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MODERN CHARITABLE REMAINDER TRUSTS – SELECTED ISSUES

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TABLE OF CONTENTS

Page

1. General description of charitable remainder trust ("CRT") 1
   - 1.1 Annuity Trust ("CRAT") 1
   - 1.2 Unitrust ("CRUT") 1
   - 1.3 2010-2011 Priority Guidance Plan 1
   - 1.4 Current climate for CRTs 2
   - 1.5 Professional Fiduciaries Act 3

2. Income taxes 4
   - 2.1 Charitable deduction 4
   - 2.2 No capital gains recognized upon creation of CRT 5
   - 2.3 CRT is tax exempt unless it receives UBTI during the year 5
   - 2.4 Taxation of distributions: 4 tier system 6
   - 2.5 S corporations 6

3. Reformation 6

4. Pledges 11
   - 4.1 Enforceability depends on state law 11
   - 4.2 Private foundation excise taxes 11
   - 4.3 Pledge to create CRT 11
   - 4.4 Finestone, "Charitable Pledges" 11

5. Multiple grantors 11
   - 5.1 LTR 9547004 11
   - 5.2 LTR 200203034 12

6. Slicing and dicing CRTs 12
   - 6.1 Gift to remainder beneficiary 12
   - 6.2 Charitable Gift Annuity ("CGA") 13
   - 6.3 Commutation of CRT 13
   - 6.4 Sale to a third party 16
   - 6.5 Purchase of remainder interest 19
   - 6.6 Division of CRT 19

7. Retirement benefits 21

Modern Charitable Remainder Trusts

1. <u>General description of charitable remainder trust ("CRT") (IRC §664)</u>

1.1 Annuity Trust ("CRAT") (IRS Sample Forms: Rev. Procs. 2003-53 through 60). A perfectly drafted CRAT nevertheless was disqualified because it was not administered properly (no annuity payments were made). The following drafting techniques may be useful:

(i) No CRAT additions allowed: Trustee must return additional transfers to transferors immediately; CRAT revocable until "Effective Date," which is day on which last asset on Schedule A transferred to CRAT; or rely on *Estate of Heggstad*, 145 Cal.App.4th 1195 (2006) and similar cases [e.g., *Kucker v. Kucker*, 192 CA 4th 90 (2011); and see 23 Am Jur 2d Deeds §49]

(ii) Timely annuity payments required: Any undistributed annuity amounts belong solely to annuitant; Trustee is holding on behalf of annuitant

1.2 Unitrust ("CRUT") (IRS Sample Forms: Rev. Procs. 2005-52 through 59)

1.2.1 Regular or standard ("STANCRUT")

1.2.2 Income only ("NICRUT")

1.2.2.1 Deficiency make-up ("NIMCRUT")

1.2.2.2 No deficiency make-up ("NO NICKNAME CRUT")

1.2.3 "Flip" CRUT [<u>see</u> Treas. Reg. §§1.664-3(a)(1)(i)(c)-(f)]: Four "requirements":

(i) Specified "flip" date or event

(ii) "Flip" occurs after sale of "unmarketable" assets

(iii) "STANCRUT" commences next 1/1

(iv) No deficiency make-up after STANCRUT

1.3 The IRS 2010-11 Priority Guidance Plan includes a project to revise the sample CRUT and CRAT forms issued in 2003 (CRUT) and 2005 (CRAT) to reflect recent laws, practice, and thinking

1.4 Current Climate for CRTs

1.4.1 Donors have fewer appreciated assets

1.4.2 Unintended effect of 2001 tax law [IRC §2511(c)] was to treat Donor's retained interest in a CRT as a taxable gift. The "phantom" taxable gift would have caused unnecessary gift taxes to be paid and/or increase estate taxes payable upon the Donor's death. Several groups suggested that donors not create CRT until guidance was issued by IRS **[IRC §2511(c) repealed by 2010 Tax Act]**

1.4.3 Another unintended effect of 2001 (and 2010?) tax law: Does "election out" of estate tax in 2010 in favor of carryover basis disqualify testamentary CRTs?

1.4.3.1 Treas. Reg. §1.664-1(a)(1)(iii)(a) defines a CRT as a trust for which a tax deduction is "**allowable**" for income, gift, or estate tax purposes

1.4.3.2 What does "allowable" mean?

1.4.3.3 Consequences of disqualification:

(i) No estate tax

(ii) Income beneficiary will receive payments taxable under the usual trust rules rather than the 4-tier system

(iii) Charity will receive its remainder interest

(iv) If "CRT" sells appreciated property, gain will be taxable. But the trustee can sell appreciated assets over time

(v) Executor may be able to allocate basis increase to CRT assets

1.4.3.4 Terminate the "CRT" (see Section 6.3 on pages 13-16)

1.4.3.5 Unless an income, gift, or estate tax deduction was "allowed," a CRT would not be subject to IRC §4947(a)(2), which makes the private foundation rules applicable to CRTs. Treas. Reg. §53.4947(1)(a) provides that "(f)or purposes of this section, a trust shall be presumed (in absence of proof to the contrary) to have amounts under section … 2055 … if a deduction would have been allowable under (that section)."

1.4.3.6 In LTR 9501004, which involved an attempt to establish a CRT by funding it with an option to acquire real estate that itself could not be transferred to a CRT, the IRS concluded that a trust for which no tax deduction was available upon its creation by a living person was not a CRT

(i) The IRS relied on Rev. Rul. 82-197 to conclude that no income tax deduction would be allowed in the year of the transfer an option to a charity, although a charitable income tax deduction would be allowed if and when the charity exercised the option to make a bargain purchase of the underlying realty

(ii) The IRS relied on Rev. Rul. 80-186 to conclude that, because the transfer of the option would not involve any consideration, the transfer would be revocable and thus not a completed gift (so no gift tax deduction)

1.4.3.7 IRS response?

1.4.4 Many organizations are reporting that they have seen a real decrease in CRTs since 2008, perhaps based on fewer appreciated assets, or tax issues

1.5 Professional Fiduciaries Act (PFA) was enacted by the Legislature in 2007, became effective on January 1, 2009

1.5.1 Administered by the Professional Fiduciaries Bureau at the California Department of Consumer Affairs, http://www.fiduciary.ca.gov/laws_regs/act.pdf.

