A Potpourri of Charitable Planning Tricks and Traps

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SECURE Act Charitable Implications

In late December, Congress has passed and the President signed legislation creating the Setting Every Community Up For Retirement Enhancement Act ("SECURE" Act). Although most of the new law deals with subjects not relevant to the charitable community, a number of the changes do have implications for charitable organizations and their donors.

Implication of Repeal of Maximum Age for Traditional IRA Contributions

Under prior law, only individuals who had not attained age 70½ by the close of the year were permitted to make contributions to a traditional IRA. (This restriction did not apply to contributions to a Roth IRA.) Under the new law, donors of any age can make contributions to an IRA. The deduction limits for such contributions are low: $6,000 in 2020 for total contributions to both traditional and Roth IRAs, plus a $1,000 catch-up contribution for individuals age 50 and older. In no event can the deduction exceed taxable compensation. Limitations also may apply if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan and if income exceeds certain levels.

IRA contributions are "above the line" so the deduction is available even to non-itemizers. Congress was concerned that because individuals over 70½ may now contribute to an IRA, donors would make tax deductible IRA contributions and then immediately roll them over tax free (up to $100,000 annually) to charity, thus allowing what are in effect tax deductible contributions to charity even for nonitemizers. Therefore the SECURE Act provides that the amount of an IRA rollover excluded from gross income is reduced by the total amount of IRA deductions allowed to the taxpayer for all years ending on or after the date the individual attains age 70½, less the amount of such reductions in prior years.

Implications of New Inherited Retirement Plan 10 Year Distribution Rule

The other main change with some charitable significance is the new 10 year distribution rule for retirement plans of employees and IRA owners who die after December 31, 2019. Under prior law, distributions to individuals from inherited qualified retirement plans could be spread over the individual's life expectancy. Under the SECURE Act, distributions must be made over no longer than a 10-year period following the death of the IRA owner. Certain exceptions apply, including distributions to spouses and minors, distributions for the benefit of chronically ill individuals, and distributions to individuals who are not more than 10 years younger than the IRA owner. The most common application of the new 10 year rule will be distributions to an adult child. One way to lengthen the distribution period for a donor with charitable interests might be to make the IRA death beneficiary a charitable remainder trust for the child. The trust would last for the beneficiary's life or a term of years and—for a donor with charitable interests—enable a considerable spread out of distributions to the child. Because the charitable remainder trust is tax exempt, it has some of the same benefits of the IRA itself, although, of course, this plan would not make sense for someone who has no charitable interests. Note also one drawback of the charitable remainder trust: payments must begin immediately, at

least as to income, whereas IRA distributions can be back loaded. The only requirement is that they must be completely distributed within 10 years. Use of a flip unitrust with sale of a nonmarketable asset used as a trigger may mitigate this disadvantage.

One drawback of this strategy is that for a relatively young child, it may be difficult to pass the 10% actuarial remainder test of Internal Revenue Code section 7520. For example, the actuarial value of the remainder in a 5% quarterly payment charitable remainder unitrust for the life of a 25-year-old beneficiary is only 9.3%. In addition, both under the old and the new law many donors may feel that 25 is too young to begin receiving a substantial stream of income. One solution might be to make the death beneficiary a charitable organization in exchange for a deferred charitable gift annuity starting at age 30 or 40. Although not all charities will issue gift annuities at such a young age, some might be willing if the annuity is less than maximum suggested American Council on Gift Annuities ("ACGA") rates. And if the child is, for example, 50 at the death of the account owner, a deferral to age 60 to provide income for retirement may well be acceptable to the issuing charity. The gift annuity language could be in the death beneficiary designation form or, if the IRA custodian will not permit this, in a separate charitable gift annuity agreement with the charity. The distribution could also be the purchase price of several deferred charitable gift annuities starting at different ages, or could be a step annuity with graduated rates if the issuing charity permits those. So long as the actuarial value is determinable as of the donor's death the actuarial value of the remainder will also be deductible for federal estate tax purposes. In order to make it determinable, the annuity contract could provide that the amount of the annuity will be set by reference to the maximum deferred charitable gift annuity payout rate recommended at the account owner's date of death by the ACGA. Charitable gift annuities have another advantage for the annuity recipient over the charitable remainder trust. An IRA distribution is ordinary income and will go into the unitrust's ordinary income tier, so all distributions to the income beneficiary will be taxed as ordinary income so long as any ordinary income remains in the top tier. Charitable gift annuities on the other hand are taxed under Internal Revenue Code section 72 like commercial annuities and part of each annuity payment is nontaxable return of investment in the contract over the annuitant's lifetime.

Make Charitable Gifts During Lifetime, Not at Death

Charitable gifts made during lifetime do double duty. A gift to charity at death by bequest is deductible for federal estate tax purposes, but there is no income tax or other benefit. The same gift made the day before death is removed from the estate for estate tax purposes (the gift tax charitable deduction, like the estate tax charitable deduction, is unlimited) but in addition the gift made the day before death to charity generates an income tax charitable deduction – two for the price of one.

Several techniques can be useful in accelerating charitable gifts into lifetime:

A. A client with charitable bequests in his or her will should consider making the gift during lifetime.

B. Alternatively, a person with charitable bequests in his or her will might consider signing a durable power of attorney giving the attorney-in-fact the right to prepay charitable bequests during lifetime.

C. If the primary dispositive document is a revocable trust, the revocable trust can provide authority to the trustee to prepay charitable distributions which would otherwise be made at death.

D. Finally, charitable remainder trusts and charitable gift annuities serve many valuable functions, but one of them is to accelerate into lifetime a charitable deduction for gifts of property or cash which will not pass to the charity until death. With a charitable remainder unitrust or annuity trust, or with a charitable gift annuity, the donor may keep an income stream and provide for the remainder to pass to charity at death, but receive an income tax deduction during lifetime.

Don't Waste the Charitable Deduction on Gifts at the First Death

Suppose that your client wishes to leave her entire estate to her husband, but also wants to make a $10,000 bequest to her alma mater. Many practitioners would simply draft a document saying, in effect, "I leave $10,000 to X charity and the residue of my estate to my husband." The problem is that this charitable bequest generates no tax benefit. There is no estate tax benefit because the marital deduction has eliminated the estate tax, and the bequest generates no income tax deduction either. A better way to handle this might be the following: "I bequeath $10,000 to my husband, and request, without intending to legally obligate him, that he make a gift of this bequest to X charity. I give and bequeath the rest and remainder of my estate to my husband."

This way the surviving spouse will receive the income tax deduction. If a marital trust or credit shelter trust is created, the will could provide that if the bequest has not been made by the surviving spouse by the time of his death, the bequest comes out of the marital trust so as to generate an estate tax deduction at that point, or if there is no marital trust the bequest could come out of the credit shelter trust.

Continued Confusion About Percentage Limitations After Enactment of Tax Cuts and Jobs Act

An apparent drafting oversight continues to create confusion about how percentage limitations work when both cash and noncash contributions are made in the same year.

Under prior law, cash gifts to charity were deductible up to 50% of the donor's contribution base. Contributions of appreciated capital gain property were (and continue to be) deductible up to 30% of the donor's contribution base. The Tax Cuts and Jobs Act raised the percentage limitation for cash gifts to 60% but as written, the full 60% limitation appears to be available only if no noncash gifts were given in the same year.

Here is an example under the *prior law* from the Harvard Manual, an excellent one-volume resource for all tax aspects of charitable giving: Assume a $100,000 contribution base, a cash gift of $22,000 and a gift of $30,000 of appreciated securities. Cash gifts come out first so if you subtract $22,000 from the $50,000 50 percent limit you are left with $28,000 in the 50% limit category. Although the $30,000 securities gift does not exceed the 30% limitation, the 30% limit is reduced to 28% because the cash gifts exceeded 20% of the contribution base. So only $28,000 of the securities would be deductible with a $2,000 carryover subject 30% limit.

Under the new law, the percentage limitation for cash gifts is 60% rather than 50%. In addition the 60% limit applies to cash only—it does not apply (as did old 50% limit) to gifts of property which would not have produced long-term capital gain if sold. It is not clear what happens if the donor makes contributions of securities or other property in the same year.

Charitable Deduction Case Example[1]

Mary Donor has a contribution base of $100,000. Sec. 170(b)(1)(H). During 2018 she makes gifts to Sec. 170(b)(1)(A) charities of $40,000 in cash and $35,000 of appreciated stock. The $40,000 cash is a 60%-type deduction under Sec. 170(b)(1)(G)(i), which excludes a 50%-type deduction under Sec. 170(b)(1)(A). The 60%-type cash deduction replaces the 50%-type deduction under Sec. 170(b)(1)(G)(iii)(I). Therefore, the $40,000 cash is fully deductible under 170(b)(1)(G)(i). The appreciated stock deduction of $35,000 is deductible under Sec. 170(b)(1)(B) as the lesser of 30% of the contribution base under Sec. 170(b)(1)(B)(i) or 50% of contribution base reduced by the cash gifts. See Sec. 170(b)(1)(B)(ii).

Charitable Deduction Method A

Under the pre-Tax Cuts and Jobs Act (TCJA) rules, the 2018 appreciated property deduction is the lesser of (1) $30,000 or (2) $50,000 (50% of contribution base) less the $40,000 cash gift deduction. Because $10,000 is lower than $30,000, the deduction is limited to $10,000. The Sec.

[1] Examples courtesy Charles Schultz, Crescendo Software

170(b)(1)(B)(ii) carryforward is $25,000. The Sec. 170(b)(1)(G)(iii)(II) Limitation Reduction provision requires a reduced deduction under "subparagraph (A) and (B)," but the reduction starts at the 50% level of Sec. 170(b)(1)(B)(ii).

Charitable Deduction Method B

Under the post-Tax Cuts and Jobs Act (TCJA) rules, the 2018 appreciated property deduction could be the lesser of (1) $30,000 or (2) $50,000 (50% of contribution base) less the $40,000 cash gift deduction. However, the Sec. 170(b)(1)(G)(iii)(II) Limitation Reduction provision requires a reduced deduction under "subparagraph (A) and (B)," with the 30% appreciated gift limit reduced by the cash gift amount. If the reduction formula starts with the 30% level, the $40,000 in cash gifts causes the 2018 appreciated deduction to be $0. The Sec. 170(b)(1)(B)(ii) carryforward is $35,000.

The dense language of the limitation reduction is almost a parody of complex tax prose:

> I.R.C. § 170(b)(1)(G)(iii)(II) Limitation Reduction — For each taxable year described in clause (i), and each taxable year to which any contribution under this subparagraph is carried over under clause (ii), subparagraph (A) shall be applied by reducing (but not below zero) the contribution limitation allowed for the taxable year under such subparagraph by the aggregate contributions allowed under this subparagraph for such taxable year, and subparagraph (B) shall be applied by treating any reference to subparagraph (A) as a reference to both subparagraph (A) and this subparagraph.

Everyone recognizes that this was undoubtedly a drafting error and that the purpose of the 2017 change was to permit an added 10% of cash gifts over the prior 50% and 30% limits. The Joint Committee on Taxation Blue Book explanation also suggests that Sec. 170(b)(1)(G)(iii) was not intended to change the prior 50% and 30% ordering. Blue Book page 51: "It is intended that any contribution of cash by an individual to an organization described in section 170(b)(1)(A) (generally, public charities and certain private foundations that are not nonoperating private foundations) shall be allowed to the extent that the aggregate of such contributions for the taxable year does not exceed 60 percent of the taxpayer's contribution base, reduced by the aggregate amount of the contributions allowed under section 170(b)(1)(A) for the year. In other words, the 60-percent limit for cash contributions is intended to be applied after (and reduced by) the amount of noncash contributions to organizations described in section 170(b)(1)(A)." Noting that a technical correction may be necessary to fix the problem, the JCT gave an example involving a donor with a $100,000 contribution base who contributes <u>unappreciated</u> property worth $50,000 and cash of $10,000. "The cash contribution limit under new section 170(b)(1)(G) is determined after accounting for noncash contributions. Thus, the $50,000 contribution of unappreciated property is accounted for first, using up the individual's entire 50-percent contribution limit under section 170(b)(1)(A) (50 percent of the individual's $100,000 contribution base), and leaving $10,000 in allowable cash contributions under the 60-percent

limit ($60,000 (60 percent of $100,000) reduced by the $50,000 in noncash contributions allowed under section 170(b)(1)(A)).”

Finally, The AICPA has submitted the following letter to the tax writers in Congress

> Dear Chairman Hatch, Chairman Brady, Ranking Member Wyden and Ranking Member Neal:
>
> The American Institute of CPAs (AICPA) respectfully recommends Congress address technical corrections on various provisions under Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act (TCJA)), which revised many sections of the Internal Revenue Code (IRC or “Code”).
>
> 3. Charitable Contribution Deduction — TCJA Section 11023
>
> The AICPA recommends that Congress provide a technical correction for section 170(b)(1)(G)(iii) as changed by the TCJA Section 11023 for the 60% of adjusted gross income (AGI) charitable deduction limitation to function as intended. We recommend that Congress replace the statutory provision with the language below:
>
> “Notwithstanding subparagraphs (A)-(F), a taxpayer may deduct a cash contribution to an organization described in subparagraph A up to 10% of their adjusted gross income in addition to any amount allowed in the current year (or under a carryover) under this subsection. Any amount contributed to an organization under this paragraph in excess of the 10% described in the preceding sentence shall be treated as a carryover paid in each of the 5 succeeding years in order of time.”
>
> The current statutory language in the TCJA reduces the allowed charitable deduction if assets other than cash are donated. This reduction results in a total percentage of 50%, rather than 60% of AGI. This reduction is the result even if one dollar of non-cash assets is donated (such as securities).
>
> This change would confirm Congress's intent to allow for the increased 60% of AGI limitation, assuming the additional amount is in cash (for example, 30% appreciated securities and 30% cash). Currently, under the TCJA, the taxpayer can only receive the increased 60% of AGI limitation if the entire donation is in cash.
>
> Sincerely,
>
> Annette Nellen, CPA, CGMA, Esq.
>
> Chair, AICPA Tax Executive Committee
>
> Washington, DC

All of which begs the question about what donors should do in reporting 2018 and 2019 gifts.

