

Hampton Roads Estate Planning Council

*Creative Uses of
Charitable Remainder and Charitable Lead Trusts*

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I. CHARITABLE GIVING STATISTICS.

A. 2008 Survey from Giving USA .

1. 2008 saw the largest drop in annual giving in more than 50 years at 5.7%, yet charitable giving remained relatively high.
2. Donors gave \$307.65 billion to charity (vs. \$314.07 billion in the prior year).
3. Giving to private foundations decreased 22.2% in 2008.

B. 2005 IRS Statistics on Noncash Contributions.

1. 25.4 million individuals made noncash contributions totaling \$48.1 billion in deductions.
2. 6.6 million of these individuals reported gifts totaling \$41.1 billion on Form 8283 (greater than \$500).
 - a. Stock gifts \$16.3 billion
 - b. Clothing \$ 7.0 billion
 - c. Household goods \$ 3.9 billion
 - d. Land \$ 2.9 billion
 - e. Conservation easements \$ 1.8 billion
 - f. Other investments \$ 1.6 billion
 - g. Art and collectibles \$ 1.2 billion

II. CURRENT ENVIRONMENT.

- A.** Decreased endowments.
- B.** Decreased gifts from individuals, foundations, and businesses.
- C.** Losses in donor's investment portfolios, real estate values, and retirement accounts.
- D.** Obama administration's 2010 budget proposals include a plan to limit the tax rate at which taxpayers with income above \$250,000 can take itemized deductions, including the charitable deduction to 28%. Several amendments to the Senate Finance Committee's markup of the America's Healthy Future Act of 2009 would cap the value of the itemized deductions for charitable

donations to 33% or 35% for those taxpayers earning more than \$200,000 per year, rather than allowing the deduction at a rate equal to the marginal tax bracket (brackets that will rise to 36% and 39.6%, respectively, in 2011).

1. Will make the IRA rollover more attractive if extended as a way to avoid income and the charitable deduction limitations.
2. Will create an incentive for the establishment of private foundations.
3. Will make grantor charitable lead annuity trusts more attractive in 2010.
4. Will make prepayment of planned future contributions in 2010 more attractive.

III. FAVORABLE GIFT TECHNIQUES IN A DOWN ECONOMY.

A. Bequests.

B. Charitable Gift Annuities.

C. Real Estate Gifts.

1. Outright transfers.
2. Gifts of an undivided interest.
3. Bargain sales.
4. Gift of remainder interest in personal residence or farm.
5. Flip charitable remainder unitrusts.

D. Charitable Lead Trusts.

1. Zeroed out charitable lead annuity trusts.
2. Grantor charitable lead trusts.
3. Varying payout charitable lead annuity trusts.
 - a. Increasing percentage payout.
 - b. Shark-fin payout.

