

# **CHARITABLE REMAINDER TRUSTS: CHARITY CAN BEGIN AT HOME**

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### **I. Introduction**

- A. Charitable remainder trusts take advantage of the fact that lifetime gifts to charity are almost always superior from a tax standpoint to testamentary charitable transfers. A bequest by Will is deductible for estate tax charitable deduction purposes. A lifetime gift has the same estate tax effect as a bequest because at the donor's death the property has been removed from the donor's estate, but in addition a portion of the lifetime gift is recaptured through the charitable income tax deduction.

Example: A testator in a 45% estate tax bracket who bequeaths \$100,000 to charity recovers 45% of it through the estate tax deduction. If the property had been given to charity during lifetime, not only would the estate tax have been saved (because the property would not have been in the donor's estate at the date of death) but a portion of the gift would have been recovered through the income tax deduction.

- B. Charitable remainder trust basic concept: Donor transfers property to trust retaining an income interest for life or lives, with remainder passing to charity at the last beneficiary's death. Donor receives an immediate income tax deduction for the actuarial value of the remainder. The life beneficiaries may (but are not required to) include the donor.

C. Historic background:

1. In the good old days (i.e., before the Tax Reform Act of 1969) donors simply established trusts providing for payment of all of the income to the donor or other life beneficiary, prohibiting invasion of corpus, and providing for the remainder to pass at termination of the life interest to the charitable remainderman.
2. The donor received an income tax deduction based on the actuarial value of the remainder following an income interest for a life or lives.
3. Why did Congress change the rules? Congress was primarily concerned that assets would be invested to produce a high rate of return with little consideration for the protection of corpus for the benefit of the remainderman. The solution was a form of trust which would pay amounts to the income beneficiaries which were not dependent upon investment return.

- D. 1. The two types of remainder trusts permitted by Section 664 are charitable remainder annuity trusts, which provide for payment of a fixed amount at

least annually, and charitable remainder unitrusts, which require payment of a fixed percentage of the trust, revalued annually.

2. The Code now provides that no charitable deduction is permitted for a charitable remainder in a split interest trust (other than a pooled income fund) unless the life or term interest is a fixed annuity or unitrust amount.
3. This is true for income tax deduction purposes (section 170(f)(2)(A)), federal estate tax charitable deduction purposes (section 2055(e)(2)) and gift tax charitable deduction purposes (section 2522(c)(2)).

## II. Tax Effects.

- A. The charitable remainder trust is exempt from tax pursuant to Section 664(c) unless it has unrelated business income. The unrelated business income problem can be a real trap—but not the disqualifying trap it used to be. See, for example, the *Leila G. Newhall* decision, 105 F.3d 482 (9th Cir., 1997) affg. 104 T.C. 236 (1995) where a unitrust was disqualified because of UBIT. The trust was funded with publicly traded stock. On liquidation of the corporation, the trust received interests in publicly traded partnerships holding various mineral and other rights. The Tax Court held that the business interests and operations of the partnerships would be attributed to the unitrust, and the decision was affirmed by the Ninth Circuit. Fortunately, Code section 664(c)(2)(A), effective January 1, 2007, provides that instead of the trust being disqualified, the UBTI will instead be subject to a 100% excise tax. Under proposed regulations, the UBTI will be allocated to the income tier, but the excise tax will be allocable to corpus. Sources of UBTI can be subtle—passthrough entities may generate UBTI and a host of transactions may generate debt-financed income. So beware.
- B. Unlike the usual trust rules, which provide for pro rata inclusion in the beneficiary's income of various classes of income, charitable remainder trust beneficiaries are taxed on a tier system providing for least desirable types of income to be exhausted first in accordance with the tier system.
- C. Ordinary income, either from current year earnings or prior year accumulations, is deemed to be distributed first, followed by capital gains, followed by tax-exempt income, followed by return of corpus.
- D. Income in the trust in excess of the current year distributions is not taxed to the trust but is accumulated by class of income for purposes of determining taxability of beneficiaries in future years.
  1. What this means is that highly appreciated assets paying little income can be sold by the trust and reinvested without capital gains cost either to the beneficiary or to the trust.

2. But if the proceeds are invested in assets producing tax-exempt income, the amounts distributed either from current year earnings or prior-year accumulations are deemed to be taxable capital gains until they are entirely exhausted.
3. The Internal Revenue Service has issued final regulations revising the ordering rules under section 664 to take into account changes to income tax rates applicable to capital gains and certain dividends.

Proposed regulations were issued on November 20, 2003 and a public hearing scheduled for March, 2004 was canceled because no requests to speak were received. Generally, the proposed and final regulations attempt to carry out the general philosophy of section 664 that the least desirable types of income (i.e., the most highly taxed) will be deemed distributed first within each tier. Thus, gain from sale of collectibles taxed at 28% is deemed distributed before 15% gain on marketable securities held for more than one year. Likewise, within the dividend tier, qualified dividends taxed at 15% are deemed distributed only after non-qualified dividends. Note that the system does not quite work as planned. Because section 664 mandates that ordinary income is deemed to be distributed first, some types of ordinary income taxed at a 15% rate (such as 15% qualified dividends) will be deemed distributed before 28% capital gain. But to change this would require a change in the Code.

The proposed as well as the final regulations require charitable remainder trusts to maintain separate classes of income within each tier even when the classes are only temporarily subject to the same tax rate (because, for example, the current tax rate applicable to one class sunsets in a future year). This has not been changed in the final regulations. The only change of substance was a change made in response to the capital gain and loss netting rules. The proposed regulations provided that a net short term capital loss is first netted against the net long term capital gain in each class before the long term capital gains and losses in each class are netted against each other. A commentator pointed out that this netting rule was inconsistent with the generally applicable netting rules and suggested that the netting rule be revised to provide that the gains and losses of the long term capital gain classes be netted prior to netting short term capital loss against any class of long term capital gain. This suggestion was adopted in the final regulations.

Another change made was to make it clear that the character of amounts distributed or deemed distributed at any time during the year would be determined as of the end of the taxable year.

Finally, in response to a comment made by this author, the final regulations have been reworded to make it clear that the tax rates applicable to a distribution or deemed distribution from a charitable remainder trust to a recipient are the tax rates applicable to the classes of income from which the distribution is derived in the year of distribution from the charitable remainder trust, and not the tax rates applicable to the income in the year it is received by the charitable remainder trust. This was confusingly worded in the proposed regulations.

### III. Common Elements of Unitrusts and Annuity trusts.

A. Unitrusts and annuity trusts have many common elements, but the two types of payouts may not be combined.

B. Life or term payments. Section 664 requires that payment be made to one or more persons, at least one of whom is not an organization described in Section 170(c) and, in the case of individuals, only to an individual who is living at the time of creation of the trust. Part of the payment can be made to a charity so long as at least one non-charitable beneficiary receives a portion of the payout as well. See PLR 200108035 for an example of such payments. See also PLR 20095032 where the Service approved a reformation permitting the trustee to make additional limited annual distributions of principal to itself as the charitable remainder beneficiary. The Service has also approved a testamentary annuity trust giving an independent trustee the authority to sprinkle the annuity between the annuitant and the charity. See PLR 9052038. The portion of the annuity or unitrust payments made to charity in such cases will not generate an additional income tax deduction and in these rulings the Service will typically require that if any of such distributions to charity are made in kind, the adjusted basis of assets distributed would have to be fairly representative of the adjusted basis of the assets available for distribution as of the distribution date.

- C.
1. It is apparent from reading Section 664 that a person does not have to be a natural person, but may be a corporation, partnership or other entity. See Section 7701 for the statutory definition of person. Charitable remainder trusts for persons who are not individuals are rare.
  2. Obviously, in the case of payments to a person who is not a natural person, the payment can only be for a term of years, and may not be for the lifetime of the "person".
  3. Payment may be made to multiple beneficiaries, either jointly or concurrently. Additional life beneficiaries will, of course, lower the charitable deduction.
  4. Period of Payment.
    - a. Both charitable remainder annuity trusts and charitable remainder unitrusts must be payable for the life or lives of one or more

individuals living at the time of the creation of the trust or for a term of years, not in excess of twenty years. (Charitable lead annuity trusts and charitable lead unitrusts need not be limited to a 20-year term.)

- b. The longer the term, the less the tax deduction.
- c. Some combinations of life or lives plus term of years will qualify, so long as the term of the trust cannot exceed lives in being at the creation of the trust

Example:

- d. To A for life and then to B for the shorter of B's life or a term of years not to exceed twenty years. So long as both A and B are living at the creation of the trust, the trust qualifies.

Note:

The key here is that the trust cannot last longer than the lives of the beneficiaries.

- e. Therefore, payment to A for life and then to B or B's estate for a term of years does not qualify. The trust could last longer than the lives of the beneficiaries living at the creation of the trust or a term not to exceed twenty years.

Also permissible: payment to A for twenty years, provided that if A dies before the expiration of the term, payment will be made to B and if B dies before the expiration of the term, then payment to C. The term cannot exceed twenty years and therefore qualifies.

- 5. The payment period can terminate earlier than it would otherwise terminate, dependent upon any contingency. Earlier rulings had held that trusts did not qualify where the unitrust or annuity payment would end upon a contingency, resulting in earlier payment to the charity. A typical such contingency is remarriage. There is no policy reason to disqualify the trust in the event of early termination since the only effect is that the charity receives the remainder earlier than it would otherwise.
- 6.
  - a. A 1984 amendment to Section 664 provided that any "qualified" contingency the effect of which is to accelerate the charitable remainder is permitted. A qualified contingency is defined in Section 664(f)(3) as any provision of a trust which provides that upon the happening of a contingency the unitrust or annuity trust payments will terminate not later than the payments would otherwise have terminated.
  - b. Thus, a trust providing for payment of a unitrust amount to X for life or until X's remarriage will qualify, even if the value of the

contingency is unascertainable. Note that the marital deduction will be available for such trusts, as Section 2056(b)(8) provides that the terminable interest rule does not apply to charitable remainder trusts.

