



Santa Barbara County's  
United Way

an income, estate and gift  
tax service for attorneys and  
other financial advisors

FOURTH QUARTER, 2005

## TECHNIQUES

# Charitable Remainder Trust and the Spousal Election: Time to Revisit and Revise

The charitable remainder trust (CRT) has proven to be an effective planning tool to meet financial and charitable goals. The tax-exempt status of CRTs and the charitable deduction created by the irrevocable transfer of assets into CRTs make them an attractive choice. However, if an outside party can invade a CRT to remove part or all of its assets, the trust could lose its tax-exempt status. Moreover, the IRS may revoke the grantor's claimed charitable deduction to the year(s) it was taken and require the trust to pay tax on its entire income since inception. Most creditors cannot invade a CRT that is properly created and administered. However, there is an important exception if the deceased donor's spouse exercises a right to a spousal share of a testamentary estate, also known as electing against the will. In several states, an election against the will can reach both probate and non-probate assets. And some state probate laws include the assets of a CRT among the non-probate assets that are subject to the election.

The IRS recently issued Rev. Proc. 2005-24 [2005-16 I.R.B. 1] that requires CRTs created after June 28, 2005 to include a written waiver of the right to elect against a will in a way that includes the CRT assets. This waiver requirement creates a patchwork of concerns for attorneys who draft or have ever drafted a CRT (concern also extends to any advisor that has ever recommended a CRT).

In this issue of *Techniques*, we examine the potential danger the spousal elective share poses for CRTs; the solution to the problem posed by the IRS; the criticism of the IRS solution; and advice on how to avoid the spousal elective share pitfall. Knowing the potential problem of the spouse's elective share and ways to avoid that problem is important to your charitably minded clients who wish to take advantage of the tax and financial rewards of CRTs.

*The Crux of the Matter*

*The Problem*

*The IRS Solution*

*Objections to the IRS  
Safe Harbor*

*What Steps an Advisor  
Should Take*

### **THE CRUX OF THE MATTER: THE UNIFORM PROBATE CODE — THE SPOUSAL SHARE — THE AUGMENTED ESTATE**

The National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgates a Uniform Probate Code (UPC) for consideration by individual state legislatures to "make laws more uniform among the states and [promote] a speedy and efficient system for estate administration." The first version of the UPC was created in 1969. The second version of the UPC arrived in 1991 (though it was revised in part in 1997, 1998, 2002 and 2003). Eighteen states have adopted the entire UPC and most other states adopted the UPC in part. As a result of NCCUSL's efforts, state probate laws are similar, but differences do exist among states.

The states that have adopted the entire UPC are: Alaska, Arizona, Colorado, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Jersey, New Mexico, North Dakota, Pennsylvania, South Carolina, South Dakota, Utah and Wisconsin.

Under the UPC, the spousal share is the statutory right of a surviving spouse to decline a bequest outlined in a will and, instead, take a percentage amount of the estate. The percentage is determined by the length of time the spouse and the decedent were married.

The UPC defines the probate estate as the property, whether real or personal, movable or immovable, wherever situated, that would pass by intestate succession if the decedent died without a valid will. Furthermore, the augmented estate includes not only the probate estate but also any irrevocable transfer in which the decedent retained the right to the income from the property if, and to the extent, the decedent's right terminated at or continued beyond the decedent's death. Thus, assets inside an irrevocable trust, such as a CRT created during the decedent's lifetime, are part of the augmented estate.

### THE PROBLEM: POTENTIAL DISQUALIFICATION OF THE CHARITABLE REMAINDER TRUST

If a spouse elects against the will and the assets of a charitable remainder trust are part of the decedent's augmented estate subject to the election, then the CRT can be invaded and assets removed to satisfy the elective share. If the CRT is invaded to satisfy the elective share, and the designated charities will not receive the full remainder, both the tax-exempt status of the trust and the charitable deduction to the trust grantor are negated. See IRC §664(d)(1)(B), (d)(2)(B). Thus, there is the possibility that the trust would pay income tax on all income received back to its origin. And invalidating the charitable deduction would require the grantor to revise his or her income tax returns for every year a charitable deduction was claimed.