E. Charitable Remainder Trusts.

1. Charitable remainder annuity trusts.

2. Flip charitable remainder unitrusts.
3. Termination of charitable remainder trust.

F. Retirement Benefits.

IV. CHARITABLE LEAD TRUSTS.

A. Executive Summary.

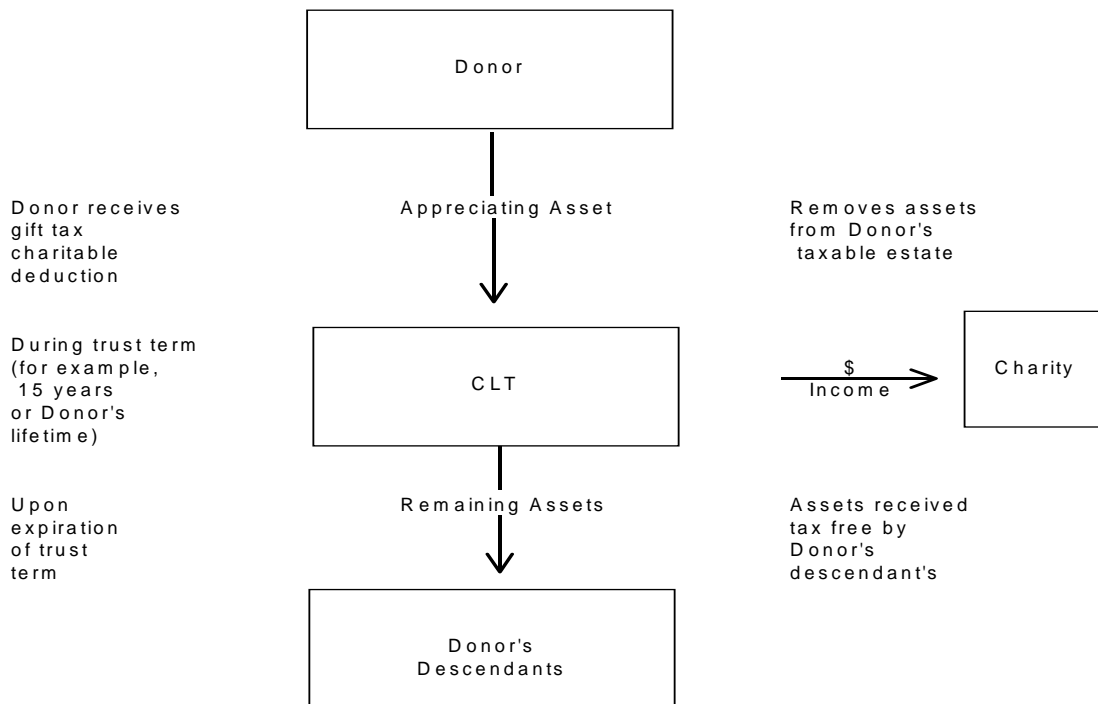
1. Income is paid to charity for a specified term (for example, a number of years or an individual's lifetime); upon expiration of the term, assets pass to descendants or other designated noncharitable beneficiaries outright or in further trust.
2. Income payments to charity may be a fixed dollar amount or a fixed percentage of trust assets revalued each year.
3. Trust may be established during donor's lifetime or at donor's death.
4. Tax advantages of trust established during donor's lifetime: reduces cost of transferring assets to noncharitable beneficiaries while offering opportunity to transfer growth tax free; removes appreciating asset and income from donor's taxable estate; avoids percentage limitations on charitable deductions.
5. Tax advantages of trust established at donor's death: estate receives deduction for value of income payable to charity; trust assets pass to descendants or other noncharitable beneficiaries with a stepped-up basis.
6. Nontax advantages: accomplishes donor's charitable objectives while keeping capital in the family without the need for "wealth replacement" techniques; charity receives income currently.
7. Disadvantages: portion of donor's income and wealth shifted to charity rather than family members; donor foregoes current income from trust assets; gift of remainder interest to noncharitable beneficiaries does not qualify for annual gift tax exclusion and generally requires donor to use portion of unified credit or pay gift tax; noncharitable beneficiaries must wait until expiration of trust term to receive assets.
8. Best candidates to establish charitable lead trust: donors with genuine charitable interests, sufficient other assets to provide for

personal cash needs, and ability to defer receipt of assets by noncharitable beneficiaries.

9. Best assets with which to fund charitable lead trust: common stocks and other assets likely to appreciate over the trust term, assets producing sufficient income to satisfy annual charitable payments, or mixture of cash and high yielding securities with nonincome producing property; assets such as limited partnership interests that have a good cash flow but can be discounted for transfer tax purposes.

B. General Overview.

1. A charitable lead trust (“CLT”) is a split-interest trust under which the income (or “lead” interest) is payable to one or more charitable beneficiaries for the term of the trust, and upon expiration of that term, the trust corpus (the “remainder” interest) is payable to one or more noncharitable beneficiaries or reverts to the creator of the trust (the “donor”).
2. The following diagram shows the basic structure and operation of a CLT created during a donor’s lifetime.



3. The Internal Revenue Service issued Revenue Procedures 2007-45 and 2007-46, which set forth sample forms for inter vivos and testamentary charitable lead annuity trusts, and Revenue Procedures 2008-45 and 2008-46, which set forth sample forms for charitable lead unitrusts.

