Comparison of Non-Recognition of Gain to a Technique Designed to Defer the Reporting of the Gain: How does a § 1031 Exchange Measure Up to a Charitable Remainder Trust?

For owners of appreciated real estate who do not want to wait until the income tax-free step-up in basis at death or cannot take advantage of the step-up in basis at death because the appreciated real estate is owned by an irrevocable trust that is not exposed to the estate tax, or by a C or S corporation, the typical approach is to use a like-kind exchange under Section 1031. When the realized gain is not recognized, the replacement property cannot obtain an income tax-free basis for a gain that is not reported, with no additional depreciation deductions except for those resulting from an additional equity investment or indebtedness. Today’s presentation will analyze how a real estate owner can use a Charitable Remainder Trust (“CRT”) to defer the reporting of the realized gain and how the investment of the after-tax proceeds received as the deferred gain is reported can be used to purchase real estate to generate additional depreciation deductions. The presentation will examine, with simple to follow numerical examples, how the use of a CRT measures up to a Section 1031 exchange.

We will first provide a brief overview of how CRTs are treated for Federal income tax purposes, how CRT treatment can be used to have more investment funds available than an income taxable sale where the after-tax proceeds are invested, and how the income tax deferral of the taxable gain released on a cash sale of the real estate is obtained. Moreover, we will demonstrate how to defer the gain from the sale of real estate without investing all the proceeds in other real estate – as is required under the straight section1031 scenario.

I. Charitable remainder trusts

A. What is a charitable remainder trust (a “CRT”)?

A CRT allows transfer of an appreciated 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 a charity. In the year of creation, the settlor of the CRT is entitled to a current charitable income tax and gift tax deduction in an amount equal to the present value of the assets that will pass to charity at the end of the CRT term.\(^1\)

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 is fixed 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 fixed dollar amount. 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 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 is tax exempt.** The CRT does not pay income taxes on the income it earns. 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 Section 664. Income earned by the CRT is reported on the CRT income tax return. If that income is not distributed, it is not subject to income tax currently. If income accumulated in the CRT with no trust income tax is later distributed to the non-charitable holder of the lead interest, the character of the trust’s income passes to the holder of the lead interest and is taxable to the non-charitable beneficiary.

2. **The settlor contributes an appreciated asset to the CRT.** The CRT sells the appreciated asset, realizing 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. The realized gain is not taxable to the CRT. However, under the Section 664 ordering rules, if trust principal is later distributed to the non-charitable beneficiary, then the gain realized by the CRT when it sold the appreciated asset is reported incrementally when and as the trust principal is distributed to the non-charitable recipient.

**Example:** S 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 and earns $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

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\(^1\) The amount for the charitable income tax deduction depends upon whether the charitable beneficiary is a public charity or a private foundation (and the use of the asset by the charity) and the income tax basis for the contributed asset. In general, if the remainder beneficiary is a public charity, the income tax deduction will be based on the fair market value of the contributed asset. If the remainder beneficiary is a private foundation, the charitable income tax deduction will be based on the lesser of the fair market value of the remainder interest or the basis of the property contributed to the CRT.
$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.

C. **The conduit rules under Section 664**

1. The income earned by the trust is not subject to income tax if 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 Section 664 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 is 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:** The $10,000,000 of sale proceeds from the sale of the appreciated asset that resulted in a $9,000,000 gain, are invested in stocks that are 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.

**Example:** Going back to our previous example 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 capital gain inherent in the $10,000,000 of trust principal.

D. **Assignment of income exposure upon the contribution of appreciated property to a CRT:**

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 contributed or on a CRT to sell the property 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 sell the property shortly after the contribution.

2. A case demonstrating this principle is *Palmer vs. Comm'r*, 62 T.C. 684 (1974), where donor was a controlling shareholder of a corporation and transferred 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 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. Comm’r, 697 F2d 473 (2d Cir. 1982), 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, New York law of promissory estoppel applied, such that 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.

