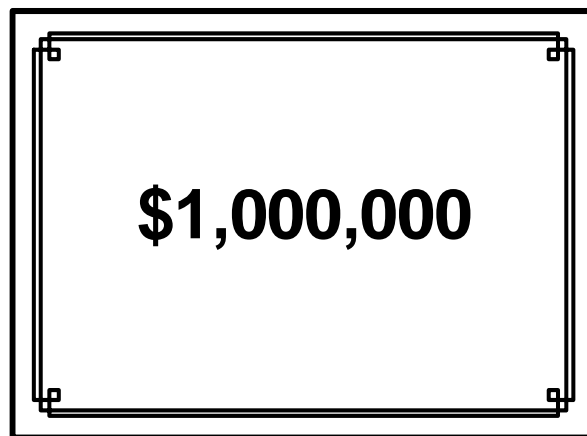


# HOW TO SELL YOUR FOUNDERS STOCK TAX-FREE



## The Charitable Remainder Trust

W. EDWARD DEAN, P.C.  
TRUSTS, ESTATES & CHARITABLE TAX PLANNING  

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2033 LEAVENWORTH STREET, UNIT E  
SAN FRANCISCO, CALIFORNIA 94133  
415-352-1440 PHONE 415-352-1441 FAX

## ABOUT THE AUTHOR

**W. EDWARD DEAN** is a tax attorney in San Francisco. He protects wealth through estate and charitable tax planning. Mr. Dean received a B.A., magna cum laude, Phi Beta Kappa, from Dartmouth College, an M.B.A. from the Amos Tuck School of Management and Finance at Dartmouth College, a J.D. from the University of Virginia School of Law, and an LL.M. in Taxation from New York University. Mr. Dean is a former editor of the VIRGINIA LAW REVIEW, the VIRGINIA JOURNAL OF INTERNATIONAL LAW, and the New York University TAX LAW REVIEW. He is a California Bar Association-certified tax specialist and a member of the San Francisco Estate Planning Council and Northern California Planned Giving Council.

Mr. Dean is a cofounder and managing director of WealthCounsel, LLC, which provides education and tools for more than 2,000 estate planning attorneys nationally. He co-authors and teaches courses in multigenerational tax planning, charitable remainder and lead trust planning, and family foundations and supporting organizations. Mr. Dean is a co-author of WealthDocs, a comprehensive estate planning drafting system, and a six-volume Generation Skipping Transfer System.

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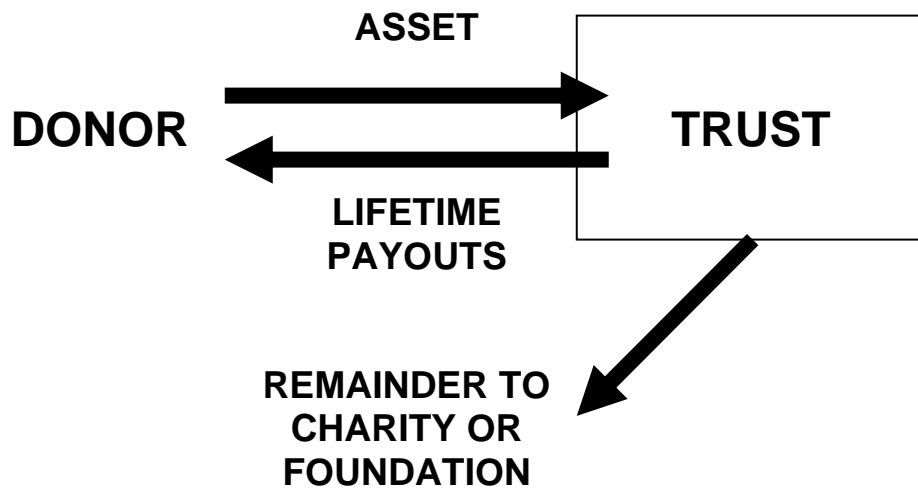
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# HOW TO SELL YOUR FOUNDERS STOCK TAX-FREE

If you are fortunate enough to own highly appreciated “founders stock”,<sup>1</sup> you undoubtedly are considering selling some of it to diversify your portfolio or generate income. Unfortunately, you must pay capital gains taxes when you sell your shares.