(i) Initially appears that the PFA would only apply to individuals and would not affect charities

(ii) Professional Fiduciaries Bureau has clarified that charitable organizations are not exempt from the PFA's rules

1.5.2 Summary of provisions

(i) PFA requires each personal who serves as a "professional fiduciary" to obtain and maintain a license issued by the Professional Fiduciaries Bureau

(A) Applies to trustees of trusts for more than three people or for more than three families

(B) Applies to trustees of CRTs – and many charitable organizations trustee CRTs

(ii) Certain individuals and entities are exempted from having to comply with the PFA

(A) Individual who serves as fiduciary for members of his/her own family

(B) Attorneys and CPAs who are licensed to practice in California

(C) Banks & Trust companies, and licensed investment advisors

1.5.3 Licensing requirements

1.5.4 Consequences of violating the PFA

1.5.5 Determining whether charitable organization is performing acts of professional fiduciary

(i) Trust administration duties

(ii) Accounting and Tax Compliance duties

(iii) Investment Management duties

1.5.6 How NPOs are handling issue

(i) Designate key person to handle administration

(ii) Outsource

(iii) Complete licensing if portfolio large enough to warrant

1.5.7 Correcting legislation

2. Income taxes

2.1 Charitable deduction

2.1.1 97 Act 10% minimum remainder interest (effective date after 7/28/97, except testamentary CRTs)

2.1.2 97 Act 50% maximum payout rate (effective date after 6/18/97, even for testamentary CRTs if death after 6/18/97)

2.1.3 Substantiation rules [IRC §170(f)(8)] do not apply to CRTs [Treas. Reg. §1.170A-13(f)(13)]. CRT Trustee signs IRS Form 8283, because donee is the CRT (even if donor is Trustee) [Treas. Reg. §1.170A-13(c)(7)(v)(B)]

2.2 No capital gains recognized upon creation of CRT (Treas. Reg. §1.1011-2)

2.3 CRT is tax-exempt unless it receives "unrelated business taxable income" ("UBTI") during the year [IRC §664(c)(1)]

2.3.1 Thus, no capital gains tax paid by CRT upon sale of appreciated property (other than "debt-financed" property; see Section 2.3.2.2 below)

2.3.2 2006 Tax Relief and Health Care Act provided for an excise tax of 100% of a CRT's UBTI rather than a loss of the CRT's tax exemption for the year [IRC §664(c)(2)]

2.3.2.1 The statute would appear to work properly if the UBTI were simply "confiscated" and otherwise ignored; but because it is treated as "Tier 1" income it will be subject to double tax when it is deemed distributed

2.3.2.2 The new rule generally will benefit a CRT with some UBTI in a particular year, but the result under the new law will be worse for a CRT with a very large capital gain realized via sale of "debt-financed" property (which gain is UBTI)

2.3.2.3 UBTI and California CRTs

(i) California passed Conformity Act of 2010 (SB401) (RTC §17755)

(A) Changed California's specified date of conformity to federal income tax law from January 1, 2005, to January 1, 2009, for taxable years beginning on or after January 1, 2010, and thereby, in general, conforms to the numerous changes that were made to federal income tax law during that four-year period, except as otherwise provided

(B) However, SB401 did not change California law to conform to IRC Section 664(c), and specifically provides otherwise

(ii) Effect of SB401 in 2011:

A CRT that is taxable in California and has UBTI will pay a 100% federal excise tax on the amount of UBTI and will not lose its federal income tax exemption, but it will lose its California income tax exemption for the taxable year that it has UBTI. By rejecting the federal fix for CRTs with UBTI, California continues to tax a CRT with even a minimal amount of UBTI on all its income for the taxable year during which the CRT has UBTI

2.3.3 Neither a CRT's distributive share of the income and gains earned by a wholly-owned foreign corporation from hedge fund investments nor dividends actually received by that foreign corporation constituted UBTI in LTR 201043041

2.3.4 CRTs are exempt from the 3.8% Medicare surtax

2.4 Taxation of distributions: 4 tier system ("wifo") [Treas. Reg. §§1.664-1(d)(1) and (2)]

2.5 S corporations. A CRT cannot be an S corporation shareholder, but an S corporation can establish a CRT

2.5.1 IRC §337(b) provides that a transfer of "substantially all" of a corporation's assets to a CRT is treated as a sale of those assets, triggering gain

2.5.2 LTR 200644013 addresses the contribution of appreciated property by an S corporation that previously was a C corporation to a "flip" NIMCRUT, and holds that the "built-in gains" ("BIG") tax is not triggered by the contribution of the property, nor by its sale by the NIMCRUT, nor by distributions of Tier 1 (ordinary) income. But Tier 2 (capital gain) distributions during the 10-year recognition period will result in recognition of the "BIG" tax to the extent of those distributions (7 years for 2009 and 2010; 5 years for 2011)

2.5.3 The S corporation rather than a shareholder probably should be the income beneficiary of a CRT (maximum 20-year term); otherwise the S corporation will be deemed to have made a distribution to the shareholder equal to the fair market value of the income interest (dividend)

3. Reformation

3.1 A testament to the complexity of the 1969 Tax Reform Act provisions defining CRTs was the continual extension for document reformations in multiple pieces of tax legislation until the 1994 Tax Reform Act permanently allowed taxpayers a limited post-death ability to comply with the strict CRT rules. IRC §2055(e)(3) now allows some defective CRTs to be reformed to qualify for the estate tax charitable deduction. Although

similar rules allow reformation for income tax [IRC §170(f)(7)] and gift tax [IRC §2522(c)(4)] charitable deductions, the realization that a CRT is defective often does not occur until the donor dies. There are three categories of CRTs, the first of which is "reformable":