Qualified Appraisal Regulations Create Additional Confusion About Valuation of Interests in Charitable Remainder Trusts

A qualified appraisal question created by the final charitable substantiation regulations (TD 9836 effective July30, 2018) is creating new confusion in the charitable community: is a qualified appraisal necessary to value interests in charitable remainder trusts holding only cash or marketable securities. This issue can arise in two primary situations. Is a qualified appraisal necessary when the income beneficiary of a qualified charitable reminder trust holding only cash or marketable securities contributes the income interest to the charitable remainder beneficiary? And is a qualified appraisal necessary to value the remainder interest when such a trust is created? In the former case, some advisors believe an appraisal is necessary and others do not. In the latter situation, in the 50 years since the Tax Reform Act of 1969 gave us current section 664 a qualified appraisal of the remainder interest has never been thought to be necessary and it is difficult to see why an appraisal should be necessary if instead of contributing a remainder in the trust to charity the donor contributes the income interest. All that is required to value the interest in either case is to consult the tables in the regulations and apply the appropriate factor to the value of the trust assets on the date of contribution. (A similar issue exists if a charitable gift annuity annuitant contributes the remaining annuity interest to charity. but there the issue is a little less critical because the deduction is limited to the donor's unrecovered basis in the contract.)

The debate about the necessity of a qualified appraisal where an income interest is contributed to the remainder beneficiary is not new. But now the situation has become even more confused by the final substantiation regulations. One well-respected commentator has recently suggested that qualified appraisals may be necessary even on *creation* of CRTs funded solely with cash or publicly traded securities because of the language in Reg. 1.170A-17(a)(12) which states that "If the contributed property is a partial interest, the appraisal must be of the partial interest." I doubt the regulations were intended to require an appraisal on creation of a CRAT or CRUT, but now I can't be 100% sure, especially given this odd comment in TD 9836:

> "Some commenters suggested that appraisers be allowed to use certain IRS valuation tables, such as those for charitable remainder trusts, other remainder interests in property, and life insurance policies, instead of a qualified appraisal. These tables may be used to value property in certain other contexts, but they do not necessarily provide a fair market value of the property contributed. Therefore, these tables are not acceptable substitutes for a qualified appraisal to substantiate deductions for charitable contributions under section 170."

It seems to me that if a charitable remainder trust holds only cash or marketable securities, a qualified appraisal—either on creation of the trust or the later gift of the income interest—adds no useful information to the Service or anyone else and the requirement of a qualified appraisal remaining life or term income interests. I also think that if the Service really intended after all these years to require qualified appraisals of remainder interests on *creation* of CRTs funded with cash or marketable securities it would have done so more plainly than in this rather elliptical reference. But the language is there and the Service needs to tell us what it means.

Inclusion of Private Foundation in Gross Estate

Suppose I create a private foundation and name myself trustee. Is the foundation included in my gross estate under Code section 2036? The answer is clearly yes. In 1972 the Internal Revenue Service issued Revenue Ruling 72-552, 1972-2 C.B. 525 which held that the foundation would be included in the donor's estate because the decedent had the power to direct disposition of funds for charitable purposes. There is no exception in the gross estate inclusion rules for charitable transfers as there is in the grantor trust rules in Code section 674(b)(4). Having concluded that a private foundation is includable in the estate under these circumstances, do we care? The answer may be surprising: usually we will want the foundation to be includable in the gross estate. Although the foundation will be includable in the estate, it will be completely offset by the charitable estate tax deduction. Why do I then usually desire includability? The reason is that assets held by the foundation will receive a new basis. Again, why should I care since the foundation is tax exempt? The reason is that the private foundation excise tax imposed by section 4940 on investment income of private foundations includes capital gains. See Code section 4940(c)(4). If the assets in the foundation get stepped up on death, the excise tax could be reduced substantially. For this reason, it may be desirable in many cases to make certain that the donor is a trustee or officer of the foundation.

In two cases, however, it may be inadvisable for a foundation to be includable. The first case is, obviously, the situation in which assets have declined in value. Then, a step down in basis would increase the excise tax. The second situation is one in which it is important to qualify for section 303 or section 6166. Swelling of the gross estate by the foundation assets may in some cases make an otherwise eligible estate ineligible.

Several Recent Private Letter Rulings Illustrate the Interplay Between Code Sections 664 and 4947

Private Letter Rulings 201713002 and 201713003

Private Letter Rulings 201713002 and 201713003 are an interesting puzzle – what were the taxpayers trying to accomplish here? Also interesting is the significance of the subtle difference in wording between section 664 and section 4947.

Grantor in each ruling created charitable remainder unitrusts. It is clear that these were qualifying unitrusts because the rulings specifically state that deductions were allowable under Code sections 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522. However, the grantor did not claim a charitable deduction, either under section 170 for income tax purposes or section 2522 for gift tax purposes. The trusts requested rulings that the section 4947(a)(2) private foundation prohibitions were not applicable to the trusts.

Let's look at those sections. Section 4947(a)(2) makes the section 4941 and 4945 private foundation prohibitions against self-dealing and taxable expenditures applicable to certain nonexempt charitable trusts and to split interest trusts such as charitable remainder trusts. (The section 4943 and 4944 prohibitions against excess business holdings and jeopardy investments do not apply to charitable remainder trusts which do not make current distributions to charity.) But section 4947(a)(2) does not apply – and this was critical in these rulings – to split interest trusts unless a deduction was *allowed* under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2) or 2522.

But do I have a qualifying charitable remainder trust if no deduction was allowed? Consistent with Regulation section 1.664-1(a)(2)(iii)(a), the IRS ruled yes. That section provides that a charitable remainder trust means a trust with respect to which a deduction is *allowable* under section 170, 2055, 2106 or 2522 and which meets the specific requirements for a charitable remainder annuity trust or a charitable remainder unitrust. Why does the regulation use the word "allowable" rather than "allowed"? Probably because otherwise certain perfectly valid charitable remainder trusts would not qualify at all. An income tax charitable deduction may be allowable but not allowed because of percentage limitations; or because the taxpayer chose not to itemize deductions; or because the contribution was of ordinary income property with zero basis. And no gift tax charitable deduction may have been taken because the donor's retained right to change the charitable remainder beneficiary prevented a completed gift for gift tax purposes. So in order not to disqualify otherwise valid charitable remainder trusts simply because no deduction was available or needed, the regulations use the word "allowable" rather than "allowed."

What were the donors trying to accomplish with this trust which qualified as a charitable remainder trust, but for which they did not take a charitable deduction? (Possibly no gift tax deduction was allowed because of the retained right to change the charitable remainder beneficiary as noted above.) Perhaps what they were trying to accomplish was to avoid gain on

sale of a highly appreciated asset in a transaction that would have otherwise violated the self-dealing rules—a sale by the trust to a family member or other disqualified person. Code section 4941(d)(1) defines self-dealing as including any sale or exchange of property between the private foundation (in this case, the charitable remainder trust) and a disqualified person such as a family member. Or perhaps the plan was to have the stock redeemed by a corporation in a transaction which would have otherwise been a self-dealing transaction because the corporation was a disqualified person as defined in Code section 4946 and a redemption offer to all shareholders was either undesirable or not practical for other reasons. A redemption offer to all shareholders can be an exception to the self-dealing rules per Reg. section 53.4941(d)-3(d)(1). So, threading the needle, the Service ruled that although the trust was exempt from tax as a qualifying charitable remainder trust, the private foundation prohibitions would not be applied by section 4947(a)(2) because no income, gift or estate tax deduction had ever been claimed. Avoidance of gain here was obviously more important than a tax deduction.

Is the ruling correct? I believe it could easily have come out the other way. As noted above, it is likely that the section 664 regulations define a charitable remainder trust as one for which a deduction was *allowabl*e, rather than *allowed*, in order to avoid accidental disqualification of charitable remainder trusts where the deduction was not allowed for other reasons. It is difficult to believe that the drafters contemplated a situation in which the deduction was voluntarily foregone in order to avoid the private foundation prohibitions: the taxpayer is still getting the tax-exempt benefits of a charitable remainder trust. Another question arises as well. What happens when the grantor dies and all or a portion of the trust is now included in the grantor's estate by section 2036? Since the benefit of the lack of a deduction was avoidance of the self-dealing rules, can the decedent now take a federal estate tax deduction? Many years may have passed and the statute of limitations may have run on the first gift. Note the language in the ruling about future events:

"For future tax years, the burden would be on the taxpayer to keep the records to show, through the life of the unitrust, that no deduction was ever taken." Without this proof that no deduction has ever been taken, section 53.4947-1(a) of the Regulations would cause section 4947(a)(2) of the Code to be applied. Does the "life of the unitrust" end the instant before or after death? The future estate tax inclusion-deduction question is part of the continuing puzzle of these fascinating rulings.

Some problems with Charitable Pledges

Some background first about charitable pledges. The Internal Revenue Service has never treated legally binding charitable pledges consistently for tax purposes.[2] On the one hand, the Service does not treat satisfaction of a legally binding charitable pledge with appreciated property as a realization event resulting in income to the donor.[3] On the other hand, the IRS views legally binding pledges as a debt for estate tax purposes—they are deductible on the estate tax return not as a charitable contribution but as a debt of the decedent.[4] This can actually be useful. If a planner is concerned that the estate of a charitably inclined client might not quite meet the 35% of adjusted gross estate tests needed to qualify for section 303 and 6166, consider having the client make charitable pledges which are legally binding under the applicable state law. These will reduce the adjusted gross estate because debts are "above the line" deductions on the estate tax return.

Here is a possible trap to consider: are there *gift* tax implications of binding charitable pledges? Private Letter Ruling 201825003 and several other rulings over the past 30 years have created more confusion than guidance on the issue. In the 2018 ruling, taxpayer conveyed a remainder interest in art to two museums, retaining possession until the death of the taxpayer and the taxpayer's spouse. The transfer was contingent, however, on receipt of a ruling from the Internal Revenue Service that because the taxpayer was retaining dominion and control over the art work until death, the transfer was not a completed gift for gift tax purposes. The deed of transfer specifically provided that the taxpayer could not sell or otherwise dispose of the art work and that the taxpayer retained no power to change the disposition of the artwork to the museum. Without much discussion, but consistent with earlier rulings, the Service held that the transfer would be a completed gift when the pledge became legally binding but for the contingency of receiving a favorable ruling.

Unspoken but seemingly assumed was that the gift of the remainder interest would not have qualified for the gift tax charitable deduction: if it would qualify, the taxpayer wouldn't care if the gift was a completed gift. In fact, the issue of whether the gift would have qualified for the gift tax charitable deduction under Section 2522 was not even discussed in the ruling. But it makes sense that the gift tax charitable deduction might not be available. A gift of a remainder interest in tangible personal property with retained life estate is not one of the exceptions to the split interest gift rules which we find in Sections 170, 2055 and 2522, and isn't that essentially what a binding pledge is? It surely gives the pledgee some kind of enforceable property interest in the promised object. Gifts of a remainder interest in a personal residence or farm qualify, and remainder interests in trusts qualify if they are in the form of a charitable remainder unitrust or annuity trust. But nothing in the Code excepts gifts of remainders in other

[2] Charitable pledges may or may not be legally binding in any particular situation, depending on state law and other factors. That is a whole other interesting topic.

[3] Rev. Rul. 55-410, 1955-1 C.B. 297

[4] Reg. Section 20.2053-5.

kinds of property, certainly not tangible personal property, and Code section 170(a)(3) also denies a charitable income tax deduction in that situation. That provision was enacted in 1964 to prevent deductions where donors conveyed a remainder interest in art to a museum, retaining a life estate. The gift is treated as made only when there are no non-charitable interests in the property.

What about simple pledges of cash? Here we have an actual published ruling right on point. In Rev. Rul. 81-110, 1981-1 CB 479 the Service ruled that a legally binding pledge to contribute cash to charity was a completed transfer for gift tax purposes when the pledge became a binding obligation of the pledgor. The specific questions were whether if X pays off the charitable pledge of Y, X's payment is a gift to Y or to the charity, and if it is a gift to Y, when is the gift to charity by Y deductible for gift and income tax purposes. Not surprisingly, the Service ruled it would be treated as a gift to the pledgor rather than to the charity since it was in payment of the pledgor's legal obligation. But suppose that we had a more straightforward case involving simply a binding pledge to make a cash gift? Private Letter Ruling 8230156 involved an agreement to contribute cash and property upon the occurrence of certain conditions. The Service ruled that an income tax deduction would be available only when the pledge was paid, but that a gift would occur for gift tax purposes at the time the donor was obligated to make the gift. Without any discussion at all, however, the Service went on to note that donors would be entitled to a gift tax charitable deduction. But why? If I make a binding pledge to contribute cash in the future, haven't I retained income from the property until the gift is made? And is that not a split interest gift that doesn't come within any of the gift tax split interest gift exceptions?

What should be the correct analysis, even in the simple cash pledge situation? I would think a promise to make a gift of cash or marketable securities is different from a promise to make a gift of a painting. Cash and marketable securities are fungible. The eventual gift may come from any one or more securities or from one of several bank accounts. I might even decide to satisfy the pledge with a distribution from my retirement plan at death. So in the case of a promise of a cash gift, the correct analysis should be that even if an irrevocable pledge of art is a completed gift, an irrevocable pledge of cash or marketable securities is not.

So what can be done in the case of a donor who wishes to make a binding pledge to contribute art at death (or earlier) to a museum? Of course, the binding pledge can be made non-binding, a mere expression of intent. Beyond that there may be ways to deal with this. For example, the donor might provide in the agreement that he agrees to contribute either X artwork or cash in an amount equal to the value of the art as finally determined for estate tax purposes. The donor could also give the charity the option to purchase the property for the cash at the same value. This should prevent the gift from being a completed gift for gift tax purposes.