A *charitable remainder trust* is one way to avoid those taxes. If you transfer your stock to such a trust and then sell it, you can reinvest your proceeds tax-free. You will be taxed only on the distributions you receive from your trust, not on income or capital gains that the trust retains.



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<sup>1</sup> The term “founders stock” refers to stock that has a very low cost basis because it was acquired by a company founder or employee for little or nothing per share.

You can establish a charitable remainder trust by signing a trust agreement that requires your trustee<sup>2</sup> to make payments to you for life or for up to 20 years<sup>3</sup> before distributing whatever remains in your trust to the Horizons Foundation.<sup>4</sup>

In exchange for your commitment (expressed irrevocably in your charitable trust agreement) to give assets that remain in the trust to the Horizons Foundation when your trust ends, section 664 of the Internal Revenue Code rewards your commitment by granting you three tax-wishes. Section 664 --

- (1) *forgives your capital gains taxes* on the sale of your stock,
- (2) grants you an immediate *charitable income tax deduction*, and,
- (3) permits you to reinvest your sales proceeds in a *tax-free environment*.

A well-planned charitable remainder trust that uses your wishes wisely will increase your income, pass more wealth to your heirs than you could pass to them after a taxable sale, and allow you to make a substantial gift to the Horizons Foundation at government expense. The satisfaction of making your world a better place can endure long after you and your heirs have realized the financial benefits of your trust.

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**2 Can I be my own trustee?** Yes. By being your own trustee, you can continue to control the assets in your trust. You can manage the trust's investments yourself or you can hire professional investment managers to do so.

**3 How long can my trust last?** Your trust need not be limited to your life. The longer your trust lasts, the more years of income you and your heirs will receive from the trust. Your trust can last either (1) for a specified number of years (but no more than twenty years) or (2) for your and your spouse's lives, then for your children's lives, and even for your grandchildren's or friends' lives. Income, estate, gift, and generation-skipping tax considerations make multiple-generation trusts relatively rare.

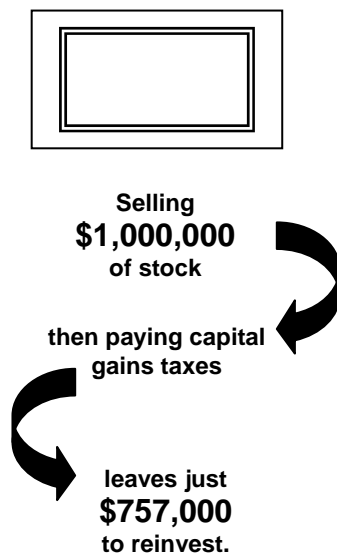
Most charitable remainder trusts benefit their donors for life. Most are established by donors in their 40s though 70s. However, charitable remainder trusts work even better for younger donors who have more years to receive income and benefit from tax-free compounding – so much better that Congress added a 1998 requirement that precludes many donors in their 20s and early 30s from using them.

**4 Can I name different charities after I establish my trust?** Even though you may name one or many charities when you initially establish your trust, you may reserve the right to change your choice of charities at any time. Many donors name a family foundation to receive the trust principal so that their children or grandchildren can make charitable distributions of income or principal. A family foundation can (1) focus your descendants' interests along whatever charitable lines you desire, (2) keep future generations of your family together by uniting them at least annually for charitable decision-making, and (3) raise the standing of your descendants within their communities by permitting them to make annual contributions from the foundation to charities or community organizations.

## The Tale of a Sale

What would happen if you sold \$1 million of stock in which your basis was essentially \$0? Let's calculate the result . . .