- c. The qualified contingency will not increase the value of the remainder for charitable deduction purposes. This is true even where the contingency is capable of valuation, as is, for example, the possibility of remarriage. But this means the contingency can be far-fetched without disqualifying the trust.
- d. Use of the qualified contingency makes possible a number of planning ideas. In *terrorem* provisions, for example, are now permitted. In private letter rulings before 1984, the Service ruled that an *in terrorem* provision disqualified a charitable remainder trust, because the term of the trust would no longer be measured by the lifetime of the beneficiary, but by the lifetime of the beneficiary or, if shorter, the beneficiary's filing of a will contest.

Example: A unitrust providing for payment of a unitrust amount to A for life or, if earlier, the date on which the St. Louis Cardinals next win the World Series, qualifies.

- 8. Further caution: The period of payment provisions can create problems even where the payment terms themselves do not specifically trigger it. For example, to prevent a present gift in a two-life charitable remainder trust, drafters often give the donor the testamentary power to revoke the successor beneficiary's interest. If the power is held by the donor and he is not an income beneficiary, the Service could disqualify the trust on the ground that the period of the trust payments is determined by reference to a life other than the beneficiary's.

#### D. Payment Amount

- 1. The payment amount from both unitrusts and annuity trusts must be at least 5% but no more than 50%. (See discussion below of 1997 TRA changes.) Note that there is no minimum payment for lead unitrusts or lead annuity trusts, PLR 9415009 to the contrary notwithstanding. A statement in that ruling to the contrary is wrong.
  - a. In the case of a charitable remainder unitrust, the payment must be at least 5% of the trust revalued annually.
  - b. In the case of a charitable remainder annuity trust, the payments must be at least 5% of the initial fair market value of the trust assets.

2. Why does the Code require, as a policy matter, that the payout to the non-charitable beneficiaries be at least 5%? The reason is that the private foundation rules prohibiting accumulations in private foundations, which were also part of the 1969 Tax Reform Act, could otherwise be easily avoided by use of a charitable remainder trust with a very low payout.

E. Taxpayer Relief Act of 1997.

1. The Taxpayer Relief of 1997 imposed additional requirements on charitable remainder trusts, the first major revision of the basic rules governing charitable remainder trusts since 1969. In order to prevent the abuses of the accelerated charitable remainder trust and the use of charitable remainder trusts for primarily non-charitable objectives, section 664 was amended for transfers to and trusts created after June 18, 1997 to add two additional requirements for a qualifying charitable remainder trust:

The payout from a charitable remainder trust (whether a unitrust or an annuity trust) may not exceed 50%.

The actuarial value of the remainder interest (determined under section 7520) must be at least 10% of the initial fair market value of the property placed in the trust.

2. The reformation provisions of section 2055(e) were amended to provide that in the event of failure to qualify, the trust could, pursuant to a proceeding commenced within the required time, be either declared void ab initio or changed by reformation to reduce the payout rate or duration of the non-charitable beneficiary's interest to the extent necessary to satisfy these requirements. Note that if the trust is reformed by reducing the payout, it need not meet the usual requirement that the reformed and unreformed interests not deviate by more than 5%. This is clear from the Committee Report. In the event the trust is declared null and void, no deduction would be allowed for a transfer, and any transaction entered into by the trust prior to being declared void would be treated as entered into by the transferor. The effect would be to have gain on the sale of assets taxed directly to the trust.
  - a. Note that without this provision, gain would not be taxed to the grantor as a grantor trust in most cases, but taxed to the trust as a taxable complex trust. However, one effect of having the trust declared null and void is that there would be no taxable transfer of any interest to a charitable or non-charitable beneficiary. Taxation of a non-qualifying (and therefore non-exempt) charitable remainder trust is dealt with



in Reg. 664-1(c) which provides in the context of a trust receiving unrelated business income as follows:

“The taxes imposed by subtitle A of the Code upon a nonexempt charitable remainder trust shall be computed under the rules prescribed by subparts A and C, part 1, subchapter J, chapter 1, subtitle A of the Code for trusts which may accumulate income or which distribute corpus. The provisions of subpart E, part 1 of such subchapter J are not applicable with respect to a nonexempt charitable remainder trust.”

- b. The rules also provided for severance of additional contributions if the contribution could cause the trust to be not qualified.
3. The rules did not apply to trusts created by wills or other testamentary instruments executed on or before July 28, 1997 if the decedent died before January 1, 1999 without having republished the will (or amended the instrument) by codicil or otherwise, or was on July 28, 1997 under a mental disability to change the disposition of the property and did not regain his competence to dispose of the property before the date of death.
4. The statute also raises a number of questions. For example, a charitable remainder trust cannot last for a term of more than twenty years. If a trust for an individual would not qualify under the 10% rule, can the trust be reformed by providing that the trust terminates not at the individual's death, but at an earlier age? This earlier age termination may have the same practical effect as a term of years trust for more than twenty years, which is not otherwise permitted. Will this be a qualifying reformation?
5. Note also that the rule has a limiting effect on trusts for children if the children are relatively young. The following chart illustrates a range of remainder percentages for one-life unitrusts at various ages, assuming an 8% section 7520 rate. (Unitrust factors, unlike annuity trust factors, are only slightly affected by interest rate changes.) Qualification of course becomes more difficult as the number of beneficiaries increases and is more difficult as mortality declines between censuses. The problem is generally more critical under new Mortality Table 2000CM than it would have been under Table 90CM.

One-Life Charitable Remainder Unitrust  
Quarterly Payout  
4% Section 7520 Rate  
Mortality Table 2000CM

Percentage Value of Remainder Interest

Age	Percentage Payout			
	5%	6%	7%	8%
25	9.5%	6.5%	4.5%	3.3%
35	14.6%	10.5%	7.8%	5.9%
45	22.0%	17.0%	15.3%	10.6%
55	32.3%	26.5%	22.0%	18.5%
65	45.3%	39.3%	34.4%	30.2%

6. Finally, note that the 10% actuarial value test is different from the 5% actuarial probability of exhaustion test made applicable to charitable remainder annuity trusts by Rev. Rul. 77-374 and did not raise the probability test from 5% to 10%. It is possible to pass the 5% probability of exhaustion test and flunk the 10% remainder test, and it is also possible to pass the 10% remainder test and flunk the 5% probability of exhaustion test.

Example 1. Assuming an 8% section 7520 rate, a one-life charitable remainder annuity trust created by a 65 year old donor paying an 9% annuity in quarterly installments passes the 10% remainder test but flunks the 5% probability of exhaustion test. The remainder is worth 21.070% of the value but the probability of exhaustion is 19.076%.

Example 2. Still assuming an 8% section 7520 rate, a one-life charitable remainder annuity trust funded created by a 25 year old donor paying a 7.4% annuity in quarterly installments passes the 5% probability of exhaustion test, but flunks the 10% remainder test. The probability of exhaustion is 0 but the actuarial value of the remainder is only 8.32% because of the donor's young age.

- F. Final Regulations. On December 10, 1998 the Internal Revenue Service issued final charitable remainder trust regulations, the most significant revision of the regulations under section 664 since they were originally promulgated after the 1969 Tax Reform Act. Proposed regulations had been issued on April 17, 1997. The final regulations made numerous substantive changes.

1. The most significant change brought about by the 1998 regulations was the official endorsement by the Service of the flip unitrust (or “combination of methods” unitrust as the regulations refer to them). The flip unitrust is an income-only unitrust either with or without a makeup provision, which upon the occurrence of an event becomes a standard unitrust.
2. The flip unitrust is particularly useful for sales of unmarketable property. Without the flip provision, once the property is sold, the trust would still be an income-only unitrust. The trustee would then be under considerable pressure to invest in income-producing assets sufficient to produce fiduciary accounting income equal to the unitrust payout percentage. The reason we have the unitrust/annuity trust system is to give the charitable remainderman and the income beneficiaries the same economic interest in the trust or to divorce the way the trust is invested from the amount of income the beneficiary has. The flip unitrust allows the trustee to invest for total return.
3. The final regulations did the following:
  - a. The flip provisions provide that the flip can occur upon the occurrence of any triggering event so long as the date or event triggering the conversion is outside the control of the trustees or of any other persons. Examples: an individual's marriage, divorce, death or birth of a child are cited as permissible triggering events, as is the sale of an unmarketable asset. It would seem that an event such as the donor's reaching retirement age or age 65 is a permissible triggering event under these rules.
  - b. Note that the regulations, perhaps unintentionally, make it is easy to cause conversion from an income-only unitrust to a regular unitrust at will. Since the flip can be triggered by the sale of an unmarketable asset, and since there is no requirement that a flip unitrust consist of some minimum percentage of unmarketable assets, it would seem that a trust could be funded with mostly liquid assets and a few shares of a closely held corporation or other unmarketable asset. The asset could be sold by the trust at the time the flip is desired. This is probably not what was intended.
  - c. The regulations provide that the flip will be effective at the beginning of the taxable year immediately following the taxable year in which the triggering event occurs, but that any makeup amount would be forfeited when the trust converts to the fixed percentage method. So if the triggering event occurs in January, the conversion to a regular unitrust will not be effective until January 1 of the following year.

- d. In addition, the regulations allowed a window to June 30, 2000 for reformation of existing income-only unitrusts to flip unitrusts.
- 4. The regulations also included some flip reformation options. Defective flips can be reformed by taking out the flip and thus becoming an income-only trust for the duration, except in the case of trusts modified within the window noted above. The regulations appear to permit amendment (as opposed to reformation) only for post-effective date defective flips.
- 5. In order to deal with the accelerated payout charitable remainder trust (such as the two-year, 80% payout unitrust) the proposed regulations had provided that regular unitrusts as well as annuity trusts would have to make unitrust or annuity payments to the beneficiaries by the close of the taxable year in which the payments were due. Income-only unitrusts were exempted because their fiduciary accounting income cannot usually be determined by December 31.