C. Tax Overview.

1. Upon creation of a qualifying CLT, the donor receives a gift tax deduction (if the trust is created during the donor's life) or an estate tax deduction (if the trust is created at the donor's death) equal to the present value of the income payable to charity over the term of the trust. Under certain circumstances, the donor may also receive an income tax deduction. The donor is subject to gift or estate tax on the present value of the remainder interest that will pass to noncharitable beneficiaries at the end of the trust term. Because the values of the income and remainder interests are calculated using an assumed rate of return at the time the trust is funded, a CLT enables the donor to realize significant tax savings if the actual investment return on the trust assets during the trust term exceeds the assumed rate, in which case the excess value passes to the noncharitable beneficiaries free from transfer tax.
2. Charitable lead trusts may be divided into two categories: trusts transfers to which qualify for charitable tax deductions ("qualifying" CLTs) and trusts transfers to which do not qualify for charitable deductions ("nonqualifying" CLTs).

D. Qualifying Charitable Lead Trusts. For a donor to receive a charitable tax deduction, the trust must satisfy certain requirements.

1. Pursuant to the trust instrument, income must be payable to one or more qualified charitable organizations in the form of either a "guaranteed annuity" or a "unitrust" interest.
 - a. A guaranteed annuity interest is a right to receive a fixed sum at least annually for a term of years or the life or lives of an individual or individuals. The sum may be stated as a dollar amount or as a formula for determining a dollar amount (for example, a percentage of the net fair market value of the property transferred to the trust valued as of the date of transfer). The payment amount is determined at the creation of the trust and does not fluctuate with the value of the trust assets or income. A CLT providing for a guaranteed annuity interest is referred to as a "charitable lead annuity trust."

- b. A “unitrust” interest is a right to receive, at least annually, payment of a fixed percentage of the net fair market value of the assets of the trust, re-determined annually, for a term of years or the life or lives of an individual or individuals. Unlike the guaranteed annuity payment, the amount of the annual unitrust payment fluctuates according to the net fair market value of the trust assets each year. The annual payout percentage, however, must be determinable upon formation of the trust and may not vary over the term of the trust. A charitable lead trust providing for a unitrust interest is referred to as a “charitable lead unitrust.”
 - c. There is no minimum or maximum annuity or unitrust payment amount and no limitation on the number of years over which the charitable lead interest may be payable (terms of years and lifetimes may be mixed and matched without the restrictions that apply to charitable remainder trusts), subject to any applicable rule against perpetuities.
 - d. Under both payment methods, the trustee is required to pay out the specified amount of charity each year, even if the trust’s income in a given year falls below the amount of the required payment. In such cases, the trustee must invade corpus or borrow to make up the shortfall. Income in excess of the guaranteed annuity or unitrust payment may be accumulated in the trust or distributed currently to the charitable beneficiary.
- 2. To receive an income, estate, or gift tax deduction, each charitable beneficiary must be described as a qualified charitable organization under Internal Revenue Code section 170, 2055, or 2522, respectively. For gift and estate tax purposes, the organization may be a public charity or a private foundation, including a private foundation affiliated with the donor. A donor may name one or more qualified charities to receive set portions of the income throughout the trust term or authorize the trustee to select charitable beneficiaries and allocate the income payment annually.
 - 3. Qualifying CLTs are generally subject to the same restrictions and excise taxes as private foundations. A CLT will not be subject to the private foundation restrictions on excess business holdings or jeopardy investments, however, if the present value of the charitable lead interest or interests does not exceed 60 percent of the net value of the trust assets on the valuation date.

4. Upon the transfer of assets to a qualifying CLT, the donor receives a deduction equal to the present value of the income interest payable to charity, as determined pursuant to Internal Revenue Code section 7520, thereby reducing the portion of the assets subject to tax. Under Internal Revenue Code section 7520, the value of the charitable interest is calculated using prescribed actuarial tables and an assumed interest rate equal to 120 percent of the Federal midterm rate for the month in which the valuation date occurs, or at the donor's election, either of the two months preceding the transfer (the "section 7520 rate"). The longer the charitable term and the higher the payout rate, the greater the value of the charitable interest and the lower the value of the taxable gift.

5. The following tables show the percentage of the initial funding of a CLT (annuity or unitrust) that would be treated as a deductible gift to charity and the percentage that would be treated as a taxable gift based on different payout rates and trust terms. (All calculations assume section 7520 rate of 3.4% and quarterly payments.)