**Double Taxation.** When you sell highly appreciated stock, the capital gains tax you pay will reduce the amount you have left to reinvest. Upon your death, estate taxes will further reduce the amount you can leave to your heirs.



**Consider the following example:** Pat and Chris, ages 47 and 42, are California citizens. Pat and Chris have a \$10 million estate. Over two-thirds of their estate consists of stock acquired for essentially nothing when Pat started the company. Pat and Chris would like to sell \$1 million of Pat's stock and reinvest the proceeds in a diversified, less volatile portfolio, that their financial adviser predicts will yield an average return of 10%.

**Paying the Capital Gains Tax.**<sup>5</sup> If Pat receives \$1 million from the sale of the stock, the entire \$1 million will be taxable as a capital gain. This much gain, coming all at once, will push Pat into a combined federal and California capital gains tax bracket of 24.3%.<sup>6</sup> Therefore, Pat will have to pay \$243,000 in federal and California capital gains taxes (24.3% times the \$1 million gain), leaving only \$757,000 to reinvest.

By reinvesting the \$757,000 that remains at a 10% rate of return, Pat will earn \$75,700 on reinvesting the *after-tax* sales proceeds in their first year. Pat must pay income taxes on the full amount, whether the proceeds are spent or reinvested, leaving only \$54,277 to spend.<sup>7</sup>

<sup>5</sup> All computations assume 2008 federal and California income tax rates and the 2009 federal and California estate tax rates because the estate tax rates that will apply in 2009 under current law appear to be the rates that Congress is most likely to adopt for 2010 and subsequent years.

<sup>6</sup> **Computing Your Capital Gains Tax Bracket.** No matter what Pat's income level is, a \$1 million capital gain will push Pat into the maximum federal and California capital gains tax brackets of 15% and 9.3%, for a total tax rate of 24.3%. If Pat had less income and could deduct state taxes, Pat's combined federal and California capital gains tax bracket would be 22.91%.  $[(1-15\%) \times 9.3\%] + 15\%$  If the state in which Pat resides did not impose income or capital gains taxes, Pat's combined federal and state capital gains tax bracket would be 15%.

<sup>7</sup> For a 10% return, we assume 2% ordinary income from dividends and interest and 8% capital gains. We also assume that Pat has a 2008 income exceeding \$336,550 and cannot deduct state taxes paid from federally taxable income, for combined an ordinary income tax rate of 44.3% and a combined capital gains rate of 24.3%.

**\$757,000**



**becomes**

**\$416,350**  
**after paying**  
**estate taxes**

**Then Paying Estate Taxes.** To make matters worse, when Pat dies, estate taxes will reduce Pat's assets further before Chris inherits them. Since anyone with an estate exceeding \$2 million is in a 45% estate tax bracket (in 2009 and thereafter)<sup>8</sup>, Pat's estate must pay 45% of the remaining \$757,000 in estate taxes, leaving only \$416,350 for Chris.

**What's left for the heirs?** From Pat's \$1 million in sales proceeds, Pat will pay \$243,000 in capital gains taxes and Pat's estate will pay another \$340,650 in estate taxes – leaving only \$416,350 of Pat's original \$1 million for Chris. After paying both capital gains and estate taxes, the government will receive almost 58% of Pat's original \$1 million in sales proceeds.<sup>9</sup>

Charitable remainder trusts eliminate these taxes.

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<sup>8</sup> Note that unless current law is changed, in 2011 the top estate tax rate returns to 55% and the lifetime exemption returns to \$1 million.

<sup>9</sup> Note that unless current law is changed, if Pat or Chris die after 2010, all amounts in excess of \$1 million will be subject to estate taxes up to a maximum rate of 55%.