3. See generally, Ferguson v. Commissioner, 108 T.C. 244 (1997), affirmed 174 F 3rd 997 (9th Cir. 1999); Marc Chrem v. Commissioner, T.C.M. 2018-164 (legal obligation); See also Rauenhurst v. Commissioner, 119 T.C. 157, 166 (2002). These court decisions applied the “anticipatory assignment of income” principle. If all of 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 CRUT is not an appreciated asset, but the right to the collection of the sale proceeds at closing. This 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 Section 1014 or is the practical equivalent of IRD under Section 691. See Peterson’s Estate v. Commissioner, 667 F.2d 675(8th Cir. 1981) (if there exists liability for damages, it is IRD). Compare Court Holding, 324 U.S. 331 (1945) (last minute distribution from a corporation of property subject to a fully negotiated contract was disregarded under substance v. form principles). Compare Lucas v. Earl, 324 U.S. 331 (1945) (assignment of income from future services is taxable to the service provider).

E. Why a Charitable Remainder Unitrust?

1. What is a Unitrust? Unlike with a CRAT, the annual payment is not a fixed amount determined at the time the CRT 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: S created a Charitable Remainder Annuity Trust, required to distribute to S 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. S contributed $1,000,000 of cash to the trust. The trust is required to distribute $50,000 (5% x $1,000,000) to S each year regardless of the trust’s annual income. During the first year, the trust principal generated $60,000 of taxable income. S 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. S received a distribution of $50,000, thereby depleting trust principal by $5,000.

**Example:** S creates a Charitable Remainder Unitrust, required to distribute to S an amount equal to 5% of the trust principal, using the value of the trust principal at the beginning of each year a distribution is made. S contributed $1,000,000 cash in trust. At the end of the first year S 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. S 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 S is entitled to receive a distribution of $50,500 (5% x $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. And, 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.**

The charitable remainder unitrust (CRUT) provides a larger immediate income tax charitable deduction than a charitable remainder annuity trust when the Section 7520 rate is less than 5%.

**Example:** An individual contributes $10,000,000 to a CRUT for a 20-year fixed term. The trust qualifies as a CRUT because the present value of the remainder interest passing to charity is not less than 10%, and the individual retains the minimum unitrust percentage allowed by the statute (5% of the value of the existing trust principal each year). At today’s Section 7520 rate of 3.2%, the CRUT will yield a $3,704,210 current charitable income tax deduction while a CRAT with the same asset, a 5% annuity and trust term will yield a $2,696,950 charitable income tax deduction (subject to basis limitations).

3. **The advantage of doing a CRT for life.** Because Section 7520 requires the use of life expectancies on the 2010 mortality tables of the US population as a whole, 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 2010 mortality tables. Under these 2010 mortality tables, an individual age 70 has a life expectancy of 15 years. Therefore, it is assumed the charity will receive the trust principal in 15 years when computing the present value of the charity’s remainder interest. Because the 2010 mortality tables are 9 years old and are based upon the 2010 census data for the entire US 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 US population as a whole. Because the actual life expectancy of a wealthy individual age 70 is more like 20 years, the charitable deduction for creation of the CRT is inflated because the required use of the 2010 mortality tables under section 7520 assumes the charity will receive a distribution of the trust principal far sooner.

Even though the 2010 mortality tables were issued on April 30, 2019, these discrepancies will still exist. The adoption of the 2010 tables will still be 9 years outdated. Moreover, they do not address the tendency of clients who create CRTs to have longer life expectancies.

F. Requirements to qualify for CRT treatment in general:

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 increase 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 amount passing to charity, thereby increasing the present value of the remainder interest.

   **Example:** 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%.

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 cannot be lower than an amount equal to 5% of the value for the trust principal, measured each year. For an annuity trust, the minimum annual distribution must be an amount fixed at the creation of the trust equal to 5.0% of the trust principal at the time of contribution.

3. **Maximum Trust Term.**

   The lead interest for the trust term can be for one life or any number of lives. If the lead interest for the trust is a fixed term, that term cannot exceed 20 years.

4. **Who can create a CRT?**

   Any 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. Therefore, an irrevocable private trust can create a CRT and designate a trust beneficiary as the holder of the non-charitable lead interest.
Example: An irrevocable trust owns an appreciated asset it would like to sell. The trust is a tax person and any tax person can create a CRT. Therefore, this irrevocable trust can create a CRT and name a trust beneficiary as the noncharitable holder of the lead interest.

