

Charitable Planning Opportunities: Charitable Lead Trusts and Charitable Remainder Trusts

Charitable Remainder Trusts Reference Outline

**Jeffrey N. Myers
Jason R. Mahon
Michael V. Bourland**

Bourland, Wall & Wenzel,
A Professional Corporation
Attorneys and Counselors
City Center Tower II
301 Commerce Street, Suite 1500
Fort Worth, Texas 76102

(817) 877-1088
(817) 429-3945 (metro)
(817) 877-1636 (facsimile)
E-mail: mbourland@bwwlaw.com

Information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

All written material contained within this outline is protected by copyright law and may not be reproduced without the express written consent of Bourland, Wall & Wenzel.

©Bourland, Wall & Wenzel, P.C.

CHARITABLE REMAINDER TRUSTS

TABLE OF CONTENTS

INTRODUCTION	6
I. WHAT IS A CHARITABLE REMAINDER TRUST (CRT), IN GENERAL	6
II. TAX ADVANTAGES OF A CHARITABLE REMAINDER TRUST	6
A. CRT Is Income Tax Exempt	6
B. Estate, Gift and Income Tax Deduction	6
III. LEGISLATIVE HISTORY	6
THE CODE, THE REGULATIONS AND THE RULINGS.....	6
I. GENERAL RULES APPLICABLE TO DEDUCTIONS OF GIFTS TO CRTS.....	6
A. Income	6
1. <u>GENERAL RULE</u>	6
2. <u>EXCEPTION</u>	6
B. Gift/Estate	7
1. <u>GENERAL RULE</u>	7
2. <u>EXCEPTION</u>	7
II. CITES - INCOME TAXATION OF SECTION 664 CHARITABLE REMAINDER TRUSTS	7
A. Distributions to Recipients of Annuity Amount or Unitrust Amount.....	7
B. Distributions to Charities	7
C. Taxation of CRT	7
III. CITES - DEFINITIONS OF CHARITABLE REMAINDER ANNUITY TRUSTS/CHARITABLE REMAINDER UNITRUSTS.....	7
A. General Rules Applicable to Both	7
B. Charitable Remainder Annuity Trusts (“CRAT”)	7
C. Charitable Remainder Unitrusts (“CRUT”).....	7
IV. CITES - CALCULATION OF FAIR MARKET VALUE OF REMAINDER INTEREST	7
V. CITES - EXCISE TAX/PRIVATE FOUNDATION RULES	7
VI. CITES - FILING OF RETURNS.....	7
VII. CITES - RULINGS - APPROVED FORMS.....	7
A. Charitable Remainder Annuity Trust (“CRAT”)	7
B. Charitable Remainder Unitrust (“CRUT”)	8
REQUIREMENTS OF A CHARITABLE REMAINDER TRUST	8
I. IN GENERAL.....	8
A. Definitions	8
II. CHARITABLE REMAINDER ANNUITY TRUST (“CRAT”) VS. CHARITABLE REMAINDER UNITRUST (“CRUT”)	8
A. CRAT.....	8
B. CRUT.....	8
1. <u>FOUR TYPES OF CRUTS</u>	8
C. No Hybrids.....	10
D. Comparison of CRATs and CRUTs	10
1. <u>ADDITIONAL CONTRIBUTIONS</u>	10
2. <u>DISTRIBUTIONS IN KIND</u>	11
III. QUALIFYING THE CRT UNDER SECTION 664.....	11
A. Valid Trust and Irrevocable Trust.....	11

B.	The Annuity Amount and Unitrust Amount	11
1.	<u>THE AMOUNT</u>	11
2.	<u>SHORT TAXABLE YEARS</u>	11
3.	<u>INCORRECT PAYMENTS</u>	12
4.	<u>REDUCTION OF ANNUITY AMOUNT OR UNITRUST AMOUNT</u> 12	
5.	<u>BEGINNING DATE FOR PAYMENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT</u>	12
C.	Term of Payment of Annuity Amount and Unitrust Amount	13
1.	<u>THE TERM</u>	13
2.	<u>ACCELERATION OF TERM</u>	13
3.	<u>SHORT TERM CRTS</u>	13
D.	Recipient of Annuity Amount and Unitrust Amount.....	15
1.	<u>NAMED RECIPIENTS</u>	15
2.	<u>AT LEAST ONE NOT A CHARITY</u>	15
3.	<u>ALL INDIVIDUALS MUST BE LIVING</u>	15
4.	<u>POWER TO SPRINKLE RETAINED BY TRUSTEE WHO WAS GRANTOR</u>	15
5.	<u>POWER TO REVOKE BY WILL</u>	15
6.	<u>AUTOMATIC TERMINATION OF SUCCESSIVE OR CONCURRENT RECIPIENT INTEREST IN THE EVENT OF DIVORCE</u>	15
E.	Charitable Remainderman	16
1.	<u>IRREVOCABLE CHARITABLE REMAINDERMAN</u>	16
2.	<u>PRESENT VALUE OF CHARITABLE REMAINDER INTEREST</u> ... 16	
3.	<u>CONCURRENT/SUCCESSIVE REMAINDERMEN</u>	17
4.	<u>ALTERNATE CHARITABLE REMAINDERMAN</u>	17
5.	<u>SUBSTITUTION OF ALTERNATE CHARITY BY GRANTOR</u>	17
6.	<u>EARLY DISTRIBUTION OF CORPUS</u>	17
7.	<u>OTHER PAYMENTS</u>	17
F.	Private Foundation Restrictions	17
G.	Taxes, Debts and Expenses.....	19
1.	<u>DEATH TAXES</u>	19
2.	<u>DEBTS AND EXPENSES OF DECEDENT-TESTAMENTARY CRTS</u>	19
H.	Trustee	19
1.	<u>GRANTOR AS TRUSTEE</u>	19
2.	<u>CHARITABLE REMAINDERMAN AS TRUSTEE</u>	20
3.	<u>GRANTOR'S RIGHT TO REMOVE AND REPLACE TRUSTEE</u>	20
I.	Avoidance of Grantor Trust Imposition.....	20
J.	Taxable Year.....	20
	TAX CONSEQUENCES OF A CRT	21
I.	INCOME TAX CONSEQUENCES	21
A.	Income	21
1.	<u>INCOME TO RECIPIENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT</u>	21
2.	<u>DISTRIBUTIONS TO CHARITY</u>	22
3.	<u>TAXATION OF CRT</u>	22
B.	Donor's Income Tax Deduction	24
1.	<u>REMAINDERMAN IS A PUBLIC CHARITY</u>	24
2.	<u>REMAINDERMAN IS A PRIVATE FOUNDATION</u>	25
3.	<u>FURTHER LIMITS APPLICABLE TO HIGH INCOME TAXPAYERS</u>	

	4.	<u>SUBSTANTIATION OF THE CHARITABLE GIFT</u>	26
	5.	<u>FEDERAL RETURN FILINGS REQUIRED FOR A CRT</u>	27
II.		GIFT TAX CONSEQUENCES	29
	A.	Who is the Recipient of the Annuity Amount or Unitrust Amount	30
		1. <u>JUST THE DONOR</u>	30
		2. <u>THE DONOR AND HIS SPOUSE</u>	30
		3. <u>SOMEBODY OTHER THAN THE DONOR'S SPOUSE</u>	30
III.		ESTATE TAX CONSEQUENCES	31
	A.	Inter Vivos CRATs and CRUTs	31
		1. <u>DONOR WAS RECIPIENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT</u>	31
	B.	Testamentary CRAT or CRUT	31
		1. <u>SPOUSE IS SOLE RECIPIENT</u>	31
		2. <u>SPOUSE AND OTHERS ARE RECIPIENTS</u>	31
		3. <u>SOMEBODY OTHER THAN SPOUSE IS RECIPIENT</u>	31
FUNDING OF CRTs		32
I.		INTRODUCTION	32
	A.	Primary Advantage 1 of a CRT	32
	B.	Primary Advantage 2 of a CRT	32
	C.	Primary Disadvantage of a CRT	32
II.		MARKETABLE SECURITIES.....	32
	A.	Low Basis Highly Appreciated Marketable Securities	32
III.		TAX EXEMPT SECURITIES.....	32
IV.		REAL ESTATE	33
	A.	Unencumbered Real Estate.....	33
		1. <u>PERSONAL RESIDENCE</u>	33
		2. <u>NON-PERSONAL RESIDENCE REAL ESTATE</u>	33
	B.	Encumbered Real Estate	33
		1. <u>UNRELATED BUSINESS TAXABLE INCOME</u>	33
V.		SUBCHAPTER S STOCK	33
	A.	Contribution of the Stock.....	33
	B.	Contribution of the Assets of S Corporation by the S Corporation	33
		1. <u>LEGALLY BINDING OBLIGATION</u>	34
		2. <u>UNRELATED BUSINESS TAXABLE INCOME</u>	34
VI.		REGULAR C CORPORATION.....	34
	A.	Excess Business Holdings	34
	B.	Legally Binding Obligation	34
	C.	Self-Dealing	34
	D.	Unrelated Business Taxable Income.....	35
VII.		LIMITED LIABILITY COMPANY	35
VIII.		OPTIONS.....	35
	A.	Old Position of Service - PLR 9240017	35
		1. <u>USE OF OPTION TO FUND CRT</u>	35
	B.	New Position of Service	35
		1. <u>PLR 9417005</u>	35
		2. <u>PLR 9501004</u>	35
IX.		OTHER ASSETS USED TO FUND CRTS	35
	A.	Qualified Retirement Plan Benefits	35
		1. <u>WITHDRAWING THE PLAN ASSETS AND THEN USING ASSETS TO FUND CRT</u>	36

2.	<u>NAMING THE CRT AS A BENEFICIARY OF THE PLAN BENEFITS AT PLAN PARTICIPANT’S DEATH</u>	36
B.	Life Insurance	37
1.	<u>PAYMENT OF PREMIUMS BY THE CRT</u>	37
2.	<u>UNRELATED BUSINESS INCOME</u>	37
3.	<u>JEOPARDY INVESTMENT</u>	37
C.	Qualified Replacement Property	38
D.	Partnership Interests Controlled by Trustee.....	38
1.	<u>SELF DEALING</u>	38
2.	<u>UNRELATED BUSINESS TAXABLE INCOME</u>	38
3.	<u>EXCESS BUSINESS HOLDINGS</u>	38
4.	<u>NO (DEFINITE) WORD YET</u>	38
	ATTACHMENT 1 - GRANTOR TRUST AVOIDANCE	39
	ATTACHMENT 2 - FORMS	40

CHARITABLE REMAINDER TRUSTS

INTRODUCTION

Used correctly, an IRC §664 charitable remainder trust (“CRT”) can accomplish a donor’s donative goals and tax goals. (All references to “sections” or “§” are to the Internal Revenue Code of 1986, as amended, or to Department of the Treasury Regulations “Treas. Reg.,” as applicable and unless otherwise stated.)

I. WHAT IS A CHARITABLE REMAINDER TRUST (CRT), IN GENERAL

A CRT is an irrevocable trust. An amount of income and/or principal from the CRT is payable to noncharitable beneficiaries, usually the grantor of the CRT and the grantor’s spouse. The remainder interest is irrevocably payable to charity.

II. TAX ADVANTAGES OF A CHARITABLE REMAINDER TRUST

A. CRT Is Income Tax Exempt

The CRT pays no income tax on its income. Therefore, the CRT is not taxed on any gain it realizes upon selling appreciated property whether donated by the grantor or appreciation occurring after donation.

B. Estate, Gift and Income Tax Deduction

The grantor of an inter vivos CRT is entitled to an immediate income and gift tax deduction in the amount of the present value of the remainder interest passing to charity. The estate of the decedent who created a testamentary CRT is entitled to an estate tax deduction for the present value of the remainder interest passing to charity.

III. LEGISLATIVE HISTORY

In 1969, Congress reacted to the abuse it perceived regarding charitable deductions resulting from gifts of remainder interests to charity. Congress believed that donors were taking income, gift and estate tax charitable deductions based on values not ultimately passing to the charity. Prior to 1969, the tests to obtain an income, estate or gift tax charitable deduction were liberal. A gift to a split interest trust with a remainder going to charity enabled the donor to receive an income, estate or gift tax charitable deduction if the interest passing to charity was presently ascertainable. Treas. Reg. §20.2055(a). Further, as long as the ability of the Trustee to invade corpus for the noncharitable beneficiary was simply subject to an ascertainable standard, the donor was entitled to the deduction. Treas. Reg. §20.2055-2(b); Estate of Sternberger v. Commissioner, 348 U.S. 187 at 194 (1955); Rev. Rul. 54-285, 1954-2 C.B. 302. Congress amended the charitable deduction sections (Sections 170, 2055 and 2522) to deny charitable deductions for gifts of remainder interests in split interest trusts unless the gift of the remainder interest was made through a trust which qualified under the newly enacted Section 664. Section 664 provides the definitional scheme for a CRT.