## The Charitable Remainder Trust Provides Relief

If Pat instead transfer the stock to a charitable remainder trust before selling it, the results will improve dramatically because Congress forgives your capital gains taxes on any asset that you transfer to such a trust before you sell it.<sup>10</sup> Here's how a charitable remainder trust would work for Pat and Chris as a couple:



**Establishing the Trust.** Suppose Pat contributes the \$1 million in stock to a charitable remainder trust for Pat and Chris's joint-and-survivor's life expectancy of 45 years. Let's also assume that Pat specifies in the trust that Pat, then Chris, shall receive 10% of the value of the trust each year.

**First Tax Benefit – Forgiveness of Capital Gains Tax.** After Pat transfers the stock to the trust, the trustee will sell it, will pay no capital gains taxes, and will reinvest the \$1 million in sales proceeds tax-free. Pat and Chris can retain total control over the investment of the sales proceeds by being their own trustees or by reserving the right to change trustees whenever they wish. They can control the assets in their trust directly, as trustees, or indirectly through their choice of trustee.

**How much more income will they receive?** The entire \$1 million will be reinvested because there will be no capital gains taxes to pay when the trust sells the stock. Therefore, \$1 million rather than \$757,000 in after-tax proceeds will be available to generate income for Pat and Chris. At a 10% rate of return, with all 10% being paid out annually, they would enjoy a \$100,000 annual income rather than the \$75,700 they would enjoy had they not established the trust. *For as long as they live, Pat and Chris will receive \$24,300 more in annual income from the trust than they would have received had they not established the trust.* Over their 45-year joint-and-survivor life expectancy, they will receive \$4,500,000 from their trust rather than the \$3,406,500 that they would have received from investing the proceeds of a taxable sale – \$1,093,500 more income during their lives.

Pat and Chris will have to pay taxes on this income, but there will be much more income to tax. Assuming that 80% of their returns are capital gains and 20% are dividends and interest, Pat and Chris will have \$71,700 in after-tax spendable income compared to \$54,277 in after-tax spendable income from an outright sale.<sup>11</sup> *Every year of their lives, Pat and Chris will have \$17,423 more after-tax income to spend – \$784,458 more in lifetime income.*

<sup>8</sup> Pat must transfer the stock to the trust *before* selling it, before signing any type of contract that commits Pat to selling it, and before the company's board of directors accepts a buy-out offer. If Pat transfers the stock to the trust after becoming subject to a binding commitment to sell it, the trust will not shelter Pat's gain from taxation.

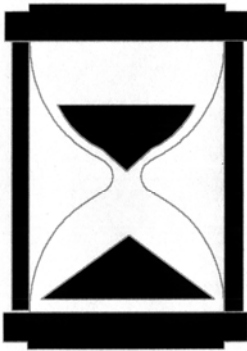
<sup>10</sup> **COMPUTING YOUR INCOME TAX BRACKET.** If we assume that Pat and Chris are in the highest federal income tax bracket of 35% and the highest California income tax bracket of 9.3%, Pat and Chris will pay a combined California and federal income tax rate of 44.3% rather than the 41.045% --  $[(1-35\%) \times 9.3\%] + 35\%$  -- they would pay if their income were low enough to qualify them to deduct state taxes from federally taxable income.

Never overlook the effect of state income or capital gains taxes if your state imposes them. If you live outside California, look up your marginal tax bracket in your own state and plug your state rate into the formula set forth above. If your state imposes neither income nor capital gains taxes, your combined state and federal tax bracket will simply equal your federal tax bracket.

**Second Tax Benefit -- The Charitable Deduction.** As if extra income were not incentive enough, consider this: In addition to being permitted to sell the stock tax-free, Pat will receive an immediate charitable tax deduction in the year Pat transfers the stock to the trust.

**Computing Your Charitable Deduction.** Based on IRS-supplied life-expectancy tables (using 45 years in this example) and the current month's IRS-supplied net present value discount rate, the IRS will deem the value of Pat's \$1 million deferred gift to charity to be \$27,670.<sup>12</sup> Pat may (subject to the 10% rule discussed below) deduct this amount against up to 30 percent of Pat's adjusted gross income in the year Pat establishes the trust. If the deduction exceeds 30 percent of Pat's adjusted gross income in the year Pat establishes trust, Pat may carry the excess deduction forward to deduct in future years.