(i) "Intent to comply" CRTs;

(ii) Pre-1969 CRTs (see LTR 200818003: reformations not authorized for CRTs established by decedents dying before 1969); and

(iii) Non-reformable CRTs, including those with no drafting error, but subject to "changed circumstances" (LTR 200649027 and Galloway case discussed in Section 3.1.10 below)

3.1.1 IRC §2055(e)(3)(F) provides "automatic reformation" if all income beneficiaries die prior to the due date of the federal estate tax return. In addition, several courts have held that IRC §2055(e) does not apply when an intervening event destroys the charitable split-interest and causes a direct transfer of property to a charity. See Flanagan v. U.S., 810 F.2d 930, 935 (10th Cir. 1987); First Nat'l Bank of Fayetteville v. U.S., 727 F.2d 741, 746 (8th Cir. 1984); Oetting v. U.S., 712 F.2d 358, 361-3 (8th Cir. 1983); see also Strick Est. v. U.S., 655 F.Supp. 1334, 1340-1 (W.D. Penn 1987)

3.1.2 The actuarial value of the reformed charitable interest must be within five percent (5%) of the actuarial value of the unreformed charitable interest; and the term of the CRT cannot be changed, except to reduce a specified term of more than 20 years to the earlier of (i) the death of all recipients or (ii) 20 years (in which case the payout would have to be increased to maintain the same actuarial value of the charitable remainder interest). This 5% rule is waived if reformation is to meet the10% minimum remainder rule

3.1.3 There is no explicit authority allowing reformation of a CRAT to satisfy the "5% probability of exhaustion" test, except perhaps IRC §2055(e) itself, which can be read to permit reformation of any attempted CRT that fails to qualify under IRC §664, provided that the IRC §2055 conditions are satisfied. Is 5% rule waived?

3.1.4 The originally specified payments to non-charitable beneficiaries must be stated as a specified dollar amount or as a fixed percentage of the value of the trust assets [IRC §2055(e)(3)(C)(ii)], unless reformation commences within 90 days of the due date of the estate tax return. This rule applies to trusts that provide for all "income" to be distributed to a non-charitable beneficiary (see LTRs 8817004, 199941004, 200330028, 200340001, 200428013 [surviving spouse's income interest qualifies for marital deduction

under IRC §2056(b)(8)], and 200632013, and Estate of Tamulis v. Comm'r, T.C. Memo 2006-183 [8/29/06, aff'd 509 F.3d 343 (7th Cir. 2007) (2007-2 USTC ¶60,553) ("substantial compliance" not sufficient without commencement of timely reformation proceedings)]. The 90-day deadline is strictly construed (ESB Fin., Trustee of Virginia Biggs Revocable Trust v. U.S., D Kan No. 07-1059-JMM (2008). The 90-day deadline prevents an estate from waiting until an audit raises the problem before commencing reformation proceedings. See also TAM 20084008 wherein the IRS concluded that a non-judicial division in accordance with a state statute of a testamentary trust into two separate trusts, one of which was devoted entirely to charity, did not result in an estate tax deduction for the value of the wholly-charitable trust

3.1.5 LTR 200302029 involved a trust created for the lifetime benefit of the decedent's brother and the brother's wife. The wife, who survived the brother, was entitled to trust income during her life, with discretionary payments of principle. Upon the wife's death, the corpus was to be paid to a designated charity. Following the decedent's death, the trustees petitioned to reform the trust to comply with the charitable remainder unitrust requirements of IRC §664(d), and the wife sought to disclaim her right to receive discretionary distributions. The IRS noted that the trust's charitable remainder interest was a reformable interest under IRC §2055(e)(3)(C), and that the reformation was qualified since it was effective as of the decedent's death, the wife's interest terminated at the same time both before and after the reformation, and the difference between the actuarial value of the reformable interest and the qualified interest after the reformation was less than 5%

3.1.6 LTRs 200306008 and 200306009 (which are identical) address the reformation of a testamentary trust that would not qualify as a charitable remainder annuity trust because less than 5% of the initial fair market value of assets was to be paid annually. The trust was reformed to provide for a 5% annual payout, with the increased portion of the payout payable to the charitable remainder beneficiary. The IRS computed the actuarial value of the qualified interest in the trust at the date of the decedent's death, and the actuarial value of the reformable interest after increasing the annual annuity payment to 5% and concluded that the values were identical. Therefore, the difference between the actuarial value of the qualified interest prior to its reformation and subsequent to its reformation did not exceed 5%, and accordingly the reformation was qualified under IRC §2055(e)(3). See also LTR 200622005 involving a CRUT and LTR 200726005, which involved a reformed testamentary CRAT (less than 5% payout) that was to terminate on the earlier of the annuitant's death or the fifth anniversary of the testator's death; the IRS considered the annuitant's death before the fifth anniversary date to be a "qualified contingency" under IRC §664(d)(9)(A)

3.1.7 LTR 200305023 approved the reformation of an irrevocable trust created by a decedent that failed to meet several IRC §664 requirements. The trust allowed the payment of debts, administration expenses, and taxes generated as a result of the

decedent's death from trust corpus and incorrectly referred to a Section of Rev. Proc. 90-31. The trustee sought court reformation of the trust to qualify as a charitable remainder unitrust. The court agreed to the reformation and, as a consequence, the IRS ruled that the decedent's estate will be allowed a charitable deduction for the present value of the CRT remainder interest

3.1.8 LTR 200402012 approved the reformation of a complicated revocable trust after the grantor's death that would not have qualified for an estate tax charitable deduction absent reformation because of the charitable remainder rules of IRC §2055(e)(2). A judicial proceeding was commenced in a timely manner, and the actuarial value of the reformed interest will not differ by more than 5% from the actuarial value of the charitable interest provided by the trust prior to reformation