Although recognizing that recent legislative changes (the 50% maximum payout and 10% minimum remainder value rules) reduced the potential for abuse, the Service felt that there was still an abuse potential which needed to be dealt with. In a compromise, the final regulations provide that payments from charitable remainder trusts other than income-only unitrusts may be made within a reasonable time after the close of the year for which the payments are due if the character of the amounts in the recipient's hands is income under the charitable remainder trust tier system or the trust distributes property owned as the close of the taxable year to pay the unitrust or annuity trust amount and the trustee elects on form 5227 to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due. In the case of trusts created before December 10, 1998 the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due without regard to the new rules if the percentage used to calculate the annuity or unitrust amount is 15% or less. The final regulations made some minor changes in the proposed regulations in response to comments received and in order to make it less likely that a non-abusive trust would violate the payment rule. Specifically, two exceptions were added to §§1.664-2(a)(1)(a) and 1.664-3(a)(1)(g). These exceptions provide that a distribution of cash made within a reasonable period of time after the close of the year may be characterized as corpus under section 664(b)(4) to the extent it was attributable to (i) a contribution of cash to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, or (ii) a return of basis in any asset contributed to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, and sold by the trust during the year for which the annuity or unitrust amount was due.

These requirements provision can still create considerable administrative difficulties in some very non-abusive situations. Take for example the simple case of a trust funded on December 28 with marketable securities. Either distribution of a small pro rated payment must be made by the end of the year, which will often be impractical or the trustee must make a complex election which is deemed to generate gain. One way to deal with the practical problem is to draft these as flip unitrusts. A donor may deliver a signed trust with a check (or stock and a stock power) to the charity on the last day of the year. The check will likely not even be deposited until January 2, at the earliest. What is the consequence of failure to make the pro rated payment by the end of the year? This problem needs to be dealt with.

6. **Appraisal of Unmarketable Assets.** The proposed regulations provided that if a charitable remainder trust held unmarketable assets and the only trustee was (a) the grantor, (b) a non-charitable beneficiary or (c) a related or subordinate party to the grantor or the non-charitable beneficiary within the meaning of Section 672(c), the trustee must value those assets using a current qualified appraisal from a qualified appraiser. The final regulations make it clear that the grantor's spouse is also a person to whom an independent trustee cannot be related or subordinate. The final regulations also provide that no qualified appraisal is required for this purpose if an independent trustee--a special trustee for valuation purposes--values the unmarketable assets. (A qualified appraisal is still necessary of course for charitable deduction substantiation purposes.) A preexisting trust requiring an independent trustee can be amended or reformed to permit a qualified appraisal instead.
7. **Application of Section 2702 to Charitable Remainder Unitrusts.** The proposed regulations dealt with a perceived abuse involving an end run around section 2702. A donor-transferor could create a term of years income-only unitrust for himself, followed by a secondary lifetime interest for a family member. Because the trust could be invested to produce no income, the retained interest was undervalued for transfer tax purposes. It operated like an old-style GRIT. To deal with this abuse, the proposed regulations extended Section 2702 to cover this case. (Section 2702 does not apply to charitable remainder trusts except to the extent that regulations provide otherwise.) In the final regulations, the Service declined to apply the new rule only to income-only trusts which did not include a makeup provision. But in response to comments by the Tax Section and others, the final regulations exempt a transfer where the retained interest of the transferor is a secondary life estate. In this case the abuse is not possible and the final regulations therefore provide that Section 2702 will not apply when there are only two consecutive non-charitable beneficial interests and the transferor holds the second of these interests. In any event, rule would not have

affected very many non-abusive situations, because 2702 does not apply in any case where there is not a taxable gift and in most two-life situations where the transferor is the first beneficiary, the transferor will have retained a testamentary power to revoke the secondary interest so as to prevent a present gift for gift tax purposes. It is therefore still possible to create an income-only term of years unitrust for transferor followed by a life estate for a secondary beneficiary and avoid the application of Section 2702, so long as the donor retains the testamentary right to revoke the secondary interest, because Section 2702 does not apply to any transfer which is not a completed gift for gift tax purposes.

8. The regulations provide that capital gains can be allocated to income in an income-only unitrust only to the extent that they arise from post-gift appreciation. (We continue to believe the Service is wrong. The definition of income should be resolved by reference to Section 643(b) and state law.) In addition, the make-up amounts are not required to be treated as a liability when valuing the assets of a NIMCRUT. This makes good practical sense, since the fair market value of the make-up obligation would have to be determined by taking into account such things as the likelihood of its payment, the age of the beneficiary and so forth, all of which are almost impossible to quantify. Flip unitrusts are an obvious case for allocating capital gains to income, since after the flip becomes effective, all makeup amounts are sacrificed. But the flip will occur only the year after the triggering event so allocating capital gains to income will produce additional income for the beneficiary if post-gift appreciation can be demonstrated.
9. Apparently, even these steps were not enough to prevent abuses by clever practitioners. So on October 21, 1999, the Internal Revenue Service published further proposed regulations dealing with abuses which were still possible after the enactment of the legislative changes. Final regulations were issued January 4, 2001 in Treasury Decision 8926. The Service acted under authority of Code section 643(a)(7) which was added to the Code in 1996 and authorizes the Secretary to issue regulations as necessary or appropriate to carry out the purposes of the rules applicable to estates, trusts and beneficiaries, including regulations to prevent the avoidance of those purposes.

In the notice of proposed Rulemaking, the Service noted that the IRS and Treasury were aware of certain abusive transactions that attempt to use a charitable remainder trust to convert appreciated assets into cash while avoiding tax on the gain from the disposition of the assets. In a typical transaction, a taxpayer would contribute highly appreciated assets to a charitable remainder trust having a relatively short term and relatively high payout rate. But rather than sell the assets to obtain cash to pay the unitrust or annuity trust payment, the trustee would borrow money, enter into a forward

sale of the assets or engage in some similar transaction. The trust would of course be structured so as to meet the 10% remainder requirements of section 664(d)(1)(D) or 664(d)(2)(D).

The regulations provide that to the extent a distribution of the annuity or unitrust amount from a charitable remainder trust is not characterized in the hands of the recipient as income from one of the categories described in Section 664(b)(1), (2) or (3) and is made from an amount received by the trust that was neither a return of basis in an asset sold by the trust nor attributable to a contribution of cash to the trust with respect to which a deduction was allowable for income, estate or gift tax charitable purposes, the trust is treated as having sold, in the year for which the distribution is due, a pro rata portion of the trust assets. The regulation applies to distributions made by charitable remainder trusts after October 18, 1999. The Service also announced that it may, in appropriate circumstances, impose the tax on self-dealing transactions under Code section 4941, may treat the trust as having unrelated business taxable income under section 512 from the transaction, and may apply applicable penalties to the participants in the transaction. The Service also held open the possibility that it may challenge the qualification of the trust under Section 664.

G. Calendar year requirement.

1. Code section 644 (former section 645) requires all trusts except wholly-charitable trusts to use a calendar year for tax reporting purposes.
2. Split-interest trusts are not wholly charitable and are therefore required to be on a calendar year.

H. Governing Instrument Requirements.

1. The Service in many rulings has issued governing instrument requirements for charitable remainder trusts. Without going into details of drafting, suffice it to say that the requirements are technical and often nit-picking. In Rev. Procs. 89-20, 89-21, 90-30, 90-31, 90-32 and 90-33 the Service issued sample charitable remainder unitrusts and annuity trusts which include much simpler language than some of the earlier Internal Revenue Service announcements. In 2003, the Service published new charitable remainder annuity trust sample forms in Rev. Procs. 2003-54 through 2003-60. These sample forms were a substantial improvement over the 1989 annuity trust forms, with good annotations and alternatives. Finally, in 2005 the Service also issued the promised—and more complex—charitable remainder unitrust forms. See Appendix C for details.

2. The earlier forms were deficient with regard to proration of partial year payments and similar technical provisions.
3. If the language of the Rev. Procs. is used and if the Rev. Proc. is referred to in the trust instrument, the Service will recognize the trust as satisfying all the requirements and will no longer normally issue rulings as to qualification.
4. The Rev. Procs. are only a starting place and need tinkering in many cases, although the 2003 and 2005 forms are a big improvement. For example, the 1989 and 1990 Rev. Procs. provided that distributions may be made only to organizations described in section 170(c). Section 170(c) organizations include private foundations. To avoid possible application of the percentage limitation cut-down rules or the 170(e) rules limiting contribution to basis, the reference should be changed to section 170(b)(1)(a), which includes only public charities, unless it is intended that the trust terminate in favor of a private foundation. In addition, the two life trust pro formas do not include a power in the donor to revoke the interest of the successor beneficiary. This is not necessary (at least for tax purposes) where the beneficiaries are spouses, but it is important to include such a provision in a two life trust where the second beneficiary is not a spouse in order to prevent a present gift for gift tax purposes. Other provisions may be desirable under state law, such as spendthrift provisions or trust powers in states which do not have statutory trust powers. Other changes will be appropriate in specific cases. The point is that the Rev. Proc. pro formas are a starting place only.
5. Rev. Proc. 2005-24, issued March 30, 2005, imposed additional spousal waiver requirements which have now been withdrawn. Some states give a surviving spouse the right to elect against an augmented estate which can include a previously funded charitable remainder trust. Because of its concern that charitable income tax deductions may have been taken for assets transferred to the trust which will not ultimately pass to charity, and because the trust will have been exempt from income taxes for many years for the same reason, the Service imposed new rules requiring spousal waivers in many cases. These burdensome and poorly thought out requirements have now been eliminated.

#### IV. Why Use Charitable Remainder Trusts?

- A. As noted above, the contribution to the trust generates an immediate income tax deduction even though the donor is able to keep a life income interest.
- B.
  1. The charitable remainder trust can often enable a donor to diversify his or her assets, increasing the donor's income without incurring capital gains cost.