**A \$1,000,000  
gift to charity  
in 46 years**



**qualifies for  
a charitable  
deduction  
today.**

**The Charitable Deduction Must Always Be at Least 10%.** In 1998, Congress decided that charitable trust payouts must not be so high that they give charities less than 10% of the benefit of the trust. Therefore, Pat will have to lower the payout rate enough to generate a charitable deduction of at least 10%.

If, for example, Pat lowered the payout rate from 10% to 6%, Pat's charitable deduction would rise from \$27,670 to \$105,600 – a deduction that does exceed 10% of the \$1 million that Pat contributed to the trust. In Pat's 44.3% bracket, this deduction will save Pat \$46,781 in income taxes.

While lowering the payout rate may at first seem to be to Pat and Chris's detriment, they will receive more income from their trust than they would at a 10% payout rate due to tax-free compounding – the third tax-wish granted to those who establish charitable remainder trusts.

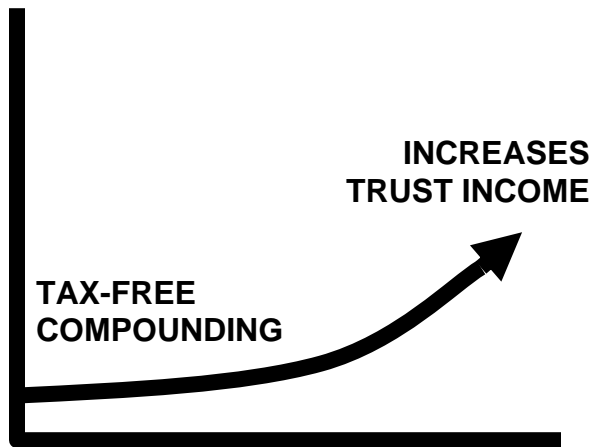
<sup>11</sup> Though no one can predict with certainty how long a charitable remainder trust will last, how much it will earn, and how much it will distribute, section 7520 of the Internal Revenue Code requires the IRS to make some assumptions. How long a trust will last is assumed through mortality tables and formulas whenever the trust is to last for the lives of one or more people. Each time a contribution is made to the trust, the amount the trust will earn each year is assumed to equal the highest monthly average market yield on medium-term Treasury bills for the three months preceding the date of transfer (the "applicable federal rate"). The amount the trust will distribute is based on the payout choices you make when you establish your trust. Based on the assumed duration of your trust, the assumed rate of return, and the assumed payout, the IRS tables calculate the net present value of the amount that will remain in the trust for charity when the trust terminates. The applicable federal rate has ranged from a peak of 11.6% in April 1989 to a low of 3.06% in July 2003. The applicable federal rate used in Pat and Chris's calculation is 8.4%.

**Third Tax Benefit -- Tax-Free Compounding.** We have now seen why forgiveness of capital gains taxes and charitable tax deductions make charitable trusts so desirable. But we have ignored the third and most powerful tax-benefit that Congress grants to those who establish these trusts – tax-free compounding.

**"Wait-and-See" Taxation.** As long as your trust retains its earnings, the government does not know whether those earnings eventually will be distributed to you, a taxpayer, or to charities that are tax-exempt. Therefore, Congress adopted a wait-and-see approach to taxing charitable trusts. As long as your trust's earnings remain in the trust, Congress does not tax them because they may someday be paid to charities. Only when your trust distributes its earnings to you does the government know that charities will not receive them. Therefore, Congress decided to tax earnings only when you receive them.

This means that your trust is taxed much like an IRA. As with an IRA, your charitable trust creates a tax-free investment environment for the assets within it. You can buy and sell assets in your charitable trust without paying taxes on your gains. You can receive interest and dividends within your charitable trust without paying taxes as well. Like taxpayers who establish IRAs, taxpayers who establish charitable trusts are only taxed on the distributions they receive.