5. The exhaustion test.

Pursuant to Revenue Ruling 77-374, an additional requirement is imposed on charitable remainder annuity trusts. Revenue Ruling 77-374 requires that there cannot be more than a 5% probability that the distributions to the annuitant will exhaust the charitable remainder annuity trust. The Internal Revenue Service has not applied this same rule to charitable remainder unitrusts because, in theory, a charitable remainder unitrust cannot be exhausted prior to the termination of the unitrust interest. For example, if a charitable remainder annuity trust 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 charitable remainder annuity trust 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 NumberCruncher. However, it can be manually computed by following two basic steps. First, calculate how many years it will take to exhaust the charitable remainder annuity trust assuming growth at the Section 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 charitable remainder annuity trust will fail the Exhaustion Test.

With the current low interest rate environment, the Exhaustion Test makes it very difficult to establish a charitable remainder annuity trust that is entitled to a charitable deduction. Why? In determining whether the probability the charitable remainder annuity trust will be exhausted, it is assumed that the charitable remainder annuity trust grows annually at the Section 7520 rate. The lower the Section 7520 rate, the smaller the charitable remainder annuity trust is expected to grow. Furthermore, the other rules surrounding charitable remainder trusts require the annual payout to be at least 5%. This means that in our current interest rate environment, a charitable remainder annuity trust will be eroding principal every year it is in existence. The longer the term of the charitable remainder annuity trust, the more likely the charitable remainder annuity trust will fail the Exhaustion Test. Many individuals will use a charitable remainder unitrust for life or a charitable remainder annuity trust for a fixed term because neither has to satisfy the Exhaustion Test.

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2 1977-2 C.B. 329
3 Practitioners generally believe that this requirement does not apply to charitable remainder unitrusts, but the Internal Revenue Service has not directly addressed the issue.
4 §§ 664(d)(1)(A) and 664(d)(2)(A).
The Exhaustion Test has severely hampered charitable giving by essentially making charitable remainder annuity trusts obsolete in our low interest rate environment. Since December of 2007, the Section 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 Internal Revenue Service realized the negative impact the Exhaustion Test has been having on charitable remainder annuity trusts and issued Revenue Procedure 2016-42\(^5\) as a reprieve. Revenue Procedure 2016-42 applies to all charitable remainder annuity trusts created on or after August 8, 2016.\(^6\) It allows for charitable remainder annuity trusts 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.\(^6\) This tool to circumvent the impact of the Exhaustion Test may not be used that often because of the administrative complexity it adds to charitable remainder annuity trusts. And, will lead most practitioners to use the Unitrust, especially with Section 7520 rates below 5%.

G. **Compare alternative choices:**

1. **Advantage of a trust term for life over a fixed term.**

   a. As a result of the exhaustion text, 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 distortions in the mortality tables with a fixed term.

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’s lives beyond the life expectancy used in the 2010 mortality tables. And, as discussed above, the unitrust avoids the application of the exhaustion test that limits the usefulness of an annuity trust.

II. **Contribution of unencumbered real estate to a CRUT.**

Our illustrative examples will assume the charitable deduction will be based upon the value of the trust principal. If the designated charity is not a public charity, then the statute provides that for certain types of assets the charitable income tax deduction will be based upon the basis of the appreciated asset, not its value. Because the charitable income tax deduction can be limited to the basis of the property with a private foundation, we recommend use of a public charity as the designated remainderman. A donor advised fund is a public charity.

A. **How the CRUT defers reporting of gain from the sale of the real estate.**

When the distribution required under the CRT is fixed at 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, as

\(^5\) 2016-2 C.B. 269

\(^6\) § 664(f)
illustrated above, will pass out each year a portion of the gain realized when the trustee sold the appreciated asset contributed to the trust.

