



TECHNIQUES

Common Problems in Drafting and Administering Charitable Remainder Trusts

In this issue, we deal with common problems that arise in drafting and administering charitable remainder trusts (CRTs). We'll help you to anticipate these dangers, and we'll suggest solutions in some of the problem areas.

CRT TAX-QUALIFICATION

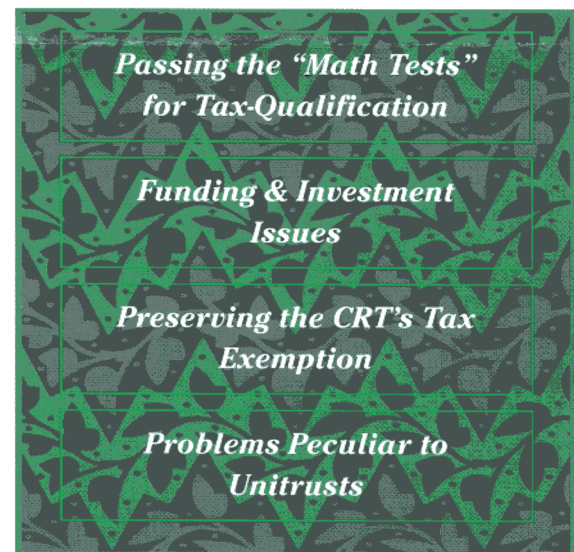
Passing the "Math Tests"

A CRT cannot pay out to its noncharitable beneficiary less than 5%, or more than 50%, of the initial value of the trust corpus in the case of a charitable remainder annuity trust (CRAT), or of the annually revalued corpus in the case of a charitable remainder unitrust (CRUT)¹. In addition, the present value of the charitable remainder interest must be at least 10% of the initial value of the corpus, and of any subsequent addition to the corpus of a CRUT².

A CRAT must pass an additional hurdle: the 5% probability test. This test assesses whether more than a remote actuarial probability exists that the trust corpus will be exhausted by payouts before the charity succeeds to its remainder interest³.

A trust that fails one of these "math tests" does not qualify as a CRT for tax purposes. A charitable deduction (for the present value of the remainder interest) will not be allowed upon creation of the trust, and the trust itself will not be income tax-exempt.

A recent private letter ruling involving a CRUT illustrates how a trust may fail the 10% minimum remainder test "inadvertently." Following the death of the grantor-beneficiary, the trust terms provided that the unitrust interests of two survivor beneficiaries would terminate at the death of yet another individual. Such a provision is permissible because a unitrust interest may terminate upon the occurrence of a "qualified contingency"⁴. However, a qualified contingency is disregarded in the actuarial calculations. Thus, the long income payout period (three beneficiaries) resulted in a failure to meet the 10% minimum charitable remainder test⁵.



Reforming the Trust

A CRT that is (1) faulty in design, or (2) doesn't reflect the donor's wishes, often may be reformed⁶. Typically, this involves getting a court of competent jurisdiction to agree, and then asking the IRS to rule that the reformation will result in a qualified trust.

Remedial action isn't always possible. The proposed changes may be so drastic that the IRS will not accept the reformation⁷.

CASES OF "MISTAKEN IDENTITY"

IRS letter rulings are instructive of mistakes made in drafting CRTs, as well as misunderstandings that may arise between a donor and his/her advisors. Often these rulings involve naming the wrong charity (or class of charity) as remainderman, designating the wrong income beneficiary, or setting up the wrong type of trust.

Wrong Charity (or Class of Charity)

The trust language may inadvertently limit the charitable remainderman to a private foundation by defining the class of permissible distributees as §170(c) organizations, without adding a reference to IRC §170(b)(1)(A), which

would restrict the permissible remaindermen to public charities only.

The opposite situation may also exist. The trust language may provide for a publicly supported charity as the remainderman when the donor's goal was for the remainder to pass to a private foundation. The IRS has permitted some CRTs to delete the reference to IRC §170(b)(1)(A), and to amend the document to provide for distribution to a private foundation to conform to the donor's intent⁸.