THE CODE, THE REGULATIONS AND THE RULINGS

I. GENERAL RULES APPLICABLE TO DEDUCTIONS OF GIFTS TO CRTS

A. Income

1. GENERAL RULE

A donor receives no charitable income tax deduction for a gift of a remainder interest to charity. IRC §170(f)(2)(A).

2. EXCEPTION

A gift of a remainder interest to charity will entitle the donor to a charitable income tax deduction if the trust is a CRT described in Section 664. IRC §170(f)(2)(A).

B. Gift/Estate

1. GENERAL RULE

A donor receives no gift or estate tax charitable deduction for a gift of a remainder interest to charity - IRC §§2522(c)(2); 2055(e)(2).

2. EXCEPTION

A gift of a remainder interest to charity will entitle the donor to an estate or gift tax charitable deduction if the trust is a CRT described in Section 664. IRC §§2522(c)(2)(A); 2055(e)(2)(A).

II. CITES - INCOME TAXATION OF SECTION 664 CHARITABLE REMAINDER TRUSTS

A. Distributions to Recipients of Annuity Amount or Unitrust Amount

- IRC §664(b)
- Treas. Reg. §1.664-1(d)

B. Distributions to Charities

- Treas. Reg. §1.664-1(e)

C. Taxation of CRT

- IRC §664(c)
- Treas. Reg. §1.664-1(c)

III. CITES - DEFINITIONS OF CHARITABLE REMAINDER ANNUITY TRUSTS/CHARITABLE REMAINDER UNITRUSTS

A. General Rules Applicable to Both

- Treas. Reg. §1.664-1(a)

B. Charitable Remainder Annuity Trusts (“CRAT”)

- IRC §664(d)(1)
- Treas. Reg. §1.664-2

C. Charitable Remainder Unitrusts (“CRUT”)

- IRC §664(d)(2) & (d)(3)
- Treas. Reg. §1.664-3

IV. CITES - CALCULATION OF FAIR MARKET VALUE OF REMAINDER INTEREST

- Treas. Reg. §1.664-4

V. CITES - EXCISE TAX/PRIVATE FOUNDATION RULES

- Treas. Reg. §1.664-1(b)

VI. CITES - FILING OF RETURNS

- IRC §6034
- Treas. Reg. §1.6012-3(a)(6)

VII. CITES - RULINGS - APPROVED FORMS

A. Charitable Remainder Annuity Trust (“CRAT”)

1. Inter Vivos CRAT for One Measuring Life (Rev. Proc. 2003-53).
2. Inter Vivos CRAT for Term of Years Annuity Period (Rev. Proc. 2003-54).
3. Inter Vivos CRAT for Consecutive Interests for Two Measuring Lives (Rev. Proc. 2003-55.)
4. Inter Vivos CRAT for Concurrent and Consecutive Interests (Rev. Proc. 2003-56).
5. Testamentary CRAT for One Measuring Life (Rev. Proc. 2003-57).

6. Testamentary CRAT for Term of Years Annuity Period (Rev. Proc. 2003-58).
7. Testamentary CRAT for Consecutive Interests for Two Measuring Lives (Rev. Proc. 2003-59).
8. Testamentary CRAT for Concurrent and Consecutive Interests (Rev. Proc 2003-60).

B. Charitable Remainder Unitrust (“CRUT”)

1. Inter Vivos CRUT for One Measuring Life (Rev. Proc. 2005-52).
2. Inter Vivos CRUT 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 2005-60).

REQUIREMENTS OF A CHARITABLE REMAINDER TRUST

I. IN GENERAL

A CRT is a trust which provides for a specified distribution to one or more beneficiaries, at least one of which is not a charity, for life or for a term of years (not to exceed 20 years), with an irrevocable remainder interest paid to charity. Treas. Reg. §1.664-1(a)(1)(i).

A. Definitions

The following definitions will be used in this outline as they are used in the regulations. Treas. Reg. §1.664 - 1(a)(1)(iii).

1. “ANNUITY AMOUNT” - the amount distributed to the noncharitable beneficiary of a charitable remainder annuity trust.
2. “UNITRUST AMOUNT” - the amount distributed to the noncharitable beneficiary of a charitable remainder unitrust.
3. “RECIPIENT” - the beneficiary who receives the Annuity Amount or Unitrust Amount.

II. CHARITABLE REMAINDER ANNUITY TRUST (“CRAT”) VS. CHARITABLE REMAINDER UNITRUST (“CRUT”)

A. CRAT

The amount paid to the Recipient is set when the trust is created. It is a fixed percentage or dollar amount of the initial fair market value of the trust assets. Thus, the Annuity Amount paid to the Recipient does not change from year to year. IRC §664(d)(1).

B. CRUT

The amount paid to the Recipient is a fixed percentage of the fair market value of the trust’s assets valued annually. Thus, the Unitrust Amount fluctuates from year to year.

1. FOUR TYPES OF CRUTS
 - a. Fixed Percentage (“Fixed Percentage Unitrust” or “Flat Unitrust”)

The Recipient receives the fixed percentage of the trust assets, valued annually. IRC §664(d)(2).

b. Lesser of Income or Fixed Percentage Without Make-Up (“NICRUT”)

The Recipient receives the lesser of the trust’s net income for that year or the fixed percentage of the trust assets valued annually. IRC §664(d)(2) and (d)(3).

c. Lessor of Income or Fixed Percentage With Make-Up (“NIMCRUT”)

The Recipient receives the lesser of the trust’s net income for that year or the fixed percentage and in a year when the trust’s net income exceeds the fixed percentage, such excess is used to make-up for past deficiencies in years when the net income was less than the fixed percentage. IRC §664(d)(2) and (d)(3).

(1) DEFINITION OF INCOME

Typically, under state trust accounting law, income excludes capital gains (i.e. capital gains are allocated to principle). Tex. Prop. Code §113.102(b)(1). However, a trust may allocate capital gains to income. Prior to December, 1998, the letter rulings were all over the map regarding whether the Trustee could allocate capital gains to income, whether only post contribution capital gains could be allocated and whether the make-up account had to be treated as a liability when valuing the NIMCRUT. The December 10, 1998, Treasury Regulations cleared this up. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution. Treas. Reg. 1.644-3(a)(1)(i)(b)(4). The preamble to the Final Regulations states that “it is unnecessary to treat the make-up account as a liability” as originally established in several private letter rulings.

d. The FLIP CRUT

The Regulations also sanctioned a fourth type of CRUT called the “FLIP CRUT.” A FLIP CRUT is a CRUT 1) where the initial Unitrust Amount to the Recipient is the lesser of income or the fixed percentage and 2) where after a triggering event, the Unitrust Amount changes (i.e. flips) to the fixed percentage. Under the Final Regulations, the following requirements must be satisfied to use the FLIP CRUT: 1) the change (FLIP) from the NIMCRUT (NICRUT) to the fixed percentage CRUT is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person; 2) the FLIP occurs at the beginning of the taxable year that immediately follows the taxable year during which the triggering event/date occurs; 3) following the flip, the CRT becomes a fixed percentage CRT (and any makeup account is forfeited). Treas. Reg. 1.664-3(a)(1)(i)(c).

(1) TRIGGERING EVENT

A triggering event based on the sale of unmarketable assets or the marriage, divorce, death or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other person. Treas. Reg. 1.664-3(a)(1)(i)(d).

(2) UNMARKETABLE ASSETS

For purposes of a FLIP CRUT, unmarketable assets are assets that are not cash, cash equivalents or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stocks, and an unregistered security for which there is no available exemption permitting public sale. Treas. Reg. §664-1(a)(7)(ii).

(3) USES

Uses of the FLIP CRUT include creating a retirement account or a deferred income stream or if the CRUT is funded with unmarketable assets.

(i) Retirement account/deferred income stream. In this instance the donor funds the FLIP CRUT with cash or securities and picks a date certain in the future as the “triggering event.” Prior to the triggering event, the Trustee invests the trust assets in growth, non-income producing assets to grow the trust corpus. Upon the date certain (i.e., retirement or date donor wants the payment stream to become fixed), the CRUT flips. The Trustee can maintain its investment strategy (i.e., growth). In order to make the unitrust payment the Trustee will either sell sufficient assets to satisfy the payment or distribute the assets in kind to the unitrust beneficiary who in turn can sell the assets. Ordinarily, unless there is undistributed ordinary income as outlined under Tax Consequences of a CRT, I.A.1, infra, the unitrust amount would be taxed to the unitrust beneficiary at capital gains rates.

(ii) Unmarketable Assets. The FLIP CRUT is also useful when the assets used to fund the CRUT are unmarketable assets and the unitrust beneficiary of the CRUT desires a payout equal to a fixed percentage of the value of the assets. The triggering event may be the sale of those unmarketable assets. During the period the trust holds the unmarketable assets, the CRUT is either a NIMCRUT or NICRUT so that the Trustee is not required to distribute undivided interests in the unmarketable assets. When the unmarketable asset is sold, the CRUT flips and then the unitrust amount is a fixed percentage.

The amendments allowing a FLIP CRUT are effective for CRUTs created on or after December 10, 1998. Under the Amendment and Notice 99-31 relief was available for the following if legal proceedings were instituted by June 30, 2000: (i) if a CRUT was created before such effective date containing a flip provision other than the one permitted by the Final Regulations, and (ii) if a CRUT was created after the effective date containing a flip provision other than one permitted by the Final Regulations. Treas. Reg. §1.664-3(a)(1)(i)(f).

C. No Hybrids

The trust must either be a CRAT or a CRUT. The trust cannot be a combination of a CRAT and a CRUT. Treas. Reg. §1.664-1(a)(2).

D. Comparison of CRATs and CRUTs

1. ADDITIONAL CONTRIBUTIONS

a. CRAT Additional contributions cannot be made to a CRAT because the Annuity Amount is based on the value of the assets only valued as of creation. The governing instrument of the CRAT must prohibit additional contributions Treas. Reg. §1.664-2(b).

b. CRUT Additional contributions can be made to a CRUT as long as the governing instrument provides a formula upon which to base the Unitrust Amount, which takes into account the additional contribution. Treas. Reg. § 1.664-3(b). However, if any contribution is made to a trust which before the contribution is a charitable remainder unitrust, and such contribution would result in such trust ceasing to be a charitable unitrust by reason of not having a charitable interest of at least 10% for the additional contribution, such

contribution shall be treated as a transfer to a separate trust under regulations prescribed by the Secretary. IRC 664(d)(4). Currently there are no regulations under this section. In the absence of Treasury Regulations, guidance has been provided in PLR 200245058. Under PLR 200245058 the Taxpayer received approval for the trust instrument to create a separate trust under the same trust agreement with a different unitrust amount from the original trust (the lowest percentage necessary to produce a 10% charitable factor, but not below the 5% minimum) in order to satisfy the 10% test for additional contributions or to allow the Trustee not to accept the contribution if the 10% test can not be satisfied.

2. DISTRIBUTIONS IN KIND

One other difference between the CRAT as compared to the NIMCRUT and the NICRUT (but not the fixed percentage CRUT) is that with a CRAT and the fixed percentage CRUT, the trustee may be forced to make a distribution in kind if the income of the CRAT or CRUT is insufficient to satisfy the Annuity Amount of the CRAT or the Unitrust Amount of the fixed percentage CRUT. A distribution in kind is deemed to be a sale of the property so distributed causing the Recipient to recognize capital gain on the property in kind distributed to him. Treas. Reg. §1.664-1(d)(Ex. 5). With CRUTs, however, if the Unitrust Amount is of the form based on the lesser of income or fixed percentage with or without make-up (i.e. a NICRUT or NIMCRUT), the trustee will not be forced to make a distribution in kind. Rather, the trustee can satisfy the Unitrust Amount based on the income earned by the CRUT. Obviously, if a non-income earning asset, such as real estate, is used to fund a CRT, it is best to choose a CRUT with the lesser of income feature (and with or without the flip feature).

3. CRUT DIVISION – PLR 200109006

A couple established a CRUT under section 664(d)(2). The couple later divorced and as part of the divorce proceeding stipulated that the CRUT would be divided into two separate CRUTs. Each new CRUT would have the same provisions as the old CRUT with the exception of being a single beneficiary trust. The Service determined that the new trusts would qualify as CRUTs under section 664(d)(2). See also PLR 200823015.

III. QUALIFYING THE CRT UNDER SECTION 664

A. Valid Trust and Irrevocable Trust

The CRT must be a valid trust under applicable state law. IRC §§664(d)(1) & 664(d)(2); Rev. Proc. 89-20, 1989-1 C.B. 841; Rev. Proc. 89-21, 1989-1 C.B. 842. The CRT must also be irrevocable. Treas. Reg. §1.664-1(a)(1)(i).