**Example:** An individual, age 59, owns a fully depreciated, unencumbered industrial park valued at $10,000,000 with a zero basis. A developer recently offered to purchase the industrial park for $10,000,000 cash so that the buildings can be demolished and be developed for its highest and best use. The contract for the sale of the real estate had not been finalized so that the contribution of the real estate to a CRT is not currently exposed to the anticipatory assignment of income obstacle. The individual contributed the appreciated real estate to a CRUT, retaining a 14.691% unitrust interest for her life. The individual maximized the retained unitrust interest so that the value of the charitable remainder interest is only 10% of the value of the trust principal, and she is entitled to an immediate $1,000,000 charitable income tax deduction.

Immediately after the CRUT received the real estate, the trustee negotiated the final sale terms, and the real estate was sold for $10,000,000 cash with the CRUT realizing a $10,000,000 long-term capital gain. During the first year the investment of the sale proceeds earns 5% or $500,000. At the end of the first year the trustee distributes $1,469,100 to the individual. Applying the 4-tier rules under Section 664, the entire amount is subject to income tax to the individual. After the $500,000 of trust accounting income is allocated, the remaining $969,100 is a tier 4 distribution of trust principal and is reported as a long-term capital gain.

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, the individual has $860,000 of cash remaining. The individual invests the after-tax cash by purchasing depreciable real estate for $860,000. We now have basis that can be depreciated under the appropriate depreciation method for the property. The individual can increase her depreciation deductions by using the $869,000 as a downpayment and financing the difference. For example, assume the individual purchases $4,000,000 of real estate with the $869,000 as a down payment and finances the remainder of the purchase price. Alternatively, the individual can accumulate the after-tax cash for a few years and then use the accumulated cash to purchase depreciable real estate.

**B. Comparison to a Section 1031 Exchange.**

With a like kind exchange, none of the realized gain is recognized. As with any non-recognition transaction, the gain can still be reported if the replacement property is eventually sold and is not reinvested in real estate. Because there is no additional basis for the realized, but not recognized gain, there are no additional depreciation deductions. However, in the context of Section 1031 replacement property, depreciation deductions can be increased by leveraging up the replacement property or adding equity. In this regard the Section 1031 exchange and the
CRT are similar. However, the similarity ends there. With the Section 1031 exchange, you have the time constraints to identify (45 days) and to close (180 days). With the CRT there is no particular time frame to reinvest. This creates more ability to opportunistically reinvest. Nor is there a requirement to reinvest in “like kind” property. Thus, you can sell real estate but invest in stocks and securities and still benefit from the tax deferral. Any reasonable investment is allowed. However, a CRT cannot invest in property that generates unrelated business taxable income. This limits the ability to invest directly in private equity transactions held through a pass-through entity. Investments in stock of a portfolio company or through a C corporation blocker should be permitted. When you reinvest the cash taken out of the CRT, the investment of that cash is not subject to any limitations (including UBTI and excess working capital).

C. **Encumbered real estate obstacles:**

1. The contribution of encumbered real estate directly to a CRT can generate taxable gain. Liabilities in excess of basis can be a significant hurdle to using the CRT. However, the up-front charitable deduction can offset all or a portion of that gain.

**Example 1:** A taxpayer owns depreciable real estate with an adjusted income tax basis of $6,000,000 and a value of $12,000,000. The appreciated real estate is encumbered by a $6,000,000 non-recourse mortgage. The taxpayer contributes the real estate to a public charity that will use the real estate for charitable purposes. Under general income tax principles, the individual is treated as having sold $6,000,000 of the real estate for the liability and having made a gift of the $6,000,000 equity in the real estate. As to the gift portion, the individual is entitled to a $6,000,000 charitable income tax deduction. The concern is how to allocate the $6,000,000 of tax basis between the sale portion and the gift portion. Pursuant to Section 1011(b), added by the 1969 Tax Act, the liability is allocated to each portion using the value for each portion. Therefore, 50% of the $6,000,000 basis is allocated to the sale portion and 50% of the $6,000,000 basis is allocated to the gift portion. As a part-sale/part-gift, the taxpayer will realize a $3,000,000 gain from the sale portion, computed as follows:

<table>
<thead>
<tr>
<th>Amount realized</th>
<th>$6,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Basis</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

The $6,000,000 charitable income tax deduction can be used to offset the entire gain.