It's been many years since the IRS model agreements for CRUTs were revised; however, a revision is expected. The 1990-vintage model CRUTs, if followed without alteration, effectively limit the donor's deductions to those applicable to private foundations⁹.

The IRS issued revised model CRAT agreements in 2003¹⁰. The new model CRAT agreements put practitioners on notice that CRATs should refer specifically to IRC §170(b)(1)(A) if the donor's intent is to restrict distribution of the remainder to public charities.

Wrong Income Beneficiary

A CRT is an irrevocable trust and generally cannot be invaded, revoked, altered or amended for the benefit of individual beneficiaries¹¹. Nevertheless, the IRS has accepted reformations of certain drafting errors affecting the income beneficiaries. For example:

- The IRS has allowed a sprinkle provision in an inter vivos CRT to be amended to provide for equal distributions to the two income beneficiaries¹².
- The IRS has allowed a trust amendment to reallocate shares among income beneficiaries pursuant to settlement of a lawsuit¹³.

The IRS has refused to accept a reformation that changed the order of the noncharitable beneficiaries¹⁴.

Wrong Type of Trust

It is surprisingly common to find rulings in which the trust failed to conform to the strict requirements of either a CRAT or a CRUT under IRC §664, or even, in some cases, to the donor's instructions.

- A 2003 ruling involved a CRUT that allowed the trust to be invaded for the benefit of the income beneficiary¹⁵.
- In a 2002 ruling, a trust had been drafted as a CRAT when the donor wanted a CRUT¹⁶.

In helping your client select a CRAT or some form of CRUT (where there are several options), keep in mind that a CRAT provides the income beneficiary with greater certainty since the annuity is a fixed amount. With a CRUT, the unitrust amount varies year-to-year based on an annual revaluation of the trust corpus. Thus, if trust assets are appreciating, a CRUT can provide an inflation hedge. This may appeal to a younger donor who expects to receive many years of payouts as the income beneficiary.

A donor may prefer a CRUT for one beneficiary and a CRAT for another beneficiary. Or, a donor may prefer a term-of-years trust for one beneficiary, and a lifetime payout for another beneficiary. The potential advantages of multiple CRTs should be balanced against the increased set-up fees and administration costs.

AFR Selection: The income tax charitable deduction for a transfer to a CRAT is less when the monthly "applicable federal rate" (AFR) is low¹⁷. The charitable deduction for a CRUT also drops when AFRs decline; however, it is less sensitive to changes in interest rates than the CRAT deduction. Generally, the higher the AFR, the greater the likelihood that the 10% minimum charitable remainder test will be satisfied.

For a *testamentary* CRT, the AFR cannot be known until the donor's death. Thus, there can be no advance assurance that the 10% test will be met when the trust comes into existence. A testamentary CRT should include a clause that allows the trust to be reformed to reduce the payout rate, shorten the trust term, or both, to meet the 10% test¹⁸. The same logic applies to the 5% probability test.

ISSUES PECULIAR TO UNITRUSTS

Many IRS private letter rulings deal with issues that arise only in CRUTs.

Changing the Valuation Date

A CRUT agreement must specify an annual valuation date. A late-in-the-year valuation date can be administratively difficult. The IRS has permitted reformation of a CRUT to change the valuation date when a last-day-of-the-year valuation was specified in the original document¹⁹.

If the valuation date is January 1, or the first business day of the new year, the final payout from the previous year may still be unpaid. Subtract the unpaid unitrust amount from the previous year in valuing the trust corpus.

Making Additional Contributions

When a CRUT does not have a net-income limitation, it can be critical to consider the trustee's cash flow requirements, including both expenses and payout obligations. In some cases, it may be appropriate to transfer additional liquid assets to the CRUT. (A CRAT is not permitted to receive additional contributions after its initial funding.)

Caution: A CRUT can receive additional contributions only if the trust is drafted to permit additional contributions²⁰. If the CRUT document forbids additional contributions, the prohibition must apply to *all* persons, not just the donor²¹.