What about a loan of artwork? Can that constitute a taxable gift? We know that loans to individuals are taxable gifts under Section 7872. The regulations under section 7872 exempt loans to charity from section 7872, but only if at no time during the taxable year will the aggregate outstanding amount of loans by the lender to all charities exceed $10,000. Why should a loan to charity be a taxable gift? Because if it were not, taxpayers would have an easy way to avoid charitable contribution percentage imitations, just as individuals were able to avoid gift tax on loans to children before the enactment of section 7872. Code section 2503(g)

specifically provides that a loan of a qualified work of art is not a taxable gift in certain circumstances. That section provides as follows:

> **Treatment of certain loans of artworks.**
>
> **(1) In general.**
>
> For purposes of this subtitle, any loan of a qualified work of art shall not be treated as a transfer (and the value of such qualified work of art shall be determined as if such loan had not been made) if—
>
> (A) such loan is to an organization described in section 501(c)(3) and exempt from tax under section 501(c) (other than a private foundation), and
>
> (B) the use of such work by such organization is related to the purpose or function constituting the basis for its exemption under section 501.
>
> **(2) Definitions.**
>
> For purposes of this section—
>
> (A) Qualified work of art. The term "qualified work of art" means any archaeological, historic, or creative tangible personal property.
>
> (B) Private foundation. The term "private foundation" has the meaning given such term by section 509, except that such term shall not include any private operating foundation (as defined in section 4942(j)(3).

This is certainly an area where more guidance would be useful!

Another—and common—issue is satisfaction of a binding charitable pledge by the donor's private foundation or donor advised fund. What happens if my private foundation pays off my charitable pledge? The Service views this as a self-dealing transaction to the foundation. Donor advised funds have similarly shied away from payment of a donor's charitable pledge, but they have a substantial enforcement problem: how do they know that a donors request to make a distribution to charity is in satisfaction of a charitable pledge? But relief may be in store. In Notice 2017-73, the Service indicated it is considering issuing "Don't ask, don't tell" regulations which would permit donor advised funds to make charitable distributions in satisfaction of a donor's binding pledge obligation, but only if the following requirements are satisfied:

1. The sponsoring organization makes no reference to the existence of a pledge when making the distribution;

2. No donor/advisor receives, directly or indirectly, any other benefit that is more than incidental; and

3. The donor/advisor does not attempt to claim a charitable contribution deduction with respect to the distribution even if the distributing charity erroneously sends the donor/advisor a written acknowledgement in accordance with Code section 170(f)(8).

The notice also discusses the problem of bifurcation. The most common situation in which this arises is the charity dinner, part of which is deductible and part of which is payment for the meal. What many donors would like to do is pay the nondeductible part themselves, and have the donor advised fund or private foundation pay the deductible part. Suppose, for example, that a ticket to a charity dinner costs $500 and the value of the meal received is $100. Many donors would like to pay the $100 personally and have their donor advised fund pay the deductible $400 part. The notice indicates it is not prepared to change its negative view of bifurcation, either for donor advised funds or for private foundations. Frankly, having been obligated to attended some of these charity dinners myself, I wonder whether attending the dinner is a benefit or a cost.

Here is a solution for a donor with a private foundation who is not certain whether the pledge will be paid personally or from the foundation: have the foundation make the pledge. Then either the donor or the foundation can pay the pledge without adverse tax consequences. If the donor decides to pay the foundation's pledge personally, it will be treated as a gift to the foundation, so the only downside maybe be a lower percentage limitation and limitation to basis if appreciated assets other than marketable securities are used to satisfy the pledge.

Internal Revenue Service Issues
Interesting Ruling on Sprinkling Charitable Remainder Trust

Private Letter Ruling 201845014
Released November 9, 2018

Sprinkling charitable remainder trusts are not common, but can be a useful tool in the right situation. The Internal Revenue Service has issued an interesting private letter ruling which provides a good roadmap for how to create one and deals with a gift tax issue not fully addressed in previous rulings.

The donor wished to create two charitable remainder unitrusts. The two trusts were essentially the same, except that the second trust included a second lifetime beneficiary. The first trust, which includes the essential details needed to understand what was going on here, provided that the grantor was the sole non-charitable beneficiary. On the death of the grantor, the trust would end and the remainder would pass to qualified charitable organizations. So far, nothing unusual. What was unusual here, however, was that only a portion of the unitrust amount was required to be paid to the grantor. The rest of the unitrust amount would be required to be distributed to the grantor-beneficiary only to the extent that the independent trustee determined it was necessary to ensure that the total portion of the unitrust amount distributed to the grantor was more than de minimis. Any part of the unitrust amount not required to be distributed to the grantor could be distributed by the independent trustee without the approval or consent of any person to such one or more of the grantor and charities in a class of charitable beneficiaries. The class of charitable beneficiaries would be those that the grantor, as an individual and not in a fiduciary capacity, designated from time to time. (The sprinkling of the unitrust amount between the grantor and the charitable beneficiaries must be made by an independent trustee to avoid having the trust treated as a grantor trust under Section 674. Although the regulations provide that receipt of the unitrust payment by the grantor is not a power triggering grantor trust treatment, there is no exception in the grantor trust rules for this kind of sprinkling power.) The power to designate the charities in the charitable class is, of course, acceptable – were if not, a grantor could not be trustee of her own private foundation in the form of a trust. The trust would become a grantor trust absent the exception in Code Section 674(b)(4), excepting from the general 674 rule a power to allocate among charitable beneficiaries.

Code section 664(d)(2), in defining a charitable remainder unitrust, makes it clear that not all of the unitrust amount must be paid to a non-charitable beneficiary: "For purposes of this section, a charitable remainder unitrust is a trust—

(A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, <u>to one or more persons (at least one of which is not an organization described in section 170(c)</u>…" (Underlining added.)

Earlier rulings have approved sprinkling unitrusts.[5] But why doesn't the sprinkling power render the amount of the income tax charitable deduction unascertainable and therefore non-deductible? Because the trust is not a grantor trust, any lead amount going to charity isn't deductible anyway, just as the lead interest in a non-grantor charitable lead trust isn't deductible.[6] So the sprinkling feature doesn't change the value of the lead and remainder interests for income tax purposes.

Previous sprinkling CRT rulings did not deal with the interesting gift tax question and there the unascertainable issue becomes important, because lead interests can qualify for a gift tax charitable deduction. No one would create a charitable lead trust if the lead interest paid to charity was subject to gift tax. Because all of the potential sprinkling amount could pass to charity but because that amount is not ascertainable when the trust is created, is there an argument that the lead interest in excess of the de minimis amount required to be paid to the non-charitable beneficiary is an immediate taxable gift not qualifying for the gift tax charitable deduction under Code section 2522 because the amount is unascertainable? The private letter ruling demonstrates an easy way to avoid this result. The donor retained the right to select the members of the charitable sprinkling class and that right remained revocable until the payment date. The power lapsed when the payment was made and at that point, the amount is ascertainable and qualifies for the gift tax charitable deduction.[7] And as noted above, the value of the remainder interest is unaffected by the sprinkling feature, so no unascertainable issue for income tax purposes, even if the gift had not been subject to grantor's retained power.

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[5] See Rev. Rul. 77-73 and PLR 200813023. Note that payment of any portion of the lead interest to charity may cause the trust to be subject to the excess business holdings and jeopardy investment provisions of Code sections 4843 and 4944. Code section 4947(b)(3)(B).

[6] IRC §170(f)(2)

[7] See Rev. Proc. 2005-52, one of the IRS sample charitable remainder trust forms, in which the Service noted: "The gift of the remainder interest will be incomplete for gift tax purposes if, for example: (i) the donor retains the power to substitute the charitable remainderman;"

What is the "Governing" Instrument for Section 642(c) Purposes?

CCA 201747005 AND CCA 201747005

Numerous section 642(c) deductions have failed because the specific distribution was not authorized by the governing instrument. In some cases, this makes perfect sense. For example in Harvey C. Hubbell Trust v Commissioner[8] the Tax Court disallowed a charitable deduction for distributions made to charity prior to the time such distributions were authorized. The trust provided that no charitable contributions were to be made until the death of the last beneficiary, so charitable distributions made before then were not made in accordance with the "terms of the governing instrument." Chief Counsel Advice 201651013 and the more recent 201747005, clearly involving the same case, are further evidence that trusts making distributions to charity continue to be vexed by the governing instrument requirement. The primary question posed in Chief Council Advice 201651013 was this: "Is a trust which has been modified pursuant to a state court order entitled to a section 642(c)(1) charitable deduction for current payments to charitable organizations which could only be made because of the modification?" Section 642(c) allows a charitable income tax deduction to a trust distributing amounts from gross income to charity but only if the distribution is made "pursuant to the terms of the governing instrument." What is the governing instrument?

Let's look first at the 2016 CCA and then see whether anything new was added to the discussion by the more recent CCA in response to the taxpayer's protest. Here are the facts, about which there seems to be no dispute. A family trust was modified by settlement agreement that divided the trust into two trusts, one for the descendants of each child of the grantor. The settlement was approved by a state court and, in earlier private letter rulings, the Service ruled that the division would not cause the trusts to lose their generation-skipping tax grandfathered status. Later, the trustees of one of the trusts filed an additional petition in state court requesting certain modifications, including modifying testamentary powers of appointment into inter vivos powers. (Both the testamentary and inter vivos powers allowed appointment of income and principal to charity.) The court approved the modification, and distributions were thereafter made to a private foundation.

On its original Form 1041, the trust did not claim a deduction for any of the payments to the foundation, but on an amended return the trust deducted both ordinary income and capital gains paid to the foundation under §642(c) and asked for a refund. The CCA was requested in connection with an examination of the return on which the charitable deduction was claimed.

The first question asked was whether the distribution was in fact made pursuant to the terms of the governing instrument or, more specifically, whether the modified instrument was the "governing instrument" for §642(c) purposes. Here the law is cloudy. On the one hand, the Supreme Court in *Old Colony Trust Co. v. Commissioner*[9] held that payments from a

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[8] TC Summary Opinion 2016-67 (2016)

[9] 57 S. Ct. 813 (1937)

discretionary trust to charity qualified for a charitable deduction even though the distribution was not required. More directly on point was the decision in *Crown Income Charitable Fund*[10] involving commutation of a charitable lead trust. Both the court of appeals and the Tax Court held that the excess distribution triggered by the commutation were not deductible under §642(c) because they were not made pursuant to the terms of the governing instrument.

A particularly narrow holding cited by the CCA is the one found in *Brownstone v. United States*[11] in which a surviving spouse exercised a general power of appointment over a marital deduction trust in favor of her estate, all of which passed to charitable organizations. The court held that the distribution to the charities was made pursuant to the wife's power of appointment and not pursuant to the governing instrument. That seems like a particularly cramped reading and not one that would prevent any perceived tax avoidance abuse. No modifications were made to any instrument by settlement, court order or otherwise, and the power was exercised in full compliance with the governing instrument's requirements. Finally, based on this background, the CCA advised that the purpose of the court order in the instant case was sought not to resolve a conflict (settlement of a legitimate dispute might be a different case) but to obtain economic and tax benefits and that, based on *Crown* and *Brownstone*, the governing instrument requirement was not met.[12]

The CCA then considered whether the amounts could be deducted as a regular distribution deduction under §661. Section 663(a)(2) provides that amounts paid or permanently set aside or otherwise qualifying for the §642(c) deduction cannot be deducted under §661. The purpose of §663(a)(2) seems to be to prevent a double deduction: you can't deduct the distribution under both sections. However, the regulations under §663 go further and have long provided that amounts paid to charity by a trust or estate are deductible *only* under §642(c). If the distribution does not qualify under that section it cannot then be deducted under §661.

The CCA delved into the 1954 legislative history of §663(a)(2) and concluded that the legislative history was unclear as to the purpose and scope of that section. But by now a number of cases have upheld the §663 regulation reading. The most celebrated and discussed were the cases of *Mott v. United States*[13] and *Estate of O'Connor v. Commissioner*[14] which upheld the Service's position that distributions to charity are deductible *only* under §642(c) and that, if they do not qualify under that section, the distributions are not deductible at all. The distributions in those cases were distribution of corpus, not income, and so did not qualify under §642(c).

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[10] 8 F.3d 571 (7th Cir. 1993), aff'g 98 T.C. 327 (1992)

[11] 465 F. 3d 525 (2nd Cir. 2006)

[12] If the two distributions had occurred in the same year, these problems could have been avoided. The trust would have gotten a distribution deduction, the estate would have picked up the income and the income would have been offset by the 642(c) charitable deduction.