B. The Annuity Amount and Unitrust Amount

1. THE AMOUNT

IRC §§664(d)(1)(A) & 664(d)(2)(A)

a. Old Rule

For transfers to a CRT on or before June 18, 1997, the governing instrument had to provide that the fixed percentage be at least 5 percent. IRC §§664(d)(1)(A) & 664(d)(2)(A).

b. New Rule

Pursuant to The Taxpayer Relief Act of 1997 (P.L. 105-34), for transfers to a CRT after June 18, 1997, the governing instrument must now provide that the fixed percentage be at least 5 percent but no more than 50 percent. IRC §§664(d)(1)(A) & 664(d)(2)(A).

2. SHORT TAXABLE YEARS

The governing instrument must contain language regarding proration of the Unitrust Amount or Annuity Amount in the event of a short taxable year (i.e. less than 12

months). The Annuity Amount or Unitrust Amount shall be the amount otherwise payable multiplied by a fraction, the numerator of which is the number of days in the taxable year of the trust and the denominator of which is 365 (366 if February 29 is a day included in the numerator). The governing instrument of the CRT must also include language providing that in the case of a trust taxable year within which occurs the termination of the CRAT or CRUT, the Annuity Amount or Unitrust Amount which must be distributed shall be the amount otherwise determined multiplied by a fraction, the numerator of which is the number of days in the period beginning on the first day of such taxable year and ending on the day that the CRT terminates and the denominator of which is 365 (366 if February 29 is a day included in the numerator). Treas. Reg. §§1.664-2(a)(1)(v)(a) & (b) & 1.664-3(a)(1)(v)(a) & (b).

3. INCORRECT PAYMENTS

The governing instrument must require that the trustee pay to the Recipient (if an undervaluation) or receive from the Recipient (if an overvaluation) an amount equal to the difference between the Annuity Amount or Unitrust Amount which the trustee should have paid and the Annuity Amount or Unitrust Amount which was actually paid to the Recipient. Treas. Reg. §§1.664-2(a)(1)(iii) & 3(a)(1)(iii).

4. REDUCTION OF ANNUITY AMOUNT OR UNITRUST AMOUNT

Generally, the Unitrust Amount or Annuity Amount must be at least 5% of the trust assets (valued annually if a CRUT or valued at initial contribution if a CRAT). However, a trust may provide for a reduction in the Unitrust Amount or Annuity Amount upon the death of a Recipient or the expiration of the term, as applicable, as long as the governing instrument of the CRT provides that, upon such death or expiration, (1) the distribution of the excess Annuity Amount or Unitrust Amount is made to a charity and (2) the total of the Unitrust Amount or Annuity Amount payable after the distribution to the charity is not less than five percent. Treas. Reg. §§1.664-2(a)(2)(ii) & 3(a)(2)(ii).

5. BEGINNING DATE FOR PAYMENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT

The CRT must function exclusively as a CRT from inception. Treas. Reg. §§1.664-2(a)(5)(i) & 3(a)(5)(i). Therefore, the payment of the Unitrust Amount or Annuity Amount must be due for the year of the creation of the CRT. However, a CRT will not be deemed to have failed to function exclusively as a CRT merely because payment of the Unitrust Amount or Annuity Amount is made after the close of the taxable year, provided that the payment is made within a reasonable time after the close of the taxable year. Treas. Reg. §§1.664-2(a)(1)(i)(a) & 1.664-3(a)(1)(i)(a). With testamentary CRTs, the CRT is deemed created in the year of the decedent's death. Treas. Reg. §1.664-1(a)(5). In this case, the governing instrument of the CRT should also include a provision allowing the executor of the decedent's estate to defer such payment for a reasonable period of time to enable the decedent's executor to complete the administration of his or her estate. Id. In that event, the governing instrument may include a requirement to defer the payment of the Annuity Amount or Unitrust Amount until the end of the taxable year of the CRT in which occurs the complete funding of the CRT. Id. If such a deferment provision is provided for, the governing instrument must provide that the trustee will pay, within a reasonable time after such funding, to the Recipient (in the case of an underpayment) or must receive from the Recipient (in the case of an overpayment) the difference between the Annuity Amount or Unitrust Amount actually paid and the Annuity Amount or Unitrust Amount required to be paid, plus interest compounded. Rev. Rul. 92-57, 1992-2 C.B. 123 (modifying the interest computation in Rev. Rul. 88-81, 1988-2 C.B. 127 and Rev. Rul. 82-165, 1982-1 C.B. 117); Rev. Rul. 88-81, *supra* (requiring such provision to be mandatory if the trustee can

defer payment of the Annuity Amount or Unitrust Amount). See also Rev. Rul. 80-123, 1980-1 C.B. 205.

C. Term of Payment of Annuity Amount and Unitrust Amount

1. THE TERM

The governing instrument must specify the term of the Annuity Amount and Unitrust Amount and the term may continue for a term of years not to exceed twenty years, the life or lives of a named individual or individuals, or the combination of a life or lives and a fixed term of years. Treas Reg. §§1.664-2(a)(5) & 1.664-3(a)(5); IRC §§664(d)(1)(A) & 664(d)(2)(A).

2. ACCELERATION OF TERM

The governing instrument of the CRT may provide for the acceleration of the term causing the assets to be distributed to charity. However, the possibility of acceleration is not taken into account in valuing the remainder interest. Treas. Reg. §§1.664-2(a)(5) & 1.664-3(a)(5); IRC 664(d)(1)(A) & 664(d)(2)(A); PLR 9138024.

3. SHORT TERM CRTS

In Notice 94-78, the Service announced its intention to challenge short term CRUTs. Notice 94-78, 1994-2 C.B. 555.

a. Explanation - The short term CRUT is a technique where appreciated assets are transferred to a short term (i.e. 2 years) CRUT and the Unitrust Amount percentage is very high (i.e. 80%). The Notice provides the following example: Grantor contributes property with a value of \$1,000,000 and basis of zero. The assets pay no income and the term of the trust is two years. The Unitrust Amount is 80% of the value of the trust assets valued annually. In year one, the Unitrust Amount is \$800,000 (80% x \$1,000,000) but such is not actually paid in year one since the trustee has a reasonable time to make the payment. At the beginning of year 2, all the CRUT assets are sold for \$1,000,000 and the year one's Unitrust Amount is distributed. The Unitrust Amount for year two is \$160,000 (80% x (\$1,000,000 - \$800,000)).

b. Proponent's Position - The position of the proponents of this strategy is that the \$800,000 distribution is a return of principal under the tier distribution rules.

c. Service's Challenges in Notice 94-78 - In Notice 94-78, the Service stated that it will attack such transaction as abusive under the following arguments: 1) substance over form in that the arrangement is a prearrangement between the grantor and the trustee and thus, such is a sale by the grantor individually; 2) an assignment of income by the grantor and thus, the gain would be attributed to the grantor; 3) the trust did not function exclusively as a CRT from its inception and thus, the CRUT will be ignored and the sale treated as one by the grantor individually and 4) the postponement of the sale of the trust assets beyond year one is the use of the assets for the benefit of a disqualified person (i.e. self-dealing).

d. Proposed Regulation's Cure to Short Term Trusts - Under the Proposed Regulation, the payment of the Annuity Amount of a CRAT or the Unitrust Amount of a fixed percentage CRUT must be made by the close of the taxable year in which it is due. If such were the case in the example above, the trustee would be required to make a distribution in kind by the end of year one. The time for the payment of Unitrust Amount in NICRUTs and NIMCRUTs can still be extended under the Proposed Regulation. The Proposed Regulation states that such extension of time is needed with NICRUTs and NIMCRUTs since the trustee of such CRUTs may not be able to determine the Unitrust Amount until after the close of the year but with fixed percentage CRUTs and CRATs, the

trustee can determine the payment amount since it is a fixed amount. The Proposed Regulation specifically states that its concern is the accelerated CRUT described in Notice 94-78. The amendment in this Proposed Regulation is proposed to be effective April 18, 1997. Fixed percentage CRUTs that currently contain a provision permitting the payment of the Unitrust Amount after the close of the taxable year need not be reformed to comply with the Proposed Regulation. Instead, the trustees of such trusts must make the payment of the Unitrust Amount within the time permitted by the Proposed Regulation.

(1) EXCEPTION

At the hearings on the Proposed Regulation, it was determined that requiring the payment by the close of the tax year for fixed percentage CRUTs and CRATs would be very burdensome. Therefore, the Service issued Notice 97-68 which provides that for the 1997 tax year, it is not necessary to make the annual payment from the fixed percentage CRUT or the CRAT by the close of the 1997 tax year as long as the percentage is 15% or less. As far as subsequent tax years, the Proposed Regulation applies but it is believed that similar Notices will be issued or the rules finalized. Notice 97-68, 1997-48I.R.B.11.

e. Final Regulations - For charitable remainder annuity trusts or fixed percentage unitrusts, the Annuity or Unitrust Amount may be paid within a reasonable time after the close of the year for which it is due if (i) the character of such amount in the hands of the recipient is either ordinary income, capital gain, or tax-exempt income (but not corpus) and/or (ii) the trust distributes property rather than cash to pay the Annuity or Unitrust Amount and the trustee elects on the trust's return to treat any income generated by the distribution as maturing on the last day of the taxable year for which the amount is due. For pre-December 10, 1998, trusts, the distribution may be made within a reasonable time after the close of the year only if the percentage used to calculate the Annuity or Unitrust Amounts is 15% or less.

f. Son of Accelerated CRT - The IRS has issued new regulations (1.643(a)-8) that modify the application of the rules governing the character of some distributions from charitable remainder trusts. These regulations are intended to combat the latest tax avoidance scheme involving charitable remainder trusts. Under the new scheme, a donor typically contributes highly appreciated assets to a charitable remainder trust that has a relatively short term and a relatively high payout rate. Rather than sell the assets to obtain the cash needed to pay the annuity or unitrust amount to the noncharitable beneficiary, the trustee borrows money or enters into a forward sale of the assets. Because the borrowing or forward sale doesn't result in current income to the trust, parties attempt to characterize the distribution of cash to the noncharitable beneficiary as a tax-free return of corpus under section 664(b)(4). Although the scheme literally complies with the rules for charitable remainder trusts, the IRS says, its results are inconsistent with the intent behind those provisions. Moreover, it says, the scheme is no less abusive than the accelerated charitable remainder trust schemes that Congress prohibited in 1997. To combat these abusive transactions, the regulations provide that a trust shall be treated as having sold, in the year for which the distribution is due, a pro rata portion of its assets, to the extent that a distribution of the annuity or unitrust amount (1) isn't characterized in the hands of the recipient as income under section 664(b)(1), (2), or (3), and (2) was made from an amount received by the trust that was neither (a) a return of basis in any asset sold by the trust nor (b) attributable to a contribution of cash to the trust for

which a deduction was allowed under section 170, 2055, 2106, or 2522. Any transaction that has the purpose or effect of circumventing that rule, the Service says, will be disregarded. The regulations apply to distributions made by charitable remainder trusts after October 18, 1999. For distributions financed by borrowing funds, entering a forward sale, or other similar transactions before the regulations' effective date, the IRS says it may (1) characterize the distributions as a gross income rather than corpus or (2) challenge the trust's qualifications under section 664. In appropriate circumstances, the regulations add, it may (1) impose the tax on self-dealing transactions under section 4941; (2) treat the trust as having unrelated business taxable income under section 512; and (3) apply any applicable penalties to the transaction's participants.

D. Recipient of Annuity Amount and Unitrust Amount

IRC §§664(d)(1)(A) & 664(d)(2)(A); Treas. Reg. §§1.664-2(a)(3) & 1.664-3(a)(3)

1. NAMED RECIPIENTS

Name the person or persons to be the Recipient of the Annuity Amount or Unitrust Amount. If there is more than one Recipient, they can be either successive or concurrent. While the Service has discontinued issuing rulings on the qualification of CRUTs for one or two measuring lives, the Service chose to rule in this case because the trust provides for unitrust payments for five measuring lives and is not covered by section 4.01(38) of Rev.Proc. 2001-3. The Service ruled the trust satisfied the requirements of section 664(d)(2)(A) and (D) and provided a factor for determining the present worth of the remainder interest. PLR 200150019

2. AT LEAST ONE NOT A CHARITY

At least one of the Recipients must not be a charity.

3. ALL INDIVIDUALS MUST BE LIVING

All individuals who are Recipients must be alive at the time of the creation of the CRT.

4. POWER TO SPRINKLE RETAINED BY TRUSTEE WHO WAS GRANTOR

The power retained by the trustee who was the grantor of CRT to sprinkle the Annuity Amount or Unitrust Amount among Recipients will cause the trust to not be a CRT. In this case, the grantor would be treated as the owner of the CRT or the portion thereof. Treas. Reg. 1.664-3(a)(3)(ii) & 1.664-2(a)(3)(ii). However, in PLR 200813006, a grantor created a CRUT and gave an independent trustee the power to sprinkle 75% of the unitrust amount among charitable beneficiaries. The grantor retained the right to remove and replace the independent trustee with another independent trustee. The service held that this trust qualified as a CRT.

5. POWER TO REVOKE BY WILL

The Grantor may retain right to revoke by will any Recipient's interest (other than charity). If done, there is no completed gift to the successive Recipient. PLR 9517020. However, the power to revoke is a retention of a power includable in the grantor's estate.