3.1.9 LTR 200746010 approved the reformation of a testamentary CLAT/CRAT that provided for distribution of "income" rather than a "guaranteed annuity" amount to charities and individuals until the death of the surviving individual; thereafter all "income" was distributable to the charities. The trust was reformed to provide for an annual annuity to the individuals until the earlier of (i) the death of the last annuitant or (ii) the date specified (the "Annuity Term"). Another annual annuity amount (the "Charitable Lead Annuity") will be distributed to the charities for the Annuity Term, after which all trust property will be held for the exclusive benefit of the charities. The IRS ruled that a charitable estate tax deduction was available for the present value of the Charitable Lead Annuity

3.1.10 A split-interest trust that is not intended to be a CRT (e.g., concurrent private and charitable beneficiaries) is not eligible for reformation under IRC §2055(e), even though the Court of Appeals recognized the unfortunate result of its holding in this non-abusive case [Galloway v. U.S. (492 F.3d 219 3d Cir. 2007) (2007-2 USTC ¶60,543)]

3.1.11 Leona Helmsley's Will creates three 5% CRUTs: $10,000,000 for brother Alvin and $5,000,000 each for two grandchildren. Since the grandchildren were at least 25 years old, the 10% minimum remainder interest test [IRC §664(d)(2)(D)] was satisfied. The Will anticipated the possibility of failing that test, however, and specifically rejected a reformation action if that test was failed, as follows: "However, anything to the contrary notwithstanding, I direct that even if the value of the charitable remainder interest is less than the minimum amount which is required for a trust to qualify as a charitable remainder trust (such minimum is currently 10 percent), I nevertheless direct that the unitrust amount of five percent not be changed, even if it means the trust would therefore not qualify as a charitable remainder trust." If a trust fails to qualify as a CRT, it will not generate an estate tax charitable deduction and will operate as a complex trust for its measuring term. The Helmsley Estate has been estimated at between $4 and $8 billion; the loss of the estate tax deduction apparently was less important than ensuring income to the grandsons for their lives

Leona Helmsley's son Jay died in 1982. Mrs. Helmsley apparently felt very strongly that her grandsons honor their father's memory by visiting his grave at least once every calendar year. Accordingly, she included a "qualified contingency" that will terminate her grandsons' income interests in their CRUTs if they fail to honor this wish. IRC §664(f)(3) offers very broad latitude in determining when a CRT will terminate. In the Helmsley case, the qualified contingency is the failure of the grandsons to sign (at least annually) a register that has been placed in the Helmsley Mausoleum. The provision shall not apply, however, during any period the beneficiary is unable to comply by reason of physical or mental disability as determined by the trustees in their sole discretion. We can only imagine all of the "Helmsley Provisions" that will now require CRT income recipients to perform all sorts of interesting behaviorally-based tasks in order to continue receiving their income streams

3.1.12 It is also possible to reform a CRT (from a NIMCRUT to a STANCRUT) in mid-stream due to "scrivener's error" (LTRs 200930048, 200818002, and 200811003). And LTR 200831002 approved reformation ab initio of a CRUT that, due to scrivener's error, failed to specify the CRUT term and the potential recipients accurately

3.1.13 LTR 200927013 approved the reformation of two testamentary annuity trusts that lacked certain mandatory CRT provisions

3.1.14 LTR 200932003 approved the reformation of a NIMCRUT to a "FLIP CRUT"

3.1.15 LTR 200932020 approved the reformation of a CRUT to eliminate a reference to IRC §170(b)(1)(A) in the definition of a qualified remainder beneficiary

3.1.16 LTR 201026005 approved the reformation of a CRT that, due to scrivener's error, specified a higher percentage payout than intended. The recipient repaid the excess amounts received, plus interest, to the CRT

3.1.17 LTR 201030015 approved the reformation of a NICRUT to a STANCRUT required by reason of a scrivener's error

3.1.18 LTR 201048031 approved the reformation of a one-life CRUT to a two-life CRUT required by reason of a scrivener's error; LTRs 201011034 and 201016033 also involved reformations by reason of a scrivener's error

3.1.19 LTR 201115003 approved the reformation of a testamentary trust that provided for "income" to two individuals together with specified amounts to two charities; at death of surviving individual, various amounts payable to other individuals and several charities (including the two charities). The trust was reformed to create two separate trusts: A CRUT and a CLAT

3.2 LTR 200922013 approved the modification under state law [not reformation under IRC §2055(e)(3)] of a pre-1969 annuity trust that was vastly overfunded to permit an early distribution to the charitable beneficiaries of the "excess" trust funds. The IRS also ruled that the trust's exempt GST status would not change. The charities purchased commercial annuities to secure the annuitants' rights to distributions; the IRS ruled that no gain or loss was recognized by reason of the modification

4. Pledges

4.1 Enforceability depends on state law

4.1.1 Consideration

4.1.2 "Detrimental reliance"

4.1.3 Public policy

4.2 A CRT is subject to most of the private foundation excise tax rules and restrictions, including the rule against self-dealing [IRC §4947(a)(2)]. The IRS believes that a prohibited act of self-dealing occurs if a donor satisfies an enforceable pledge by means of a transfer to a CRT; in its view, this occurs because the CRT assets are thereby used for the benefit of a disqualified person, since they will be used to satisfy the donor's pledge (i.e., debt) to charity (see LTR 9714010). Note that LTR 9714010 overruled and revoked LTR 9233053, which involved the very same transaction. [The IRS did grant relief to this taxpayer under IRC §7805(b), which permits it to give a ruling prospective-only application rather than applying it retroactively to transactions already completed]

4.3 A pledge to create a CRT, however, should not be a prohibited act of self-dealing by virtue of Treas. Reg. §53.4941(d)-2(c)(3), so long as the pledge is fulfilled in a timely manner

4.4 For more about pledges, see Finestone, "Charitable Pledges," 21 Charitable Gift Planning News, No. 7/8 (July/August 2003)

5. Multiple grantors

5.1 LTR 9547004 held that a proposed CRT to be established by eight grantors was an "association" (taxable as a corporation) rather than a "trust" under federal tax law, and therefore the entity could not be a charitable remainder "trust"