**Harnessing the Power of Tax-Free Compounding.** Your investments will grow faster when they grow tax-free. Suppose, for example, that our 47-year-old Pat and 42-year-old Chris were to leave part of their 10% in annual trust earnings in their trust each year. The part that remained in the trust would not be taxed. If Pat and Chris's goal was to have an income stream that grew by 4% to keep up with inflation, their choice of a 6% payout would accomplish just that. The 4% that they left in the trust would increase the trust's value by 4% each year. Since Pat and Chris chose to receive 6% of the trust's value each year, their income would increase by 4% each year as their trust value increased. Over their 45-year life expectancy, their income would increase dramatically.



**Compare.** Let's compare the results of inflation-proofing after a taxable sale to inflation-proofing with a charitable trust. Let's see how Pat and Chris's decision to receive just 6% of their trust's 10% return each year harnesses the power of tax-free compounding.

**Inflation-Proofing after a Taxable Sale.** Because they are in the highest tax brackets, Pat and Chris would receive a \$75,700 annual income if they were to sell their stock without a trust and pay capital gains taxes before investing their sales proceeds. After

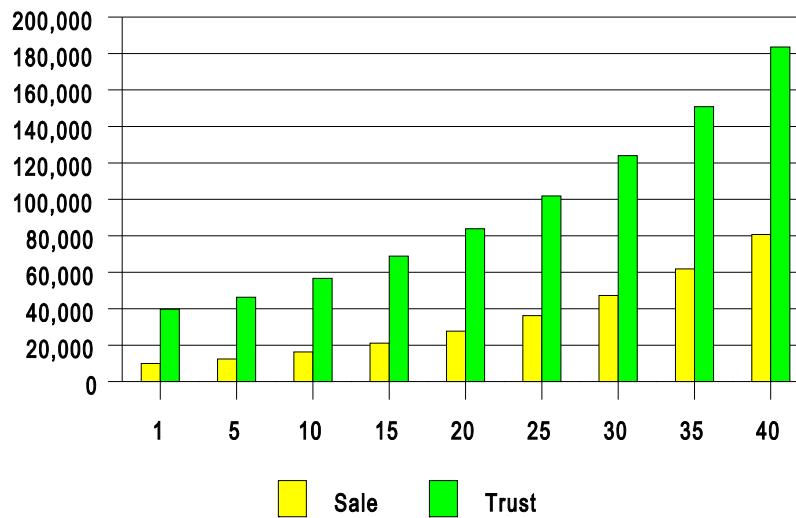
paying taxes on that \$75,700, they would have just \$54,277 in after-tax, spendable income. To add 4% in savings to their \$757,000 in investments, they would have to save \$30,280 of their \$54,277 in spendable income, leaving only \$23,997 to spend.

**Inflation-Proofing in a Charitable Trust.** Contrast this to Pat and Chris's after-tax income if they added 4% to their charitable trust's value each year by choosing to receive only a 6% annual payout rather than 10%. In the first year of the trust, Pat and Chris would pay a \$16,980 tax on the \$60,000 that they would receive, leaving \$43,020 to spend, with the undistributed \$40,000 remaining in the trust tax-free. Pat and Chris will not need to save any portion of their \$43,020 after-tax income to keep the investment account growing by 4%.

**The Power of Tax-Free Compounding.** With each passing year, the trust's 6% payout to Pat and Chris will pull farther and farther ahead of the income they would have received had they simply sold their stock and saved enough each year to protect against inflation. The after-tax income they would receive due to tax-free compounding, when added to the tax savings from their charitable deduction, would rise from \$2,442,465 (for taxable sales proceeds returning 10% over Pat and Chris's 45-year life expectancy) to \$6,432,131 (for a trust paying 6%) – an extra \$3,989,666 in after-tax, spendable income during their lives.

