B. Illustration of Capital Gain Deferral

Example 10: On January 1, Senior, age 65, contributes to a CRUT $10,000,000 worth of zero-basis stock in a public company and retains an annual 19.71% unitrust interest for life when the §7520 rate is 3.2%.[24] By maximizing the unitrust percentage, Senior limited the immediate income tax charitable deduction to 10% of the value of the asset contributed to the trust, or a $1,000,000 charitable income tax deduction. The trustee sells the stock and invests the entire $10,000,000 of sale proceeds in a diversified portfolio of marketable securities earning a 5.0% rate of return. Under the 2000 CM mortality tables, Senior's life expectancy is 17.8 years. Therefore, Senior is estimated to live to age 82.7. Because there is a 50% probability Senior will still be alive in 17.8 years, a life insurance company rates Senior in excellent health and estimates that she will live to age 93, an additional 10 years. The following table illustrates the portion of the $10,000,000 capital gain reported by Senior each year upon the receipt of each annual unitrust payment using the assumption that the trust earns a 5% rate of return on its investments. The table carries out its projections beyond Senior's 17.8-year life expectancy because in 17.8 years 50% of the people age 65 will still be living. Instead, the financial projections take into account how long Senior is expected to survive.

[24] The annual payment must be made on the last day of the trust's taxable year, the calendar year. If the trust is created later in the year, the first annual payment is prorated using the number of days for the first year.

Year	Beginning Principal	Add: Income	Less: Distributions	Ending Principal	Capital Gain From Principal
1	$10,000,000.00	$500,000.00	$1,951,900.00	$8,548,100.00	1,451,900.00
2	$ 8,548,100.00	$427,405.00	$1,668,503.64	$7,307,001.36	1,241,098.64
3	$ 7,307,001.36	$365,350.07	$1,426,253.60	$6,246,097.83	1,060,903.53
4	$ 6,246,097.83	$312,304.89	$1,219,175.84	$5,339,226.88	906,870.95
5	$ 5,339,226.88	$266,961.34	$1,042,163.69	$4,564,024.53	775,202.35
6	$ 4,564,024.53	$228,201.23	$ 890,851.95	$3,901,373.81	662,650.72
7	$ 3,901,373.81	$195,068.69	$ 761,509.15	$3,334,933.35	556,440.46
8	$ 3,334,933.35	$166,746.67	$ 650,945.64	$2,850,734.38	484,198.97
9	$ 2,850,734.38	$142,536.72	$ 556,434.84	$2,436,836.26	413,898.12
10	$ 2,436,836.26	$121,841.81	$ 475,646.07	$2,083,032.00	353,804.26
11	$ 2,083,032.00	$104,151.60	$ 406,587.02	$1,780,596.58	302,435.42

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Year	Beginning Principal	Add: Income	Less: Distributions	Ending Principal	Capital Gain From Principal
12	$1,780,596.58	$ 89,029.83	$ 347,554.65	$1,522,071.76	258,524.83
13	$1,522,071.76	$ 76,103.59	$ 297,093.19	$1,301,082.16	220,989.60
14	$1,301,082.16	$ 65,054.11	$ 253,958.23	$1,112,178.04	188,904.12
15	$1,112,178.04	$ 55,608.90	$ 217,086.03	$ 950,700.91	161,477.13
16	$ 950,700.91	$ 47,535.05	$ 185,567.31	$ 812,668.65	138,032.26
17	$ 812,668.65	$ 40,633.43	$ 158,624.79	$ 694,677.29	117,991.36
18	$ 694,677.29	$ 34,733.86	$ 135,594.06	$ 593,817.09	100,860.20
19	$ 593,817.09	$ 29,690.85	$ 115,907.16	$ 507,600.78	86,216.31
20	$ 507,600.78	$ 25,380.04	$ 99,078.60	$ 433,902.22	73,698.56
21	$ 433,902.22	$ 21,695.11	$ 84,693.37	$ 370,903.96	62,998.26
22	$ 370,903.96	$ 18,545.20	$ 72,396.74	$ 317,052.42	53,851.54
23	$ 317,052.42	$ 15,852.62	$ 61,885.46	$ 271,019.58	46,032.84
24	$ 271,019.58	$ 13,550.98	$ 52,900.31	$ 231,670.25	39,349.33
25	$ 231,670.25	$ 11,583.51	$ 45,219.72	$ 198,034.04	33,636.21
26	$ 198,034.04	$ 9,901.70	$ 38,654.26	$ 169,281.48	28,752.56
27	$ 169,281.48	$ 8,464.07	$ 33,042.05	$ 144,703.50	24,577.98
Totals		$3,393,930.87	$13,249,227.37		$9,855,296.50