5.1.1 Husband and wife to contribute $1,006,000 (including appreciated property)

5.1.2 Six grandchildren to contribute $940,000 (including appreciated property)

5.2 LTR 200203034 held that a proposed CRT to be established by a corporation for the benefit of itself and its shareholders was an "association" rather than a "trust," because the portion of the CRT benefiting the shareholders was deemed to be indirectly transferred from the corporation to the shareholders and re-transferred to the CRT by the shareholders; hence, more than one grantor

6. Slicing and dicing CRTs

6.1 Gift to remainder beneficiary. An income beneficiary of a CRT who gives all or a portion of the beneficiary's income interest to the charitable remainder beneficiary thereof is entitled to an income tax charitable deduction and generally a gift tax charitable deduction for the value of that income interest at the date of the gift, provided that the income interest was not created to avoid the "partial interest" rule of IRC §170(f) [Rev. Rul. 86-60; LTRs 200808018 (gift of 1/3 income interest, resulting in outright distribution of 1/3 via merger); 200802024; 200633013; 200630006; 200205008; 200140027; and 200152018]. The same result occurs with respect to a pre-1969 TRA GRIT (LTR 200834013) and a pre-1969 CRAT (LTR 200922013) (see Section 3.2 on page 6)

6.1.1 Evidence of the income beneficiary's good health is required

6.1.2 Using the lowest possible IRC §7520 rate will maximize the deduction

6.1.3 If a NIMCRUT is involved, the deduction might be based on the lower of the value of (i) a STANCRUT interest or (ii) an "income" interest for donor's life (see Section 6.3.10 below)

6.1.4 A "Qualified Appraisal" may be required

6.1.5 If all income interests are transferred to the charitable remainder beneficiary, the CRT should terminate in favor of the charity via "merger" (depends on state law of trusts) (e.g., see LTR 200808018)

6.1.6 Although not addressed in these rulings, perhaps CRT income beneficiaries can give their interests to charities other than the remainder beneficiary

6.1.7 Income beneficiaries must irrevocably release any rights to designate charitable remainder beneficiaries

6.1.8 A "spendthrift" restriction in the CRT that is valid under state law could frustrate the beneficiary's transfer of an income interest

6.1.9 Gift tax complications under IRC §2522(c)(2) may arise if there are multiple income beneficiaries

6.2 Charitable Gift Annuity ("CGA"). An income beneficiary of a CRT may transfer that interest to the charitable remainder beneficiary in exchange for a CGA. The donor/income beneficiary will be entitled to charitable income and gift tax deductions for the difference in value between the income interest and the CGA [LTR 200152018]

6.2.1 A "Qualified Appraisal" may be required

6.2.2 If the donor's entire income interest is transferred, the CRT should terminate in favor of the charity via "merger"

6.2.3 The CRT interest is capital gain property for purposes of the charitable income tax deduction contribution limits [30% of agi; IRC §170(b)(1)(C)]. A portion of each annuity payment will be long-term capital gain [Treas. Reg. §1.011-2(c), Example 8]. Donor will have no basis in the transferred income interest [IRC §1001(e)(1)]. Donor will not recognize any undistributed capital gains previously realized by the CRT

6.2.4 This CGA plan may be attractive to an NICRUT beneficiary after considering the tax savings from the income tax deduction, the higher annuity rates available to older annuitants, and the favorable taxation of CGA payments

6.2.5 If the CRT income beneficiary transferred the income interest to a charity other than the charitable remainder beneficiary in exchange for a CGA, after which the CRT was terminated as described hereinbelow, the original charitable remainder beneficiary would receive the present value of the remainder interest immediately, and the new charity would receive the present value of the income interest immediately and would benefit from the CGA. This might be particularly attractive if the CRT remainder beneficiary does not issue CGAs

6.3 Commutation of CRT. The beneficiaries of a CRT can agree to terminate the CRT in compliance with state law (the consent of the attorney general may be required). The income and the charitable remainder beneficiaries each will receive a lump sum distribution equal to the present value of their respective interests determined under IRC §7520 and using the methodology described in Treas. Reg. §1.664-2(c) [CRAT] or §1.664-4 [CRUT]; see Section 6.3.10 below regarding NIMCRUTs

6.3.1 Because no charitable deduction is involved, the IRC §7520 rate for the month of the transaction must be used

6.3.2 LTR 200127023 approved the termination of a term-of-years CRT

6.3.3 LTR 200208039 approved the termination of a lifetime CRT. The income beneficiary and the beneficiary's physician attested to the fact that there was no knowledge of any adverse medical condition affecting the beneficiary's life expectancy

6.3.4 The income beneficiary will recognize capital gain equal to the value of the income interest. The IRS viewed this transaction as a "sale" to the remainder beneficiary (but see Section 6.3.14 below). According to the IRS, the income beneficiary has no basis under IRC §1001(e)(1); the exception in IRC §1001(e)(3) does not apply because the entire interest in the CRT's assets is not being sold to a third party (LTRs 200739004 and 200314021)

6.3.5 The IRS also ruled in LTRs 200739004, 200310024 (partial termination), and 200127023 that no "self-dealing" would result from the transaction

6.3.6 LTR 200408031 approved the termination of a CRT involving one current and two successor income beneficiaries at the death of the current beneficiary (see also LTRs 200324035 and 200304025)

6.3.7 LTR 200441024 concluded that an early termination of a term-of-years 10% CRUT was not a termination of a private foundation under IRC §507; was not an act of self-dealing under IRC §4941; and was not a taxable expenditure under IRC §4945; and the amount realized by the income beneficiary was long-term capital gain [with no basis offset under IRC §1001(e)(i)]. The State Attorney General had no objection to the proposal