[13] 462 F.2d 512 (Ct. Cl. 1972), cert. denied, 409 U.S. 1108 (1973)

[14] 69 T.C. 165 (1977)

The CCA then looked to commentators and found that opinions were divided. After looking at the supporting commentators, the CCA then looked at those who disagreed. The first CCA is worth quoting at length:

> However, at least as many secondary sources in this area disagree with the disallowance under §661(a), at least under some facts. Another standard treatise, Ferguson, M. Carr, et al, Federal Income Taxation of Estates, Trusts, & Beneficiaries (current through 2016), states at §6.10: "The analysis [explaining why a single payment should not allow double deduction under §§642(c) and 661(a)] does not, however, answer the question whether amounts that pass to charity in such a way as not to qualify for the deduction under §642(c), such as amounts that pass to nonqualified quasi-charitable organizations or are used for purposes that are not exclusively charitable, escape the proscription of §663(a)(2). Obviously, such amounts do not qualify "for the deduction provided in §642(c)." Are they therefore deductible as distributions under §661? A literal reading of the statute strongly suggests that many such amounts should be. Even an undisputedly charitable beneficiary would be treated the same as any other beneficiary under the distribution rules, if it were not for §§642(c) and 663(a)(2). When no deduction is available under §642(c), §663(a)(2) seems to plainly not apply.
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> Ferguson then acknowledges that the *Mott* analysis is attractive under its facts because allowing the §661 deduction would allow the shifting of almost all of the estate's DNI to the charity, thus causing those amounts to escape taxation altogether, with the estate and the taxable beneficiaries paying little or no tax on the amounts ultimately received by those beneficiaries. "It is hardly surprising that a court would try to avoid this sort of awkwardness. What is surprising is that the same court that during the same year resorted to an extremely literalistic interpretation of the same statutory structure in deciding *Harkness v. U.S*[15] in which the taxpayer was unquestionably over-taxed, would have so openly defied the statute in *Mott*." In *Harkness*, a decedent's will divided the residual estate into equal parts, one for the benefit of his wife, and the other to be further divided into four trusts for his children, with all estate and inheritance taxes to be paid out of the children's share. In a year prior to final distribution of the residue, the executors paid a series of distributions totaling approximately $27.5 million to the widow, $8.4 million to the children's trusts, and $18.9 million in state and federal estate taxes. In other words, the total payments out of each half share were very nearly equal, with the taxes and children's payments together equivalent to the widow's payments. This was intentional on behalf of the executors, who would make an equalizing distribution to one side whenever a distribution or tax payment was made on the other, with the goal of keeping the corpus balance in the remaining residue equal, so that the income tax liability would also be equal, not requiring any calculations based on one side having more or less than a half interest. This was apparently an accepted practice under state law. The Court did not accept this tracing of additional payments to corpus, but applied the general rule of §662(a)(2) and divided the DNI proportionally to the beneficiaries based

[15] 199 Ct. Cl. 721 (1973), cert. denied 94 S. Ct. 115 (1973)

on their relative distributions, 76% to the widow rather than the claimed 50%. The *Harkness* dissenter actually criticizes the §662 anti-tracing rule on Constitutional grounds as creating an impermissible unapportioned direct tax on principal. The dissent also notes that *Mott* allowed tracing to defeat the taxpayer while the majority was disallowing it to the same end in the present case.

Ferguson continues: "Much water has passed under the bridge since the decisions in *Mott* and *Harkness*. To be sure, *Mott* now has a substantial judicial following. On the other hand, in extending the separate share rule to estates, as well as to trusts, Congress has not only overruled *Harkness*; it eliminated the over-taxation that accompanied its literalistic interpretation of the statute. In extending the separate share rule to estates, Congress also eliminated the need to depart from the statute in cases like *Mott*, to keep the estate and its other beneficiaries from going essentially tax-free on income charity never receives. By requiring the allocation of a Subchapter J entity's DNI among each of its separate shares, the separate share rule eliminates both over-taxation in cases like *Harkness* and under-taxation in cases like *Mott*. Under current law, Mrs. Harkness would remain taxable, but only on her share of the estate's DNI. Likewise, in *Mott*, the estate and its other beneficiaries would be taxable on all of its DNI, except that portion, if any, properly allocable to the charity's separate share. In short, under current law, there is no reason, in a case like *Mott*, for the court not to interpret the statute literally, and to allow a distribution deduction under §661 for a charitable distribution that does not also qualify for the deduction under §642(c), or for a distribution to a nonqualified quasi-charity. Each of the cases to the contrary arose well before Congress's extension of the separate share rule to estates. Stripped of their rationale, they no longer deserve deference. All that remains is the innocuous sentence in the regulation, which even the *Mott* court admitted found no support in the statute. Whether the regulation, as interpreted by the Service remains valid, now that Congress has extended the separate share rule to estates, is not obvious." Now that the separate share rule applies to estates, the abuse the courts worried about in Mott and O'Connor is not possible. Is the time ripe for the courts to reconsider those cases?

The CCA punted on the third issue, which was whether capital gains includable in DNI would also be deductible under §661, in view of the fact that no deduction was permitted under that section at all. Somewhat inconsistently perhaps, in Rev. Rul. 2004-5[16] the Service ruled that a charitable deduction which passed to the trust from a partnership was deductible under section 642(c) even though the governing instrument said nothing at all about charitable distributions. The Service had litigated this issue unsuccessfully in earlier cases.[17]

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[16] 2004-1 C.B. 295

[17] Estate of Bluestein, 15 T.C. 770 (1950), acq, 1951-1 C.B. 1; Estate of Lowenstein, 12 T.C. 694 (1949)

Subsequent CCA 201747005

CCA 201747005 was the Service's response to taxpayer's protest. Not surprisingly, the Service confirmed its earlier narrow view of the governing instrument requirement. The Service first rejected the trust's argument that the plain language of section 642(c)(1) allows a deduction for any charitable deduction that is not *ultra vires*. The Service's response was that a distribution made pursuant to a court order modifying a will is not made "pursuant to the terms of governing instrument" in the absence of a controversy involving interpretation of the instrument. The Service distinguished Old Colony because there the trust authorized but did require the trustees to make current distributions to charity. Also found not parallel by the Service was Love Charitable Foundation[18] involving a distribution to a foundation where the trust did not clearly authorize the trustee to make the payments and Crown Income Charitable Fund discussed above where the trust did not permit commutation. In this particular case, however, the trust was modified by court order and the question was whether the court order would be respected. Citing Revenue ruling 59-15, 1959-1 CB 164, the Service rejected application of the court modification since it did not arise from a conflict. It distinguished various private letter rulings which, in the Service's view, involved situations where state court orders were respected because either an ambiguity was clarified or there had been a scrivener's error. The most difficult case for taxpayer is the Brownstone case discussed above. The trust argued with respect to Brownstone that it would likely not be followed in another jurisdiction because it goes against the policy that charitable deductions are not to be narrowly construed. A better reading is that once modified by court order, the trust *was* the governing instrument. That argument carries a great deal of weight with this writer. In fact, one has to wonder what abuse the Service is concerned about.

The latest CCA also discussed the implications of Commissioner v. Bosch's Estate[19] involving when the Service must respect a modification of the trust under state law. The Service, predictably, argued that an order not from the highest court of the state would not be respected. "The Service is not arguing that the Modification Order is invalid or that it is not binding on the parties to the state law procedure. However, the decree does not determine the federal tax consequences of the modification; it only determines the rights of the parties under the modification order under the laws of the state." The taxpayer correctly pointed out that this seems inconsistent with Revenue ruling 73-142 where the Service did respect a court's construction of a trust in question. The taxpayer made additional arguments regarding the validity of Regulation section 1.663(a)-2 should the taxpayer's other arguments fail to carry the day.

The bottom line for this observer is that the narrow interpretation of "governing" instrument serves no policy purpose, prevents no tax abuse that I can divine, and seems generally inconsistent with a general policy of encouraging charitable giving. The end result of the trust division and the inter vivos distribution was to get dollars to charity earlier than they would have

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[18] 710 F.2d 1316 (8th Cir. 1983), affg. 540 F. Supp 238 (DC-MO., 1982)

[19] 387 U.S. 456(1976)

gotten them under the original, unmodified document. I understand that the case was ultimately settled on a basis reasonably satisfactory for the taxpayer. This case is far different from the Service's clearly correct view of the law in the Green[20] case, where there were very good reasons consistent with the statute to deny a fair market value 642(c) deduction. There the trust attempted to deduct the full fair market value of appreciated property distributed to charity, even though the gain had not been recognized. That was an easy case: unrealized gain is not "gross income" within the meaning of Code section 642(c).

[20] Green v. U.S., (880 F.3d 519 (10th Cir. 2018) *rev'g* 117 AFTR 2d 2016-700, (DC OK, 2016)

Drafting Issue for Year-End Charitable Remainder Unitrusts Solved by the Flip Unitrust

The final charitable remainder unitrust regulations issued in 2001 created administrative problems for charitable remainder unitrusts which may be alleviated by using a flip unitrust—a trust which is an income only until the first year after the occurrence of a triggering event. In order to counter the abuses of the accelerated unitrust, the regulations provide that normally payments from charitable remainder trusts other than income-only unitrusts must be made within the unitrust's taxable year. However, the regulations provide a rather complicated alternative: payments may be made within a reasonable time after the close of the year for which the payments are due if the character of the amounts in the recipient's hands is income under the charitable remainder trust tier system or the trust distributes property owned as the close of the taxable year to pay the unitrust or annuity trust amount and the trustee elects on form 5227 to treat any income generated by the distribution as occurring on the last day of the taxable year for which the amount is due.[21] The final regulations made some minor changes in the proposed regulations in response to comments received and in order to make it less likely that a non-abusive trust would violate the payment rule. Specifically, two exceptions were added to §§1.664-2(a)(1)(a) and 1.664-3(a)(1)(g). These exceptions provide that a distribution of cash made within a reasonable period of time after the close of the year may be characterized as corpus under section 664(b)(4) to the extent it was attributable to (i) a contribution of cash to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522 , or (ii) a return of basis in any asset contributed to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, and sold by the trust during the year for which the annuity or unitrust amount was due.

These requirements can still create considerable administrative difficulties in some very non-abusive situations. Take for example the simple case of a trust funded on December 28 with marketable securities. Either distribution of a small prorated payment must be made by the end of the year, which will often be impractical or the trustee must make a complex election which is deemed to generate gain. One way to deal with the practical problem is to draft these as flip unitrusts with the triggering event being December 31 of the first year of the trust. A donor may deliver a signed trust with a check (or stock and a stock power) to the charity on the last day of the year. The check will likely not even be deposited until January 2, at the earliest. What is the consequence of failure to make the pro-rated payment by the end of the year? The flip unitrust comes to the rescue by eliminating the need for the partial payment or election. This works because the anti-abuse regulation does not apply to an income-only unitrust. So consider making all year-end unitrusts flip trusts and make the trigger December 31.

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[21] In the case of trusts created before December 10, 1998 the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year for which it is due without regard to these rules if the percentage used to calculate the annuity or unitrust amount is 15% or less.

Use of Qualified Contingencies in Charitable Remainder Trusts

I. Code Section 664(f) provides that a trust which otherwise qualifies as a charitable remainder trust may include any qualified contingency. A qualified contingency is defined as any provision of the trust which provides that upon the happening of the contingency the unitrust or annuity trust payments will terminate no later than such payments would otherwise terminate under the trust. In English, this means that a charitable remainder trust can provide for early termination and acceleration of the remainder upon the happening of any event specified in the instrument.

A. Section 664(f)(2) provides that for purposes of determining the amount of any charitable contribution (or the actuarial value of any interest) a qualified contingency shall not be taken into to account.

B. Section 664(f) was added to the code in 1984 retroactive to transfers made after December 31, 1978. What planning opportunities does the qualified contingency exception present?

C. In terrorem clauses. An in terrorem clause provides that if a beneficiary contests a will or trust, the beneficiary will be treated as if he or she predeceased the testator.

1. Prior to 1984, the Internal Revenue Service ruled in a number of private letter rulings that the presence of an in terrorem provision in a charitable remainder trust disqualified the trust because the term of the trust was not measured solely by a term of years or the life or lives of one or more beneficiaries as required by Section 664. See Private Letter Rulings 7732011, 7942073 and 8321028.

2. The presence of Section 664(f) made those rulings obsolete. A qualifying contingency can be anything at all, no matter how remote or impossible to value, so long as the only effect of the contingency is to accelerate the charitable remainder. An in terrorem provision seems to be exactly the kind of qualified contingency Section 664(f) was designed to permit. So the in terrorem provision can be included in charitable remainder trusts without fear of disqualifying the trust under Section 664.

3. Note that with all such qualified contingencies, including in terrorem provisions, the contingency is not taken into account for any actuarial valuation purposes even if the contingency can, in fact, be valued.

D. What else can be done with qualified contingencies? Qualified contingencies may make possible creative payment sequences which were not permissible before Section 664(f) was added to the code.

Example: Suppose that A creates a charitable remainder trust solely for the benefit of child B. As B will inherit the bulk of A's estate, A would like to terminate the charitable remainder trust on A's death if it should occur prior to the death of B.

1. This would not have been permitted prior to Section 664(f) because the measuring life would have been a life other than the life of the beneficiary.

2. Section 664(f) permits this payment sequence. Since the only effect of A's death will be to terminate the trust early, the use of the qualified contingency exception makes permissible a payment sequence which was not permissible before Section 664(f). A payment sequence which on its face seems not permissible can be sometimes be tailored to meet the qualified contingency exception.

E. The remarriage charitable remainder trust. Suppose that donor wishes to create a testamentary charitable remainder trust for his or her spouse, which will provide that the unitrust or annuity trust payments to the spouse will cease on the spouse's remarriage. Such a provision may also be desired in a charitable remainder trust established as part of a divorce. What is the effect of the remarriage penalty?

1. It is clear that the remarriage provision is a qualified contingency under Section 664(f).

2. What about the marital deduction? The remarriage penalty makes the spouse's interest a terminable interest, but does it qualify for the marital deduction anyway?

3. Section 2056(b)(8) establishes a special rule granting an automatic marital deduction to the spouse's interest in a charitable remainder trust. If the surviving spouse of the decedent is the only non-charitable beneficiary, the terminable interest rule does not apply.

4. Does the remarriage penalty make the spouse's interest, however, unascertainable and therefore not deductible? The answer should be no. Section 664(b) provides that for "purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency shall not be taken into account." (underlining added). The real question is: does the underlined parenthetical language apply for chapter 11 and chapter 12 purposes as well as for income tax purposes? Since for income tax purposes the actuarial value of any interest other than the charitable remainder is irrelevant, it appears that the Section 664(b) language does apply for estate tax valuation purposes as

well, particularly since section 2055(e)(2) specifically references Section 664(b).

5. Note that no marital deduction will be permitted if another beneficiary follows the spouse's interest. (See further in these materials for a more detailed discussion of this issue.) Where a remarriage provision will be included, and the donor wishes to include a secondary beneficiary, the obvious alternative of the QTIP followed by a charitable remainder trust will not work either because the spouse's interest in the QTIP will not qualify for the marital deduction with the remarriage penalty.

F. Are there other qualified contingency planning opportunities?

G. Obviously, qualified contingencies are not permitted in charitable lead trusts, since the purpose would be to accelerate the non-charitable remainder. There is no policy objection to accelerating the charitable interest in the charitable remainder trust but plenty of policy objections to accelerating the non-charitable interests in a lead trust!