6. AUTOMATIC TERMINATION OF SUCCESSIVE OR CONCURRENT RECIPIENT INTEREST IN THE EVENT OF DIVORCE

In PLR 9511029, the Service ruled that the automatic termination of a successive or concurrent Recipient's interest in the CRT due to divorce, will not disqualify the trust as a CRT.

7. TRUST AS RECIPIENT

In Revenue Ruling 2002-20 the Service amplified and superceded a previous ruling allowing a CRUT to pay the annuity or unitrust amount to a trust for an individual. Here, the factual circumstances are clarified when an individual creates a CRT for someone who is financially disabled, that is unable to manage his or her own financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not

less than 12 months. The Service lists three situations when the arrangement will qualify and held that a trust may qualify as a charitable remainder annuity or unitrust under section 664 if the annuity or unitrust amounts will be paid for the life of a financially disabled individual to a separate trust that will administer these payments on behalf of that individual and, upon the individual's death, will distribute the remaining assets either (i) to the individual's estate, (ii) to the individual's estate after reimbursing the state for any Medicaid benefits provided to the individual, or (iii) subject to the individual's general power of appointment after reimbursing the state for any Medicaid benefits provided to the individual. Of course, the remainder of the CRT must be paid to charity.

8. ASSIGNMENT OF INTEREST - PLR 200124010 – Assignment of Trust Principal Won't Affect CRUT Status

An individual set up a CRUT that required an independent third party trustee to pay the individual the unitrust amount during his lifetime and then pay his estate a prorated amount and upon his death to three charities. The individual wanted to shut down the CRUT early and proposed assigning the principal to the three charitable remainder beneficiaries. The Service ruled that the assignment wouldn't adversely affect the trust's qualification provided that the charities are organizations described in section 170(c). However, consider PLR 200127023 where it was determined that instead of distributing the assets to charity, the trustee would distribute the actuarial value of the unitrust amount to the unitrust beneficiary and the remainder to charity. In this instance the Service ruled that the unitrust beneficiary will be treated as disposing of his interest in the trust in exchange for money and property and will realize income from the sale. Good news is that it will not be an act of self-dealing; however, the uniform basis rules will be disregarded and the individual must recognize the entire amount realized from the disposition. Then again, in PLR 200152018, the Service approved the transfer by the unitrust beneficiary of his entire unitrust interest to the charity in exchange for a charitable gift annuity. Additionally, the Service stated that the individual was entitled to an income tax charitable deduction (subject to the 30% limitation).

E. Charitable Remainderman

IRC §§1664(d)(1)(C) & 664(d)(2)(C); Treas. Reg. §§1.664-2(a)(6) & 1.664-3(a)(6)

1. IRREVOCABLE CHARITABLE REMAINDERMAN

The governing instrument must provide that at end of the term, the entire corpus of the CRT go to charity. Such charitable interest can pass outright or it can continue in trust for the benefit of the charity.

2. PRESENT VALUE OF CHARITABLE REMAINDER INTEREST

a. Old Rule

For transfers to a CRT on or before July 28, 1997, the present value of the remainder interest ultimately passing to the charitable remainderman had to equal at least 5 percent of the net fair market value of the property transferred to the CRT on the date of the contribution to the CRT.

b. New Rule

Pursuant to The Taxpayer Relief Act of 1997 (P.L. 105-34), for transfers to a CRT after July 28, 1997, the present value of the remainder interest ultimately passing to the charitable remainderman must equal at least 10 percent of the net fair market value of the property transferred to the CRT on the date of the contribution to the CRT. IRC §§664(d)(1)(D) & 664(d)(2)(D). Further, for charitable remainder annuity trusts, the CRAT must also meet the “not-so-remote-as-to-be-negligible-5%-probability” test of Rev. Rul. 77-374. That ruling provides that a charitable remainder annuity trust doesn't qualify for a charitable deduction (and by implication isn't a qualified trust) unless the possibility that

the charitable transfer will not become effective is so remote as to be negligible. If there is more than a 5% probability that the noncharitable income beneficiary will survive the exhaustion of the trust assets, that probability isn't negligible. Rev. Rul. 77-374. The Tax Court upheld the "5% probability test" in Moor, 43 TCM 1530 (1982). However, the court also held that the test is satisfied as long as the trust's annual earnings can be reasonably anticipated to exceed the required annual payout to the beneficiary.

3. CONCURRENT/SUCCESSIVE REMAINDERMEN

The governing instrument may provide for more than one charitable remainderman. If so, they can be concurrent or successive charitable remaindermen.

4. ALTERNATE CHARITABLE REMAINDERMAN

The governing instrument must provide that if the named charitable remainderman is not a qualified charity under the Internal Revenue Code at the time of the distribution, then the distribution must go to an alternate charitable remainderman that is a qualified charity under the Internal Revenue Code at the time of the distribution and the governing instrument must provide the means in which the alternate charity is selected.

5. SUBSTITUTION OF ALTERNATE CHARITY BY GRANTOR

The grantor may substitute an alternate charity as the remainderman. Rev. Rul. 76-8, 1976-1 C.B. 179; PLR 200034019.

6. EARLY DISTRIBUTION OF CORPUS

Treas. Reg. §§1.664-2(a)(4) & 1.664-3(a)(4)

The governing instrument may permit the trustee of a CRT to make an early distribution of corpus to charity as long as, in the case of distributions in kind, assets distributed have adjusted bases fairly representative of the adjusted bases of all assets available. PLR200124010. Further, the governing instrument may provide that the grantor reserves the right to terminate the trust resulting in the acceleration of the distribution to the charity. PLR 9138024.

7. OTHER PAYMENTS

Treas. Reg. §§1.664-2(a)(4) & 1.664-3(a)(4)

No other payments can be made other than (1) the Annuity Amount or Unitrust Amount, (2) early distributions to charity or (3) distribution to charity upon termination.

F. Private Foundation Restrictions

1. SELF-DEALING

Trust must not be involved in self-dealing as precluded by IRC § 4941(d). Includes any direct or indirect: a) sale or exchange or leasing of property between a trust and a disqualified person; b) lending of money or extension of credit between a trust and a disqualified person; c) furnishing of goods, services, or facilities between a trust and a disqualified person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the disqualified person, Treas. Reg. § 53.4941(d)(3)(b)(1); d) payment of compensation (or payment or reimbursement of expenses) by a trust to a disqualified person, unless it is for personal services and such compensation is reasonable and necessary to carry out the exempt purpose and is not excessive, Treas. Reg. § 53.4941(d)(3)(c)(1); e) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and, f) agreement by a private foundation to make any payment of money or other property to a government official [as defined in § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. IRC § 4941(d).

A disqualified person is a substantial contributor to the CRT (an individual, trust, estate, corporation or partnership who or which contributes an aggregate amount in excess of

\$5,000 to the CRT, if his or her total contributions are more than 2% of the total contributions received), or a family member of a substantial contributor (spouse, descendants and spouses of descendants), or persons owning more than 20% of an entity which is a substantial contributor to the CRT (includes an entity in which a disqualified person [considering the attribution rules of I.R.C. § 4946(a)(4)] owns more than 35%).

Reimbursement for Expenses: Reimbursement to disqualified persons for travel expenses cause the CRT, the disqualified person and the Trustee to be potentially liable for penalty taxes for self-dealing, for making non-charitable expenditures, or possibly both. Such reimbursement of expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the CRT and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is “reasonable and necessary.” Treas. Reg. § 53.3941(d)-3(c)(1). Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. § 1.162-2(a). The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is “excessive.” Under Treas. Reg. § 1.162-7, an amount spent on director’s services will not be deemed “excessive” if it is only such as would be paid “for like services by like enterprises under like circumstances.” Treas. Reg. § 1.162-7 (i.e. As the organization would pay to someone independent of the CRT).

A grant by one private foundation (a CRT in this case) to another private foundation does not constitute self-dealing within the meaning of I.R.C. § 4941 even when one entity serves as Trustee of both foundations. Rev. Rul. 82-136 (1982-2 C.B. 300). *See also* Treas. Regs. Examples 53.4941(d)-2(f)(2).

Excise Tax on Acts of Self-Dealing: Any disqualified person who engages in an act of self-dealing is assessed an excise tax of 5% of that amount involved in the transaction for each year that the transaction is uncorrected. Additionally, a foundation manager who knows the act is prohibited but approves it may also be subject to a tax of 2.5% of the amount involved (up to \$10,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected and the 5% was initially assessed, the disqualified person is subject to being assessed an additional tax of 200% of the amount involved. Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to \$10,000 for each such act.)

2. EXCESS BUSINESS HOLDINGS

Section 4943 imposes an excise tax on the value of the “excess business holdings” of any private foundation. A private foundation created after May 26, 1969 has excess business holdings to the extent that it, together with all disqualified persons, owns in the aggregate more than 20% of the voting stock of an incorporated business enterprise (or corresponding interests in non-incorporated business enterprises). In general, where a private foundation acquires excess business holdings by gift or bequest, the foundation has five years from the date it acquires such holdings to dispose of them.

However, the excess business holdings provisions of Section 4943 and the “jeopardy investment” provisions of Section 4944 discussed below do not apply to any qualified CRT that has no charitable recipient of the Annuity Amount or Unitrust Amount IRC §4947(b)(3)(B). If the governing instrument permits payment of the Annuity Amount or Unitrust Amount to a charity and no additional charitable deduction was taken resulting therefrom, the CRT is still excluded from such prohibitions. Treas. Reg. §53.4947-1(c)(2)(ii) (Ex. 2). Or, the CRT is excluded from such prohibitions if the Trustee is prohibited from engaging in such prohibitions during any time the Annuity Amount or Unitrust Amount is made to a charitable recipient. Rev. Rul. 72-395, 1972-2 C.B. 340.

3. JEOPARDY INVESTMENTS

Section 4944 imposes an excise tax on a private foundation (and under some circumstances foundation managers) for investing any amount in such a manner as to jeopardize the carrying out of its exempt purposes. The imposition of an excise tax on “jeopardy” investments is intended to assure that the foundation managers adopt a “prudent person” approach toward the investment of foundation assets.

4. TAXABLE EXPENDITURES

Section 4945 imposes an excise tax on each “taxable expenditure” made by a private foundation. The term “taxable expenditure” includes amounts paid or incurred by a private foundation: (1) to influence legislation; (2) to influence the outcome of a public election or carry on voter registration drives; (3) as a grant to an individual for travel, study or other similar purposes (unless the IRS gives advance approval of the foundation’s grant-making procedures); (4) as a grant to an organization other than a “public charity” described in Section 509(a) or an “exempt operating foundation” described in Section 4940(d)(2) (unless the foundation exercises “expenditure responsibility”); and (5) for any purpose other than one specified in Section 170(c)(2)(B).

5. RESTRICTIONS ON INVESTMENTS

The governing instrument must not include a provision restricting the Trustee from investing the CRT assets in a manner which could result in annual realization of income or gain from the sale of CRT assets. Treas. Reg. §1.664-1(a)(3).

G. Taxes, Debts and Expenses

1. DEATH TAXES

Estate tax cannot be paid from a CRT. If such taxes were payable by the CRT, then the CRT would not exclusively operate as a CRT from its inception. The governing instrument must contain provisions for the payment of estate taxes from sources other than the trust itself. In PLR 8819021, the life interest of a survivor income beneficiary took effect only if the survivor beneficiary furnished funds for payment of federal estate taxes or state death taxes for which the trust was liable. Rev. Rul. 82-128, 1982-C.B. 71. Be careful in defining death taxes. The term “death taxes” does not necessarily include estate taxes. PLR 9225026.

2. DEBTS AND EXPENSES OF DECEDENT-TESTAMENTARY CRTS

The governing instrument must not permit the debts and expenses of a decedent’s estate to be made from the assets of a testamentary CRT. Treas. Reg. §1.664-1(a)(6) (Ex. 3).