6.3.8 In 2005, the IRS issued LTR 200525014 allowing a donor and the donor's private foundation to terminate a CRT and distribute the CRT assets between them based on the actuarial values of the parties' respective interests. The IRS ruled the termination would not be self-dealing under IRC §4941(a)(2). In 2006, however, the IRS first revoked that 2005 ruling in LTR 200614032, and then reconsidered the matter after the donor exercised a reserved power to change the charitable beneficiaries of the CRT. Originally, the remainder beneficiary was the donor's private foundation. As amended, the CRT remainder interest instead will pass to six public charities. In LTR 200616035, the IRS ruled that terminating the CRT via a "sale" by the donor of the donor's income interest to the public charities will not be self-dealing (see also LTR 200633011)

6.3.9 LTR 200846037 approved the early termination of a CRT and division of assets between the donors and a remainder beneficiary that was a "supporting organization" of which the donors were directors. The IRS indicated that the supporting organization was a public charity, and that the ruling would not have been granted if the remainder beneficiary were a private foundation. LTR 200727013 concluded that the early termination of two CRTs involving husband and wife donors and division of CRT assets between the donors and the charity would not involve self-dealing and would not result in the imposition of an IRC §507(c) termination tax. The donors would recognize capital gains equal to the value of the income interest, computed using the methodology under Treas. Reg. §1.664-4 using the IRC §7520 rate on the date of termination. LTR 200827009 also approved the early termination of a CRUT

6.3.10 LTRs 200733014 and 200725044 approved early terminations of NIMCRUTs involving lump sum payments to the income recipients based on the actuarial values of their interests taking into account the net income provisions of the NIMCRUTs. The LTRs advised that "(o)ne reasonable method to calculate the actuarial value of the income and remainder interests is the following: The computation of the remainder interest is found using a special factor as indicated in section 1.7520-3(b)(1)(ii) of the regulations. The special remainder factor is found by using the methodology stated in section 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where section 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the section 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor. Based on this methodology, the calculation of A's income interest in B may be demonstrated as follows: The section 7520 rate for May 2006 is 5.8 percent. Assuming the termination occurred in May 2006, the lesser of this rate and the trust's stated payout percentage is 5.8 percent. The assumed taxpayer's age as of the nearest birthday is 75. Based on Table 90CM, interest at 5.8 percent, an unadjusted payout rate of 5.8 percent, and quarterly payments made at the end of each quarter, the present value of the remainder interest in a unitrust which falls in at the death of the person aged 75 is $0.56904 for each $1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is $1.00 minus $0.56904, or $0.43096 for each $1.00 of the trust estate." Note that no value is attributed to the "make-up" aspect of the NIMCRUT. The New York City Bar has requested more guidance about this in a letter to the IRS dated April 4, 2008

6.3.11 LTR 200809044 approved the termination of a no make-up NIMCRUT that would terminate on the earlier of the death of the survivor of two individuals or 20 years from its inception, and provided an appropriate actuarial factor

6.3.12 LTR 200802033 approved the early termination of a testamentary CRAT and distribution of CRAT assets among the CRAT beneficiaries as agreed by them to settle estate litigation involving disputes among the estate, the trustee of the CRAT, and CRAT annuitant, and the CRAT remainder beneficiaries

6.3.13 LTRS 200922013 through 027 approved the premature distribution of a CRAT's "excess" assets to the charitable remainder beneficiaries and the purchase by the remainder beneficiaries of commercial annuities to secure the CRAT's annual payments to the current beneficiaries, and held that the modification did not result in any realization of income under IRC §1001(a) or under Cottage Savings Ass'n v. Comm'r

6.3.14 The IRS recently added CRTs that are to terminate prematurely "in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust" to its "no-ruling" list [Rev. Proc. 2011-3, Section 4.01(39)]. The IRS will not rule whether that transaction is treated as a "sale" [Section 4.01(42)] or as a sale of a "capital asset" [Section 4.01(43)]. Under Section 5.09 of Rev. Proc. 2009-3, the IRS also had refused to rule whether the termination of a CRT prior to its stated term caused the CRT to cease qualifying as a CRT. The topic was under study, with further guidance expected in a revenue ruling, revenue procedure, regulation, or announcement. Rev. Procs. 2010-3 and 2011-3 included no such provision

6.4 Sale to a third party. The beneficiaries of a CRT presumably can sell their respective interests in the CRT to a third party for their respective fair market values (after which the CRT should terminate in favor of the buyer via "merger" under state law). Rev. Proc. 2011-3 could apply to these transactions as well as to commutation transactions described in Section 6.3 above. The suggestion in Rev. Proc. 2009-3 that either transaction might disqualify a CRT is unfortunate:

(i) There is no active project to issue guidance on the issue. Rev. Rul. 2008-41 concerned "vertical" divisions (see Section 6.6 below) and did not address "horizontal" commutations. The 2010-2011 Plan does not promise guidance on the qualification issue. It does promise guidance on the uniform basis rules as applied to trusts, presumably including CRTs, but the value of clarifying the uniform basis rules as applied to the sale transaction described in Notice 2008-99 (discussed in Section 6.4.2 below), or to a commutation of a CRT, is lessened if an issue of qualification under IRC §664 continues with respect to these transactions; and

(ii) The significance of disqualifying a CRT upon a commutation or sale of interests would turn on whether, and to when, the disqualification was retroactive. Similar questions arise when a CRT is found to have violated the requirement that it "function exclusively" as a CRT, and that requirement might be the technical basis for

attacking a commutation. Cf., Estate of Melvin B. Atkinson v. Comm'r, 115 T.C. 26 (2002), aff'd 309 F.3d 1290 (11th Cir. 2002); CCA 200628026 (7/14/06) (a perfectly drafted CRT nevertheless can be disqualified if it is not administered properly) (see Section 1.1 on page 1)

6.4.1 The income beneficiary hopes to recognize capital gain equal to the value of the income interest (sale proceeds) reduced by the income beneficiary's basis, relying on the exception in IRC §1001(e)(3) because the entire interest in the CRT is being sold to a third party