CHARITABLE LEAD TRUSTS FOR TERM OF YEARS

<u>Term of Years</u>	<u>Payout Rate</u>	<u>Unitrust</u>		<u>Annuity Trust</u>	
		<u>Charitable Lead</u>	<u>Taxable Remainder</u>	<u>Charitable Lead</u>	<u>Taxable Remainder</u>
5	3%	13.85%	86.15%	13.76%	86.24%
	5%	22.20%	77.80%	22.93%	77.07%
	7%	29.89%	70.11%	32.10%	67.90%
10	3%	25.78%	74.22%	25.40%	74.60%
	5%	39.47%	60.53%	42.32%	57.68%
	7%	50.85%	49.15%	59.25%	40.75%
15	3%	36.06%	63.94%	35.24%	64.76%
	5%	52.91%	47.09%	58.74%	41.26%
	7%	65.54%	34.46%	82.23%	17.77%

CHARITABLE LEAD TRUSTS FOR LIFE OF INDIVIDUAL

<u>Term for Ages</u>	<u>Payout Rate</u>	<u>Unitrust</u>		<u>Annuity Trust</u>	
		<u>Charitable Lead</u>	<u>Taxable Remainder</u>	<u>Charitable Lead</u>	<u>Taxable Remainder</u>
55	3%	50.87%	49.13%	48.80%	51.20%
	5%	67.87%	32.13%	79.45%	20.55%
	7%	78.08%	21.92%	90.45%	9.55%
65	3%	39.07%	60.93%	37.45%	62.15%
	5%	54.86%	45.14%	62.96%	37.04%
	7%	65.73%	34.27%	79.58%	20.42%
75	3%	26.83%	73.17%	26.25%	73.75%
	5%	39.65%	60.35%	43.75%	56.25%
	7%	49.62%	50.38%	59.93%	40.07%

CHARITABLE LEAD TRUSTS FOR TERM OF JOINT LIVES OF INDIVIDUALS

<u>Term for Ages</u>	<u>Payout Rate</u>	<u>Unitrust</u>		<u>Annuity Trust</u>	
		<u>Charitable Lead</u>	<u>Taxable Remainder</u>	<u>Charitable Lead</u>	<u>Taxable Remainder</u>
55/55	3%	59.89%	40.11%	57.15%	42.85%
	5%	77.73%	22.27%	91.79%	8.21%
	7%	87.37%	12.63%	98.43%	1.57%
65/65	3%	48.13%	51.87%	46.43%	53.57%
	5%	65.97%	34.03%	77.12%	22.88%
	7%	77.35%	22.65%	93.29%	6.71%
75/75	3%	34.86%	65.14%	33.98%	66.02%
	5%	50.54%	49.46%	56.64%	43.36%
	7%	62.13%	37.87%	76.76%	23.24%

6. For a charitable lead annuity trust, the lower the section 7520 rate at the time the trust is created, the greater the charitable deduction.

7. Changes in the section 7520 rate have little impact upon the valuation of charitable unitrust interests, although if the unitrust payout rate is lower than the section 7520 rate, the unitrust will produce a larger charitable deduction than the annuity trust because the excess of the assumed return over the payout rate is deemed to cause an increase in the trust assets from which the unitrust payout will be calculated.