H. Trustee

1. GRANTOR AS TRUSTEE

The grantor may be the trustee of a CRT even if the grantor is also a Recipient. Rev. Rul. 77-285, 1977-2 C.B. 213, PLR 9504012, PLR 200029031. In this case, the grantor must be careful to avoid imposition of the grantor trust rules.

a. Compensation to Grantor as Trustee -The trustee, who is also the grantor, may be entitled to reasonable compensation as trustee as long as 1) the compensation is not paid out of the grantor’s Annuity Amount or Unitrust Amount and 2) the compensation is reasonable and not excessive. Rev. Rul. 74-19, 1974-1 C.B. 155; Treas. Reg. §53.4941(d)-3(c)(1). In PLR 200135047 the Service addressed compensation for trustees of a private foundation, but the core issue of self-dealing is worth addressing. The trustees of the trust were required under state law to perform various duties such as physical custody and management of trust assets, accurate recordkeeping, personnel matters, investment decisions, and grantmaking. The trust intended to provide the trustees compensation and reimbursement of expenses for the performance of these services. The Service concluded that the trustees were disqualified persons under section 4946 (i.e., foundation managers) and that compensation would be self-dealing unless an exception applied. The Service ruled that because the

compensation is for “personal services”, is reported to be “reasonable and not excessive” and is necessary to carry out the trust’s exempt purpose, the compensation satisfies an exception to the self-dealing rules. PLR 200135047

b. Independent Valuation Trustee - The legislative history of section 664 indicates that Congress contemplated denying the charitable deduction when a grantor of a CRT, who was also Trustee, transferred hard-to-value assets (i.e. all assets other than cash, cash equivalents and marketable securities) to a CRT unless an independent trustee valued the hard to value assets. H.R. Rep. No. 413, 91st Cong., 1st Sess. 60 (1969), 1969-3 C.B. 200, 239. Thus, if the grantor is the trustee of a CRT, the governing instrument must provide that the annual valuation of the hard to value assets be prepared by an independent valuation trustee. The December 10, 1998, Regulations changed this requirement. Under the Regulations, a trust’s unmarketable assets must either be valued by an independent trustee or by a qualified appraiser. Treas. Regs. 1.664-1(a)(7). An independent trustee is a person other than the grantor, or the grantor’s spouse, a noncharitable beneficiary or a party related or subordinate to either of them. Treas. Regs. 1.664-1(a)(7)(iii). A co-trustee who is independent may value the trust’s unmarketable assets. A qualified appraiser is defined in Treas. Regs. Section 1.170A-13(c) and is more fully explained below at Donor’s Income Tax Deduction, I.B.4(a)(3).

2. CHARITABLE REMAINDERMAN AS TRUSTEE

The charitable remainderman may serve as trustee. It is necessary to check applicable state law to ensure the charity has trustee powers. Under Texas law, a charity can be the trustee of a CRT of which it is a beneficiary. Article 1396-2.31 of the Texas Nonprofit Corporation Act. Under federal law, the same is true as long as the proper notice is provided to the donor of the CRT. The Philanthropy Protection Act of 1995. Pub. L. 104-62.

3. GRANTOR’S RIGHT TO REMOVE AND REPLACE TRUSTEE

The governing instrument of a CRT may permit the grantor to remove and replace the trustee and the grantor can appoint himself as trustee. Rev. Rul. 77-285, 1977-2 C.B. 213.

I. Avoidance of Grantor Trust Imposition

A trust that is taxable as a grantor trust cannot qualify as a CRT. IRC §664(c); Treas. Reg. §1.664-1(a)(4). If it did, the trust’s income is taxable to the grantor. It is imperative to exclude any power of the grantor to cause the CRT to be taxable as a grantor trust. See Attachment 1 for pitfalls in this area.

J. Taxable Year

The taxable year of a CRT must be the calendar year. IRC §645.

TAX CONSEQUENCES OF A CRT

I. INCOME TAX CONSEQUENCES

A. Income

1. INCOME TO RECIPIENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT

The distributions to the Recipient of the Annuity Amount or Unitrust Amount are includable in the Recipient's gross income.

a. Characterization Rules

(1) FIRST - ORDINARY INCOME

The distribution is ordinary income to the extent of the CRT's ordinary income for that year and undistributed ordinary income from prior years. IRC §664(b)(1); Treas. Reg. §1.664-1(d)(1)(i)(a).

(2) SECOND - CAPITAL GAINS

The distribution is treated as capital gains to the extent of the CRT's capital gains for that year and undistributed capital gains from prior years. IRC §664(b)(2); Treas. Reg. §1.664-1(d)(1)(i)(b).

(3) THIRD - OTHER INCOME (includes tax exempt income)

The distribution is treated as other income to the extent of the CRT's other income for that year and prior years. IRC §664(b)(3); Treas. Reg. §1.664-1(d)(1)(i)(c).

(4) FOURTH - CORPUS

After all of the above is distributed, the distribution is one of corpus. IRC §664(b)(4); Treas. Reg. §1.664-1(d)(1)(i)(d).

b. Example Illustrating Four-Tier System

The NIMCRUT received \$7,500 of income for 1996, all of which was tax-exempt bond interest. It had no undistributed ordinary income or capital gain, except for \$30,000 in undistributed capital gain of prior taxable years, and its unitrust amount for 1996 was \$9,000. The amount distributable for 1996 was \$7,500 and, under the four-tier system, this amount will be characterized as capital gain rather than tax-exempt income (even though it actually arose in 1996 from tax-exempt sources). This is because no tax-exempt income will be deemed distributed until all undistributed capital gain for the current year and all prior years is deemed distributed. Thus, the trust's undistributed capital gain income goes down by \$7,500 and its undistributed tax-exempt income goes up by the same amount for purposes of characterizing 1997 and later distributions. Treas. Reg. §1.664-1(d)(1)(iii).

c. Distribution In Kind

The Unitrust Amount or Annuity Amount may be satisfied by making a distribution of property other than cash. This could happen with a CRAT or a fixed percentage CRUT where the Recipient is entitled to the fixed percentage. If the Annuity Amount or Unitrust Amount is satisfied by making a distribution in kind, the distribution in kind is deemed to be a sale of the property resulting in realization of gain by the CRT. Treas. Reg. §1.664-1(d)(5). For example, if a donor funds a fixed percentage CRUT with closely held C stock and then the stock cannot be sold after such funding, the trustee will be obligated to distribute enough stock to the donor to meet the annual fixed percentage and the CRUT will realize the capital gain on that stock even though it was not sold; that capital gain will be passed through to the Recipient under the income tax characterization rules above in I.A.1.a. causing the Recipient to recognize gain.

(1) CURE ONE - NIMCRUT

If the CRUT is a NIMCRUT version, the trustee would only be required to distribute the lesser of the annual net income or the fixed percentage. Thus, the distribution in kind would not be needed to satisfy the Unitrust Amount. However, the disadvantage of this approach is that the Recipient of the Unitrust Amount would often be limited to income. (Be attentive to the definition of income. See above at **Requirements**, Part II, B.1.c.).

(2) CURE TWO - The FLIP CRUT

The Final Regulations permit the use of a FLIP CRUT. (See above **Requirements**, Part II B.1.d.) A FLIP CRUT is a CRUT, funded with unmarketable assets, that initially provides for a Unitrust Amount equal to lesser of income (with or without make-up) or the fixed percentage and upon the sale of the unmarketable assets, flips to a fixed percentage Unitrust Amount.

2. DISTRIBUTIONS TO CHARITY

a. Distributions of Annuity Amount or Unitrust Amount to Charitable Recipient

The characterization order of the distribution is 1) ordinary income, 2) capital gains, 3) other income, and 4) corpus. Treas. Reg. §1.664-1(e)(1).

b. Early Distributions to Charity of Items Other than Annuity Amount or Unitrust Amount.

The characterization order of the distribution is 1) corpus, 2) other income, 3) capital gains, and 4) ordinary income. Treas. Reg. §1.664-1(e)(1).

3. TAXATION OF CRT

a. General Rule

The CRT is a tax exempt entity and thus, pays no income tax. It pays no income tax on any of its income and it recognizes no gains on sales of appreciated properties. IRC §664(c).

b. Exceptions

(1) STEP TRANSACTION

a. The Binding Commitment

The courts will collapse separate transactions if, when the first step was undertaken, there was a binding commitment to undertake the later steps. Maine Foods, Inc. v. Commissioner, 93 T.C. 181 (1989).

b. Interdependent Series of Transactions

The courts will collapse a series of transactions if they were so interdependent that the “legal relations created by one transaction would have been fruitless without the completion of the series” Id. at 199.

c. Pre-Arranged Series of Transactions

If appreciated property is contributed to a CRUT or CRAT and if the trustee of the trust is obligated, as of the date of the contribution, to sell such property, the Service will ignore the CRUT or CRAT as the seller of the property. Instead the donor is deemed the seller and the donor will recognize the gain. Palmer v. Commissioner, 62 T.C. 684 (1974).

d. Anticipatory Assignment of Income

The court stated that “once the right to receive income has “ripened” for tax purposes, the taxpayer who earned or otherwise created that right, will be taxed on any gain realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income...to determine whether a right has “ripened for tax purposes, a court must consider the realities and substances of events to determine whether the receipt of income was practically certain to occur.” Ferguson v. Commissioner, 9th Circuit, Tax Ct. Dkt. Nos 98-70095, April 7, 1999.

(2) GRANTOR TRUST TAXATION

This is really not an exception. If the trust is a grantor trust, it is not a CRT under Section 664. Treas. Reg. §1.664-1(a)(4). The drafter of the CRT must be careful not to include any provision which causes the CRT to be a grantor trust. See Attachment 1 for listings of items that will and will not cause grantor trust status.

(3) CRT HAS UNRELATED BUSINESS TAXABLE INCOME

Prior to the Tax Relief and Health Care act of 2006 (“TRHCA”), a CRT that had unrelated business taxable income in a taxable year lost its exempt status for that taxable year. As a result of the TRHCA, a CRT which has unrelated business taxable income in excess of \$1,000 will be subject to an excise tax equal to 100% of its unrelated business taxable income; Treas. Reg. §1.664-1(c); IRC §512(b)(12); Tax Relief and Health Care Act of 2006, P.L. 109-432, §424. The excise tax paid on the unrelated business taxable income is treated as being paid out of the corpus and is not allowed as a deduction to ordinary income. In this manner, the allocations under the four tier system are not affected by the excise tax.

a. Unrelated Business Taxable Income Defined

Unrelated Business Taxable Income is defined as income derived by an organization from any unrelated trade or business regularly carried on by the organization in excess of \$1,000. IRC §512(a)(1). An unrelated trade or business is one in which the conduct of the business is not substantially related to the exercise of the organization’s charitable functions. IRC §513(a).

i) The Sale of Assets by the CRT

The sale or disposition of inventory or property held primarily for sale to customers in the ordinary course of business will create unrelated business taxable income to the extent the proceeds therefrom exceed \$1,000. The sale or disposition of any other property will not create unrelated business taxable income. IRC §512(b)(5) & (b)(12).

b. CRT Has Debt Financed Income

Unrelated business taxable income includes any income from debt financed property. IRC §514(a). A CRT has debt financed income if the CRT acquires realty subject to a mortgage. The two exceptions are as follows:

i) Testamentary CRTs

The CRT will not have unrelated business taxable income for a period of ten years following the gift as long as it does not assume the debt. IRC §514(c)(2)(B); Treas. Reg. §§1.514(c)-1(b)(3).

ii) Inter vivos CRTs

The CRT will not have unrelated business taxable income for a period of ten years following the gift as long as (i) the debt was placed on the property more than five years before the date of the gift; (ii) the property was held by the donor for more than five years before making the gift; and (iii) the CRT does not assume the debt. Id.; See, PLR 9533014 (wherein the donor remained liable on the nonrecourse debt qualifying for the exception); but see, PLR 9015049 (wherein the grantor remained personally liable on the debt causing the CRT to disqualify because it was a grantor trust).

c. Examples of Transactions Causing Unrelated Business Taxable Income in a CRT

i) Borrowing from an insurance policy in the CRT - PLR 8745013

ii) Holding property subject to debt - IRC §514

iii) Income from oil and gas working interests - PLR 8834039

d. Examples of Transactions **Not** Causing Unrelated Business Taxable Income in a CRT

i) A third party using the assets of the CRT as collateral on a loan to the charitable remainderman - PLR 8807082

ii) Operation of business which receives rents from real property - PLR 9245036

iii) When the business is the donor of a CRT and the CRT sells assets of the business other than inventory and assets customarily held for the sale to customers - PLR 9340043; PLR 9413020

B. Donor's Income Tax Deduction

The value of the donor's federal income tax deduction is a function of 1) the type of charitable remainderman, 2) the kind of property contributed to the CRT, and 3) whether, at the end of the non-charitable term, the assets are a) distributed outright to the charitable remainderman or b) held in trust for the benefit of the charitable remainderman. IRC §170.

1. REMAINDERMAN IS A PUBLIC CHARITY

a. Public Charity Defined for This Purpose - IRC §170(b)(1)(A)(i)-(vi) & (viii).

For this purpose, a public charity includes churches, educational institutions, hospitals and medical institutions, university endowment funds, governmental units, publicly supported organizations under sections 170(c)(2) & 509(a)(2) (i.e. museums, drama companies, ballet companies, etc.), supporting organizations under section 509(a)(3), private operating foundations and two types of private foundations - distributing foundations and foundations that maintain a common fund.

b. Charitable Income Tax Deduction - Fair Market Value of Remainder Interest Subject to Applicable Percentage Limitation

The donor gets a federal income tax deduction for the fair market value of the remainder interest passing to charity subject to the following percentage limitations;

1. GIFT OF CASH AND NONAPPRECIATED PROPERTY

(a) Passes Outright to Public Charity At End of Non-Charitable Term - In year of gift, the donor's fair market value charitable income tax deduction is limited to 50% of his Adjusted Gross Income ("AGI") with a five year carry-forward. IRC §170(b)(1)(A); Treas. Reg. §1.170A-8(a)(2).