6.4.2 Example: Donor creates a CRT for the benefit of the donor's spouse and funds the CRT with low basis property. The charitable remainder interest is worth 10% of the value of the property. The CRT sells the property and reinvests in marketable securities. In a later year, the spouse and the charity agree to terminate the CRT with each selling its respective interest to a third party for its actuarial fair market value. If the spouse can receive the income share of the CRT free of tax, the property in effect will have been sold tax-free at a cost of about 6% (10% remainder interest less 4% income tax savings). For this to occur, four hurdles (described below) must be overcome [as a policy matter, this should **not** work because it in effect extends the benefit of a CRT's tax exemption to the non-charitable beneficiary. The IRS 2010-11 Priority Guidance Plan includes a project to provide guidance regarding the applicability of the uniform basis rules to CRTs, and the IRS now has identified this transaction (and "similar" transactions) as "transactions of interest" under Treas. Reg. §1.6011-4(b)(6) and IRC §§6111 and 6112 in Notice 2008-99]. The four "hurdles" are the following:

(i) Sale must not trigger recognition of gain previously realized by CRT (seems correct);

(ii) Spouse's interest must be a capital asset (seems correct);

(iii) Spouse's basis in the income interest must equal the actuarial share of the CRT's basis (uncertain, but seemed to be correct under uniform basis rules until Notice 2008-99); and

(iv) Spouse must be able to use basis to offset gain (seems correct)

6.4.2.1 The ACGA in a letter dated January 12, 2009, written by Conrad Teitell, Esq., has suggested a solution implementing an "adjusted uniform basis" rule, but this is not what IRC §1001(e) provides

6.4.2.1.1 The income beneficiary's basis in the income interest would be the beneficiary's pro rata share of the CRT's basis, reduced by the beneficiary's pro rata share of any undistributed amounts then in Tier 2 (capital gains)

6.4.2.1.2 See Examples in ACGA letter

6.4.2.1.3 ACGA letter includes additional recommendations:

(i) That the "adjusted uniform basis" rule apply to CRT commutation transactions described in Section 6.3 above. This may require legislation in view of IRC §1001(e);

(ii) Allow use of a "qualified appraisal" to value a NIMCRUT income interest in these transactions;

(iii) Other rules relating to early termination of CRTs, including issuance of a reporting form to be used in connection therewith

6.4.2.2 Sterling Foundation Management LLC in a letter dated January 31, 2009, written by its Chairman, James Lintott, has reviewed the "legitimate" reasons for selling a CRT income interest and urges the IRS to address the "abusive" transactions as narrowly as possible by, for example, not prohibiting these transactions entirely, but disallowing any use by the income beneficiary of any share of the CRT's basis (the Notice did not suggest a prohibition, but rather the imposition of penalties for underpayment of income taxes)

6.4.2.3 What about a rule applicable to all transactions that the income beneficiary recognizes income in the same manner as though the CRT were deemed to have sold all its assets and the income beneficiary received a CRT distribution (i.e., Tiers 1, 2, 3, 4)? No manipulation seems possible, but again this is not what the IRC provides

6.4.2.4 What should be the income tax consequences to a CRT income beneficiary who commutes or sells the income interest in a CRT funded entirely with income in respect of a decedent (e.g., funded via IRA beneficiary designation)? Capital gain?

6.5 Purchase of remainder interest

6.5.1 Low IRC §7520 rate reduces the value of a CRAT remainder interest and can make a purchase quite attractive if the remainder beneficiary is willing to sell its remainder interest at the value calculated for income tax deduction purposes

6.5.2 Example: Donor creates a 20-year CRAT, funded with $1,000,000 when IRC §7520 rate is 4.0%. An annuity of 6.622% results in a charitable income tax deduction of $100,000 (10%). Donor's children purchase remainder interest for $100,000 cash (or more, perhaps in year 2). If CRAT earns/grown at annual rate of 6.622%, $1,000,000 left after 20 years. Children would have had to invest $100,000 @12% annually for 20 years to realize $1,000,000 (after tax)

6.5.2.1 And the donor is entitled to a $100,000 income tax deduction in the year the CRAT is created (the charity does receive $100,000)

6.5.2.2 And CRAT invests in tax-exempt environment for 20 years

6.5.3 This technique also can be considered in connection with remainder interests in personal residences and farms

6.6 Division of CRT

6.6.1 Rev. Rul 2008-41 rules as follows with respect to "pro rata" (i.e., equal share for each original recipient) division:

6.6.1.1 Separate trusts continue to qualify as CRTs

6.6.1.2 Each separate trust's basis in assets equals pro rata share of original CRT basis, and holding period includes original trust holding period

6.6.1.3 No "termination" excise tax under IRC §507(c)

6.6.1.4 No self-dealing (all costs paid by recipients; but see LTR 200616008 in which the IRS ruled that the CRT could pay the legal fees incurred to accomplish the division; the IRS apparently has had a change of heart about this issue)

6.6.1.5 No taxable expenditure under IRC §4945

6.6.2 Situation 1: Equal division into three separate CRTs, with assets of CRT for benefit of first recipient to die added equally to remaining CRTs, and with assets of CRT for benefit of second recipient to die added to remaining CRT, and with ultimate

distribution to charity at death of last recipient to die. Apparently additions to a CRAT are allowed under these circumstances. If the CRT is included in a recipient's estate (because the recipient was the donor), the basis of the CRT assets should be adjusted ("stepped-up") to date of death values

6.6.3 Situation 2: Equal division into two separate CRTs upon divorce, with assets of each separate CRT passing to charity at death of each spouse

6.6.3.1 No additional income tax deduction even though value of charitable remainder increased. If successor life estate included, adverse estate tax consequences would result: CRT assets would be included in estate of first spouse to die, but no marital deduction for survivor's successor interest. And survivor must pay estate tax from personal funds (CRT cannot furnish funds for estate taxes)