### THE IRS CREATES A SAFE HARBOR: REV. PROC. 2005-24

In May 2005, the IRS issued notice under Rev. Proc. 2005-24 that outlines a solution to the potential pitfall of CRT disqualification by a spousal election against the will. The IRS has taken a prophylactic approach: all CRTs created after June 28, 2005 must be accompanied by a written waiver signed by the spouse that irrevocably waives the right of election with regard to CRT assets. To reach this safe harbor, the waiver must fit these specifications:

1. The spouse must irrevocably waive the right of election to whatever extent necessary to ensure that no part of the trust (other than the annuity or unitrust interest when the spouse is the named recipient under the terms of the trust) may be used to satisfy the elective share. The waiver must be: valid under applicable state law, and written, signed and dated by the spouse. The spouse does not need to waive the right to receive annuity or unitrust payment from the CRT, and careful drafting will avoid waiving rights not in issue.
2. For CRTs created on or after June 28, 2005, the waiver must be executed on or before the date that is six (6) months after the due date for the tax return of a Split-Interest Trust for the year in which the **latest** of the following occurs:
  - a. the creation of the trust;
  - b. the date of the trust grantor's marriage to the spouse;
  - c. the date the grantor first becomes domiciled or a resident in a state or jurisdiction whose law provides the right of election that could be satisfied from assets of a CRT; or
  - d. the effective date of applicable state law creating a right of election.
3. The CRT trustee must retain a copy of the signed waiver with the official trust records until such time as the waiver may be material to the administration of the trust under the IRC.

The IRS will disqualify any CRT created **after** June 28, 2005 that does not contain the spousal waiver *even if* the spouse does not (intend to) exercise the statutory right. A CRT created **before** June 28, 2005 does not necessarily require the spousal waiver and the CRT will not be invalidated for its susceptibility to the spousal elective share unless a spouse actually exercises such a right.

#### Should a spouse waive rights in a CRT created *prior to June 28, 2005*?

Cautious advisors will instruct their clients to obtain a waiver. Perhaps your client resides in a state in which a spousal share does not reach non-probate assets or the augmented estate. Perhaps the spouse of your client would never elect against the will since your client's estate plan effectively provides for the spouse. However, circumstances change – your client could move to a state in which a spousal waiver does reach the augmented estate. Instead of moving forward with the hope that a worst-case scenario will not arise, consider getting the spousal waiver to use the safe harbor the IRS has provided.

**Suppose a CRT was created after June 28, 2005 by a grantor domiciled and residing in a state in which a spousal waiver does not reach CRT assets. Should a waiver nevertheless be obtained?** Rev. Proc. 2004-25

states that no waiver of the right to elect is required if the applicable state law does not: (1) provide a spouse with a right of election to receive an elective share of the grantor's estate; or (2) include CRT assets in the grantor's (augmented) estate. However, cautious advisors should consider the possibility that the grantor may change residence or the state may itself amend its probate laws to include the UPC provision for both the elective share and the augmented estate. Rather than leaving the question of whether the trust loses its tax-exempt status to another time, advisors should take proactive steps to ensure the trust is protected by a safe-harbor waiver.

### OBJECTIONS TO THE IRS SAFE HARBOR

The introduction of the spousal waiver has inspired a good deal of consternation and criticism from philanthropic groups and practitioners. One notable example is an open letter dated May 5, 2005 by the American Council on Gift Annuities (ACGA) that addresses several perceived drawbacks posed by Rev. Proc. 2005-24 (in part):

1. Many practitioners may not be aware of the existence of Rev. Proc. 2005-24.
2. A CRT grantor may not necessarily know if his state enacts a new law that creates a spousal right of election to an augmented estate thus requiring a waiver.
3. A CRT grantor who remarries may not understand the need to obtain a waiver.
4. A waiver that anticipates a change in the law or a change in residence may fail to meet statutory requirements.
5. A spouse may be incapacitated or unable to sign a waiver (or an amended waiver).

The ACGA letter also suggests the IRS take alternative action to address the problem. The ACGA proposes that the IRS simply treat all charitable remainder trusts the way Rev. Proc. 2005-24 treats pre-June 28, 2005 trusts and not require a waiver of the right of election. In the unlikely event the right of election is exercised, the estate should report as income any income tax charitable deduction taken by the grantor when the grantor created the trust on the grantor's final income tax return. Also, if the right of election is exercised, the estate tax charitable deduc-

tion should be reduced – the grantor's estate should receive a deduction for the value of assets that actually go to the charitable remainder organization at the grantor's death (and not to pay the spouse's elective share). If, at the grantor's death, trust payments are to continue for the life of a successor recipient(s) before the charity gets its remainder interest, the estate tax charitable deduction should be reduced to account for the reduction in the present value of the charitable remainder after the spousal share assets are removed from the trust.