(b) Held in Trust For the Benefit of Public Charity At End of Non-Charitable Term - In year of gift, the donor's fair market value charitable income tax deduction is limited to 30% of his AGI with a five year carry-forward. IRC §170(b)(1)(B); Treas. Reg. §1.170A-8(a)(2).

2. GIFT OF APPRECIATED PROPERTY

(a) Passes Outright to Public Charity At End of Non-Charitable Term - In year of gift, the donor's fair market value charitable income tax deduction is limited to 30% of his AGI with a five year carry-forward. IRC §170(b)(1)(C)(i); Treas. Reg. §1.170A-8(a)(2).

(b) Held in Trust For the Benefit of Public Charity At End of Non-Charitable Term - In year of gift, the donor's fair market value charitable income tax deduction is limited to 20% of his AGI with a five year carry-forward. IRC §170(b)(1)(D); Treas. Reg. §1.170A-8(a)(2). IRC §170(e), which limits the charitable income tax deduction to the donor's adjusted basis in the property, does *not* apply. This section applies in two situations as follows: 1) as to gifts of appreciated property *to a private foundation* and 2) as to gifts *for the use of a private foundation*. IRC §170(e)(B)(ii). A gift to a CRT is not a gift to a private foundation. Under IRC §4947(a)(2), a CRT is made subject to the private foundation excise tax restrictions but this section does not provide the CRT is a private foundation. Thus, the gift is *not to a private foundation*. A gift to a CRT which continues as a trust at the end of the non-charitable term for the benefit of a public charity is not a gift for the use of a private foundation. Rather it is a gift for the use of a public charity. *See*, Treas. Reg. §1.170A-8(a)(2). However, if, at the end of the non-charitable term, the CRT wants to not be subject to the private foundation excise tax restrictions and private foundation reporting requirements, it will be necessary for the trustee of the CRT to file a Form 1023 to qualify the trust as a public charity. IRC §4947(a)(1); IRC §509(a). This is because at that time, the trust is a private foundation unless it can be shown to be otherwise. *Id.*

2. REMAINDERMAN IS A PRIVATE FOUNDATION

a. Private Foundation Defined For This Purpose - IRC §170(b)(1)(A)(i)-(vi) & (viii).

For this purpose, private foundation is defined as all organizations other than those defined as public charities for this purpose. In other words, it includes all private foundations except 1) an operating foundation, 2) a distributing foundation and 3) a foundation that maintains a common fund.

b. Charitable Income Tax Deduction

(1) GIFT OF CASH AND NONAPPRECIATED PROPERTY

The donor gets a charitable income tax deduction in the year of the gift for the fair market value of the remainder interest passing to charity limited to 30% of his AGI with a five year carry-forward. IRC §170(b)(1)(B). This is the deduction and applicable percentage limitation regardless of whether, at the end of the non-charitable term, the assets pass outright to the private foundation or are held in trust for the benefit of the private foundation.

(2) GIFT OF LONG-TERM APPRECIATED PUBLICLY TRADED SECURITIES

On June 30, 1998, the rule lapsed which allowed the donor to get a charitable income tax deduction in the year of the gift for the fair market value of the remainder interest passing to charity limited to 20% of his AGI with a five year carry-forward. However, the deduction was revived under the Tax and Trade Relief Extension Act of 1998 (Section 170(e)(5)(D) of the Code which created the lapse was stricken). Unlike previous relief where the deduction was extended (initially from December 31, 1994 to July 1, 1996 and then to June 30, 1998) the latest relief appears to be permanent; therefore, a charitable income tax deduction is currently allowed for a gift of marketable securities to a CRT valued at the fair market value of the remainder interest passing to charity, limited to 20% of the taxpayers AGI. This is the deduction and applicable percentage limitation regardless of whether, at the end of the non-charitable term, the assets pass outright to the private foundation or are held in trust for the benefit of the private foundation.

(3) GIFT OF ALL OTHER APPRECIATED PROPERTY

The donor's charitable income tax deduction is based on the donor's adjusted basis in the property contributed limited to 20% of his AGI with a five year carry-forward. IRC §170(e)(1)(B)(ii). This is the deduction and applicable percentage limitation regardless of whether, at the end of the non-charitable term, the assets pass outright to the private foundation or are held in trust for the benefit of the private foundation.

c. Planning Idea - Name as the charitable remainderman the donor's family foundation. Although the donor's income tax deduction is normally lower or limited to property's basis, this can be a technique to enable the family to retain control of the assets as the officers, directors and members of the family foundation.

3. FURTHER LIMITS APPLICABLE TO HIGH INCOME TAXPAYERS

- IRC §68

An individual whose AGI exceeds \$100,000 (as indexed; \$126,600 in 1999 for married persons filing jointly - the "Threshold Amount") the charitable deduction for that year is reduced by the lesser of 3% of AGI in excess of the Threshold Amount or 80% of the total amount otherwise allowed as itemized deductions. For taxable years beginning in calendar year 2006 and 2007, 3% of AGI limitation was reduced to 2%. For taxable years beginning in calendar years 2008 and 2009, the 3% of AGI limitation is reduced to

1%. For taxable years beginning after December 31, 2009, there is no limitation for high income taxpayers.

4. SUBSTANTIATION OF THE CHARITABLE GIFT

a. Qualified Appraisal

(1) WHEN MUST THE APPRAISAL BE DONE?

The qualified appraisal is required when the CRT holds unmarketable assets as defined in Treasury Regulation §1.664-1(a)(7)(ii). Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale. The appraisal must be prepared no earlier than 60 days prior to the date that the contribution is made and must be prepared no later than the due date of the return (with extensions) on which the deduction is claimed. Treas. Reg. §1.170A-13(c).

(2) THE CONTENTS OF A QUALIFIED APPRAISAL - Treas. Reg. §1.170A-13(c)

(a) The appraisal must be prepared, signed, and dated by a qualified appraiser as defined below.

(b) The appraisal must include the following information:

- A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
- In the case of tangible property, the physical condition of the property;
- The date (or expected date) of contribution to the donee;
- The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor which relates to the use, sale or other disposition of the property contributed. This includes restrictions on the donee's right to use or dispose of the donated property, all provisions which confer on anyone, other than the donee charity, the right to income from the donated property or the right to possession of the property, including voting rights to securities, a right of purchase, or a provision which earmarks the donated property for a particular use. As an added precaution, all agreement between the donor and the donee charity relating to the gift should be attached to the appraisal and incorporated into it by reference;
- The name, address, and taxpayer identification number of the qualified appraiser and, if the qualified appraiser is a partner in a partnership, an employee of any person (whether an individual, corporation, or partnership), or an independent contractor engaged by a person other than the donor, the name, address and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

- The qualifications of the qualified appraiser;
- A statement providing that the appraisal was prepared for income tax purposes;
- The date or dates on which the property was valued;
- The appraised fair market value of the property on the date (or expected date) of contribution;
- The method of valuation used to determine the fair market value, such as the income approach, the market data approach, or the replacement-cost-less-depreciation approach);
- The specific basis for the valuation, if any, such as any specific comparable sales transactions;
- A description of the fee arrangement between the donor and the appraiser.

(3) THE QUALIFIED APPRAISER - Treas. Reg. §1.170A-13(c)

(a) An appraiser who signs the appraisal summary upon its presentation to him by the donor. In this regard, no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property.

(b) To be a “qualified appraiser” the appraiser must sign and complete Internal Revenue Service Form 8283, Section B, denoted “Appraisal Summary.” The Appraisal Summary includes declarations by the appraiser that:

- i) The individual holds himself or herself out to the public as an appraiser;
- ii) Because of the appraiser’s qualifications as described in the appraisal, the appraiser is qualified to make appraisals of the type of property being valued.
- iii) The appraiser is not:
 - The donor or the taxpayer who claims or reports the deduction under §170 for the contribution of the property being appraised;
 - A party to the transaction in which the donor acquired the property being appraised (i.e. the person who sold, exchanged or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange or gift), unless the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price;
 - The donee of the property;
 - Any person employed by any of the foregoing persons or related to any of the foregoing persons under Section 267(b) (e.g. if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting);

- Any person whose relationship with any of the persons listed in (1) through (4) above would cause a reasonable person to question the independence of such appraiser. For example, an appraiser who is regularly used by any person described in (1) through (3) above and who does not perform a substantial number of appraisals for other persons has a relationship with such person that is similar to that of an employee and cannot be a qualified appraiser with respect to the property contributed.

iv) The appraiser understands that a false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability, and consequently the appraiser may have appraisals disregarded pursuant to 31 U.S.C. Section 330(c).

(4) WHAT IS DONE WITH THE QUALIFIED APPRAISAL, THE APPRAISAL SUMMARY, AND FORM 8283?

(a) Qualified Appraisal

The Qualified Appraisal is not required to be filed with the donor's federal income tax return. It must be kept with the donor's records.

(b) Appraisal Summary

The Appraisal Summary is required to be filed with the donor's federal income tax return.

(c) Form 8283

The original of Form 8283 must be filed with the donor's federal income tax return. The donor must keep a copy with his records.

5. FEDERAL RETURN FILINGS REQUIRED FOR A CRT

a. Form 5227

Form 5227, Split Interest Trust Informational Return, is an informational return that must be filed annually by the trustee of the CRT.

b. Form 1041-A

Form 1041-A, Trust Federal Income Tax Return, is another informational return that must be filed by the trustee of the CRT if such trust has gross income in excess of \$600.00.

c. Form 8282

Form 8282, Donee Information Return, must be filed by the trustee of the CRT if such trust sells, exchanges, or otherwise disposes of the trust assets within two years after the date the CRT received the property.

d. Form 709

Form 709, Federal Gift (and Generation Skipping Transfer Tax) Return, must be filed on April 15th of the year following the gift.

II. GIFT TAX CONSEQUENCES

A. Who is the Recipient of the Annuity Amount or Unitrust Amount

1. JUST THE DONOR

The donor gets a charitable gift tax deduction for the value of the remainder interest passing to charity. IRC §2522(a).

2. THE DONOR AND HIS SPOUSE

a. Spouse is only other Recipient of Annuity Amount or Unitrust Amount

The donor has made a gift to his spouse of the value of Annuity Amount or Unitrust Amount going to his spouse but such gift is shielded by the marital deduction if the spouse is the only other Recipient of the Unitrust Amount or Annuity Amount. IRC §2523(g). The donor also gets a charitable gift tax deduction for the value of the remainder interest passing to charity. IRC §2522(c)(2)(A).

b. Spouse and Others are Recipients of Annuity Amount or Unitrust Amount

For example, the donor, then his spouse and then their children are the Recipients. The donor has made a gift to his spouse which does not qualify for the marital deduction. IRC §2523(g). Further, the donor has made a gift to his children. However, the donor can retain the right to revoke by will his spouse's and children's rights to the Annuity Amount or Unitrust Amount without disqualifying the trust as a CRT and if so, the gifts are incomplete. Treas. Reg. §§1.664-2(a)(4); 1.664-3(a)(4); PLR 9517020; PLR 9326049. If done, the retention of the right to revoke by the donor results in the CRT assets being includable in the donor's estate at his later death. Rev. Rul. 79-243, 1979-2 C.B. 343; IRC §2038(a)(1); PLR 9326049.

3. SOMEBODY OTHER THAN THE DONOR'S SPOUSE

The donor has made a gift to that person in the amount of the present value of the Annuity Amount or Unitrust Amount unless the donor retains the right to revoke by will that person's right to the Annuity Amount or Unitrust Amount. Again, such retention of the power to revoke causes the gift to be incomplete but causes the assets subject to the power to revoke to be includable in the donor's estate.

(a) IRC Section 2702 Abuse

To circumvent the gift tax rules, previously a grantor would create a NIMCRUT first for a term of years for himself and then for the life of a child. Ordinarily, in such a case, the interest retained by the grantor will be valued at zero pursuant to IRC section 2702 causing the value of the grantor's gift to that other Recipient to equal the entire fair market value of the property transferred to the CRT less the present value of the remainder interest passing to charity. The Regulations under IRC §2702 included a broad exception for CRTs.

The Service has perceived an abuse whereby a NIMCRUT is used and funded with low income producing assets until the second Recipient's interest takes effect. At that time, the trustee invests in high income producing assets and the second Recipient gets the lesser of the trust's net income or the fixed percentage plus with regard to a NIMCRUT the ability to withdraw a make-up amount if the annual trust net income exceeds the fixed percentage amount thereby transferring substantial payments to the second Recipient without gift or estate tax.

(b) Final IRC §2702 Regulations

The Final Regulations amend Code Sec. 2702 regulations to limit the CRT exception to charitable remainder annuity trusts and fixed percentage charitable remainder unitrusts. In addition, an exception is provided for a secondary life interest in the donor. Code Sec. 2702 will not apply to a CRT with two

consecutive noncharitable interests, where the donor has the second of the two interests. A third exception applies where the unitrust's distributions are permitted only to the donor, the donor's U.S. citizen spouse, or both. All of these new rules apply to trust transfers on or after May 19, 1997. Treas. Reg. 25.2702-1(L)(3).