- E. Income Tax Deduction for Qualified Grantor CLT.** To receive an income tax charitable deduction upon formation of a qualified CLT, the donor must be treated as the owner of the property transferred to the trust for income tax purposes under the “grantor trust” rules of Internal Revenue Code sections 671 through 679. The donor’s income tax deduction is limited to 30 percent of the donor’s contribution base (20 percent if the trust is funded with appreciated property or the charitable beneficiary is a private foundation). As owner of the trust property, however, the donor continues to be taxed on the income earned during the term of the trust without the benefit of further income tax deductions for the amounts paid to charity. Thus, while the donor receives an upfront income tax deduction equal to the actuarial value of the charitable income interest, this deduction is “recaptured” over time as the donor is taxed annually on the trust income. If the donor dies or ceases to be treated as the owner of the CLT before the full recapture of the previously allowed charitable deduction, the remaining uncaptured portion is accelerated and taxed to the donor or the donor’s estate. Consequently, a charitable lead grantor trust effectively defers rather than eliminates income tax, which may prove advantageous to individuals who expect to be in lower income tax brackets in future years.
- F. Income Tax Treatment of Qualified Nongrantor CLT.** A donor is not entitled to an income tax deduction upon formation of a qualifying nongrantor CLT. For income tax purposes, a nongrantor CLT is treated as a separate entity and taxed as a complex trust. Although the trust itself is not exempt from income tax, it will receive a deduction under Internal Revenue Code section 642(c) for amounts of gross income paid to charitable organizations pursuant to the terms of its governing instrument. In contrast to the income tax deduction rules applicable to individuals, a qualifying nongrantor CLT is not subject to percentage limitations on income tax charitable deductions, and there is no requirement that the recipient beneficiary be a domestic organization. Income in excess of that distributed to charity and any undistributed capital gains are taxed to the trust. The noncharitable remainder beneficiaries are not taxed on the trust income during the term of the trust.
- G. Estate and Gift Tax Deductions.** Upon formation of a qualifying CLT during the donor’s lifetime (an “inter vivos” CLT), the donor receives a gift tax deduction equal to the present value of the charitable income interest

and, if the trust assets are to pass to beneficiaries other than the donor, is subject to gift tax on the present value of the remainder interest. If the donor creates a CLT at the donor's death (a "testamentary" CLT), the donor's estate will be entitled to an estate tax deduction equal to the present value of the charitable income interest. Whether inter vivos or testamentary, when the CLT terminates and the remaining trust assets pass to the noncharitable beneficiaries, no further tax is imposed.

H. Transfer Tax Savings.

1. A qualified CLT enables a donor to achieve meaningful tax savings. First, because the present value of the remainder interest factors in the delay in the noncharitable beneficiaries' receipt of and control over the trust assets, these assets are valued at a discount, resulting in lower gift or estate tax liability for the donor. Although the value of the charitable interest is limited to the value of the property transferred to the trust, it is possible for the donor to create a CLT with a charitable interest equal (or nearly equal) to the value of the property transferred to the trust. In such a case, the remainder interest passing to the noncharitable beneficiaries would be equal to zero or of nominal value, and the donor would incur no (or nominal) gift or estate tax.

2. The following table shows payout rates and trust terms that "zero out" the remainder value for transfer tax purposes. (Assumes section 7520 rate of 3.4% and quarterly payments).

**CHARITABLE LEAD ANNUITY TRUST FOR TERM OF YEARS
Payout Rates to Zero Out or Produce Nominal (Unitrust) Remainder Value**

<u>Term of Years</u>	<u>Annuity Payout Rate</u>
10	11.814%
15	8.513%
20	6.886%
25	5.927%
30	5.302%

3. Second, using the guaranteed annuity format, if the trustee's investment of the transferred assets yields a higher return than the section 7520 rate during the trust term, any excess return passes to the noncharitable beneficiaries free from transfer tax. For

example, a donor wishes to make annual gifts of \$5,000 to her alma mater. She transfers \$36,800 to a charitable lead annuity trust under which the Trustee is required to make annual payments of \$5,000 to University for ten years, and at the end of ten years, to pay the remaining assets to the donor's daughter. Assuming the section 7520 rate is 3.4% percent at the time the assets are transferred to the trust, the donor is entitled to a gift tax deduction of \$36,800 (thus, no gift tax is due). During the 10-year term of the trust, the trust assets earn an annual return of 10 percent. At the end of the term, after making its last payment to University, the Trustee will distribute the remaining assets, worth \$15,768, to the donor's daughter, free of gift tax.

4. Because the income payments to charity under the unitrust format are keyed to the annual value of the trust property, appreciation or income above the assumed interest rate during the trust term inures to the benefit of charity as well as the noncharitable remainder beneficiaries (as charity receives increased unitrust payments), and the predicted balance between the value of charity's interest and the noncharitable beneficiaries' interest will be maintained throughout the term of the trust. Consequently, although a charitable lead unitrust does offer a tax-advantaged method of transferring assets to charity and noncharitable beneficiaries, it does not offer the same opportunity as a charitable lead annuity trust to maximize tax-free transfer of appreciation and excess income to noncharitable beneficiaries.