IRS Issues Helpful Revenue Procedure on Charitable Remainder Annuity Trust Exhaustion Test

Rev. Proc. 2016-42

The 5% exhaustion test of Rev. Rul. 77-374[22] has made it extremely difficult to create charitable remainder annuity trusts ("CRATs") in our current low interest rate environment. Rev. Proc. 2016-42[23] issued by the Service on August 8 provides a drafting solution which permits a CRAT which would otherwise fail the exhaustion test on creation to qualify. Credit goes to the California Bar Association and attorneys Charles T. Parks, Jr., William Finestone and Susan Leahy who outlined the proposal in a series of articles published in Tax Notes and elsewhere.

Background

As interest rates have dropped over the past decade, creation of qualifying charitable remainder annuity trusts ("CRATS") has become much more difficult for two reasons. First, section 664(d) includes an actuarial qualification test that both charitable remainder unitrusts and charitable remainder annuity trusts must pass: unless the actuarial value of the charitable remainder is at least 10% at the time the trust created, the trust fails to qualify. In addition, Rev. Rul. 77-374 imposes a second test that applies only to CRATs: the probability of exhaustion as calculated at inception of the trust must be no more than 5%. Although charitable remainder unitrusts are essentially impervious to interest rate changes[24] annuity trusts are extremely sensitive. The lower the interest rate, the less a stream of annuity payments is discounted. If the interest rate were zero, the right to $100 a year for 10 years would be worth $1000. So the retained annuity in a CRAT is worth more—and the charitable deduction less—when interest rates are low. For the same, reason annuity payments from a charitable *lead* annuity trust are also valued much higher when interest rates are low, so CLATs, unlike CRATS, are very favorable in a low interest rate environment.

Long before the 10% remainder test was added to the Internal Revenue Code in 1997, the Internal Revenue Service issued Rev. Rul. 77-374 dealing with a related but different issue. There the Service examined a testamentary CRAT created by a decedent who died in 1973. The trust provided for payment of a 10% annuity to a female[25] age 61 years. The federal interest rate in effect at the time the trust was established was 6%, so assuming a 10% payout the trust would at some point run out of money actuarially. In the ruling example, the trust was exhausted in 16 years and the probability that the 61 year old female would survive to age 77 was greater than

[22] 1977-2 C.B. 329

[23] It was initially misnumbered by the IRS as Rev. Proc. 2016-41.

[24] Unitrusts are completely unaffected by interest rates if unitrust payments are made annually and there is no gap between valuation date and payment date.

[25] Prior to 1984 the Service required separate actuarial tables for male and female measuring lives.

63%[26], so under the analysis of the ruling the trust failed to qualify as there was a greater than 5% chance the trust would exhaust before passing to charity. The Service cited Rev. Rul. 70-452[27] in which it ruled that a charitable deduction was not allowable where the probability exceeded 5% that a non-charitable beneficiary would survive the exhaustion of a fund in which the charity had a remainder interest. Note that the exhaustion test does not apply to unitrusts which by definition can never exhaust.[28]

Although both are harder to pass when interest rates are low, the 5% exhaustion test works very differently from the 10% remainder test and it is possible to pass either test without passing the other. The 5% exhaustion test can apply to a trust paying annually at the end of each year only if the annuity payout rate is higher than the applicable section 7520 rate.[29] The 10% test, on the other hand, can be flunked even where the payout rate is substantially below the section 7520 rate – for example, where you have a very young beneficiary or multiple beneficiaries.

To illustrate this, assume an applicable[30] section 7520 rate of 1.4%, a 70 year old grantor and a CRAT paying a 5% annuity quarterly at the end of each quarter. The trust flunks the probability of exhaustion test – the probability of exhaustion under these assumptions is 14.4%. However, the actuarial value of the charitable remainder is over 37%. On the other hand, a CRAT paying a 9% annuity quarterly at the end of each quarter to a 25 year old established in a month when the applicable section 7520 rate is 10%, passes the exhaustion test because the assumed rate of return of 10% exceeds the payout rate of 9%. However, because the beneficiary is only 25 years old, the actuarial value of the charitable remainder is only 8.8%. The new Revenue Procedure deals only with the 5% exhaustion test, not the 10% remainder test of section 664(d). The 10% requirement is statutory and only Congress can change that.

[26] Life expectancies have increased considerably since then. Even under our current unisex tables, the probability of living from 61 to 77 is almost 69%.

[27] 1970-2 C.B. 199

[28] Although the exhaustion test could in theory apply to a term of years CRAT, a term of years CRAT which will exhaust actuarially will never pass the 10% remainder test.

[29] The Rev. Proc. states incorrectly that "If the § 7520 rate at creation of the trust is equal to or greater than the percentage used to determine the annuity payment, then exhaustion will never occur under this test." That will always be true for a trust paying annually at the end of each year. But a trust paying more frequently than annually can flunk the exhaustion test even if the 7520 rate at creation of the trust is equal to the percentage used to determine the annuity payment. For example, the probability of exhaustion is 7.844% for a CRAT for a 60-year-old measuring life paying a 10% annuity quarterly at the end of each quarter even though the applicable 7520 rate is also 10%.

[30] Section 7520 permits use of the interest rate in effect the month the trust is created or either of the two prior months.

Low Interest Rate Exhaustion

The exhaustion test became really critical when interest rates dropped to historically low levels. In fact CRATs became impossible to do for most donors. For example, at the August, 2012 1.0% 7520 rate, a CRAT paying a 6% annuity to two individuals age 81 (assuming quarterly payments) flunked the 5% exhaustion test. Another example: at the August 2012 7520 interest rate of 1%, a 6.0% CRAT created for a 79-year old beneficiary flunked the exhaustion test. In fact, a 74 year old cannot create a charitable remainder annuity trust at all at a 1.0% section 7520 rate because even at a 5% annuity level—the minimum permitted payout—a trust paying quarterly payments flunks the exhaustion test! (I am ignoring the two-month interest rate look back election.)

The Solution of Rev. Proc. 2016-42

The drafting solution proposed by the Rev. Proc. is made possible because of the qualified contingency provision of Code section 664(f), which was added to the Code in 1984.[31] Code Section 664(f) provides that a trust which otherwise qualifies as a charitable remainder trust may terminate early because of any qualified contingency. A qualified contingency is defined as any provision of the trust which provides that upon the happening of the contingency the unitrust or annuity trust payments will terminate no later than such payments would otherwise terminate under the trust. In English, this means that a charitable remainder trust can provide for early termination and acceleration of the remainder upon the happening of any event specified in the instrument. Section 664(f)(2) provides that for purposes of determining the amount of any charitable contribution (or the actuarial value of any interest) a qualified contingency shall not be taken into account. Prior to 1984, the Internal Revenue Service ruled in a number of private letter rulings[32] that the presence of an in terrorem provision in a charitable remainder trust disqualified the trust because the term of the trust was not measured solely by a term of years or the life or lives of one or more beneficiaries as required by Section 664 but by the earlier of the death of the beneficiary or the filing of a will contest. A qualifying contingency can be anything at all, no matter how remote or impossible to value, so long as the only effect of the contingency is to accelerate the charitable remainder. With all such qualified contingencies, including in terrorem provisions, the contingency is not taken into account for any actuarial valuation purposes even if the contingency can, in fact, be valued.

The Rev. Proc. used the section 664(f) qualified contingency exception as the tool to solve the exhaustion problem. It did this by allowing a trust drafter to include qualified contingency language terminating the trust if at some later time the remaining trust value, as discounted from the date of creation, is about to be reduced to 10% of its initial fair market value by the next payment. This is done by taking the current trust value, subtracting the next payment

[31] Did some taxpayer with a problem know a representative or two? The qualified contingency provision was added to the Code in 1984 but applied retroactively to transfers occurring after 12/31/78 and even extended the statute of limitations so the lucky taxpayer could get a refund.

[32] See Private Letter Rulings 7732011, 7942073 and 8321028.

and then discounting the balance by the number of years which will have elapsed from trust creation until the next payment at the interest rate in effect when the trust was created. Here is the Rev. Proc. language for the sample provision to be used in an inter vivos CRAT for one measuring life:

> "The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient's death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus, when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to $[1 / (1 + i)]^t$, where t is the time from inception of the trust to the date of the annuity payment, expressed in years and fractions of a year, and i is the interest rate determined by the Internal Revenue Service for purposes of section 7520 of the Internal Revenue Code of 1986, as amended (section 7250 rate), that was used to determine the value of the charitable remainder at the inception of the trust. The section 7520 rate used to determine the value of the charitable remainder at the inception of the trust is the section 7520 rate in effect for [insert the month and year], which is [insert the applicable section 7520 rate]."

For a testamentary CRAT the Rev. Proc. suggests replacing the phrase "the property is transferred to the trust" with "of my death" and provides guidance for changes in the pro forma trust forms announced in Rev. Proc. 2003-55, Rev. Proc. 2003-59, Rev. Proc. 2003-56, 2003-2 C.B. 249, and Rev. Proc. 2003-60.

Notice how the formula works. The trust ends not when the trust has declined to 10% of its original value, but when the remaining assets *as discounted* have declined to less than 10% of their original value. In the IRS example, the trust still has 21% of its original value before the next payment, and 16% of its original value after the next payment. But because that remaining value is discounted, it falls to 9.3984% of the trust original value. So remember the downside of using the Rev. Proc. language: the beneficiary's annuity may end unexpectedly because of a downturn in the market just when the beneficiary really needs the income.

Administrative Challenges

Use of this qualified contingency solution will require administrative diligence on the part of trustees because it will require monitoring in order to ascertain whether the trust is about to exhaust, and the calculation has to be done exactly one day before each payment is due. You can't do it two days before the payment is due because the trust could drop in value the next day. So it might be that you will have failed to terminate the trust when the contingency occurred even though you are required to with unforeseen results that I haven't quite thought through. What happens if you lose track and don't terminate it when you should have? Fortunately though, because you only need to know the facts in existence when the trust is created to determine for every future date the threshold amount for termination, a table can be generated

when the trust is created which can be consulted at the time of each payment. The author has created software to generate this table. In addition, the calculation only has to be done when there's been a very substantial decline in the value of the trust.

The Rev. Proc. illustrates the necessary calculation with this example:

> On January 1, Year 1, Donor transfers property valued at $1,000,000 to Trust, an inter vivos trust providing for an annuity payment of $50,000 (5 percent of the value of the initial trust corpus) on December 31 of each year to S for S's life followed by the distribution of trust assets to Charity. Trust includes the precise language of the sample provision in section 5 of this revenue procedure providing for an early termination contingency and specifies the § 7520 rate in effect for January, Year 1, which is 3 percent. But for the early termination provision, Trust meets all of the requirements of § 664(d)(1). In accordance with this revenue procedure, the IRS will treat the early termination contingency as a qualified contingency under § 664(f). Therefore, the early termination provision does not cause Trust to fail to qualify as a CRAT under § 664. In addition, Trust qualifies as a CRAT regardless of whether it passes the probability of exhaustion test on January 1, Year 1.
>
> Each year, prior to payment of the annuity to S, the trustee performs the calculations required to determine if Trust will terminate early in accordance with the terms of the qualified contingency. In each year from Year 1 through Year 17, the trustee determines that the value of the trust corpus, minus the $50,000 annual payment, and then multiplied by the specified discount factor, is greater than 10 percent of the initial trust corpus. The value of the trust corpus as of December 30 in Year 18 is $210,000. Only in Year 18 does the value of the trust corpus as of December 30, when reduced by the annuity payment and multiplied by the specified discount factor, fall below 10 percent of the value of the initial trust corpus. The calculations required to determine if Trust will terminate early in Year 18 are as follows:
>
> 1. $1,000,000 x 10 percent = $100,000
>
> 2. ($210,000 – 50,000) x $[1 / (1 + .03)]^{18}$
>
> $160,000 x $(1/1.03)^{18}$
>
> $160,000 x 0.97087418
>
> $160,000 x 0.587397 = $93,984.
>
> Because the value of the trust corpus ($210,000), when reduced by the annuity payment ($50,000) and then multiplied by the specified discount factor (0.587397), is less than 10 percent of the value of the initial trust corpus

> ($100,000), Trust terminates on December 30, Year 18, and the principal and income remaining in Trust (including the annuity payment for Year 18 that otherwise would have been payable to S) then must be distributed to Charity.[33]

One aspect of this formula is likely to confuse people. The formula says use a discount factor where t is the time from inception of the trust to the date of the annuity payment expressed in years and fractions of a year or t in the formula. In the example in the Rev. Proc., the trust was created on January 1 and the payment was due on December 31. The example then says the discount factor was computed with t = 18 but because the payment was due the day before the anniversary date t should be 17 and 364/365 or 17.99726, not 18. Because this is a cliff test these details matter.

So professional fiduciaries are not likely to be thrilled by the additional administrative burden imposed by the annual monitoring and calculating. Software will come to the rescue for banks and trust companies handling more than the occasional CRAT.

Practical Significance

Although the solution is helpful and ingenious, the number of drafters taking advantage of the Rev. Proc. solution may be limited. For many clients, especially younger clients, the possibility of an increase in income through a charitable remainder unitrust will be more attractive. CRATs are more limited than unitrusts because income-only and flip unitrusts (which flip from income-only to regular unitrusts on the happening of an asset sale or other event) are not possible with a CRAT. And for many donors, a charitable gift annuity will provide higher income and often more favorable tax treatment of the payments with less administrative cost than a separately invested CRAT. Donors may well find something else about the new strategy very unappealing: there is a possibility that the trust may end at a future time even though they are counting on lifetime income. IRS example in the Rev. Proc. the trust would have to terminate even though 21% of the trust still remained. But for donors who want an annuity and wish to retain the ability to change the charitable remainder beneficiary, to invest the assets themselves or to create a trust for more than two measuring lives, the qualified contingency solution to the 5% exhaustion test may be just the thing. Just remember: you still have to pass the 10% remainder test of section 664(d).