III. ESTATE TAX CONSEQUENCES

A. Inter Vivos CRATs and CRUTs

1. DONOR WAS RECIPIENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT

IRC §§2036(a); 2055(e)

a. Donor was Sole Recipient

The value of the CRT assets is includable in the donor's estate but such inclusion is shielded by the estate tax charitable deduction for the value of the assets passing to charity at the donor's death.

b. Spouse is Sole Succeeding Recipient of Annuity Amount or Unitrust Amount

The value of the CRT assets is includable in the donor's estate but such inclusion is shielded by (1) the marital deduction for the value of the Annuity Amount or Unitrust Amount going to the spouse and (2) the charitable deduction for the value of the remainder interest going to charity.

c. Spouse and Others Are Succeeding Recipients of Annuity Amount or Unitrust Amount

The value of the CRT assets is includable in the donor's estate. The value of the Unitrust Amount or Annuity Amount going to the Recipients is not shielded by the marital deduction. The value of the remainder interest passing to charity is shielded by the charitable estate tax deduction.

2. DONOR WAS NOT A RECIPIENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT

a. Somebody Other Than Spouse Was Recipient

The value of the CRT assets is not includable in donor's estate unless the donor retained the testamentary power to revoke such Recipient's interests. In that case, the donor's estate is entitled to a charitable estate tax deduction for the value of the remainder interest passing to charity.

B. Testamentary CRAT or CRUT

1. SPOUSE IS SOLE RECIPIENT

IRC §§2055(c); 2036(a); & 2056(b)(8)

The value of the CRT assets is includable in the donor's estate but such inclusion is entirely shielded by the marital deduction and the charitable deduction.

2. SPOUSE AND OTHERS ARE RECIPIENTS

IRC §§2055(c); 2036(a); & 2056(b)(8)

The value of the CRT assets is includable in the donor's estate. The value of the Annuity Amount and Unitrust Amount passing to the spouse and other recipient is not shielded by the marital estate tax deduction but the value of the remainder interest passing to charity is shielded by the charitable estate tax deduction.

3. SOMEBODY OTHER THAN SPOUSE IS RECIPIENT

IRC §§2036(a) & 2055(c)

The value of the CRT assets is includable in the donor's estate but the value of the remainder interest passing to charity is shielded by the charitable estate tax deduction.

FUNDING OF CRTs

I. INTRODUCTION

A. Primary Advantage 1 of a CRT

Nonrecognition of Capital Gains

A CRT is a tax exempt entity and therefore, upon the sale of an asset, capital or otherwise, the CRT recognizes no gain. A donor can contribute highly appreciated property to a CRT and benefit from the appreciated value of the asset because the donor's Unitrust Amount from a CRUT will be greater due to such assets high value not reduced by income tax on the appreciation. The donor benefits from the appreciation and at the same time the donor avoids payment of the tax from the appreciation. The key here is to make sure that as of the date of the funding (not just creation) of the CRT that there is no legal obligation to sell such asset. The trustee must be under no legal obligation to sell the asset. If, when the trust receives the asset, the trustee is subject to an obligation to sell, the Service will ignore the gift to the CRT and treat the transaction as if the donor sold the asset. The donor then gets the worst of both worlds -- payment of tax and loss of the asset. Palmer v. Commissioner, 62 T.C. 684 (1974); Rev. Rul. 78-197, 1978-1 C.B. 83 (wherein the Service acquiesced to the position of Palmer).

B. Primary Advantage 2 of a CRT

Growth of Assets in a Tax Exempt Entity

Since a CRT is a tax exempt entity, the value of the assets in the CRT can grow at a faster rate because gain realized on the sale of assets of the CRT is not recognized for income tax purposes in the CRT. The Recipient of the Unitrust Amount from a CRUT gets the benefit from such growth since the fixed percentage is applied to a larger capital base.

C. Primary Disadvantage of a CRT

Reduction of Assets Ultimately Passing to Donor's Family

The chief disadvantage of a CRT is that charity ultimately gets the assets in the CRT and not the donor's family. One way to curtail this disadvantage is to set up a non-estate taxable side fund for the donor's family with, among other options, an irrevocable life insurance trust. The death benefits paid to a properly structured irrevocable life insurance trust are excludable from the insured's estate and thus, the death benefits can be used as a non-estate taxable way to replace those assets going to charity in the CRT. The insured normally will pay the premium on the insurance policy through gifts to the irrevocable life insurance trust.

II. MARKETABLE SECURITIES

A. Low Basis Highly Appreciated Marketable Securities

The trustee of an inter vivos CRT is able to sell low basis, highly appreciated marketable securities without gain recognition. IRC §664(c). The sale proceeds can then be invested to produce payments to the Recipient, usually the grantor, in the form of the Annuity Amount or Unitrust Amount. In this way, the grantor benefits from the appreciation of his securities via his Annuity Amount or Unitrust Amount but has no taxable recognition of the gain from the sale of the securities while the proceeds or that in which they are invested are held by the CRT.

III. TAX EXEMPT SECURITIES

If the CRT also has realized (but unrecognized) capital gains, the Recipient may still have to recognize the income therefrom upon receipt of the Annuity Amount or Unitrust Amount under the tier approach applicable to distributions to Recipients. Thus, investment by the CRT in tax free securities may not be wise unless the return to the Recipient after income tax at capital gains rates is greater than the return to the Recipient after income tax at ordinary income tax rates if the CRT investments produce ordinary income (i.e. interest, dividends, etc...).

IV. REAL ESTATE

A. Unencumbered Real Estate

1. PERSONAL RESIDENCE

It is not a good idea to transfer a donor's personal residence to a CRT, whether unencumbered or encumbered, because the donor cannot live in the residence without committing a prohibited act of self-dealing. Rev. Rul. 76-357, 1976-2 C.B. 285.

2. NON-PERSONAL RESIDENCE REAL ESTATE

It is wise to use a NICRUT, a NIMCRUT or a FLIP CRUT so the trustee will not be forced to make a distribution in kind to make the distribution to the Recipient if the income of the CRT is not sufficient for the entire annual payment. If such was contributed to a CRAT or the fixed percentage CRUT, the trustee could be forced to make a distribution in kind because the trustee is required to distribute the Annuity Amount or Unitrust Amount based on the fixed percentage. A distribution of just the annual net income is not an option with the CRAT or fixed percentage CRUT.

B. Encumbered Real Estate

There are problems with using encumbered real estate to fund a CRT.

1. UNRELATED BUSINESS TAXABLE INCOME

Debt financed income is unrelated business income. IRC §514(a). A CRT with unrelated business income remains exempt, but the unrelated business income is subject to a 100% tax. Treas. Reg. §1.664-1(c); IRC §512(b)(12); Tax Relief and Health Care Act of 2006, P.L. 109-432, §424. Generally, if a CRT is funded with encumbered real estate, it will have unrelated business taxable income. Id. The two exceptions are as follows:

a. Testamentary CRTs - The CRT will not have unrelated business taxable income for a period of ten years following the transfer if it does not assume the debt. IRC §514(c)(2)(B); Treas. Reg. §§1.514(c)-1(b)(3).

b. Inter vivos CRTs - The CRT will not have unrelated business taxable income for a period of ten years following the gift as long as (i) the debt was placed on the property more than five years before the date of the gift; (ii) the property was held by the donor for more than five years before making the gift; and (iii) the CRT does not assume the debt. Id. But see, PLR 9015049 (wherein the grantor remained personally liable on the debt causing the CRT to be disqualified because it was a grantor trust).

V. SUBCHAPTER S STOCK

A. Contribution of the Stock

A CRT is not a qualified subchapter S shareholder and therefore, a donor cannot use subchapter S stock to fund a CRT. Rev. Rul. 92-48, 1992-1 C.B. 301. Section 1361 which deals with permissible shareholders of an S corporation has been amended to take effect on January 1, 1998. Such section provides that an organization which is 1) described in section 501(c)(3), and 2) exempt from tax under section 501(a), can be a shareholder of an S corporation. IRC §1361(c)(7)[6]. From a literal reading of such new section, it appears that a CRT still cannot be a permissible shareholder of an S corporation. A CRT is not exempt from tax under section 501(a). Rather, a CRT is exempt from tax under section 664(c). Further, even if this new section did permit a CRT to be a permissible S shareholder, pursuant to the new section, the dividends and the capital gain on a stock sale in excess of \$1,000 would be unrelated business taxable income thereby causing all the income of the CRT to be taxable for that year.

B. Contribution of the Assets of S Corporation by the S Corporation

The S corporation is a permissible donor of a CRT and may contribute its assets to a CRT. PLR 9340043. However, a trust will not qualify as a CRUT where the S corporation is the unitrust beneficiary for a term of years followed by an individual for the lifetime of the individual. PLR 200203034. Where the corporation is the beneficiary, the term of the CRT must be limited to a

term of years not to exceed twenty. Treas. Reg. §1.664-2(a)(5) and 1.664-3(a)(5). PLR 9340043. The shareholders of the S corporation report the charitable income tax deduction for the contribution on their personal income tax returns based upon the allocation from the S corporation's Form K-1's. If the CRT later sells the assets, there are several considerations.

1. LEGALLY BINDING OBLIGATION

As of the funding of the CRT, the trustee of the CRT must not have been legally bound to complete the sale. The obligation to sell must not have been entered into prior to such funding. *Palmer v. Commissioner*, 62 T.C. 684 (1974).

2. UNRELATED BUSINESS TAXABLE INCOME

The type of assets to be sold is crucial in determining whether the CRT will have unrelated business taxable income. There are two main types of properties that will cause unrelated business taxable income if sold by the trustee of the CRT. The first type of asset that will generate unrelated business taxable income is property held primarily for sale to customers in the ordinary course of business (i.e. inventory). IRC §512(b)(5); PLR 9340043. The second type of asset that will generate unrelated business taxable income is any asset which is encumbered with debt since such asset will create debt financed income which is unrelated business taxable income. IRC §514(a). The sale of other assets by the CRT will not create unrelated business taxable income. For example, equipment and buildings (as long as not inventory) will not create unrelated business taxable income. PLR 9413020.

VI. REGULAR C CORPORATION

Regular C Corporation stock can be used to fund a CRT. However, there are several considerations.

A. Excess Business Holdings

The CRT is treated as a private foundation for most purposes. Under Section 4943 private foundations may not, considering the attribution rules with other disqualified persons, own more than 35% (20% in some cases) of the voting stock of the corporation. However, with respect to the CRT the excess business holdings prohibition does not apply where a deduction was allowed under sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522 for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary. IRC §4947(b)(2). Since a CRT affords a deduction under section 170, the excess business holdings prohibition does not apply as long as a charity is not a Recipient of the Annuity Amount or Unitrust Amount. *Id.*

B. Legally Binding Obligation

As with all sales of assets transferred to a CRT, there must be no legal obligation to sell such assets prior to the contribution of the assets to the CRT. *Supra*, *Palmer*.

C. Self-Dealing

Prior to the contribution of stock to the CRT it is necessary to explore the relationship between the donor and the corporation; a family member of the donor and the corporation; and, between other donor corporations and corporation whose stock is gifted. There are several traps within the self-dealing rules which could create a prohibited act of self-dealing. Examples of the traps include a sale or exchange or leasing of property between a CRT and a disqualified person (unless it is without charge) IRC § 4941(d)(1)(A) and (2)(A); lending of money or other extension of credit between a CRT and a disqualified person (unless no interest is charged) IRC § 4941(d)(1)(B) and (2)(B). If the donor of the stock continues to own, considering attribution, after the gift to the CRT more than 35% (20% in some cases) of the voting stock of the corporation, the corporation cannot redeem the stock because this is prohibited self-dealing. However, if the offer to redeem is made on identical terms to all other shareholders who own the same class of stock, such redemption is specifically excepted from the self-dealing rules. IRC §4941(d)(2)(f); Treas. Reg. §53.4941(d)-3(d).

D. Unrelated Business Taxable Income

The sale of the stock itself will not create unrelated business taxable income. IRC §512(b)(5). Any income received as dividends from the stock will not create unrelated business taxable income. IRC §512(b)(1).