2. For example, a donor may have highly appreciated securities paying a 4% dividend. In order to diversify or increase his income, the donor could sell the securities and reinvest the proceeds in higher yielding assets, but the amount reinvested would be reduced by capital gains taxes incurred.
- C. The charitable remainder trust makes it possible to achieve diversification without capital gains cost. Stock can be contributed to a charitable remainder trust, sold without capital gains cost and the proceeds reinvested in higher yielding assets. This can be a useful way to sell a closely-held business. If the trust sells a closely-held business, be aware of the Jorgl case, T.C. Memo 2000-10, in which the Tax Court held that where the donor gives a non-compete covenant as part of the transaction, even if not compensated, part of the sale price must be allocated to the non-compete and taxed to the donor as an assignment of income. This seems an unnecessarily harsh result.
- D. The effect of all of this is to greatly reduce the cost of charitable giving for charitably-inclined donors.
- E. If cash is contributed, the cash can be invested in tax-exempt securities, yielding tax-exempt income to the donor, provided that there is no express or implied understanding that the trustee will so invest and so long as the agreement does not prohibit the trustee from investing so as to achieve a reasonable return. (And if there is no non-exempt accumulated income from prior years.) See Rev. Rul. 60-370, 1960-2 C.B. 203, in which the Service ruled that where the trustee is under an expressed or implied obligation to sell or exchange the property contributed for tax exempt securities, the donor will be deemed to have sold the property and to have realized the gain himself.
- F. Unlike a pooled income fund, the CRAT or CRUT investments can be separately managed and tailored to a particular donor's needs, or can be invested with endowment funds.

V. Differences between Annuity Trusts and Unitrusts.

A. Unitrusts

1. As noted above, the charitable remainder unitrust must provide for payment of a fixed percentage (at least 5%) of the trust revalued annually.
2. The unitrust must explicitly either permit future contributions or must prohibit them.
3. If future contributions are permitted by testamentary addition, the instrument should contain language providing for interest on delayed distributions from the estate at 10% interest or at such other interest rate as may then be required

by federal regulation. See Regulation Section 1.664-1(a)(5), T.D. 7955. Generic language incorporating whatever federal rate is then in effect should be included.

B. Annuity trusts must prohibit future contributions.

C. Variations on the unitrust theme.

1. The charitable remainder unitrust, which calls for payment of a percentage of the trust revalued annually, may also provide that if the income of the trust is less than the unitrust amount, only the income need be paid. The valuation of the charitable remainder is not affected.
2. The trust may, but is not required to, provide that if income is less than the unitrust amount in any year, deficiencies can be made up in future years in which income exceeds the unitrust amount. The calculation of the remainder (and therefore the charitable deduction) is made without taking into account the income-only feature.
3. Why use an income-only unitrust?
  - a. Income-only unitrusts are appropriate where a donor contributes appreciated property paying less than the unitrust amount, with the expectation that the property will be sold and reinvested in higher yielding assets, but it may take some time to make the sale.
  - b. For example, a donor may contribute unproductive real estate which will be sold by the trust. Until the property is sold, the trust may have little or no income, making it impossible to pay the unitrust amount and at least theoretically requiring a distribution of a portion of the asset in order to make each unitrust payment.
  - c. The annuity trust may not have an income-only exception. The annuity amount must be paid whether or not the asset produces income. For this reason, annuity trusts are not appropriate where unproductive property may be held by the trust before sale.
  - d. The flip unitrust discussed above is an income-only unitrust which become a regular unitrust beginning with January 1 of the year after a triggering event occurs.

D. Annuity trust versus unitrust.

1. Which one should the donor use? Where productive property will be contributed, the choice between the annuity trust and the unitrust depends on several factors.
2. Some donors like the idea of a fixed income amount which will never vary, regardless of investment performance. For these donors, the annuity trust may be attractive. Such donors should also consider charitable gift annuities if the charitable institution is an appropriate issuer. The fixed amount may be unattractive to younger donors because of inflation over many years.
3. The unitrust, on the other hand, provides a hedge against inflation. As the assets increase in value, the unitrust amount will increase. It can also, however, work the other way if the assets decrease in value.
4. Generally, the annuity trust will produce a higher charitable deduction. (See discussion below on computation on deduction.)

E. Annuity trust five percent probability test.

Amazingly enough, even though you can compute a charitable factor for the charitable remainder annuity trust, it may still fail to qualify if there is a more than a 5% probability, actuarially determined, that the trust assets will be exhausted before the remainder vests. See Revenue Ruling 77-374, 1977-2 C.B. 329. 10% interest assumptions made it much less likely than the old 6% assumptions that the test would not be met. With the floating interest rates of section 7520, the probability of exhaustion test must be considered more carefully. When interest rates are low, it is much easier to flunk the test. For example, with a section 7520 rate of 6.0% (and the section 7520 rate has been as low as 2% in February, 2009) the youngest permitted age for an 7% quarterly annuity is 65. Many practitioners were shocked to learn that an 7% annuity payable quarterly to a 64 year old donor flunked the test. You need to worry about the probability of exhaustion test even if the payout rate of the annuity does not exceed the AFR if the payments are made other than annually. For example, an 8% annuity payable quarterly to a donor age 50 flunks the test even in a month when the AFR is also 8%. The reason is the effective payout is actually more than 8% because the payments are made more frequently than annually. Is the ruling correct? It has not yet been litigated. Possible solution: consider using a charitable gift annuity if the recommended annuity rate is acceptable. See attached memo sent to charitable clients in February, 2009 regarding the 2.0% 7520 rate for that month.

An unanswered question is whether the trust itself is qualified if no charitable deduction is allowed. Will capital gains realized by the trust be sheltered or not? PLR 9532006 says the that to be a qualified CRAT, a deduction must be allowable.

That ruling was a reversal of the Service's original view of the question in PLR 9440010.

F. Why use a charitable annuity trust at all? The deduction for a charitable gift annuity is identical to the deduction for a gift to a charitable remainder annuity trust, and avoids many of the problems of the annuity trust. Whenever a charitable remainder annuity trust is being contemplated, a gift annuity should be considered as well. Not only does the 5% probability of exhaustion test not apply, but both the governing instrument requirements and administration are markedly simpler with the gift annuity. A charitable remainder annuity trust may be preferable if there are concerns about the charities ability to make the annuity payments. A gift annuity must be for one or two lives--term of years gift annuities and gift annuities for more than two lives are not permitted, and in these cases, too, an annuity trust must be used.

G. Computing the charitable deduction.

1. Charitable remainder annuity trusts.

Remainder factors for charitable remainder annuity trusts are computed on an actuarial basis. The average practitioner never needs to know the actuarial formulas, as the Service publishes tables to compute many of the factors, both term of years factors and factors dependent upon a life estate. Computer programs (including the author's) are available to calculate the factors.

2. The actuarial computation of the remainder factor of an annuity trust depends on two components, an interest assumption and mortality table assumptions.

3. Interest Assumptions. The regulations under Section 664 have required the use of varying rates of interest, steadily rising since the 1970's.

a. In the early 1970's the tables were revised to assume a return of 6% and in 1983 the tables were further revised to assume an interest rate of 10%. Section 7520, passed as part of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) requires use of interest assumptions of 120% (adjusted to the nearest two-tenths of 1%) of federal midterm rates, assuming annual compounding. This interest rate is published on the IRS web site and other web sites. The link to the IRS site is:

<http://www.irs.gov/app/picklist/list/federalRates.html>

b. In the case of charitable gifts, such as computations for a charitable remainder trust, donors may use either the federal interest rate for the month of the gift or may elect the federal interest rate for either of the two months prior to the month of the gifts.

- c. Effect on Charitable Deduction. Because the annuity is a fixed amount, a higher interest assumption means that the amount going to charity will presumably be greater. Therefore, a higher interest rate produces a larger deduction. Because the interest rate for the following month is announced on approximately the 20th of each month, donors really have a four month period to choose from: the month of the gift, either of the two months preceding the gift, or the following month if donor can wait until the following month to make the gift.
- 4. Mortality Assumptions. TAMRA also required the use of updated mortality assumptions for gifts made after April 30, 1989, based on the 1980 census. New tables were issued effective May 1, 2009 using data from the 2000 census.
- 5. How to compute the charitable remainder in a charitable remainder annuity trust. The IRS publishes factors for a remainder interest after one or two lives. (IRS publication 1457) To determine the charitable deduction, subtract the published remainder factor from one to determine the income factor. The income factor divided by the interest rate gives an annuity factor. Multiply the annuity factor times the amount of the annual annuity to determine the amount of the annuity and subtract that from the amount transferred to determine the amount of the charitable contribution.

Example: Donor age 75 creates a charitable remainder annuity trust paying an annual annuity of \$7000 to himself for life and then to his wife, age 70, for her life. The Federal interest rate for the month of the gift is 6.0%. The published remainder factor for these ages at 6.0% is .39854. That factor subtracted from one equals .60146. That factor divided by 6.0% gives an annuity factor of 10.0243. The annuity factor of 10.0243 when multiplied times the \$7000 annual annuity produces a value for annuity of \$70,170. That figure subtracted from the \$100,000 gift produces a value for the charitable remainder of \$29,830.

Note: If the payment is due more frequently than annually, the annuity factor must be multiplied by a frequency of payment adjustment which is itself interest-sensitive.

- 6. How to compute the remainder in a charitable remainder unitrust.
  - a. Because the unitrust payment is a percentage of the entire trust revalued annually, the relative size of the remainder and life estate "pots" stays the same and, therefore, the interest assumption is essentially irrelevant in determining the deduction. In fact if the

payments are made annually with no gap between valuation date and payment date, the interest rate will play no part in determining the factor. The formula for the remainder in a term of years unitrust is:  $(1-p)^n$  where  $p$  = the payout rate and  $n$  = the number of years of the term. For example, the remainder in an 8% payout ten year term unitrust is  $(1-.08)^{10}$  or .92<sup>10</sup> or .434388.