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[33] Because of differences in rounding conventions, the term of years remainder factor in the IRS actuarial tables (Publication 1457) for an 18 year term and a 3% discount rate is actually 0.587395 rather than 0.587397. For calculations for a whole number of years should we use the published IRS factor or the factor calculated using the formula in the Rev. Proc.?

2015 Amendment to Code Section 664—What Was That All About?

There was a charitable provision sleeper in the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") which I don't think anyone saw coming. It wasn't even included in the section of the act dealing with incentives for charitable giving (such as making permanent the IRA charitable rollover provision), but was hidden much further in the Act in revenue provisions. Section 344 of the act provided as follows:

> **SEC. 344. CLARIFICATION OF VALUATION RULE FOR EARLY TERMINATION OF CERTAIN CHARITABLE REMAINDER UNITRUSTS.**
>
> (a) IN GENERAL.—Section 664(e) is amended—
>
> (1) by adding at the end the following: ''In the case of the early termination of a trust which is a charitable remainder unitrust by reason of subsection (d)(3), the valuation of interests in such trust for purposes of this section shall be made under rules similar to the rules of the preceding sentence.'', and
>
> (2) by striking ''FOR PURPOSES OF CHARITABLE CONTRIBUTION'' in the heading thereof and inserting ''OF INTERESTS''.
>
> (b) EFFECTIVE DATE.—The amendment made by this section shall apply to terminations of trusts occurring after the date of the enactment of this Act.

What is this section trying to accomplish? First, some background. A standard charitable remainder unitrust pays a fixed percentage of trust assets, as revalued at least annually, to the income beneficiary or beneficiaries. Internal Revenue Code section 664(d)(3) permits a variation on the unitrust theme, allowing a charitable remainder unitrust to pay the income beneficiary the *lesser* of trust fiduciary accounting income or the unitrust amount. An income-only unitrust may also provide – or not provide – that if in later years trust income exceeds the unitrust amount for the year, deficiencies can be made up for prior years when income was less than the unitrust amount. These are the well-known NICRUT and NIMCRUT. In calculating the actuarial value of the charitable interest in an income-only charitable remainder unitrust, Code section 664(e) says that the income-only feature is ignored:

> "For purposes of determining the amount of any charitable contribution, the remainder interest of a charitable remainder annuity trust or charitable remainder unitrust shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year."

The Senate report to the 1969 Tax Reform Act described the Senate amendment allowing an income-only unitrust, and stated that the amount of a charitable contribution deduction would be computed ignoring the income-only feature:

> "A second modification of the annuity trust and unitrust rules made by the committee provides that the charitable remainder trust must be required by the trust instrument to distribute each year 5 percent of the net fair market value of its assets (valued annually in the case of a unitrust and valued at the time of the contribution in the case of an annuity trust) or the amount of the trust income, whichever is lower. In valuing the amount of a charitable contributions deduction in the case of a remainder interest given to charity in the form of an annuity trust or a unitrust, it is to be computed on the basis that the income beneficiary of the trust will receive each year the higher of 5 percent of the net fair market value of the trust assets or the payment provided for in the trust instrument."

Although the Code provision mentions only value of the charitable remainder, it should follow that the income interest would be similarly valued. The Tax Court's 2015 decision in Estate of Schaefer (145 TC 134) was consistent with this, holding that for purposes of calculating the 10% actuarial remainder test of section 664 the income-only feature is ignored. That case involved an inter vivos income-only charitable remainder unitrust which was later brought into the donor-beneficiary's estate by section 2036. The Service disallowed the estate tax charitable deduction for the remainder since it failed the 10% qualification test of section 664. The estate argued unsuccessfully that the remainder should be valued taking into account the income-only feature.

But what about cases where we are not valuing the remainder for charitable deduction valuation purposes but cases where instead the income beneficiary and the charitable remainder beneficiary decide to whack up and terminate the trust, with the income beneficiary getting assets equal the actuarial value of the income interest and the charitable remainder beneficiary getting assets equal to the actuarial value of the remainder interest. Do we take into account the income-only feature in that situation? One's first reaction might be no – don't we have to be consistent in how we value these interests, and if the income-only feature is ignored for purposes of calculating the charitable deduction shouldn't it be ignored for all purposes? On the other hand, if the trust provides for, say, payment of the lesser of fiduciary accounting income or a 10% unitrust amount, isn't ignoring the income-only feature in our current low interest environment going to mean that a lot more is going to pass out to the income beneficiary on division than the beneficiary could ever expect to receive if the trust were not terminated, and isn't that self-dealing under Code section 4941 or otherwise abusive?

The Service has addressed this issue in several private letter rulings. In the earlier rulings[34] the Service approved division of income-only unitrusts without requiring that the income-only feature be taken into account in allocating trust assets. But in more recent rulings[35] the Service ruled that division of the trusts without taking into account the income-only feature would be self-dealing. Instead, the Service required that trust be divided as if the unitrust payout percentage were equal to the 7520 rate in effect at the time of the division. Here is what the Service had to say in Private Letter Ruling 201325018:

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[34] PLRs 200208039 and 200304025

[35] PLRs 200725044, 200733014 and 201325018 for example

> One reasonable method not resulting in a greater allocation of assets to Husband and Wife than appropriate is the following: The computation of the remainder interest is found using a special factor as indicated in § 1.7520-3(b)(1)(ii). The special remainder factor is found by using the methodology stated in § 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where § 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the § 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor…In this case, the income beneficiaries are not expected to receive more than they would during the full term of Trust under the above-described methodology for valuing their interests in a charitable remainder trust with a net income make-up feature.

We have it on good authority that the purpose of Section 344 of the Act was to reverse the position the Service took in these later PLRs. But there are several odd things about the Act as it was written. Note first that the provision is called a "clarification." If so, why does the "clarification" apply only to terminations of trusts occurring after the date of enactment? But even more important, the amendment to section 664 doesn't fix the perceived problem! *It says nothing at all about self-dealing* – no amendment was made to Code section 4941. Just because the income interest is "valued" without taking into account the income-only feature, it doesn't necessarily follow that a division which results in the income beneficiary getting substantially more on the division than would otherwise be paid out is not self-dealing. And how can the charity and the trustee ever consent to such a division without violating their respective fiduciary duties? If the trust can only be divided by court order, shouldn't the state attorney general object? The numbers can be significant. Take for example a $1,000,000 unitrust providing for quarterly payments to a 70 year old income beneficiary of the lesser of a 10% unitrust amount or trust income. Suppose further that in the month of division the 7520 rate is 2.0 %. If we ignore the income only feature on division, the income beneficiary would receive $694,350. If instead we use the IRS methodology in the PLRs to avoid self-dealing, the income beneficiary would receive only $238,810. Even the IRS solution in the PLRs is a tad too generous because it allowed division assuming a 2% unitrust payment, not a 2% fiduciary accounting income payment, which is all the income beneficiary was entitled to. The actuarial value for a 70 years old of a straight income interest of 2% is only $237,400. It is difficult to see how a division of a net-income CRUT which results in the income beneficiary's receiving far more than he or she could ever dream of receiving otherwise could not be self-dealing and the amendment to section 664 just doesn't address this. This amendment to section 664 is not good for charities and one hopes that trustees, charitable remainder beneficiaries, and state attorney generals will all do their duty when interest rates are low and resist divisions which so grossly overpay the income beneficiary absent some pretty unusual circumstances.

There is another situation in which the Act applies, namely the transfer of an income-only unitrust interest by the income beneficiary to the charitable remainder beneficiary causing

termination of the trust. The Act would apply in this case as well although here no new ground was broken. Although in PLR 200205008 the Service limited the deduction for the gift of an income interest in a net income unitrust to the lesser of the unitrust value or the value of the income interest, that appears to be an aberration as PLRs 200524014 and 200808018 say just the opposite.

Tentative Thoughts on Way to Avoid Gain on Division of Charitable Remainder Trusts

Numerous private letter rulings have consistently held that termination and division of a charitable remainder trust on an actuarial basis between the income beneficiary and the charitable remainder beneficiary will not be self-dealing so long as the charitable remainder beneficiary is not a private foundation. See PLRs 200525014, 200616035 and 200614032.[36] Nothing new here and these divisions are commonplace.

The Service views this transaction as if the income beneficiary had sold the income interest to the charitable remainder beneficiary. Once the income beneficiary owns all of the pieces, with a court order if necessary, the trust terminates. The income interest is a capital asset[37] but the income beneficiary has zero basis in the income interest.[38]

Example: Assume the actuarial value of the income interest and remainder interest each equal 50% and that the trust has $1,000,000 of assets.

IRS view: on division of the trust, donor is deemed to have sold his $500,000 income interest to the charity for $500,000 and income beneficiary has $500,000 of capital gain.

Issue: is there a solution that avoids this result without also abusing the system by avoiding taxation of gain held in the CRT tiers?[39]

Possible solution: Since the Service fictionalizes the transaction as a sale of the income interest to the charitable remainder beneficiary, what if instead the income beneficiary actually buys the remainder interest from the charity? I'll assume for simplicity that the income beneficiary actually has $500,000 of cash lying around to do this, but he could also borrow from a bank and repay the loan from the assets received on termination of the trust.

Assumptions: $1,000,000 trust
Actuarial value of income interest: $500,000
Actuarial value of remainder interest: $500,000

IRS view: on termination of trust by division, donor is deemed to have sold a $500,000 capital asset with zero basis to the charity. Result: capital gain of $500,000.

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[36] In Rev. Proc. 2008-4, 2008-1 C.B. 121 announced that the Service would no longer issue rulings on the tax consequences of termination of a charitable remainder trust.

[37] See McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946) and Rev. Rul. 72-243,1972-1 C.B. 233

[38] Internal Revenue Code section 1001(e). Why does 1001(e) apply at all here? See materials on "What is an income interest."

[39] For example the kind of abuse stopped by the proposed regulations under sections 1001 and 1014.

What if this is restructured so income beneficiary buys the charity's remainder interest?

Case I – Assume trust has no undistributed income in its tiers, only high basis assets. Income beneficiary buys remainder from charity for its actuarial value of $500,000, the trust collapses and no income to beneficiary. What is income beneficiary's basis in the trust assets? The beneficiary should be able to allocate his $500,000 purchase price to the remainder interest—he already owned the income interest. Reg. § 1.1014-8 gives an example of the purchase of a remainder interest in a testamentary trust. The facts assume that decedent created a trust paying income to A for life, remainder to B.

"Thus, if, in example (1) of paragraph (b) of this section B [remainder beneficiary] sold his remainder interest to C for $547 in cash, C's basis for the stock distributed to him upon the death of A terminating the trust is $547."

In the case of a CRT the income beneficiary already has $500,000 of basis in the income interest—a pro rata portion of the basis of assets contributed less distributions received. He has kept a piece of the trust and had basis allocable to that piece of $500,000. (This example assumes no gain in the tiers.) No trust level income that should be taxed to income beneficiary is avoided so the transaction is in no way abusive but avoids $500,000 of capital gain that would have been incurred if the income beneficiary and charity had simply divided up the trust. Section 1001(e) should not apply because the income beneficiary has not disposed of the term interest but quite the opposite: he has acquired the remainder interest.

Of course the difference with a taxable trust is that there is no untaxed income in the tiers.

Therefore we turn to ---

Case II – Assume trust was funded with an asset worth $1,000,000 and the donor's basis in the asset was $500,000. The trust sold the assets and has $500,000 of undistributed tier 2 capital gain. Income beneficiary buys remainder from charity for its actuarial value of $500,000, and the trust collapses. There should be no income on merger of interests. The assets in his hands attributable to the remainder should have a basis equal to his $500,000 purchase price for the remainder. Consistent with both the uniform basis rules and proposed regulations, his uniform basis in the income interest should be limited to his allocable share of the basis of assets transferred to the trust ($250,000) reduced by prior distributions and undistributed income in the tiers giving him a basis of 0 for the income interest but $500,000 for the entire assets received. Gain has not been avoided, only deferred. Remember: the income beneficiary gave up $500,000 of cash to do this and should get the benefit of losing an asset which could have been used to make purchases without triggering gain. In a case such as this where there has been no disposition of the term interest—he is getting his own assets back—there is no reason to deprive him of his remaining uniform basis in the income interest, reduced by prior distributions and realized but undistributed income in the tiers. But is there any authority for all of this, especially for the reduction of basis to prevent abuse? As a matter of fact there is: REG-154890-03 issued in response to a transaction identified as a transaction of interest in Notice 2008-99. How did

this abuse work? Remember that section 1001(e) provides that the basis of an income interest in a trust, whether a life estate or a term interest, is zero. However, section 1001(e) does not apply to a sale or other disposition of *all* of the interests. So the abuse works like this: taxpayer establishes a charitable remainder trust and contributes appreciated assets to the trust which are sold and reinvested in other property. Donor-grantor claims an income tax deduction for the actuarial value of the remainder. The income beneficiary and charity then sell all of their respective interests in the charitable remainder trust to an unrelated third party. Taxpayer takes the position that because both the income and remainder interests have been sold, section 1001(e) does not apply to the transaction and that therefore gain on the beneficiary's term interest is computed by taking into account the portion of the uniform basis allocable to the term interest under the sections 1014 and 1015 regulations. This uniform basis is "derived from the basis of the new assets acquired by the CRT rather than the Grantor's basis and the assets contributed to the CRT." The technique could effectively eliminate the capital gain on a portion of the appreciated property. The proposed regulation dealt with the basis issue this way:

> Accordingly, these proposed regulations provide a special rule for determining the basis in certain CRT term interests in transactions to which section 1001(e)(3) applies. In these cases, the proposed regulations provide that the basis of a term interest of a taxable beneficiary is the portion of the adjusted uniform basis assignable to that interest reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in section 664(b)(1); and (2) the amount of undistributed net capital gain described in section 664(b)(2). These proposed regulations do not affect the CRT's basis in its assets, but rather are for the purpose of determining a taxable beneficiary's gain arising from a transaction described in section 1001(e)(3).