VII. LIMITED LIABILITY COMPANY

In PLR 200043047, the Service ruled that a charitable remainder unitrust could participate in a limited liability company. Under this ruling, two individuals created fifteen charitable remainder unitrusts. Each unitrust was for the benefit of a particular child or grandchild. The family also established an LLC to coordinate family investments. The fifteen unitrusts planned to invest in the LLC by contributing combined assets equal to approximately 80% of the LLC's current assets. As the family members individually contribute more assets to the LLC, this percentage is expected to decline. The LLC will be a disqualified person with respect to each unitrust. Additionally, the LLC elected to be treated as a partnership for tax purposes. The IRS ruled that (1) the CRT's participation in an LLC fund (including deposits and withdrawals) will not be a (sale or exchange) between the LLC and the CRUT pursuant to the self-dealing rules of IRC § 4941(d)(1)(a); (2) the CRUT's participation in an LLC fund (including deposits and withdrawals) will not be a "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation" pursuant to the self-dealing rules of IRC § 4941(d)(1)(E); and (3) the CRUT's reimbursement to the LLC of investment expenses incurred because of the CRUT's participation in an LLC fund will not be self-dealing given that these payments will be for personal services, reasonable and necessary for the carrying out of the CRUT's exempt purpose, as long as the amounts are not excessive.

VIII. OPTIONS

A. Old Position of Service - PLR 9240017

In PLR 9240017, the Service ruled that an option could be an asset used to fund a CRT and the Annuity Amount or Unitrust Amount would be based on the value of the contract right to purchase the donor's property at the purchase price provided in the option. The Service further ruled that the grantor would not recognize gain or loss on the assignment of the option to a third party.

1. USE OF OPTION TO FUND CRT

In a situation where a donor would like to fund a CRT with an asset but such asset cannot be used to fund the CRT, such as with subchapter S stock, the donor would fund the CRT with an option to purchase the "bad" asset.

B. New Position of Service

1. PLR 9417005

In PLR 9417005, the Service withdrew PLR 9240017 without explanation. The Service stated that "no inference should be made from [the]...withdrawal as to the proper tax treatment of the transfer to a CRT of an option to purchase property."

2. PLR 9501004

In PLR 9501004, the Service ruled that the transfer of an option to a CRT disqualified the trust as a CRT. The Service's rationale was that 1) the gift of an option is incomplete; and 2) an income tax charitable deduction is not allowable for the option. The result of such is that a CRT funded with an option fails to function exclusively as a CRT from its inception disqualifying the trust as a CRT.

IX. OTHER ASSETS USED TO FUND CRTS

A. Qualified Retirement Plan Benefits

Qualified Retirement Plan benefits can be used to fund a CRT.

1. WITHDRAWING THE PLAN ASSETS AND THEN USING ASSETS TO FUND CRT

The assets are withdrawn from the qualified plan causing income taxation. However, if the assets withdrawn are contributed to a CRT, an income tax charitable deduction will also be allowed in that year based on the value of the remainder interest passing to charity.

2. NAMING THE CRT AS A BENEFICIARY OF THE PLAN BENEFITS AT PLAN PARTICIPANT'S DEATH

There would be no estate tax by naming an *intervivos* or testamentary CRT as the beneficiary of the plan benefits at the plan participant's death. The participant's surviving spouse would be the Recipient of the Annuity Amount or Unitrust Amount with the remainder passing to charity. The participant's estate would be entitled to both a marital and charitable deduction for the value of the qualified plan benefits made payable to the CRT.

a. Qualification of Trust as a CRT

Designating a CRT as the beneficiary of retirement plan benefits will not disqualify the trust from being a CRT. PLR 9253038; PLR 9237020.

b. Is a CRT a Designated Beneficiary of Qualified Plan Benefits?

A trust is a designated beneficiary of a qualified retirement plan if as of the later of the date on which the trust is named as a beneficiary or the participant's required beginning date (April 1 of the year following attainment of the age 70 ½) and as of all subsequent periods during which the trust is named as a beneficiary, the following requirements are met: (1) it is a valid trust under state law (or would be but for the fact that there is no corpus), (2) it is irrevocable or will, by its terms, become irrevocable upon the death of the participant, (3) the trust has only identifiable individual beneficiaries and (4) a copy of the trust document is given to the plan administrator. A copy of the trust document must be provided to the plan administrator before his required beginning date and the participant must agree that if the trust document is later amended, the participant will, within a reasonable time, provide the plan administrator with a copy of the amendment. If the participant dies before required beginning date, the trustee of the trust must provide a copy of the trust document to the plan administrator by the end of the ninth month beginning after the participant's date of death. Prop. Reg. §1.401(a)(9)-1, Q&A D-5. However, when a trust has multiple beneficiaries, all of the beneficiaries must qualify as designated beneficiaries. Prop. Reg. §1.401(a)(9)-1, Q&A E-5 & H-2(b). A charity is not a designated beneficiary. Prop. Reg. §1.401(a)(9)-1, Q&A D-2, D-5 & D-6. Thus, a CRT will not qualify as a designated beneficiary.

(1) EFFECT

The effect of the CRT not qualifying as a designated beneficiary is that the distribution of the plan benefits will be accelerated to a term of either five years (if the death of the participant is before the required beginning date) or the life expectancy of the participant (if the death of the participant is after the required beginning date) causing accelerated income realization. However, since a CRT is tax exempt, such acceleration is irrelevant.

c. Income Tax Consequences

(1) TO RECIPIENT OF ANNUITY AMOUNT OR UNITRUST AMOUNT

The Recipient will have recognizable income as the Recipient of the Annuity Amount or Unitrust Amount.

(2) **PLAN PARTICIPANT'S ESTATE TAX RETURN**

The decedent's (who was the plan participant) estate tax return will reflect a charitable estate tax deduction in the amount of the value of the remainder interest passing to charity resulting in more of the estate ultimately passing to heirs.

B. Life Insurance

A life insurance policy may be used to fund an inter vivos CRT. PLR 8745013. This would be advantageous if the goal of the donor is to provide income for his or her surviving spouse for such survivor's lifetime. However, several issues need to be considered.

1. **PAYMENT OF PREMIUMS BY THE CRT**

The CRT must preclude the use of the income of the trust to pay the premiums on a life insurance policy on the life of the donor or the donor's spouse. If income is used, the trust is a grantor trust and such will disqualify the trust as a CRT. IRC §§677(a)(3) & 664(c). There are two ways around this rule:

a. **Use CRT Principal to Pay Premiums**

Be careful how you define "income" for this purpose. Income includes capital gains for federal income tax purposes. IRC §61. However, generally, income does not include capital gains for trust accounting purposes. For example, under Texas law, unless provided otherwise in the governing instrument, capital gains are allocated to principal. Texas Trust Code §§113.102(b) & 111.002. Be sure to restrict the trustee from using income, as defined for federal income tax purposes, for payment of the premiums on the life of the grantor or the grantor's spouse so the Service cannot find that capital gains, i.e. income for federal income tax purposes, are used to pay the premiums. PLR 8839008.

b. **Allocate Amounts Received to Principal in a CRUT - Lesser of Income Form**

A CRT that pays premiums on a life insurance policy will not be a grantor trust if (i) a NIMCRUT or NICRUT is used, and (ii) the amounts received on account of the insurance policy are allocated to principal. PLR 9227017. Since the Unitrust Amount is limited to income and the amounts received are allocated to principal, the amounts received will be a part of the remainder payable to charity. *Id.* It is suggested that for this purpose principal, to which amounts received are allocated, be defined for trust accounting purposes to not run afoul of the issue above.

2. **UNRELATED BUSINESS INCOME**

In PLR 8745013, the Service ruled that borrowing by the trustee from the cash value of an insurance policy caused unrelated business income.

3. **JEOPARDY INVESTMENT**

A life insurance policy could be a jeopardy investment under Section 4944 if the investment in the premium by the CRT outweighs the death benefit to be received by the CRT. In Rev. Rul. 80-133, a donor-insured donated a life insurance policy to a private foundation. The donor-insured had a ten year life expectancy. The private foundation began paying the premiums. The Service ruled that each payment by the private foundation was a jeopardizing investment because at the end of 8 years, the investment by the private foundation would have been greater than the death benefit under the policy. The Service stated "an investment shall be considered to jeopardize the carrying out of the exempt purpose of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence,...in providing for the long-term and short-term financial needs of the foundation to carry out its exempt purpose. In the requisite standard of care and prudence the foundation managers may take into account the expected return of an investment and

the need for diversification within the investment portfolio. Rev. Rul. 80-133, 1980-1 C.B. 258.

C. Qualified Replacement Property

In PLR 9547022, an individual sold his stock in a company to an employee stock ownership trust under an employee stock ownership plan sponsored by that firm. The individual reinvested the sale proceeds in qualified replacement property (“QRP”) and deferred gain under Section 1042. The individual proposed to transfer a portion of that QRP to a CRUT he established. Because no gain is realized on the transfer of the QRP to the trust, the Service ruled that the contribution to the CRUT will not cause a recapture of gain previously deferred under Section 1042.

D. Partnership Interests Controlled by Trustee

A CRT may be funded with partnership interests and the general partner may be the trustee of the CRT.

1. SELF DEALING

The initial funding of a CRT with partnership interests when the Trustee of the CRT is the general partner of the partnership is not an act of self dealing. PLR 9633007. However, any other transactions must be carefully scrutinized under the self-dealing rule to ensure no violation.

2. UNRELATED BUSINESS TAXABLE INCOME

The sale of the partnership, itself, will not create unrelated business taxable income. IRC §512(b)(5). If the partnership engages in an unrelated trade or business, the net income in excess of \$1,000 from such unrelated trade or business flowing through to the CRT will be unrelated business taxable income. IRC §§512(a) & 512(b)(12). If the unrelated trade or business generates rents from real property, such is not unrelated business taxable income, unless such property is debt financed. IRC §§512(b)(3) & 512(b)(4).

3. EXCESS BUSINESS HOLDINGS

The excess business holding prohibition does not apply to CRTs so long as a charity is not a Recipient of the Unitrust Amount or Annuity Amount. IRC §4947(b)(3).

4. NO (DEFINITE) WORD YET

The Proposed Regulation stated that the Service was studying the effect of a NICRUT or NIMCRUT funded with partnership interests when the general partner in control of the partnership distributions is the trustee of the CRUT. The Service does not like the general partner of the partnership, also the trustee of a CRUT, having the discretionary power to make partnership distributions thus, having the discretionary power to make the payment of the Unitrust Amount to the Recipient. The Final Regulations do not include any mention of this issue, so it is not clear whether the Service has reached any conclusion one way or the other on this issue. However, in PLR 200043047 the Service did approve numerous family CRTs investment in a limited liability company (to be treated as a partnership for tax purposes). There was no mention whether or not the CRTs were NIMCRUTs or NICRUTs.

ATTACHMENT 1 - GRANTOR TRUST AVOIDANCE

I. Grantor Trust Avoidance

A. Non-Exclusive Listing of Items Which Can Cause the Imposition of the Grantor Trust Rules

The following is a nonexclusive list of items which can cause the grantor of a trust being taxed on the income of the trust:

1. Grantor Is Personally Liable on a Debt of Property Contributed to Trust.

Under IRC §677(a) and Treas. Reg. §1.677(a)-1(d), the CRT has been held to be a grantor trust if the grantor remains personally liable on a debt on property contributed to a CRT. PLR 9015049.

2. The Trustee of a CRT is Able to Buy Life Insurance with the “Income” of the CRT on the Life of the Donor or the Donor’s Spouse

Under IRC §677(a)(3), the CRT has been held to be a grantor trust if the trustee is not precluded from using “income” of the trust to purchase life insurance on the life of the grantor or the grantor’s spouse. It is crucial to define “income” for this purpose as defined for federal income tax purposes in order to prohibit the trustee from using capital gains to purchase a life insurance policy. In PLR 8839008, the Service ruled that although the trustee was prohibited from using income for trust accounting purposes, the trustee was not prohibited from using income for tax purposes. Thus, the trustee, purchased a life insurance policy with corpus for trust accounting purposes and income for tax purposes. The trust was held to be a grantor trust. All CRTs, even if not funded with life insurance policies, should prohibit the trustee from using income, as defined for federal income tax purposes, to buy a policy on the life of the grantor or the grantor’s spouse.

B. List of Items that Have Not Caused Imposition of Grantor Trust Rules

The following is a nonexclusive list of items which the Service has ruled will not cause a CRT to be a grantor trust.

1. Grantor’s retention of right to change charitable remainderman - PLR 9504012; Rev. Rul. 76-8, 1976-1 C.B. 179
2. Grantor’s retention of right to terminate all or a portion of the trust corpus accelerating distribution to charity - PLR 9442017
3. Grantor’s acting as trustee - PLR 9504012
4. Grantor’s retention of right to remove and replace trustee - Rev. Rul. 77-285, 1977-2 C.B. 213
5. Grantor’s retention of investment authority over trust except to the extent of valuing those assets having no readily ascertainable fair market value - PLR 9442017
6. Grantor or grantor’s spouse as Recipient of Annuity Amount or Unitrust Amount - PLR 9504012

ATTACHMENT 2 - FORMS

(NOT PROVIDED IN THIS OUTLINE)

If you desire a copy of this attachment please contact Terry Monger at the following:

Phone: (817) 877-1088

Fax: (817) 877-1636

Email: tmonger@bwwlaw.com

If you have email, these documents can be provided to you free of charge. The documents can be mailed to you for the cost of postage and our firm's copying cost. A statement will be included when you receive the materials.