- b. Again, published tables show the remainder factors in a charitable remainder unitrust. (IRS publication 1458).
- c. If the payment is for any payout frequency other than annually with the first payment due at the time of the gift, the annual payout must be multiplied by an adjustment factor to determine an adjusted payout rate and from that rate, the actual charitable factor is determined. This adjustment factor is interest-dependent, but interest rates will make relatively little difference in the deduction because only the adjustment factor is interest-sensitive. A higher interest rate will produce a lower adjusted payout rate and, therefore, a slightly higher charitable deduction.

## IX. Gift and Estate Tax Rules.

### A. One life intervivos charitable remainder trusts.

1. Gift Tax. The donor is making an immediate gift of a future interest to charity, which qualifies for the federal gift tax charitable deduction.
2. Estate Tax Inclusion Where Donor is Beneficiary. On the donor's death, because the donor retained an interest in the trust which did not in fact end before his death, a portion of the trust is includable in his estate under Section 2036, but the estate receives a full dollar for dollar offsetting charitable estate tax deduction under Section 2055, resulting in no tax effect from the inclusion. The portion includible in the case of an annuity trust is the amount of the trust necessary to support the annuity. Rev. Rul 76-273, 1976-2 C.B. 268 and Rev. Rul 82-105, 1982-1 C.B. 133. In a one life trust the amount includible will rarely be of any consequence.
3. Estate Tax Inclusion Where Donor is Not a Beneficiary. If the donor is not a beneficiary, the trust will not be included in the donor's estate unless the donor has retained other powers to cause inclusion. For example, see PLR 200932020, where grantor and grantor's spouse created a charitable remainder trust for the son of the grantors. Each grantor retained the right to change the charitable remainder beneficiary. The Service ruled that the right to change the charitable remainder beneficiary would cause inclusion under section 2036 of the husband's portion of the remainder interest. The interest

will qualify, fortunately, for an estate tax charitable deduction under Code section 2055.

- B. Testamentary charitable remainder trust. The estate of the donor receives an immediate federal estate tax charitable deduction for the value of the charitable remainder based on the beneficiary's age at the death of the testator.
- C.
  - 1. Two life intervivos charitable remainder trust for donor for life and a successor life beneficiary. Donor is making a charitable gift of a remainder interest after two lives. The donor is also making a present gift to the successor life beneficiary which as a future interest doesn't qualify for the \$10,000 gift tax annual exclusion.
  - 2. A present gift can be avoided, however, if the donor is the first beneficiary, by providing that the donor retains the testamentary power to revoke the successor beneficiary's interest.
  - 3. The mere presence of the power prevents the establishment of the trust from constituting a present gift. On the death of the donor, the trust will be included in the donor's estate. If the successor beneficiary survives, the estate has a charitable estate tax deduction for the remainder based on the then-age of the successor beneficiary. The life interest of the successor beneficiary may generate estate tax. If the successor beneficiary predeceased the donor, the remainder is fully deductible for estate tax purposes.
  - 4. Note, however, that if the successor beneficiary is the donor's spouse, the donor's spouse's interest qualifies for the marital deduction despite the fact that it would generally be a terminable interest. Section 2056(b)(8) provides a special marital deduction for the surviving spouse of the decedent where the surviving spouse is the only non-charitable beneficiary of a qualified charitable remainder trust. A similar provision in Section 2523(g) provides a marital deduction for gift tax purposes. This special marital deduction provision does not, at least literally, apply if there is another non-charitable beneficiary after the spouse's interest, as the spouse is not then the only non-charitable beneficiary. There is no policy reason for this restriction. In such cases, a QTIP followed by a charitable remainder trust on the surviving spouse's death should be considered.
  - 5. Should the power to revoke the successor beneficiary's interest be included where the successor beneficiary is the donor's spouse? Although no longer necessary to prevent a gift for gift tax purposes (because of the special marital deduction provision noted above) the power may be useful in the event of divorce and it adds additional flexibility.

6. Special caution on tax allocation. Because the Service was concerned that two-life charitable remainder trusts for persons other than the donor's spouse could generate an estate tax payable from the charitable remainder trust, therefore reducing the amount ultimately passing to charity, the Service ruled in Revenue Ruling 82-128, 1982-2 C.B. 71 that two-life remainder trusts must include language providing that no federal estate or other death taxes can be payable from the unitrust or annuity trust and that if any taxes become so payable the successor beneficiary must provide for payment of the taxes from another source or the beneficiary's interest will not commence. The pro forma trusts issued by the Service include appropriate language.

D. Testamentary charitable remainder trust for testator's spouse.

1. A testator can create a charitable remainder trust for the benefit of his or her spouse, as noted above. The surviving spouse's interest will qualify under the marital deduction provisions and the remainder will qualify for the estate tax charitable deduction, thus resulting in no tax at all on the donor's death.
2. Donor could, alternatively, use a qualified terminable interest property trust (QTIP) for the surviving spouse. The entire trust would be deductible as a marital deduction, would be includable in the surviving spouse's estate and would qualify in her estate for complete charitable deduction, resulting, again, in no tax.
3. Which is preferable, a testamentary charitable remainder trust or a qualified terminable interest property trust with remainder to charity?
  - a. The QTIP has the advantage of flexibility. The testator can permit invasion of principal and give the spouse special powers of appointment to take care of unanticipated changes of circumstance.
  - b. The big advantage of the charitable remainder trust is that income in excess of the unitrust or annuity payment amount is not subject to tax, and capital gains incurred in the trust will not be subject to tax. In rare cases the inclusion of the property in the surviving spouse's estate may affect the size of her estate for tax purposes and, therefore, for 6166 or 2032A purposes.
4. A charitable remainder trust can terminate on remarriage, as noted above. A QTIP must last for the spouse's lifetime.
5. Why not use both: a QTIP which can be invaded for the spouse's support with the excess over what could possibly be needed for the spouse in a charitable remainder trust.



X. Charitable Remainderman.

- A. The charitable remainderman must be an exempt organization. If the charity named is a public charity, the gift will be deductible with a 50% percentage limitation rather than subject to the private foundation cut down rules.
- B. The donor or the beneficiaries can retain the testamentary power to substitute one charity for another charity or to add charities so long as all are qualified charities. This provision should be limited to public charities, unless the donor specifically wants the right to name private foundations. The effect of being able to name private foundations will be to reduce the percentage limitation for long term capital gain property to 20% of adjusted gross income or 30% for cash gifts.
- C. The provision for changing charitable remaindermen is very useful in adding flexibility to the charitable remainder trust and has no adverse tax consequences for the donor, since the trust will be in the donor's estate anyway (and qualify for a complete charitable estate tax deduction if he is the only beneficiary).

XI. Miscellaneous Items.

- A. Section 170(a)(3) had often been interpreted as providing that no future interest in tangible personal property qualifies for a charitable deduction and, therefore, tangible personal property may not be contributed to a charitable remainder trust. Actually, however, Section 170(a)(3) provides that a contribution of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or there standing in a relationship to the taxpayer described in Section 267(b) or 707(b). That Section should therefore may mean that no deduction is permitted the donor until the trust sells the property. Finally, the Internal Revenue Service has acknowledged that this interpretation of this statute is correct. In PLR 9452026, the taxpayer proposed funding a charitable remainder unitrust with tangible personal property--in this case a musical instrument. The Service ruled that the deduction would be allowable at the time the property is sold and that the trust qualifies as a charitable remainder trust. What is not clear is whether the donor's deduction will be limited to basis because of the related use requirements of section 170(e)(1)(b)(i). Can a technical argument be made that since the deduction is not deemed to have occurred until the property is no longer owned by the trust, and since at that point the trust holds cash, that the gift is considered one of cash rather than tangible personal property and therefore the cut down to basis is not required? The service did not answer that question in PLR 9452026 because the contribution was limited to basis there in any event since the remainder beneficiary could have been a private foundation. It is interesting to note that the Service ruled favorably despite the fact that no deduction was permitted at the time the trust was funded. This seems to fly in the face of PLR 9501004. In this ruling, the Service held that a contribution of a deep-in-the-money option to a unitrust disqualified the

charitable remainder unitrust because no income or gift tax deduction was allowable at the time the property was contributed to the trust. (Use of an option would be handy in order to keep the trust out of the line of ownership of possibly tainted real estate, or to enable donors to contribute S corporation stock.)

- B. If residential property is contributed to a unitrust, the donor should not reside in the property after the date of gift because he will be deemed to have retained an interest other than a unitrust interest. Have the donor move out before the gift.

## XII. Qualified Reformations.

- A. Because the Service interpreted all of the rules in such a nit-picking way, disqualifying many trusts, Congress in 1984 provided generous relief by means of special fix up provisions. If the trust attempted to comply with the 1969 rules, the statute provides an essentially unlimited opportunity to reform the trust. If the trust does not specify payments to noncharitable beneficiaries in terms of either dollar amounts or fixed percentages, the reformation must be commenced within ninety (90) days after filing the estate tax return or, in the case of a trust for which no estate tax return will be filed, within ninety (90) days after the due date for the first trust income tax return. Many trusts include language permitting the trustee to amend the trust to comply with Section 664. In cases where language is not included and there is no state law power to amend, the reformation proceeding can be commenced in the state courts.
- B. The actuarial value of the reformed interest cannot differ more than 5% from the actuarial value of the unreformed interest.
- C. The fix-up statute even permits reformation of some trusts which did not attempt to meet the 1969 requirements.

## XIII. Severance of charitable remainder trusts.

- A. What if the charity and the income beneficiary want to terminate the trust early and simply split up the trust in accordance with their present actuarial interests? The Service in a number of prior private letter rulings – PLR 200314021 and PLR 200127023, for example – has approved just that. (The Service has consistently applied a different rule to charitable lead trusts, which must prohibit commutation whether they are lead unitrusts or lead annuity trusts. See Revenue Ruling 88-27, 1988-1 C.B. 331 and PLR 9734057.)
- B. In the earlier private letter rulings, the Service permitted commutation and division of charitable remainder unitrusts holding, in addition, that the income beneficiary would be treated as having sold his or her remaining life interest to the charity in exchange for the commuted value of the income interest, and that section 1001(e) of the Code would deny any basis to the income interest.