What about a case where the trust has zero basis assets?

Case III -- – Assume trust was funded with an asset worth $1,000,000 and the donor's basis in the asset was zero. The trust sold the assets and has $1,000,000 of undistributed tier 2 capital gain. Income beneficiary buys remainder from charity for its actuarial value of $500,000, the trust collapses and there should be no income to beneficiary on merger of interests. The assets in his hands will have a basis of his $500,000 purchase price for the remainder plus his basis of zero in the income interest for a total basis $500,000. But hasn't some gain in the tiers now gone untaxed? Not really: gain has not been avoided, only deferred. As in the above example the income beneficiary gave up $500,000 of cash to do this and should get the benefit of losing an asset which could have been used to make purchases without triggering gain. No tax on gain has been avoided over what would have been the case if the trust had simply been divided and the income interest were deemed sold under the IRS fiction: if the trust had simply been divided actuarially, under the IRS fiction the income would have "sold" his interest, have gotten $500,000 of assets and been taxed on $500,000 of capital gain. He will still be taxed on $500,000 of gain when he sells the assets but the gain will be deferred until then.

What about the section 507 termination tax? Internal Revenue Code section 507 (which section 4947(a)(2) makes applicable to charitable remainder trusts) provides that on termination of private foundation status, a termination tax can be imposed in certain situations. The most usual way of avoiding the private foundation termination tax is by transfer of all of the assets to a public charity which has been in existence for at least 60 calendar months. In my proposed division situation, all of the assets of the trust would be distributed to a private individual so does the termination tax apply in that situation? I think it does not, based on language in many private letter rulings in which the trust proceeds were divided actuarially between the income and remainder beneficiaries. In those cases of course, not all of the assets were distributed to the public charity either. So how do the rulings manage to avoid the section 507 termination tax? The language in PLR 201325021 is typical:

> "Furthermore, because the effect of the transaction is to vest the income interests with the income beneficiaries and the remainder interests in the remainder beneficiary, the trust no longer will be a split-interest trust and § 4947(a)(2) will no longer apply and § 507 will not apply."

The same reasoning should apply in my proposed solution. Ultimately, the same is true here: the charity ends up with the value of its interest and the income beneficiary ends up with the value of its interest.

In addition, the logic of this ruling suggests that when the trust collapses because the income beneficiary now owns all the pieces, the trust should not be treated as carrying out income to the income beneficiary under the tiers -- the trust is no longer a split interest trust at that point.

Division of Charitable Remainder Trust After Divorce

To: File

From: Larry Katzenstein

Date: August 29, 2014

Re: Benny Factor Charitable Remainder Trust

This memorandum will summarize the issues and proposed strategy for the Benny Factor Charitable Remainder Unitrusts.

Background

Benny Factor has created two charitable remainder unitrusts with essentially the same terms. Each provides for a 6% unitrust payment in equal shares to Benny and Joan Factor until the first to die, after which the entire unitrust amount is paid to the survivor for life. Each trust provides that upon the death of the last to die of Benny and Joan, the trust will be distributed to a family foundation to be created. If the family foundation is not in existence, the trustee is directed to distribute the trust assets to qualified charities selected by the trustee.

At the time the trusts were created, the charitable remainder trusts would have generated no estate tax at the death of either Benny or Joan. Before the divorce, the estate tax treatment would have been as follows:

1. The trusts would be includable in Benny's estate[40] because he was the sole grantor and retained a unitrust interest sufficient to cause inclusion of all or a substantial portion of each trust in his estate under Internal Revenue Code section 2036.

2. If Benny were survived by Joan, her interest would have qualified for the estate tax marital deduction provided for a surviving spouse's interest in a charitable remainder unitrust under section 2056(b)(8) of the Internal Revenue Code.

3. If Joan predeceased Benny, the entire amount of the trust includable in Benny's estate would have been offset by an equal estate tax charitable deduction.

[40] If interest rates rise substantially it is possible that only a portion of the trusts would be includable in Benny's estate. At our current low interest rates, the trusts would be entirely includable in his estate.

Current Situation

Because Benny and Joan were divorced in 2012, on Benny's death, if Joan survives him, the trusts will be includable in his estate as noted above, but the interest of Joan will not be deductible as no marital deduction for her interest is available. Instead, the trusts would be includable in Benny's estate but the estate tax charitable deduction would eliminate estate tax only on about 44% of the trust assets. The other 56% of the trusts' assets, representing Joan's interest, would be subject to a 40% estate tax which will reduce the amount Benny intends to pass to his children from his other assets by as much as $10,000,000 to $12,000,000. Note that the charitable remainder trusts were dealt with in the final judgment of dissolution of marriage but only by way of an acknowledgement that the trusts would continue after the divorce.

Proposed Solution

The proposed solution is a division of each charitable remainder trust into two one-life trusts, one for the life of Benny only and one for the life of Joan only. Each trust would be funded with an amount equal to the current actuarial value of Benny and Joan's respective interests at the time of the division. At the present time, using the parties' nearest ages and the current section 7520 rate, approximately 56% of the trust assets would fund each separate trust for Joan for her life alone and 44% of the trust assets would be used to fund the trusts for Benny's life alone. Benny's trusts would be still be includable in his estate but because they would not have a successor non-charitable beneficiary, his estate would receive an offsetting charitable estate tax deduction for the entire amount included in his estate. Neither trust would be includable in Joan's estate as she was not a grantor.

How Do We Accomplish This?

In 2008, the Internal Revenue Service issued Revenue Ruling 2008-41 which approved pro rata division, incident to a divorce, of a charitable remainder trust into separate trusts, one for each recipient living at the time of the division. The Service ruled that the division would not cause the trusts to fail to qualify as charitable remainder trusts and would not trigger imposition of various excise taxes. In this ruling and subsequent private letter rulings the division was approved either by the court having jurisdiction over the trust or the marital relationship. The rulings required that the divided trusts be funded with a pro rata portion of each separate asset in each trust so as to make certain that each trust fairly represented overall appreciation and depreciation and so that manipulation of capital gains could be avoided.

We therefore recommend that the trusts be divided as described above on an actuarial basis but that the division be undertaken only after obtaining a court order modifying the divorce final judgment. Not only was this procedure followed in the rulings, but in addition we want to make certain that the division would not trigger capital gains tax. Because arguably the interests of Benny and Joan are different after the division, we would want to foreclose any argument under the Supreme Court's Cottage Savings[41] reasoning that the sale resulted in capital gain.

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[41] Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991)

Internal Revenue Code section 1041 provides that certain transfers of property between spouses which are "incident to divorce" will not result in taxable sale or exchange treatment. The temporary regulations under section 1041 provide that a transfer of property will be considered "related to the cessation of the marriage" if the transfer is pursuant to a divorce or separation agreement and the transfer occurs not more than six years after the date on which the marriage ceases. A divorce or separation agreement includes a modification or amendment to the decree or instrument. Since the judgment in this case was entered in November, 2012, we will be well within the six year period necessary to avoid possible sale or exchange treatment.

Avoiding Estate Tax Inclusion of Joan's Separate Trust

Obviously, it will be essential to avoid estate tax inclusion of Joan's separate trusts in Benny's estate if he predeceases her. Because even after the division he will be considered the sole grantor of those trusts, any retained powers he would hold with respect to her trusts could cause estate tax inclusion in Benny's estate even if he is not a beneficiary. The one retained power which could cause inclusion is the fact that the trust remainder will pass to a private foundation under Benny's control. Therefore, as part of the process we would want to make certain that the foundation documents include provisions stating that any assets passing to the foundation from these charitable remainder trusts will be segregated and only trustees other than Benny will be able to make decisions with regard to charitable applications of those funds. This is not a hypothetical concern. See Estate of Revson v. United States, 5 Cl. Ct. (1984) and Rev. Rul. 72 -552, 1972-2 C.B. 525. In the Revson case a charitable lead trust created during the lifetime of the grantor made payments to a private foundation of grantor and the grantor's control of distributions from the private foundation caused estate tax inclusion of the charitable lead trust. Private letter rulings such as PLR 201323007 describe the kind of steps I suggest.

Action Steps

1. Obtain Joan's consent to the proposal.

2. Obtain a court order modifying the divorce decree to allow division of the trusts on an actuarial basis between Benny and Joan, with each trust to be funded with a pro rata portion of each asset of the trust being divided.

3. Create the private foundation and include provisions limiting Benny's discretion regarding assets coming into the foundation from these charitable remainder trusts. One possibility is to make Benny's daughter trustee.

4. Divide the trusts and obtain new tax ID numbers.

Actuarial Division Analysis of Benny Factor Unitrust Split

The trust is a joint and survivor charitable remainder unitrust payable quarterly for the joint lifetime of Benny and Joan and then all to the survivor. As of today, Benny and Joan's nearest ages are 64 and 56 respectively. During the time that both Benny and Joan are living, each is entitled to one half of the total unitrust payment. After the death of the first to die, the entire unitrust payment is payable to the survivor for the survivor's life. I have computed the value of the beneficiaries' respective interests in the unitrust as follows:

Benny's interest: 34.4375 % of trust value

Joan's interest: 44.6775 % of trust value

Value of charitable remainder: 20.885 % of trust value

The computation was done using the August, 2014 section 7520 rate of 2.2% and using the current mortality table 2000CM using actuarial factors from IRS Publication 1458.

The computation requires three steps. The first step is a calculation of the right to receive one half of the total unitrust payment until the first to die of the two beneficiaries. The second step is a calculation of the right of Joan to the entire unitrust payment for such period as she survives Benny. The third step is a calculation of the right of Benny to the entire unitrust payment for such period as he survives Joan.

Step one: As noted above, the first required calculation is the value of the right to receive one half of the unitrust payment until the first to die of Benny and Joan. This is calculated by adding together the value of a one life unitrust interest for each beneficiary and then subtracting from that the value of a joint and survivor unitrust interest as follows:

Lifetime unitrust factor age 64:	0.62433
Lifetime unitrust factor age 56:	0.72673
Total:	1.35016
Minus joint and survivor factor:	0.79115
= Value of interest until first to die:	0.55991
Value for each is one-half:	0.279955

Step two: The second step requires valuing the right to receive the entire unitrust payment for such period as Joan survives Benny. This is determined by subtracting the single life unitrust factor for Benny from the joint and survivor factor as follows:

Joint and survivor factor ages 64 and 56:	0.79115
Minus single life factor for 64 year old:	0.62433
Equals:	0.16682

Therefore the value of Joan's two interests is 0.279955 plus 0.16682 for a total of .446775.

Step three: The third step requires valuing the right to receive the entire unitrust payment for such period as Benny survives Joan. This is determined by subtracting the single life unitrust factor for Joan from the joint and survivor factor as follows:

Joint and survivor factor ages 64 and 56:	0.79115
Minus single life factor for 56 year old:	0.72673
Equals:	0.06442

Therefore the value of Benny's two interests is 0.279955 plus 0.06442 for a total of 0.344375.

As proof of the calculation, the total value of both interests is 0.79115. According to IRS tables, the actuarial factor for a remainder interest in a charitable remainder unitrust paying quarterly until the second to die of two persons age 64 and 56 at a 2.2% discount rate is 0.20885:

Joan's interest:	0.446775
Benny's interest:	0.344375
Remainder interest:	0.20885
Total of all interests:	1.00

The final step is to determine the relative percentages with which to fund each trust. This is simply done as follows:

Trust Funding Percentages	
Value of Joan's interest:	0.446775
Value of Benny's interest:	0.344375
Total	0.79115
Joan's trust:	56.4716%
Benny's trust:	43.5284%
Total income interest:	100%

Questions For Discussion

1. Should we consider including in a joint and survivor unitrust a provision dividing the trusts actuarially between the spouses in the event of divorce? Do we need a court order in that case?

2. If the problem were found more than 6 years after the divorce will the parties incur capital gains tax under a Cottage Savings analysis?

Marital Deduction Issues in Split Interest Gifts

Planners for charitably inclined married couples often focus so intently on the charitable deduction aspects of a proposed gift that they lose sight of an equally important issue, namely the marital deduction. Charitable planning for married couples is fraught with marital deduction issues and traps.

I. Simple cases not involving split interest gifts.

A. The simplest case is the married couple with no non-charitable interests which desires that the entire estate pass to charity on the second death. In such cases, the first spouse can simply leave the entire estate outright to the surviving spouse, and the surviving spouse can leave the entire estate on the second death to the charity. The marital deduction is assured in such cases on the first death as is the charitable deduction on the second death.

B. Where one spouse wants some portion of his or her estate to pass to charity immediately on the first death, a charitable bequest by the first spouse to die is simple and straightforward. It also, however, produces no tax advantage if the entire residue of the estate will qualify for the marital deduction and there will therefore be no estate tax.

1. A better strategy is a bequest of a specific dollar amount to the surviving spouse with a non-binding request that the surviving spouse use the bequest to make a charitable gift. In this manner, the surviving spouse will receive an income tax deduction, and the cost of the gift will be reduced by approximately one-third.

2. Where the first spouse to die creates a credit shelter trust or marital trust for the surviving spouse, the will can also provide that if the survivor spouse has not made the gift by the time of the survivor spouse's death, the bequest will come out of the trust.

C. QTIP for surviving spouse with remainder to charity. The first spouse to die may, however, be unwilling to leave the entire estate to the surviving spouse because of uncertainty that the surviving spouse will honor the first spouse's desires. An obvious solution here is the QTIP for surviving spouse with remainder to charity. The trust will qualify for the marital deduction in the first spouse's estate, be includable in the second spouse's estate under Section 2044 and qualify in the surviving spouse's estate for an offsetting charitable estate tax deduction. Section 2044(c) provides that for all purposes of Chapters 11 and 12, the QTIP property will be treated as passing from the decedent. The final regulations made this clear, not that there was ever any doubt as to this one: For purposes of section 1014 and chapters 11 and 13 of subtitle B of the Internal Revenue Code, property

included in a decedent's gross estate under section 2044 is considered to have been acquired from or to have passed from the decedent to the person receiving the property upon the decedent's death. Thus, for example, the property is treated as passing from the decedent for purposes of determining the availability of the charitable deduction under section 2055 and the marital deduction under section 2056.