Changing the Type of CRUT

The IRS has permitted a "straight CRUT" to be reformed into a NIMCRUT, a net income with make-up CRUT²². At times, the IRS has permitted an income limitation to be dropped when it was inadvertently included in the

original document²³. On the other hand, some rulings have concluded that the trust is disqualified, or that self-dealing results, if the income limitation is dropped²⁴.

Flip CRUTs: If the donor wants to drop the income limitation at some point in the trust term, the attorney should utilize a “flip CRUT” *ab initio*. The trust document will include a clause that drops the income limitation on a specific date, or when a qualified “triggering event” occurs²⁵.

A triggering event generally must be out of the donor’s control. However, the regulations allow marriage, divorce, death, the birth of a child, and the trustee’s sale of unmarketable assets to be permissible “triggering events,” notwithstanding potential donor control or influence over the timing of these events²⁶.

Consider using a flip CRUT, or a net-income limitation, when it may be difficult to meet the annual payout requirements; when, for example, the CRUT is funded with illiquid, hard-to-sell assets such as real estate. **Caution:** Any makeup amounts will be forfeited when the trust flips to a straight CRUT.

FUNDING AND INVESTMENT ISSUES

A CRT document cannot mandate that a particular asset be held or sold. The reason is that the tax regulations do not allow a provision that “restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets”²⁷.

Here are some fact situations in which the IRS found that this regulation had been violated:

- wife was required to agree on investments²⁸;
- son had powers over successor trustee²⁹;
- trustee was required to follow investment advice³⁰;
- overly restrictive limitations on trustee with regard to investment in specified mutual funds³¹.

Use of trust assets by a beneficiary ordinarily will violate the self-dealing rules, and, in some situations, also may violate the rule against restricting the trustee’s investments³².

Certain valuation precautions, such as a qualified appraisal or an appraisal by an independent trustee, have to be taken when the trust is funded with (or subsequently invests in) “unmarketable assets”³³.

THE TRUST’S TAX EXEMPTION

Unrelated Business Income

While a CRT is usually exempt from income tax³⁴, it can lose its exempt status *with respect to all of its income for the year* if it receives unrelated business income³⁵.

For example, an actively managed coin-laundry operation in a CRT-owned apartment building might not be considered passive rental income, which is exempt. Thus, it could give rise to unrelated business income.

Income from flow-through entities, such as family limited partnerships and limited liability companies, also may expose a CRT to unrelated business income. This could be debt-financed income, such as income from the entity’s trading of securities on margin.

Anticipatory Assignment of Income

Also, watch out for “anticipatory assignment of income” issues. The IRS may assert that gain realized inside the trust is properly taxable to a donor who tried to “assign” income to the trust. The issue often arises in a real estate context when the donor has entered into a contract for sale prior to the gift to the CRT. (For a recent ruling in which the donor prevailed, see PLR 200321010.) It may help to introduce an independent trustee who can witness to the IRS that it was the independent trustee’s decision to sell trust assets.

OTHER ADMINISTRATION ISSUES

A CRT can lose its tax-qualified status if it is poorly administered — even if it was initially tax-qualified at its inception.

For example, one CRAT failed to obtain an estate tax charitable deduction at the grantor’s death because the trust had never actually paid the required annuity. Moreover, the trustee “double-faulted” by allowing the CRAT to be invaded to pay estate taxes³⁶. *Atkinson* serves as a warning that tax-qualification may be lost if the trustee disregards the IRC §664 requirements and/or the terms of the trust.