As the above table illustrates, the deferred reporting of the capital gain is front-loaded. After 10 years, Senior has reported $7,916,968 of the $10,000,000 capital gain. But, the $1,000,000 charitable income tax deduction can be used to offset $1,000,000 of the $1,451,900 capital gain reported at the end of the first calendar year if the 30% of adjusted gross income limitation does not apply. If the 30% limitation applies, the unused charitable income tax deduction can be carried forward for five years.

Had Senior directly sold the $10,000,000 of marketable securities and paid federal and state income taxes on the capital gain, using a combined effective income tax rate of 30%, Senior would have netted $7,000,000 after the payment of income taxes. The advantage from the income tax deferral is that Senior will always have more than $7,000,000 invested to generate income, without considering the tax savings from the $1,000,000 charitable income tax deduction. The $7,000,000 threshold to generate investment income is always exceeded when combining the remaining principal in the trust and the after-tax amount Senior will net after paying the income taxes on the capital gain reported as a tier 4 distribution. For example, at the end of 10 years, Senior will have received and reported $7,916,968 of tier 4 capital gains and after the 30% combined income tax rate, Senior's after-tax amount will be $5,541,877. The combination of the remaining trust principal and Senior's after-tax $5,541,877 is $7,624,909.

If Senior survives for 27 years to age 92, Senior will have received a current income tax charitable deduction of $1,000,000 for the actual $144,703.50 of trust principal passing to charity upon Senior's death.

Individuals who do not want to take the risk of dying prematurely[25] can eliminate that risk by creating a CRT for a fixed term. The drawback is that for a fixed 20-year CRUT term, the maximum unitrust percentage is only 11.071%. Using a 5% investment rate of return, and the maximum unitrust percentage, at the end of 20 years the trust principal passing to charity is $2,857,550.87, far more than the $433,902.22 of remaining trust principal at the end of 20 years if the CRUT was for life. But the client is receiving a current income tax deduction of $1,000,000 for the $2,857,550.87 distributed to charity if death occurs after the year 20 distribution.[26]

III. CONCLUSION

As the materials illustrate, the CRUT must be custom designed to accommodate a variety of factors such as the age of the individual and the projected rate of return on the investment of the sale proceeds. One must also consider whether a fixed-term CRUT may be more appropriate if the measuring life will have a low unitrust percentage.[27] The above examples used a 5% investment rate of return. If the investment rate of

[25] Senior can reinsure the risk of an early death by purchasing layered term insurance for the first 5 or 10 years in an amount to provide a death benefit equal to the trust principal passing to charity during that period.

[26] Using a 5% discount rate, the present value of the right to receive $2,857,550.87 at the end of 20 years is only $1,076,885, which about equals the current $1,000,000 charitable income tax deduction.

[27] The unitrust percentage of a lifetime CRUT is 9.859% for a 50-year-old and 7.072% for someone age 40. Therefore, the 20-year fixed-term CRUT may be better.

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return is less than 5%, the CRUT payment will conduit out a larger capital gain portion. If greater than 5%, the CRUT capital gain passed out as a tier 4 distribution will be less. The overall income tax benefit of the CRUT is that there will be a larger amount of trust principal to generate investment income than if the entire gain is exposed to immediate income tax. And, one must also factor in the tax savings from the current charitable income tax deduction. One must financially illustrate the alternatives using different assumptions so that the potential client can weigh the impact of each factor and make a final decision as to the most appropriate structure to implement.

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