D. An aside on the question of QTIP versus charitable remainder trust. Instead of using a QTIP, the first spouse to die might instead have left the entire estate in a charitable remainder unitrust or annuity trust for the surviving spouse with the remainder on the surviving spouse's death passing to charity. What are the advantages and disadvantages of using a CRAT or CRUT instead of a QTIP?

1. The estate tax result will still be no tax, at either death. The actuarial value of the charitable remainder qualifies for an estate tax deduction under Section 2055. The actuarial value of the spouse's interest qualifies for a marital deduction under code Section 2056(b)(8), even though the interest is not an income interest for life meeting QTIP requirements. Section 2044 will not operate to put the trust in the surviving spouse's estate, so no charitable deduction is necessary there.

2. The major advantage of the QTIP is that the principal can be invaded for the surviving spouse's benefit.

3. The big disadvantage of the QTIP is that capital gains in the trust will be subject to tax whereas capital gains and accumulated income in a charitable remainder trust in excess of the payout are not subject to tax.

4. Inclusion of the QTIP of the surviving spouse's estate may have other implications as well which should be considered in special cases. Inclusion will increase the size of the surviving spouse's estate, which could be detrimental for Section 303, 2032A and 6166 purposes. This could be significant in cases where less than the entire estate is passing to charity (and there will be a tax) on the second death.

5. There may be other things that can be done with a CRAT or CRUT that cannot be done with a QTIP. Example: Moneyed spouse wants to provide for the surviving spouse and wants the assets remaining at the second death to pass to charity. However, moneyed spouse also wants to terminate the surviving spouse's interest on remarriage or some other event. The trust cannot be a QTIP unless the surviving spouse has a qualifying income interest for life. Section 2056(b)(8), on the other hand, which allows a marital deduction for a spouse's interest in a CRAT or a CRUT, provides that paragraph (1) of section 2056 shall not apply to any interest in a qualified section 664 trust which passes or has passed from

the decedent to the surviving spouse. Paragraph (1) is the terminable interest rule. In addition, Section 664(f) provides that a trust will be a qualified charitable remainder trust even if the trust may terminate on the happening of a contingency or event which has the effect of accelerating the charitable remainder. Read together, these provisions mean that the charitably inclined testator can establish a qualified charitable remainder trust for his or her surviving spouse which will terminate on the surviving spouse's remarriage or death and still get a marital deduction and a charitable deduction. The regulations confirm this conclusion. Although it is clear that a remarriage provision (or any other contingency terminating a spousal trust before the spouse's death) is fatal for 2056(7) purposes, regulation section 20.2056(b)-8(a)(1) provides explicitly that "if an interest in property qualifies for a marital deduction under section 2056(b)(8), no election may be made with respect to the property under section 2056(b)(7)." The additional requirements of a QTIP, such as the terminable interest rule, cannot therefore apply.

6. The qualified contingency can be anything, no matter how unlikely or remote--the remarriage of the surviving spouse, the Cardinals winning the World Series, etc.

7. Note that for purposes of valuing the charitable contribution or the actuarial value of any interest, the qualified contingency is not taken into account.

8. Finally, income in respect of a decedent can be paid to a CRAT or CRUT and the income will be free of tax. That would not be true of course with the QTIP.

II. Treatment of Specific split interest arrangements in the regulations.

A. Charitable remainder unitrust and annuity trust. As we have seen, Section 2056(b)(8) provides a marital deduction for the donee spouse's interest in a qualified charitable remainder trust. The parallel gift tax section, section 2523(g), provides a marital deduction for gift tax purposes as well.

B. Watch this trap! Both of those sections provide a marital deduction only if after the transfer "the donee spouse is the only non-charitable beneficiary other than the donor". So those sections deny a marital deduction to the donor to a charitable remainder trust created for the joint lifetime of the donor and the donor's spouse, followed by the donor's child. An income tax charitable deduction will be available for the remainder and the trust will be a qualified charitable remainder trust, but no gift or estate tax marital deduction will be available, even though the actuarial value of all of the interests can be easily determined. This makes no sense and the statute should be amended to provide a marital deduction for the

actuarial value of the spouse's interest. In private letters rulings 8742001 and 8730004 the Service ruled that no marital deduction is available in precisely this situation.

1. The regulations amplify this. Regulation section 20.2056(b)-8 provides as follows:

   "In the case of a charitable remainder trust where the decedent's spouse is not the only non-charitable interest beneficiary (for example, where the non-charitable interest is payable to the decedent's spouse for life and then to another individual for life), the qualification of the interest as qualified terminable interest property is determined solely under section 2056(b)(7) and not under section 2056(b)(8). Accordingly, if the decedent died on or before October 24, 1992, or the trust otherwise comes within the purview of the transitional rules contained in §20.2056(b)-7(e)(5), the spousal annuity or unitrust interest may qualify under §20.2056(B)-(7)(E) as a qualifying income interest for life."

   There is no policy reason to deny a marital deduction in that situation for the portion of the trust passing to the surviving spouse. The drafting solution is a QTIP for the surviving spouse followed by a CRAT or CRUT for the second beneficiary.

2. The Energy Policy Act of 1992 added Code section 2056(b)(10) which provides that although section 2056(b)(7)(B)(iv) provides that a specific portion of property shall be treated as separate property, the portion must be treated on a fractional or percentage basis. The regulations provide that although section 2056(b)(8) precludes a marital deduction under that section in cases where the spouse is not the only non-charitable beneficiary, the marital deduction <u>may</u> be available for trusts created before the effective date of the Energy Policy Act of 1992 (generally October 24, 1992), not under 2056(b)(8) but under the QTIP provisions. The Service asked for comments as to whether a unitrust or annuity interest for spouse followed by another non-charitable beneficiary may qualify under the QTIP provisions in view of the 1992 amendments. (An election would still be necessary.) This avenue seems more likely for annuity trusts than unitrusts: the last sentence of 2056(b)(7)(B)(ii) provides that to the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property regardless of whether the property from which the annuity is payable can be separately identified. A legislative fix may to be the only possible fix for unitrusts.

C. Retention of Right to Revoke Surviving Spouse's Interest in a Qualified Charitable Remainder Trust. Before the enactment in 1981 of the special gift and estate tax marital deduction provisions for charitable remainder trusts, a common

technique in order to prevent a present gift in the case of two-life spousal inter vivos charitable remainder trusts was to include a provision permitting the donor to revoke the surviving spouse's survivorship interest by will. This prevented the initial transfer from being a completed gift to the spouse for gift tax purposes. Many practitioners have deleted that provision as unnecessary. But is it? There are no apparent disadvantages to retention of the power, and if the spouses are ever divorced, the donor spouse may be unhappy if he or she does not have the right to revoke the successor spouse's interest. So there may be good non-tax reasons to keep these provisions.

D. The Service's pro forma CRATs and CRUTs include sample power of revocation language. Note also that with spousal trusts, Revenue Ruling 82-128, 1982-2 C.B.71, requiring language in two life instruments to avoid the possibility of estate tax being charged to the trust, cannot be ignored on the theory that there will be no estate tax. There could be state inheritance taxes and the spouses could be divorced before the first death.

E. Where jointly-held property is contributed to the trust, the power of revocation should only apply to the donor spouse's interest in the joint property, not the entire property.

III. Gifts of Remainders in a Personal Residence.

A. What are the marital deduction implications of gifts of a remainder in a personal residence? Where the donor contributes his or her residence to charity reserving a life estate for the donor and the donor's spouse, is a marital deduction available? Note that there is no automatic marital deduction under 2056(b)(8) for split interest gifts other than charitable remainder trusts.

B. 1. Because the surviving spouse's interest terminates at death, and property passes to a third party, the interest of the surviving spouse is a terminable interest. Does it, however, qualify for QTIP treatment if a QTIP election is made?

2. The spouse will not receive income from the property. However, the regulations under section 2056(b)(7) confirm that a marital deduction is available for the surviving spouse's right to occupy a personal residence. See regulation section 20.2056(b)-6(g)—Example:

(1):

> "Life estate in residence. D owned a personal residence valued at $250,000 for estate tax purposes. Under D's will, the exclusive and unrestricted right to use the residence (including the right to continue to occupy the property as a personal residence or to rent the property and receive the

income) passes to S for life. At S's death, the property passes to D's children. Under applicable local law, S must consent to any sale of the property. If the executor elects to treat all of the personal residence as qualified terminable interest property, the deductible interest is $250,000, the value of the residence for estate tax purposes."

Note that in this Example (1) the interest was not an interest in trust, but merely a legal life estate. The implications for marital deduction purposes seem to be as follows:

a. Where the donor spouse owns the entire residence, the deed should permit the donor spouse to revoke the successor beneficiary spouse's interest by will in order to prevent a gift for gift tax purposes. No gift tax marital deduction is available for the spouse's interest because of the intervening interest of the Donor spouse.

b. Where the property is held jointly, the deed should provide that each spouse reserves the right by will to revoke the surviving spouse's survivorship interest in the first spouse's contribution.

c. When the first spouse dies, his or her interest will be includable in his or her estate and a QTIP election should be made on the estate tax return to qualify the survivor spouse's interest.

d. Even this may not be enough. To qualify as a QTIP, the surviving spouse must have what under state law is equivalent to a legal life estate. A right to occupy the residence is not enough: In the regulation quoted above, the spouse also had the right to rent the property. The extent of rights in a legal life estate is a question of state law. In Private Letter Ruling 9033004, the Service noted that use must include both the right to occupy the property as a personal residence and the right to convey the life estate to others. The deed should make clear that what is being retained is a full legal life estate, including the right to occupy the property, lease the property and convey the life interest. Merely reserving the right to use and occupy the property may be insufficient in many states to obtain a marital deduction.

e. This is another trap. How many donors' executors actually make a QTIP election for gifts of a remainder interest in their personal residence to charity? Is there any reason the marital deduction shouldn't be automatic in this case as it is with the charitable remainder trust? Should an election out be permitted?

III. Pooled Income Fund.

A. Section 2056(b)(8) and section 2523(g) do not provide automatic marital deductions for a gift to a pooled income fund. However, the spouse's interest qualifies as a QTIP and, again, the QTIP election must actually be made to secure the marital deduction. See regulation section 20.2056(b)-6(g)—Example (13):

> "Pooled Income fund. D's will provides for a bequest of $200,000 to a pooled income fund described in section 642(c)(5), designating S as the income beneficiary for life. If D's executor elects to treat the entire $200,000 as qualified terminable interest property, the deductible interest is $200,000."

This is another unnecessary trap and a legislative fix to make the marital deduction automatic would be advisable. Should an election out be permitted?

1. As with the charitable remainder trust, there are excellent non-tax reasons for retaining the right to revoke the surviving spouse's interest in the pooled income fund gift. The donor's interest will be includable in his estate under section 2036 and will qualify for a marital deduction if an election is made on a federal estate tax return.

2. The Joint Committee report on section 2056(b)(7) noted that for QTIP qualification purposes, the stub period income from the last payment to the date of the spouse's death need not actually be paid in the case of a pooled income fund gift. Cf. Howard Estate, Cf. Howard Estate, 910 F.2d 633 (9th Cir. 1990) revg. 91 T.C. 329 (1988).

3. Effect on basis. If a QTIP election is made, the surviving spouse's interest in the QTIP/pooled fund will be includable in the surviving spouse's estate, receive a stepped up basis, and be deductible as a charitable deduction. The result is a wash for estate tax purposes. But the step-up in basis for the assets in the pooled income fund may be relevant where there are short-term capital gains, since short-term loans are taxable to a pooled income fund. How many pooled fund trustees adjust basis on the surviving spouse's death? Will they even know whether a QTIP election was made?

4. In the two-life situation, the successor spouse's interest does not qualify for a gift tax marital deduction because it has not yet vested in the surviving spouse. (See regulation section 25.2523(F)-(1)(c)(2) on the question of an intervening interest between the donor and the spouse.) This may be another reason to retain the right to revoke the surviving spouse's interest by will.

5. Unlike the charitable remainder trust situation, there is no problem with pooled income gifts for the donor and the donor's spouse, followed by third beneficiary. In the charitable remainder trust situation we saw that section 2056(b)(8) denies a marital deduction in that situation. There is of course no such issue with the QTIP/pooled income fund gift. The entire fund will be includable in the surviving spouse's estate under section 2044, and the surviving spouse's estate would receive a charitable deduction based on the then actuarially-determined value of the reminder interest taking into account the age at that time of the third beneficiary.

IV. Charitable Gift Annuities. Here the story is somewhat different. Section 2056(b)(7) and Section 2523(f) provide for a marital deduction in the case of a joint and survivor annuity where only the donor spouse and the donee spouse have the right to receive payments until the death of the last spouse to die. In such case, the donee spouse's interest is treated as a qualifying interest for life and the donor spouse is treated as having made an election with respect to the annuity unless the donor spouse elects out. Note that the statutory language includes the same requirement as 2056(b)(8) that no marital deduction is permitted if there is a non-charitable interest following the spouses' interest. This is of little significance with gift annuities since sections 501(m) and 514(c)(5) already require that gift annuities be for not more than two lives.

A. As with charitable remainder trusts, the donor may retain the right to revoke the successor spouse's interest.

B. Are there any cases where the executor might want to elect out of marital deduction treatment?

C. The amendments permitting the marital deduction were passed in 1988, retroactive to 1981. The Service has issued regulations outlining the procedure for refunds of gift or estate tax paid. The final regulations reserved judgment on joint and survivor annuities, and those regulations will be issued later.

Testamentary gift annuities for a spouse. One of the main questions here is how to set the amount of the annuity, since no charitable or marital deduction will be permitted if the amount of the annuity is unascertainable. Perhaps incorporating the then current American Council on Gift Annuities recommended rates would be one technique.