- C. In private letter ruling 200525014, the Internal Revenue Service found no self dealing or other problems with the early termination of a charitable remainder unitrust and division of trust assets between the charity and the income beneficiary on an actuarial basis. In PLR 200614032 the Service revoked that earlier ruling. The latest PLR provided that the letter did not constitute an adverse letter ruling with respect to these issues, but the revocation certainly indicates the Service's second thoughts and it is interesting to speculate on what might be behind the revocation. So why in the latest private letter ruling has the Service had second thoughts? One's first speculation might be that what bothered the Service was the fact that although the trust provided for the payment of lesser of income or a 15 percent unitrust amount, division on an actuarial basis would result in putting far more back in the grantor's hands than the grantor would have received from just the income payments, because section 664 provides that for actuarial calculation purposes the income-only feature in a NIM-CRUT is ignored.
- D. But word from lawyers who have been involved with similar ruling requests report what's really going on here. In the middle of 2004 the IRS Exempt Organizations group put a hold on all early CRT early termination rulings so that the issue could be examined more fully. What apparently prompted the review was a flood of CRT termination ruling requests which apparently caused the Service to wonder if something was up.
- E. The legal issue which caused the revocation of PLR 200525014 arose only because the charitable remainder beneficiary was a private foundation. But I now know the legal issue which caused revocation of the 2005 private letter ruling. As noted above, the Service takes the view that the early termination of a CRT is in effect a sale by the income beneficiary of his interest in the trust to the charitable remainder beneficiary. If this recharacterization of the transaction as a "sale" is correct, the sale to a private foundation would be a prohibited self-dealing transaction—this is what caused the Service to revoke the private letter ruling. That this is really what was going on became clear with the release of PLR 200616035, superseding PLR 200614032. and all becomes clear. In the latest PLR, the Service issued a favorable ruling because, pursuant to powers in the instrument, the grantor substituted public charities for private foundations as charitable remainder beneficiaries.
- F. Two comments:
1. This problem only arises because of the Service's odd view that what is involved is a sale, rather than merely a division between the parties of their respective interests, with each simply taking what is already his. It is only this legal fiction of a sale that creates the problem in the first place.
  2. Although the 2005 private letter ruling involved a private foundation, the Service had put a hold on all early termination rulings, including those

involving public charities. I am told by one of the attorneys involved in a similar ruling request that the Service will apparently start ruling favorably again on terminations where the remainder beneficiary is a public charity, but will not rule favorably where the remainder beneficiary is a private foundation.

G. Termination of income-only unitrusts.

If an income-only unitrust is terminated by division of the trust between the income and remainder beneficiary, is the amount to which the income beneficiary is entitled based on net income or on the unitrust amount? Those of us who work in this field – at least most of us – would have thought that since Code section 664 requires in computing the charitable deduction that the income-only feature be disregarded, the same would apply in the case of division. In fact, in numerous private letter rulings (see, for example, PLR 200127023 and PLR 200408031) held that on division of a NIMCRUT the actuarial value of the income interest would be calculated using the discount rate in effect under section 7520 and the methodology under Regulation section 1.664-4. That methodology assumes taking into account only the unitrust percent rather than an assumed income rate. But in PLRs 200725044 and 200733014, the Service seems to have changed course and ruled that on division of a NIMCRUT, a reasonable method of calculating the actuarial value of the income interest would be to use as the percentage payout the lower of the stated percentage distribution rate or the section 7520 rate in effect for the month of the termination. This seems wrong to me, and we await further developments.

XIV. Pooled Income Funds.

- A. A pooled income fund is a pool of donated funds, somewhat like a mutual fund. Each donor receives the income from his or her share of the fund and at the death of the beneficiary or beneficiaries, that portion of the fund is severed and distributed to the charity. The donor receives an immediate income tax deduction at the time property is contributed to the fund.
- B. Unlike a charitable remainder trust beneficiary, the pooled income fund beneficiary actually retains the income from his or her share of the fund rather than a unitrust or annuity trust interest.
  - 1. Because the charity must control the pooled fund directly or indirectly, Congress was not concerned that the funds would be invested without regard to the interest of the remainderman.
  - 2. The charity must maintain control of the fund, but this does not mean that the charity must be the trustee. As long as the charity has the right to remove the trustee and name a new trustee, it will be deemed to have complied with the pooled income fund rules.

C. The trust is not an exempt trust as such. All of the income is deductible under the regular distribution deduction rules, and long term (as defined) capital gains are deductible as charitable set asides under Section 642 (c)(3). Gains from the sale of assets held one year or less are subject to tax.

D. Specific Requirements.

1. Obviously, in order to constitute a pool, there must be more than one donor to the fund.
2. The trust must prohibit the donor or any beneficiary from serving as a trustee of the pooled income fund.
3. The trust must prohibit investment in tax exempt securities.
4. There are a number of other more technical drafting requirements.
5. In Rev. Proc. 88-53, 1982 C.B. 712 the Service issued a sample declaration of trust and announced that it will no longer be necessary for a taxpayer to request a ruling as to qualification of a substantially similar trust and the Service normally will not issue such a ruling.

E. Taxation of Beneficiaries.

Each beneficiary is taxed on his or her pro rata share of the income. There must be at least four valuation dates per year, and the value on the valuation dates determines the value of the fund for allocation of contributed interests. Where contributions are

made between valuation dates, many drafters provide for averaging the values on the dates before and after each valuation. This avoids having to revalue the fund each time there is a contribution. It may also be unfair, however, where there has been great appreciation or depreciation in the fund. An alternative would be to prorate any changes between valuation dates on a daily basis.

F. Charitable Contribution.

1. The donor receives a charitable contribution based on the value of the remainder interest. As with charitable remainder gifts, the older donor receives a greater deduction.
2. Instead of an interest assumption, the fund's highest return in the three previous years is substituted. For funds in existence less than three years, the Service has announced that average interest rates for the three years preceding establishment of the fund, less 1%, should be used.

G. Transfer Tax Rules.

1. The transfer tax rules parallel those for charitable remainder trusts discussed above. However, where a donor creates an interest for donor and then donor's spouse, there is no comparable provision to 2056(b)(8) which automatically qualifies the spouse's interest for the estate tax marital deduction. The interest in a pooled fund does, however, almost by accident qualify as qualified terminable interest property. Therefore, in the typical case where a donor contributes property to a pooled fund for the donor's life and then for the donor's spouse for life, the donor should retain a power to revoke the successor interest to prevent a present gift at the time the pooled fund gift is made. Upon the death of the donor, the donor's executor (if the donor's spouse survives) should make a QTIP election for the spouse's interest in the pooled income fund. This was acknowledged in the final marital deduction regulations.
2. Why use a pooled income fund rather than a charitable remainder trust? A main reason, from the charity's standpoint, is simplicity of administration. No separate trust vehicle is required and much smaller contributions can be economically accepted. The pooled fund offers the same advantage of being able to accept appreciated property and sell it without incurring capital gains tax. The pooled fund is also a very handy vehicle for the planned giving officer who, on the afternoon of December 31st, finds a donor who wishes to make a last minute gift. But current low interest rates and the availability at many charities of charitable gift annuities make pooled income funds, for now, pretty much of a dead letter.

## **APPENDIX A**

To: Our Charitable Clients

From: Lawrence P. Katzenstein

Date: October 1, 2011

Re: October 7520 rate

As you may be aware, the section 7520 rate for October has dropped to an unprecedented low of 1.4%. The previous low was last December's 1.8%. As recently as May, the 7520 rate was 3.0%. (The historic high was the May, 1989 11.6% rate.) The 0.6% drop in the September section 7520 rate—down all the way from 2.0% to October's 1.4%—creates special opportunities for individuals with philanthropic interests. Charitable lead annuity trusts and charitable gifts of a remainder in a personal residence are particularly attractive now because of the low interest rate. However the low interest rate also makes some charitable vehicles less attractive or, in some cases, not available at all. Note that for all of the charitable planning vehicles, the 1.4% October rate can be used for gifts made in October, November or December.

### **Charitable Lead Annuity Trusts**

A charitable lead annuity trust is in many ways the opposite of a charitable remainder annuity trust: the trust provides for payment of an annuity interest to charity, typically for a term of years, with the remainder payable to other family members. It is both an estate planning device and a charitable giving vehicle. If a charitable lead annuity trust is established during life, the donor is making a taxable gift of the remainder. The lower the interest rate, the less the gift for gift tax purposes. If over the term of the trust the investment performance exceeds the section 7520 rate in effect when the trust is created, the value of the gift for gift tax purposes will be less than the value of the assets actually passing to family members, and the excess will be a free transfer to family members for transfer tax purposes. At the October 7520 rate, the investment performance must exceed only a 1.4% rate of return to result in a gift and estate tax free transfer to family members. That is why this low interest rate makes charitable lead annuity trusts so attractive now. You might want to make selected wealthy donors aware of the current attractiveness of charitable lead annuity trusts.

As charitable lead trusts are typically structured, the donor does not receive an income tax deduction for creating a charitable lead trust. But since the donor is not taxed on the trust income, the economic result is the same as if the income were received by the donor and then fully deductible. (An income tax deduction is available for the actuarial value of the charitable gift only if the trust is structured so that the donor is taxed on the income of the trust during the trust term even though the donor will not receive the income. This can be useful as a way of accelerating a charitable deduction into a high income year, such as the year in which the donor sells a business or has unusually high income for some other reason.)

Charitable lead trusts are a very technical subject and I can provide you with a more detailed outline and technical discussion if you wish.