I. Sale of Remainder Interest In A Charitable Lead Annuity Trust

1. There is an alternative way to leverage use of the GST exemption with a CLAT, if the CLAT is created in conjunction with a separate generation-skipping trust.
2. **Example.** In 2009, Client funds a 15-year CLAT with \$2,000,000 of property and pays an annuity of \$200,000 per year to specified charities. The CLAT provides that at the end of the term, the CLAT property will be distributed in equal shares to Client's three children, and any deceased child's share is payable to the child's estate. Client's husband predeceased Client and a \$1,000,000 GST trust was created at his death. Shortly after the CLAT is created, the trustees of the GST trust purchase the remainder interest in the CLAT from the children for \$275,000. At the end of 15 years, the GST trust receives \$2,000,000 or more of assets, which should be fully GST exempt because they were acquired for full and adequate consideration.

3. The remainder interest in a CLAT is valued for purposes of the sale in the same manner as it is valued for purposes of determining the initial gift when the trust is created. The value of the remainder interest equals the value of the property less the value of the retained annuity, which is a qualified interest under Internal Revenue Code section 2702.
4. The sale of a remainder interest in a CLAT may have income tax consequence to the selling remaindermen. The CLAT will have a uniform basis in the transferred property equal to the basis in the hands of the grantor (adjusted for gift tax paid, if any). The remaindermen are treated as having a proportionate share of that basis for the purpose of determining gain if the remainder interest is sold.
5. **Example.** The \$2,000,000 of assets transferred to the CLAT have an aggregate basis of \$1,000,000. The remainder interest represents about 14% of the value in the trust ($\$275,000/\$2,000,000$) so the remaindermen have about 14% of the basis, or \$140,000. If the children sell the remainder interest in the CLAT to a GST trust, they would recognize gain of about \$135,000 ($\$275,000 - \$140,000$). If the CLAT is funded with cash, and the remainder interest is sold shortly after the trust is funded, the remaindermen should recognize little or no gain.
6. The GST trust that acquired the remainder interest takes a basis in it equal to what it paid. For instance, the GST trust in the example above will have a basis in the remainder interest of \$275,000. When the CLAT terminates, the GST trust probably should take a basis in the assets it receives equal to its basis in the remainder interest. It thereafter would recognize gain (or loss) as assets are sold. If the distribution upon termination of the CLAT is in the form of cash, the IRS would probably conclude that the GST trust would recognize gain immediately to the extent the cash exceeded its basis.

J. GST Considerations. Although the formation of a CLT is not subject to immediate generation-skipping transfer (GST) tax, if the remaining assets pass to “skip persons” (for example, the donor’s grandchildren) at the end of the trust term, the expiration of the term will be a taxable termination resulting in GST tax. For a charitable lead unitrust, all or a portion of the donor’s GST exemption can be precisely allocated when the trust is created, with an opportunity for leverage because the amount of the allocation necessary to produce a zero inclusion ratio is the discounted present value of the remainder interest rather than the value of the assets ultimately passing to the remainder beneficiaries. For a charitable lead annuity trust, however,

GST exemption cannot be precisely allocated upon creation of the trust because calculation of the future GST tax (and therefore, the appropriate allocation of the donor's GST exemption) is based in part upon the value of the trust assets actually passing to the noncharitable beneficiaries at the end of the trust term. Because it is generally impossible to predict this value, it is advisable to delay allocating GST exemption until the end of the lead interest to avoid allocating too much or too little GST exemption.

K. CLAT with Increasing Payout.

1. The IRS Forms for charitable lead annuity trusts provide that the "governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded." Rev. Proc. 2007-45, 2007-9 I.R.B. 89, Sec. 5.02(2).
2. One alternative is to vary the payout rate by steadily increasing it over the term. This method of payment still qualifies as a guaranteed annuity, since the amount received by the charity may be calculated as of the date of the initial transfer. This method allows the trust's growth to be sheltered from depletion during the early years of the trust. For example, assume \$50 million is contributed to a CLAT with a term of 20 years, the section 7520 rate is 3.4%, and the payout rate starts at \$445,000 and increases by 20% each year. With a 4% growth rate, the charity receives a total of \$83,169,504 (compared to \$69,730,000 with a straight percentage payout of 6.973% to zero out the remainder), while the remainder interest is \$8,910,811 (compared to \$5,734,886 with a straight percentage payout).
3. Another alternative is to provide a low, steady payout rate until the last year of the term when the charity receives a balloon payment (referred to as a shark-fin CLAT). For example, assume \$50 million is contributed to a CLAT with a term of 20 years, the section 7520 rate is 3.4%, and the payout rate is 0.01% or \$5,000 each year until the final year. In order for the present value of the remainder to be zero, the final payment to the charity must be \$97,450,000. With a 4% growth rate, the remainder interest is \$11,962,267. Longer terms, such as 25 years or 30 years, will produce greater payments to the charity, as well as greater remainder interests.