6.6.3.2 Could spouses divide CRT "pro rata" based on respective value of income interests, thereby taking each spouse's age into account? LTR 201029002 approved the non pro rata division of a CRUT upon divorce (the parties agreed to the split). The IRS also ruled that the division was an income **realization** event, but there was no gain **recognition** because the transaction involved a transfer of property incident to divorce (IRC §1041). The IRS also ruled that neither spouse will be deemed to have made a gift because the transfers were effectuated pursuant to a divorce decree, even though the IRC §2516 timing requirements were not satisfied [see, *Harris v. Comm'r*, 340 US 106 (1950)]. The IRS also issued favorable private foundation, self-dealing, and taxable expenditure rulings

6.6.3.3 Must both spouses agree, or can divorce court order a division? (See Section 6.6.3.5 below)

6.6.3.4 A CRUT established by a married couple with community property can be divided into two equal CRTs (one for each spouse) upon the couple's divorce without any adverse tax consequences (LTRs 200333013; 200340022; 200728026; 200831029; 200831030; 200831031; and 200832021)

6.6.3.5 In *Marriage of Lancashire*, 2d Civil No. B209599 (an unpublished opinion), the California Court of Appeal held that the beneficial interest of a married couple in a CRT established with community property assets remained community property, and thus was subject to the jurisdiction of the divorce court. The CRT did not contain a "transmutation" clause

7. Retirement benefits

7.1 Retirement plan death benefits paid to a CRT are received with no income tax. Thus, the non-charitable CRT beneficiaries can receive a life income generated by reinvestment of the entire amount of the retirement benefit, rather than the after-tax proceeds, which could be substantially less. The beneficiaries then will be able to receive more annual income from the CRT than they would receive by investing the after-tax value of any retirement benefits distributed to them directly. In addition, the decedent's estate is entitled to an estate tax charitable deduction for the value of the charitable remainder gift (and an estate tax marital deduction for the value of the income interest if the decedent's surviving spouse is the sole noncharitable beneficiary [IRC §2056(b)(8)]. Designating a CRT as beneficiary does not, however, increase total revenue to the individual beneficiaries, especially if the life-expectancy payout method is available. The CRT nevertheless may be more attractive than naming the individual beneficiaries directly if long-term deferral is not available (the retirement plan may not offer a life-expectancy payout), especially after the estate tax benefits of the charitable deduction are considered

7.2 Retirement plans generally are transferred via beneficiary designations. Care must be taken in order to designate a CRT as beneficiary. The beneficiary can be a funded CRT, an unfunded CRT, or an estate or revocable trust that provides for the creation of a CRT at death

7.3 The IRS has ruled (LTR 199901023) that with respect to IRA proceeds passing to a CRT the IRC §691(c) income tax deduction is allowed only to the CRT and not to the income beneficiaries (which probably results in no benefit to anyone in view of the CRT 4-tier system of income allocation)

7.4 What are the income tax consequences to a non-charitable CRT beneficiary who commutes or sells his or her interest? Capital gain?

7.5 A CRT can help solve some of the estate and tax planning problems that exist for retirement plan benefits

7.5.1 Benefit older individual. Naming an older non-spouse individual outright as beneficiary of retirement benefits may result in distributing the benefits to the beneficiary rapidly (over the beneficiary's short life-expectancy), so income taxes will be paid rapidly and the senior adult will have less available in later years. Benefits left to a CRT, however, will result in a steadier income from the CRT that will last for the elderly beneficiary's entire life (rather than terminate at the end of an artificial life-expectancy). The participant's estate also will be entitled to an estate tax charitable deduction for the value of the remainder interest. But the individual beneficiary cannot receive more from the CRT than the specified payout amount, regardless of need.

"Inherited IRA" provisions may reduce or eliminate this advantage (see paragraph 7.5.3 below)

7.5.2 Income for several adults. Naming a CRT having several adult beneficiaries as beneficiary of a retirement plan avoids all minimum required distribution problems, because the CRT receives full distribution immediately upon the participant's death with no income taxes. The CRT will produce a relatively steady income that can be split among the adults living from time to time. Because the value of the charity's remainder interest must be at least 10% of the CRT value, this approach is available only for a small group of adult beneficiaries

7.5.3 Lump sum only plan. Many qualified retirement plans offer a lump sum distribution as the only permitted form of death benefit. A CRT can be used to approximate the life-expectancy payout that is not available under these retirement plans. If the beneficiaries live a long time, their aggregate payout may exceed the amounts they would have received had they been named outright beneficiaries. Even a non-spouse beneficiary who qualifies as a "designated beneficiary" can transfer funds from an inherited retirement plan account via a direct rollover to an "inherited IRA" established to receive the distribution in the name of the deceased participant and payable to the same beneficiary, provided the rollover is completed in a timely manner. Thus, the beneficiary can preserve the life-expectancy payout ("stretch" IRA) rather than be forced to accept a lump-sum payment (but see paragraph 7.5.5 below)

7.5.3.1 The IRS issued Notice 2007-7, which clarifies a number of issues relating to the "inherited IRA" rollover rules

7.5.3.2 The IRS also has stated that a non-spouse beneficiary can use the life-expectancy payout method provided that the rollover is made by December 31 of the year after the participant's death ("Employee Plan News" dated February 13, 2007). A "direct rollover" (Trustee-to-Trustee) is required

7.5.4 QTIP alternative. A QTIP with a charitable remainder beneficiary can't qualify as a designated beneficiary eligible to use the life-expectancy payout method, because the charity is not an individual. Thus, a rapid payout from the plan to the QTIP may be required, which would result in rapid income taxation of the benefits. No such problem exists if a CRT is beneficiary rather than a QTIP, because a CRT is tax-exempt. This will ensure a lifetime income for the surviving spouse without a rollover and the decedent can select the ultimate beneficiary (a charity). And if the spouse is the only CRT beneficiary, no estate tax is payable at either spouse's death

7.5.5 "Stretch" IRA alternative. How long will the beneficiary continue to implement the "stretch" feature?

7.6 The Public Good IRA Rollover Act of 2011 (S.557) would, among other things, make permanent the IRA Charitable Rollover provisions, eliminate the $100,000 limitation, and allow rollovers to CRTs by donors beginning at age 59½

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