### **Gifts of a Remainder in a Personal Residence**

The other charitable strategy which is particularly attractive given current low interest rates is a gift of a remainder in a personal residence or farm with retained life estate. With this gift, the donor deeds his or her personal residence to charity, reserving the right to live in the house for the remainder of the donor's lifetime. An income tax deduction is available for the actuarial value of the remainder. The lower the section 7520 rate at the time of the gift, the greater the income tax deduction. To illustrate how dramatically interest rates affect this kind of gift, assume a donor age 70 who wishes to contribute the remainder interest in her residence to charity. Assume also that the residential property has a fair market value of \$1,000,000, of which \$800,000 represents the value of the house and \$200,000 the value of the land. If the 7520 rate were 6%, the deduction would have been \$386,194. Using the October, 2011 interest rate of 1.4%, the deduction rises to \$627,490—a dramatic increase. You may want to make certain donors are aware of this opportunity. This makes a great deal of sense for a client planning to leave his or her estate to charity at death in any event. A gift of the remainder interest now generates a large current income tax deduction as well as an eventual estate tax deduction. In the rather rare case where the charity wishes eventually to acquire residential property from a donor in need of current income, the actuarial value of the remainder interest can be considered the purchase price of a charitable gift annuity. This will only make sense in specialized situations because it will require using current revenues to acquire a future gift.

### **And Now for the Bad News**

The bad news about the unusually low section 7520 rate is that certain gifts will now be less desirable than they were before. The income tax deduction for charitable gift annuity donors as well as donors to charitable remainder annuity trusts will be dramatically reduced. (Charitable remainder unitrusts are essentially unaffected by interest rate swings.) In addition, the unusually low interest rate creates certain traps for both charitable gift annuities and charitable remainder annuity trusts.

### **Charitable Gift Annuities**

The tax law provides that in order for the charity's gain on the sale of a charitable gift annuity not to be taxed as unrelated business income, the value of the annuity must be less than 90% of the value of the property exchanged for the annuity. Some gift annuities for younger donors, even those issued at American Council on Gift Annuities recommended rates, may not pass this test. You need to run the calculation and if necessary reduce the gift annuity rate to whatever level is necessary to generate a charitable deduction of 10% or higher. Annuities issued at American Council on Gift Annuities recommended maximum annuity rates will normally pass the 10% test. But as interest rates fall, it is important to make certain that the 10% test is met. New CGA rates became effective on July 1 (see details at [www.acga-web.org](http://www.acga-web.org)). The new ACGA rate schedule notes that:

“While the Committee keeps a close eye on current economic activity, historically the Council has not made quick reactions to short-term economic fluctuations since



charitable gift annuities are intended to be long-term in nature. If economic events warrant a change in assumptions that would affect the rates schedules, the Council will issue relevant communications. Please note that when the Applicable Federal Rate (AFR) falls to low levels, charities may have to reduce the gift annuity rates they offer in order to comply with the IRS 10% rule. With the AFR dipping below 3.2%, the rate at which the current schedules of gift annuity rates will pass the 10% test, annuities for younger donors, and many deferred payment gift annuities will no longer pass this test using the current schedule of rates. Charities will need to lower their gift annuity rates in these circumstances in order to pass the 10% test.”

But the news for CGAs is not all bad. Although the income tax deduction on purchase of a charitable gift annuity is lower when interest rates are low, the amount of each payment *excluded* from income under section 72 will be *higher*. So a non-itemizer or other donor who cares more about how much income is taxable than about the charitable deduction will find the charitable gift annuity especially attractive now. Those donors should elect to use the lowest available 7520 rate.

### **Charitable Remainder Annuity Trusts**

In addition to dramatically reducing the deduction for gifts to charitable remainder trusts, the low interest rate creates two possible traps. The first trap is that under the tax law, a qualifying charitable remainder annuity trust or unitrust must have a charitable remainder with an actuarial value of at least 10% of the value of the property transferred to the trust. This test becomes much more difficult to pass when interest rates are low. In addition, charitable remainder annuity trusts also have to pass a separate test requiring that there be no more than a 5% probability that the trust will be exhausted before the charitable remainder vests. This test also becomes more difficult to pass when interest rates are low. For example, at the October 1.4% 7520 rate, a charitable remainder annuity trust paying a 6% annuity to two individuals age 81 (assuming quarterly payments) flunks the 5% exhaustion test. Another example: at the October 1.4% 7520 rate, a 6.0% charitable remainder annuity trust created for a 79-year old beneficiary flunks the exhaustion test. In fact, a 73 year old cannot create a charitable remainder annuity trust at all at a 1.4% section 7520 rate because even at a 5% annuity level—the minimum permitted payout—a trust paying quarterly payments flunks the exhaustion test! It is extremely important that any charitable remainder annuity trust created pass both of these actuarial tests. The 5% exhaustion test does not apply to charitable remainder unitrusts or charitable gift annuities.

### **Turning Lemons into Lemonade**

In one respect, however, the low interest rate creates an opportunity for beneficiaries of existing charitable remainder annuity trusts. The fact that the present value of the charitable remainder is now unusually low also means of course that the value of the annuity itself is quite high. There may be donors who would be willing to donate all or a portion of their remaining annuity interests to the charitable remainder beneficiary. They will be entitled in that event to a charitable deduction for the actuarial value of the annuity released, and that deduction is much enhanced because of the current low interest rate. For example, suppose a 70 year old beneficiary of a charitable remainder annuity trust paying \$6000 per year is willing to contribute her remaining life interest to the charitable

remainder beneficiary. If she had made the gift in a month when the section 7520 rate was 8% her deduction would have been \$46,757. If she were to release her interest in October when the 7520 rate is only 1.4%, her deduction increases from \$46,757 to \$75,506. Note that the same is not true of a gift of a charitable gift annuity interest. That interest, unlike the annuity interest in a CRAT, is an ordinary income asset and the deduction will be limited to unrecovered basis in the contract.

A NOTE ABOUT UNITRUSTS. We have not discussed unitrusts in this memorandum because interests in unitrusts are affected only slightly (and in some cases not at all) by interest rates.

## **Appendix B**

### **Internal Revenue Service Issues Sample Charitable Remainder Annuity Trusts**

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In Revenue Procedures 2003-53 through 2003-60, the Internal Revenue Service has issued sample charitable remainder annuity trusts replacing sample forms issued in 1989 and 1990. The new forms are a significant improvement over the prior forms, and the explanatory language provided by the Internal Revenue Service will provide useful guidance for practitioners. The Service has not yet issued its sample charitable remainder unitrust forms, which of course will have many more variations than the annuity trust forms, but the annuity trust forms are a good start.

The specific forms issued are as follows:

1. Inter vivos charitable remainder annuity trust (CRAT) for one measuring life – Rev. Proc. 2003-53.
2. Inter vivos CRAT for a term of years – Rev. Proc. 2003-54.
3. Inter vivos CRAT with consecutive interests for two measuring lives – Rev. Proc. 2003-55.
4. CRAT for concurrent and consecutive interests for two measuring lives – Rev. Proc. 2003-56.
5. Testamentary CRAT for one measuring life – Rev. Proc. 2003-57.
6. Testamentary CRAT for a term of years – Rev. proc. 2003-58.
7. Testamentary CRAT with consecutive interests for two measuring lives – Rev. Proc. 2003-59.
8. Testamentary CRAT with concurrent and consecutive interests for two measuring lives – Rev. Proc. 2003-60.

The trust language itself is straightforward and to the point, and each form includes alternate provisions. As with the prior forms, the new forms must be used with care, although the thorough annotations provided by the Service will prevent many more inadvertent errors than the previous versions.

Examples of the kinds of alternatives provided by the Service, as well as explanatory cautions in the explanatory material, are the following:

1. The annotations point out that if the trust is funded with unmarketable assets, the initial fair market value of the assets must be determined exclusively by an independent trustee or must be determined by a qualified appraisal from a qualified appraiser as defined in the regulations.

2. The prior IRS forms included language to the effect that the charitable remainder beneficiary must be an organization described in Code section 170(c). This was a trap for many, because section 170(c) includes private foundations, which have lower income tax percentage limitations. In addition, the deduction for gifts of appreciated property other than marketable securities is limited to basis if the charity is a private foundation. The explanatory annotations include a warning and alternative language for the case (which is the usual one) where the donor wishes the charitable beneficiary to be a public charity. An example of why care is needed can be seen in PLR 200932020: the document required that the charitable remainder beneficiary be a public charity, but the named charitable remainder beneficiary was in fact a private foundation. The Service permitted reformation to correct an obvious scrivener's error.

3. The annotations point out that the annuity amount may be payable to members of a named class in a term of years trust even if the members of the class are not living or ascertainable at the creation of the trust. The annotations also point out that sprinkling powers cannot be held by certain persons without causing the trust to be treated as a grantor trust for income tax purposes.

4. The forms point out that the annuity amount may be paid in equal or unequal installments throughout the year. Unequal installments create complexities of valuation, and most practitioners will want to avoid unequal payments.

5. The annotations point out that generally the annuity amount must be paid before the close of the taxable year in which it is due, and refer the reader to the regulations under section 664 which were adopted to prevent abuses related to the 2-year, high pay out charitable remainder trust.

6. The annotations point out that the trust may provide for an amount other than the annuity to be paid in the discretion of the trustee to a charitable organization, and further point out that if distribution is made in kind, the adjusted basis of distributed property must be fairly representative of adjusted basis of property in the trust.

7. The annotations point out that the charitable remainder beneficiary may be selected by the trustee or some other person, or that the power to name the charitable beneficiary may be retained by the donor. In that case the gift will be incomplete for gift tax purposes, but the charitable income tax deduction will still be available. The forms also include alternate provisions in which the donor retains the right to substitute the charitable remainderman.

8. Another interesting provision referred to in the annotation is the qualified contingency provision of section 664(f) which permits a trust to end early upon the happening of any contingency, whether or not the actuarial value of the contingency can be determined. The qualified contingency

is ignored for valuation purposes, but it will not disqualify the trust.

There are several changes most practitioners will want to make in the forms.

1. First, the forms provide as the default that the final payment will be prorated. In many cases this necessitates a payment of the stub period annuity to the beneficiary's estate for the period after the last payment and until the beneficiary's death. Most practitioners will want to provide that the final payment will be the regular payment preceding the beneficiary's death.