L. Nonqualifying CLTs. A nonqualifying CLT is one in which the charitable income interest is not expressed as a guaranteed annuity or unitrust interest (for instance, a trust that is required to pay all of the income earned in a

taxable year to charity). The donor of a nonqualifying CLT typically retains a power that renders the gift incomplete upon formation of the trust (for example, the power to designate the charitable beneficiary each year), and consequently does not receive a charitable gift tax deduction upon formation of the trust. Rather, the donor receives a gift tax deduction each year that the trust distributes income to charity. Whereas the donor generally does not receive an income tax deduction upon creation of a nonqualifying trust, the donor does shift the income tax liability from the transferred assets to the trust. In turn, the trust receives an income tax deduction under Internal Revenue Code section 642(c) for annual distributions to charity. Thus, the donor may effectively avoid the income tax charitable deduction limitations through the trust's unlimited income tax charitable deduction. By establishing a nonqualifying CLT, the donor also avoids the private foundation rules and related excise taxes.

M. Planning Considerations.

1. Annuity or Unitrust. When the donor wishes to maximize the amount of assets ultimately passing to the noncharitable beneficiaries tax free, or anticipates an inflationary climate over the term of the trust, the guaranteed annuity format will generally be preferable to a unitrust format. The guaranteed annuity format may also be simpler from an administrative standpoint, as the annual valuation required by a unitrust may prove costly or burdensome, particularly if trust assets are difficult to value. When the donor wishes for the charitable beneficiaries to share any appreciation in the trust assets, anticipates a decrease in the value of the trust corpus or a general economic downturn, or wishes to obtain a greater degree of GST certainty and protection, the unitrust format may be preferable. Another advantage to the unitrust format is the donor's ability to make additional contributions to the trust and receive gift tax charitable deductions for these contributions.
2. Inter Vivos or Testamentary. The advantages of an inter vivos CLT are the immediate removal of an appreciating asset and its income from the donor's estate on a leveraged basis, and the maximization of growth passing to noncharitable beneficiaries tax free. The principal advantage of a testamentary CLT is the unlimited estate tax charitable deduction. If noncharitable beneficiaries do not have an immediate need for the assets, a CLT may be established with a sufficiently lengthy term so that the present value of the charitable interest is equal to the full value of the trust assets, thereby eliminating the estate tax payable on the assets used to fund the trust. Because the assets are included in the donor's estate, the noncharitable beneficiaries receive the assets

with a stepped-up basis equal to their value on the date of the donor's death.

3. Selection of Trustee. Although the donor of a nongrantor CLT relinquishes ownership of the trust assets during the trust term, at the end of the term the assets pass to the donor's designated beneficiaries or revert to the donor. Selecting a trustee to carry out the donor's intent and ensure proper management of the assets during the interim is therefore essential. The donor generally may serve as trustee of a nongrantor CLT, provided the donor possesses only routine administrative powers. However, if the donor retains the power to select or change the charitable beneficiaries (or clearly controls a trustee with that power), the trust assets will be included in the donor's taxable estate at the donor's death. Further, if payments from a CLT are made to a charity of which the donor is an officer or director, and the donor may participate in selecting recipients of grants funded with such income, the trust assets may be included in the donor's taxable estate. To avoid this result, measures must be taken to insulate the donor from any decisions relating to the recipient charity's use of income received from the CLT. One or more members of the donor's family (other than the donor's spouse) generally may serve as trustee without adverse tax consequences and receive reasonable compensation for their services. If the remainder interest passes to the donor's family, it may be advisable to appoint a disinterested corporate or unrelated co-trustee to serve with the family member.
4. Comparison with Outright Gift or Bequest to Charity. By structuring a charitable gift as a series of payments from a charitable lead annuity trust rather than an outright gift, a donor will have the added ability to transfer assets to non-charitable beneficiaries free of tax as long as the investment return on the trust assets outperforms the section 7520 rate.
5. Comparison with Accumulation Trusts. A taxable gift to a sprinkling trust that accumulates its after-tax income for a specified period will generally result in a greater amount of wealth remaining in the family than if a CLT were created for the same period. (This is so even when a generation-skipping transfer tax is imposed upon termination of the trust.) The advantage of a CLT is the minimization of transfer tax costs at the outset while accomplishing the donor's charitable objectives.