### WHAT STEPS SHOULD AN ADVISOR TAKE?

Assuming the IRS does not amend or revoke Rev. Proc. 2005-24, here are some basic steps an advisor should take:

- Advisors for all parties involved with CRT formation and administration (grantor, trustee, non-charitable beneficiaries and charitable beneficiaries) need to review charitable remainder trusts established before June 28, 2005 and decide whether a spousal waiver is appropriate.
- Advisors creating a new CRT should insist that the spouse sign a waiver, whether or not the waiver is absolutely necessary under applicable state law. As noted, the grantor may move into a state with different probate laws that make the waiver necessary, or the state of residence may change the probate laws that will make the waiver necessary. The IRS requires a waiver to meet state requirements so a generic waiver may not meet specific state requirements.
- Discussion of the spousal waiver could create tension between the spouses, especially if the spouse is not a non-charitable beneficiary of the trust. Because the waiver effectively disclaims a property right to assets, the spouse waiving his or her interest might have to seek independent counsel to be fully informed before making this decision.
- Advisors should educate CRT clients about the need for a spousal waiver even if the client is not currently married.
- Advisors should monitor IRS notices for any further revision of Rev. Proc. 2005-24 (the IRS has previously revised its procedures in light of constructive criticism).

In any event, practitioners and advisors need to take proactive steps to be certain their clients understand the import of Rev. Proc. 2005-24.

## *Effective Disclaimer Preserves Estate Charitable Deduction*

In his will, the testator bequeathed the residue of his estate to his daughter as an individual, but, in the event she disclaimed the bequest, the residue would go to a private foundation. The daughter and her husband were co-executors of the estate, and, also, the president and vice-president of the private foundation respectively. Under Reg. §25.2518-2(d)(2), a beneficiary that disclaims a bequest cannot retain a discretionary power to direct the enjoyment of the disclaimed interest. Would the daughter's disclaimer be a "qualified disclaimer" in view of her powers as an officer of the foundation?

The IRS permitted the daughter to disclaim the bequest, provided the private foundation amended its bylaws and charter of incorporation to segregate all gifts received by charitable bequest so that neither the daughter, nor her husband, would have discretionary power to direct the distribution of any funds received by the Foundation by a disclaimer of said funds. The disclaimer was effective under IRC §2518 and the estate tax charitable deduction was allowed under IRC §2055.

Source: PLR 200519042.

## *Reformed Trust Retains its Tax-Exempt Status, Avoids Characterization of Self-Dealing*

A donor created a Charitable Remainder Unitrust (CRUT) with the intent that the trust qualify as a Net Income Charitable Remainder Unitrust and that post-contribution capital gains would be included as part of the CRUT income. However, the irrevocable trust document did not contain a provision that allocated realized post-contribution capital gain to trust accounting income. The Trustee nevertheless administered the trust as if the provision had been included. The Trustee sought a state court ruling to permit an amendment *ab initio* that stated post-contribution capital gain will be allocated to trust income pursuant to IRC §643(b). The amendment resulted in additional payment from the trust to non-charitable beneficiaries.

In seeking a private letter ruling, the Trustee asked the IRS to rule on the issue of whether the additional income payments would be considered a form of self-dealing prohibited under IRC §4941. The IRS concluded that the judicial reformation of the trust *ab initio* did not disqualify the trust under IRC §664, nor did including the post-

contribution capital gains realized in trust income represent self-dealing under IRC §4941(d)(1)(E).

Source: PLR 200532022

## *IRS Releases New Sample CRUT Forms*

The IRS recently released sample CRUT forms with annotations and alternate provisions with instructions for use and applicability. The sample forms are:

- Inter vivos CRUT for one measuring life
- Inter vivos CRUT for a term of years
- Inter vivos CRUT for consecutive measuring lives
- Inter vivos CRUT for concurrent and consecutive measuring lives
- Testamentary CRUT for one measuring life
- Testamentary CRUT for a term of years
- Testamentary CRUT for consecutive measuring lives
- Testamentary CRUT for concurrent and consecutive measuring lives

The next issue of *Techniques* will feature a complete analysis of the new sample CRUT forms.

Source: Rev. Proc. 2005-52 through 2005-59.

This newsletter is for information and discussion purposes only.  
Each professional must evaluate the tax and financial consequences of each individual situation.  
The topics covered in this newsletter are discussed in more detail in our booklet, a copy of which you can receive simply by returning the enclosed card.



**United Way  
of Santa Barbara County**  
[www.unitedwaysb.org](http://www.unitedwaysb.org)

Judy Goodbody, CFRE, CRTP  
Gift Planning Services Officer

320 East Gutierrez Street  
Santa Barbara, CA 93101  
Tel 805/965-8591, ext. 120  
Fax 805/962-3461

[jgoodbody@unitedwaysb.org](mailto:jgoodbody@unitedwaysb.org)  
[www.unitedwaysb.org/endowment.html](http://www.unitedwaysb.org/endowment.html)