Footnotes

1. IRC §§664(d) (1)(A), (2)(A)
2. IRC §§664(d)(1)(D), (2)(D)
3. Rev. Rul. 77-374, 1977-2 C.B. 329
4. IRC §664(f)
5. PLR 200414011
6. IRC §2055(e)(3)
7. see, e.g., PLR 200350012
8. see PLRs 9818027, 9826021, 9826022
9. Rev. Proc. 90-31, 1990-1 C.B. 539
10. Rev. Procs. 2003-53 through 2003-60, 2003-31 I.R.B. 230-279
11. Reg. §1.664-2(a)(4), 1.664-3(a)(4)
12. TAM 9845001
13. PLR 8518032
14. PLR 9143030
15. PLR 200340001
16. PLR 200251010; see also the recent PLR 200422005
17. IRC §7520
18. see IRC §2055(e)(3)(J)(ii)
19. PLRs 200233005, 200233006, 200233007, 200233008
20. Reg. §1.664-3(b); see also Rev. Rul. 72-395, 1972-2 C.B. 340
21. PLR 7727017
22. PLR 200218008
23. PLRs 200338006, 200244011, 9822041, 9804036
24. PLR 9516040, PLR 9522021, PLR 9506015
25. Reg. §1.664-3(a)(1)(i)(c), (d)
26. Reg. §1.664-3(a)(1)(i)(d)
27. Reg. §1.664-1(a)(3)
28. PLR 7928076
29. PLR 7948108
30. PLR 8041100
31. PLR 8238085
32. see Rev. Rul. 73-610, 1973-2 C.B. 213
33. see Reg. §1.664-1(a)(7)
34. IRC §664(c)
35. IRC §664(c); see *Newhall Unitrust v. Comm’r*, 104 T.C. 236 (1995), *aff’d* 105 F.3d 482 (9th Cir. 1997)
36. *Estate of Melvine B. Atkinson v. Comm’r*, 115 T.C. 26 (2000), *aff’d per curiam* CA-11, 2002, *cert denied*, No. 03-86 (S. Ct. 10/14/03); see also Rul. 82-128, 1982-2 C.B. 71

Interest Was Deductible on Delayed Charitable Bequest

An estate was compelled to delay payment of a \$10 million charitable bequest for two-and-one-half years after the decedent's death until the organization's exempt status could be (favorably) determined. Under applicable state (Texas) law, the estate was required to pay interest at a statutory rate on the specific bequest because distribution was delayed by more than one year after the issuance of letters testamentary.

After paying the legally mandated interest, the estate filed for a refund of federal estate tax in federal district court. The estate's theory was that since the bequest was made contingent on the organization's charitable status at the decedent's death, the interest expense should be deductible as an estate administration expense under IRC §2053 (in addition to the \$10 million estate tax charitable deduction for the bequest itself). The district court upheld the estate's interest deduction and its claim for an estate tax refund.

Incidentally, the organization in question was not listed in IRS Pub. 78, the usual source for determining an organization's tax-exempt status. However, it was affiliated with an organization that was so listed, and therefore was determined to be tax-qualified for estate tax charitable deduction purposes.

Source: *Turner v. U.S.*, 2004-1 USTC ¶60,478 (N.D. Tex. 2004)

CBO Examines the Effect of Reduced Estate Taxes on Charitable Giving

An analysis by the Congressional Budget Office (CBO) estimates the potential effect of federal estate tax repeal or reduction on charitable giving. The CBO projects that a permanent increase in the federal estate tax exemption to either \$2 or \$3.5 million would reduce charitable giving by less than 3 percent. However, permanent repeal of the estate tax would have a greater impact, and decrease giving by 6 to 12 percent. According to the CBO analysis, the changes would affect not only charitable bequests but lifetime giving as well.

While repealing or reducing the tax would leave individuals with more wealth for philanthropic uses, they might also have less incentive to give without the threat of an estate tax. The CBO report describes the "cost" of charitable giving as increasing without the subsidy of a charitable deduction, or the need to reduce one's estate for federal estate tax purposes.

The CBO's theoretical projections should be balanced against the empirical results since EGTRRA was enacted in 2001. *Giving USA 2004*, the annual report on U.S. philanthropy, reports that bequests actually increased by 12.8 percent in 2003 over the previous year to an estimated \$21.8 billion — notwithstanding the prospects of an increasing estate tax exemption, a decreasing top estate tax rate, and Congressional proposals to make the 2010 repeal permanent.

Source: CBO, "Estate Tax and Charitable Giving," July 2004, available at <http://www.cbo.gov/Pubs.cfm>.

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