The above treatment under Section 1011(b) applies if the encumbered asset is contributed to a CRT. If the maximum unitrust percentage is used in the above example, the 10% value for the charitable remainder interest would be limited to a $600,000 charitable income tax deduction that can be used to offset a portion of the $3,000,000 gain.
Example 2: A taxpayer owns depreciable real estate with an adjusted income tax basis of $6,000,000 and a value of $12,000,000. The appreciated real estate is encumbered by a $4,000,000 non-recourse mortgage. The taxpayer contributes the real estate to a public charity that will use the real estate for charitable purposes. Under general income tax principles, the individual is treated as having sold $4,000,000 of the real estate for the liability and having made a gift of the $8,000,000 equity in the real estate. As to the gift portion, the individual is entitled to a $8,000,000 charitable income tax deduction. Under Section 1011(b) 1/3 of the $6,000,000 basis is allocated to the sale portion and 2/3 of the $6,000,000 basis is allocated to the gift portion. As a part-sale/part-gift, the taxpayer will realize a gain from the sale portion, computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
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</tr>
<tr>
<td>Less: Basis</td>
<td>($2,000,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$2,000,000</td>
</tr>
</tbody>
</table>

The $8,000,000 charitable income tax deduction can be used to offset the entire gain.

Example 3: A taxpayer owns depreciable real estate with an adjusted income tax basis of $6,000,000 and a value of $12,000,000. The appreciated real estate is encumbered by a $8,000,000 non-recourse mortgage. The taxpayer contributes the real estate to a public charity that will use the real estate for charitable purposes. Under general income tax principles, the individual is treated as having sold $8,000,000 of the real estate for the liability and having made a gift of the $4,000,000 equity in the real estate. As to the gift portion, the individual is entitled to a $4,000,000 charitable income tax deduction. Under Section 1011(b) 2/3 of the $6,000,000 basis is allocated to the sale portion and 1/3 of the $6,000,000 basis is allocated to the gift portion. As a part-sale/part-gift, the taxpayer will realize a gain from the sale portion, computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount realized</td>
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</tr>
<tr>
<td>Less: Basis</td>
<td>($4,000,000)</td>
</tr>
<tr>
<td>Realized gain</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>

The $4,000,000 charitable income tax deduction can be used to offset the gain, subject to the 60% limitation if the taxpayer has no other income.

2. Reducing the impact of Section 1011(b).
You may be able to mitigate the gain under Section 1011(b) by a recapitalization of the partnership into a Class A interest and a Class B interest.

**Example:** The taxpayer owns a partnership interest in a real estate partnership. The taxpayer’s allocable share of the partnership’s real estate is: value $10,000,000, adjusted basis zero and liabilities $6,000,000. The value of the taxpayer’s partnership interest is $4,000,000. The taxpayer’s partnership interest will be reorganized as a Class A interest, with a zero basis, a $6,000,000 allocation of liabilities, and assets valued at $7,000,000. The Class B interest will be allocated zero basis, no liabilities and assets valued at $3,000,000. The taxpayer then contributes the Class B interest to a CRT.

3. The section 1031 exchange can work better with encumbered real estate. Encumbrances on real estate do not preclude nonrecognition treatment under section 1031 as long as the replacement property is subject to liabilities at least equal to those on the relinquished property. Even if the liabilities are less on the replacement property, additional equity invested can offset any “boot” resulting from the decrease in debt. **Note that liabilities in excess of basis are not a bar to section 1031 nonrecognition treatment.**

It should be noted that when liabilities are involved with a section 1031 exchange, the nonrecognition treatment is not permanent. Since the replacement property will not received depreciable basis to the extent of nonrecognition of gain treatment, as the debt principal is amortized, there will be phantom income which over time will at least equal the gain that was not recognized in the 1031 exchange. Moreover, the phantom income may be ordinary income (assuming it comes from rental income). You might say that in a section 1031 exchange, there is deferral of capital gain but also a conversion of capital gain into ordinary income – compared to if the gain were recognized up front. With the CRUT, the gain is deferred. But when it is recognized by the holder of the noncharitable lead interest, it will retain its character as capital gain.