## ANNUAL NET INCOME

TAXABLE SALE VERSUS CHARITABLE TRUST



**No matter what your rate of return, a higher initial amount, compounding tax-free, will always grow faster than a lower initial amount that is taxed every year.**

## Providing for Your Children

Anyone who has made a substantial gift to charity knows how deeply satisfying this can be. However, if you have a family, you may also believe that charity begins at home. If the Internal Revenue Code gave you a choice, you probably would prefer that your children, rather than charities, inherited the principal of your trust.

If Pat and Chris have children, they may want their children to inherit as much as or more than the \$416,350 that they would have inherited had Pat and Chris simply sold their stock, paid capital gains taxes, then paid estate taxes. Let's consider how Pat and Chris might use some of their extra charitable trust income to provide for their children.



**The Insurance Teeter-Totter.** The most common way that donors like Pat and Chris create an inheritance for their children is by using *part* of the *extra* lifetime income from their trust to purchase a second-to-die life insurance policy. The policy would pay insurance proceeds to their children when Pat and Chris died -- just when their charitable trust would terminate and distribute its assets to charities. Pat and Chris can determine how much their children will inherit simply by deciding where to position their extra \$3,989,666 (from a trust paying 6%) on the "insurance teeter-totter". They have three options:



**ALL FOR ME.** You could choose to spend all the extra income yourself because you need it, because you do not have children, because your children will be inheriting a great deal of money anyway, or simply because, after making many sacrifices to give your children a good start in life, it is time for you to enjoy your income yourself.



**ALL FOR THEE.** You instead could choose to give all your extra income to your children to insure them an inheritance many times greater than they would have received after a taxable sale, either because you have ample income yourself or because you simply enjoy helping your children as much as possible.



**ALL FOR WE.** Most donors to charitable trusts choose to share part of their extra income with their heirs and spend part themselves. For example, Pat and Chris might purchase just enough insurance to pay their children the \$416,350 that they would have received after paying capital gains and estate taxes on a taxable sale. Then again, they might purchase a \$1 million policy to restore to their children the full value of their stock or even a \$3 million policy to more than replace what the children would have received had they inherited the entire charitable trust principal after Pat and Chris's deaths and paid a 46% estate tax.

Suppose, for example, that during the first 35 years of their trust, Pat and Chris paid \$378,000 of their extra \$3,989,666 in lifetime income to purchase a \$3 million life insurance policy. This would leave them with more than \$3.6 million in extra income to spend themselves. If they established an irrevocable life insurance trust to keep the policy from being taxed in their estates, their children would receive the entire \$3 million tax-free upon their deaths.

Pat and Chris would receive more income and their children would receive a greater inheritance than either would receive from a taxable sale. Moreover, their charitable trust would grow tax-free over their 45-year life expectancy from its original \$1 million to \$5,298,749. This will be Pat and Chris's charitable legacy, payable either to their choice of charities or to a family foundation that their descendants can control for generations.

Let's compare the results of a taxable sale to the results of a sale through a charitable trust paying 6% combined with a \$3 million replacement life insurance policy held in an estate-tax-free irrevocable life insurance trust:

	TAXABLE SALE	6% TRUST
<b>LIFETIME NET INCOME<sup>13</sup></b>	<b>\$2,442,465</b>	<b>\$6,054,131</b>
<b>CHARITABLE DEDUCTION</b>	<b>\$0</b>	<b>\$105,600</b>
<b>BEQUEST TO HEIRS IN THE FIRST YEAR AND AT LIFE EXPECTANCY</b>	<b>\$416,350 to \$1,727,711</b>	<b>\$3,000,000 in tax-free life insurance</b>
<b>GIFT TO CHARITIES OR TO A FAMILY FOUNDATION IN FIRST YEAR AND LIFE EXPECTANCY</b>	<b>\$0</b>	<b>\$1,000,000 to \$5,298,749</b>
<b>CAPITAL GAIN &amp; ESTATE TAX</b>	<b>\$583,650</b>	<b>\$0</b>

Reflect on these results for a moment. Compare your lifetime net income from a taxable sale to your lifetime income from a charitable trust, then do the same for your charitable deduction, for your bequest to your heirs, for your gifts to charities, and for your capital gains and estate taxes. Which column would you choose if you were Pat and Chris?