2. As noted above, most practitioners will want to limit the charitable remainder beneficiary to public charities described in section 170(b)(1)(A), as provided in the alternative language.

3. Most practitioners will want to include a spendthrift provision, at least where the beneficiary is not the donor. The advisability and effect of a spendthrift provision will depend on state law.

4. In the two-life trusts, the forms have much simpler language regarding payment of taxes on the first death than were used in some of the prior IRS pronouncements. The two-life trust form does not include as a default provision a retained testamentary power to revoke the interest of the successor beneficiary so as to prevent a gift for gift tax purposes. Most practitioners will want to include that provision, even in the case of trusts for spouses. Where the donor has retained the right to change the charitable remainder beneficiary, including a power to revoke the survivorship interest of the spouse will avoid the necessity for filing a gift tax return. Note that this power must be testamentary rather than a lifetime power to avoid grantor trust treatment. (By contrast, the power to designate a different charitable remainder beneficiary may be an inter vivos or a testamentary power.)

5. Surprisingly, the testamentary forms do not have language reducing the amount of the annuity to the extent necessary to avoid failing the 10% minimum remainder requirement of section 664 or the 5% exhaustion test of Revenue Ruling 77-374. This is important in testamentary trusts because at the time the will is written, the section 7520 rate at the date of death will not be known. In a testamentary CRAT, practitioners should always include language reducing the annuity to the extent necessary to pass these two tests.

In one respect, the generally useful forms are unnecessarily nitpicking. The term of years trust provides for an annuity to be paid for a term of not more than 20 years. This 20 year limitation is of course required by section 664. However, the explanatory material accompanying the term of years trust states that the period must not exceed 20 years, and then includes the following sentence: "Thus, for example, the annuity period of a CRAT for a term of 20 years will end on the date preceding the 20<sup>th</sup> anniversary of the date the trust was created." But surely a trust ending on the 20<sup>th</sup> anniversary date of the trust should qualify. Requiring that the term end one day before the 20<sup>th</sup> anniversary seems unnecessarily nitpicking and undoubtedly, many trusts have been written calling for the trust to terminate on the 20<sup>th</sup> anniversary date.

But, in general, the forms and the annotations are a useful improvement.

# **Appendix C**

## **Internal Revenue Service Issues Sample Charitable Remainder Unitrusts**

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In Revenue Procedures 2005-52 through 2005-59, the Internal Revenue Service has issued sample charitable remainder unitrust forms replacing the sample forms issued in 1990. As with the annuity trust forms issued in 2003, the new forms are a significant improvement over the prior forms and the explanatory material and annotations provided by the Internal Revenue Service are very useful. The specific forms issued are as follows:

1. Inter vivos charitable remainder unitrust (CRUT) for one measuring life – Rev. Proc. 2005-52.
2. Inter vivos CRAT for a term of years – Rev. Proc. 2005-53.
3. Inter vivos CRUT with consecutive interests for two measuring lives – Rev. Proc. 2005-54.
4. Inter vivos CRUT for concurrent and consecutive interests for two measuring lives – Rev. Proc. 2005-55.
5. Testamentary CRUT for one measuring life – Rev. Proc. 2005-56.
6. Testamentary CRUT for a term of years – Rev. proc. 2005-57.
7. Testamentary CRUT with consecutive interests for two measuring lives – Rev. Proc. 2005-58.
8. Testamentary CRUT with concurrent and consecutive interests for two measuring lives – Rev. Proc. 2005-59.

The forms are more complicated than the annuity trust forms, of course, because there are more flavors of unitrusts: regular unitrusts, income-only with makeup, income-only without makeup, and flip unitrusts (referred to by the Service as “combination of methods unitrusts”).

The forms track closely the annuity trust forms issued in 2003 and many of the comments one could make about the forms were also true of the annuity trust forms. But a number of the items are specific to unitrusts. For example, the annotations note that if an additional contribution is made to an existing charitable remainder unitrust and the contribution does not satisfy the 10% test of section

664(d)(2)(D) the contribution is treated as a transfer to a separate trust under section 664(d)(4). The annotations also include information and language regarding unitrusts with more than one valuation date. It will be rare when more than one valuation date will be desirable, because of the considerable complexities such a provision entails.

The annotations also include alternate language for testamentary additions to unitrusts and alternate methods of computing the deferred payments.

The annotations to the income-only variants take into account changes in state law definitions of income and provide that proceeds of sales of assets may be allocated to income under the terms of the governing instrument if not prohibited by applicable local law. Further, a discretionary power to make the allocation may be granted to the trustee to the extent that the applicable estate statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially. One assumes that prior IRS pronouncements prohibiting allocation of pre-gift gain to income still govern.

The annotations to the flip unitrust—which can make a one time change from an income only (with or without makeup) to a regular unitrust—note that the change may not be discretionary with or in the control of the trustees or any other persons. However, the usual trigger will be the sale of unproductive property which is, of course, within the control of the trustees. I suppose what the Service is really saying is that only events of independent significance count. There is something new in the flip unitrust forms: separate and detailed language regarding proration of the unitrust amount in years both before and after the effective date of the triggering event.

Interestingly, and perhaps even bizarrely, the two life trusts, which will almost always be for husband and wife, say nothing about the waiver requirements of Revenue Procedure 2005-24. The forms include no sample waiver language for a spousal interest and the annotations do not even mention the existence of the necessity imposed by Revenue Procedure 2005-24. Has the Service had a change of heart, or are they merely punting on the exact requirements? Or maybe spousal waivers is some else's department.

The trust language itself is straightforward and to the point, and each form includes alternate provisions. As with the prior forms, the new forms must be used with care, although the thorough annotations provided by the Service will prevent many more inadvertent errors than the previous versions.

Examples of the kinds of alternatives provided by the Service, as well as explanatory cautions in the explanatory material, are the following:

1. The annotations point out that if the trust is funded with unmarketable assets, the annual or more frequent fair market value determination must be made by an independent trustee or must be determined by a qualified appraisal from a qualified appraiser as defined in the regulations.
2. The old IRS unitrust forms included language to the effect that the charitable remainder beneficiary must be an organization described in Code section 170(c). This was a trap for



many, because section 170(c) includes private foundations, which have lower income tax percentage limitations. In addition, the deduction for gifts of appreciated property other than marketable securities is limited to basis if the charity is a private foundation. The explanatory annotations include a warning and alternative language for the case (which is the usual one) where the donor wishes the charitable beneficiary to be a public charity.

3. The annotations point out that the unitrust amount may be payable to members of a named class in a term of years trust even if the members of the class are not living or ascertainable at the creation of the trust. The annotations also point out that sprinkling powers cannot be held by certain persons without causing the trust to be treated as a grantor trust for income tax purposes.

4. The forms point out that the unitrust amount may be paid in equal or unequal installments throughout the year. Unequal installments create complexities of valuation, and most practitioners will want to avoid unequal payments.

5. The annotations point out that generally the unitrust amount must be paid before the close of the taxable year in which it is due, and refer the reader to the regulations under section 664 which were adopted to prevent abuses related to the 2-year, high pay out charitable remainder trust.

6. The annotations point out that the trust may provide for an amount other than the unitrust amount to be paid in the discretion of the trustee to a charitable organization, and further point out that if distribution is made in kind, the adjusted basis of distributed property must be fairly representative of adjusted basis of property in the trust.

7. The annotations point out that the charitable remainder beneficiary may be selected by the trustee or some other person, or that the power to name the charitable beneficiary may be retained by the donor. In that case the gift will be incomplete for gift tax purposes, but the charitable income tax deduction will still be available. The forms also include alternate provisions in which the donor retains the right to substitute the charitable remainderman.

8. Another interesting provision referred to in the annotation is the qualified contingency provision of section 664(f) which permits a trust to end early upon the happening of any contingency, whether or not the actuarial value of the contingency can be determined. The qualified contingency is ignored for valuation purposes, but it will not disqualify the trust.

There are several changes most practitioners will want to make in the forms.

1. First, the forms provide as the default that the final payment will be prorated. In many cases this necessitates a payment of the stub period payment to the beneficiary's estate for the period after the last payment and until the beneficiary's death. Most practitioners will want to provide that the final payment will be the regular payment preceding the beneficiary's death.

2. As noted above, most practitioners will want to limit the charitable remainder beneficiary to public charities described in section 170(b)(1)(A), as provided in the alternative language.

3. Most practitioners will want to include a spendthrift provision, at least where the beneficiary is not the donor. The advisability and effect of a spendthrift provision will depend on state law.

4. In the two-life trusts, the forms have much simpler language regarding payment of taxes on the first death than were used in some of the prior IRS pronouncements. The two-life trust form does not include as a default provision a retained testamentary power to revoke the interest of the successor beneficiary so as to prevent a gift for gift tax purposes. Most practitioners will want to include that provision, even in the case of trusts for spouses. Where the donor has retained the right to change the charitable remainder beneficiary, including a power to revoke the survivorship interest of the spouse will avoid the necessity for filing a gift tax return. Note that this power must be testamentary rather than a lifetime power to avoid grantor trust treatment. (By contrast, the power to designate a different charitable remainder beneficiary may be an inter vivos or a testamentary power.)

In one respect, the generally useful forms are unnecessarily nitpicking. The explanatory material accompanying the term of years trust states that the term of a term of years trust must not exceed 20 years, and then includes the following sentence: “Thus, for example, the unitrust period of a CRAT for a term of 20 years will end on the date preceding the 20<sup>th</sup> anniversary of the date the trust was created.” But surely a trust ending on the 20<sup>th</sup> anniversary date of the trust should qualify. Requiring that the term end one day before the 20<sup>th</sup> anniversary seems unnecessarily nitpicking and undoubtedly many trusts have been written calling for the trust to terminate on the 20<sup>th</sup> anniversary date. Do all of these fail to qualify? Actually, now that we have a required 10% minimum actuarial value for both CRATs and CRUTs, the term limitation is really unnecessary, but it will be up to Congress to change that.