**Why must I purchase insurance?** The "lifetime net income" and "bequest to heirs" entries in the table, above, assume that Pat and Chris pay \$378,000 of their extra after-tax income for a \$3 million insurance policy, but you really do not have to purchase insurance to create an inheritance for your heirs. You could instead invest the extra income from your trust rather than spending it, thereby increasing your estate, or you could give your children all or part of that income each year whenever you received distributions from your trust. However, unless your health or age makes insurance too costly for you, you can almost always create more wealth by purchasing a life insurance policy than you or your children can create by investing yourselves. Insurance companies can invest your premiums tax-free, even when they invest in investments that would be taxable if you invested in them in your own name. You would have to achieve extremely high investment returns to outperform an investment in an insurance policy.

Moreover, insurance policies eliminate the risk that you might not live to your life expectancy. None of us know how long we are going to live. If you fail to live to your life expectancy, you will not receive all of the extra income that you planned on receiving from your trust. You will neither receive enough income nor have enough time to create the kind of inheritance you can create with an insurance policy.

No one enjoys paying insurance premiums, but in this case, Pat and Chris would be paying for the insurance out of the extra income they receive from the charitable trust, so the trust will pay for the policy. Insurance policies can create a lot more wealth while eliminating the mortality risk of a charitable remainder trust plan.

<sup>13</sup> The 6% trust column assumes \$6,432,131 in lifetime trust distributions less \$378,000 in insurance premiums.

## DESIGNING YOUR OWN CHARITABLE REMAINDER TRUST

Tax advisors use spreadsheets to help you decide whether a taxable sale or a charitable trust is right for you, what type of trust is best, and what the trust payout should be.

**What kind of payout flexibility will I have in my trust?** When designing a charitable remainder trust, you have many options. You can determine when you receive payments and how much you receive by choosing the type of trust and the payout rate that is most appropriate for you. You can even use your trust to accumulate wealth tax-free, then pay it out to you only when you want it.

- **ANNUITY TRUSTS** pay you a fixed amount each year. You select the amount when you establish the trust. The amount will never vary, no matter how well or poorly the trust's investments perform. This trust is usually selected by older people who prefer a fixed income stream, even though this will not protect them from inflation.
- **STANDARD UNITRUSTS** pay you a percentage of the trust's annual value. As the value of the trust rises or falls, your distributions from the trust rise and fall. This trust insures you a steady payment stream, in good investment years and bad, and protects you from inflation as the trust increases in value.
- **NET INCOME "SPIGOT" TRUSTS** pay you the net income of the trust. With good planning, these trusts take maximum advantage of tax-free compounding. You can define capital gains as income and only sell when you need income. You can invest in low-income, growth-oriented securities in the early years to minimize income and maximize tax-free compounding, then switch to high income investments to maximize payments when you retire or need them. You even can add an annuity or partnership "spigot" that allows you to turn distributions on and off at will. A "spigot trust" will give you the best of all worlds. It will allow you to store up all your earnings in your trust tax-free and take your distributions whenever you want and in the exact amounts you want. You will have shifted your trust assets from a system that taxes everything you earn to one that only taxes you on earnings you withdraw from your trust to spend. You will have shifted from an income tax system to a consumption tax system.

## CONCLUSION

Whenever you are considering a taxable sale, consider using a charitable remainder trust to avoid paying capital gains taxes, to qualify for a charitable tax deduction, and to harness tax-free compounding. Charitable remainder trusts can produce more income for you, a greater inheritance for your heirs, and a substantial gift to charity, all at the government's expense. In doing so, they let you retain more of your capital and enjoy more income today while making your world a better place tomorrow.