N. Examples of Use.

1. Unified Credit Gift Through Segregation of Portion of Portfolio. Facts: Widower with one child and a modest estate consisting largely of a blue chip portfolio wishes to make provision for his

child and his university and use a portion of his unified credit to remove future growth from his gross estate. Solution: Create a simple inter vivos charitable lead annuity trust with high basis common stocks and daughter as trustee. Pay fixed amount annually to each charity for the donor's life. Instruct broker to issue checks once a year.

2. Leverage of Unified Credit. Facts: Estate owner wishes to make the most effective use of his unified credit at death and does not mind making his children wait to receive their inheritances. Solution: Create a testamentary charitable lead unitrust for a term of years and let the children designate the charitable recipients.
3. Leverage of GST Exemption. Facts: In addition to making the most effective use of his unified credit, the estate owner wishes to maximize the advantages of his GST exemption. Solution: Create a testamentary charitable lead unitrust for a term of years with the grandchildren as remaindermen.
4. Reduction of Estate Taxes. Facts: Estate owner wishes to reduce estate taxes and is willing to defer his children's receipt of their inheritances for an extended period. Solution: Create a testamentary charitable lead unitrust for a term of years commencing at the death of the estate owner, or at the surviving spouse's death in the case of a marital trust.
5. Source for Funding Donor Advised Fund. Facts: Individual wishes to support a community foundation by creating a donor advised fund for his family. Solution: Create an inter vivos or testamentary charitable lead annuity or unitrust providing the community foundation with income payments that in the aggregate will create an appropriately funded donor advised fund.
6. Substitute for Private Foundation. Facts: Husband and wife like the idea of a private foundation as a vehicle for lifetime charitable giving but do not want the capital to be lost by the family. Solution: Create an inter vivos charitable lead annuity or unitrust with one spouse as grantor and the other as trustee. The trustee spouse makes the lead payments to the family's favorite charities periodically during the year just as could be done through a private foundation.
7. Source for Funding Private Foundation. Facts: Family has existing private foundation, and parents desire to enhance its endowment without depriving the children of their ultimate inheritances. Solution: Create an inter vivos charitable lead

annuity or unitrust for a relatively short term with the family foundation as the charitable recipient.

8. Funding Family Charitable Giving. Facts: Parents and children annually give substantial amounts to various charitable organizations and intend to continue this pattern, and parents wish to make taxable gifts to shift growth from their gross estates but do not want to sacrifice their cash flow and existing standard of living. Solution: Create a long-term inter vivos charitable lead unitrust with parents' income-producing assets and children as trustees.
9. Widow's Gift of Marital Trust Assets. Facts: Widow with independent wealth and ability to make a lifetime withdrawal or appointment of the marital trust created by her husband desires to use his assets to establish an endowment in his name and memory at his university while removing growth in the assets from her gross estate. Solution: Create an inter vivos charitable lead annuity or unitrust with a payout rate and term to give the university the necessary endowment amount.
10. Rate Arbitrage or Reduction of Large Unusual Gain. Facts: Taxpayer anticipates being in a lower bracket in future years and desires to use charitable planning to reduce his taxes without depriving his family of the underlying assets. Solution: Create an inter vivos grant charitable lead annuity or unitrust, with a payout rate and term suitable to the grantor, and structured as a grantor trust.
11. Art Collection. Facts: Widow with large art collection desires to use the collection to provide an endowment to her university and to reduce her estate taxes. Solution: Create a testamentary charitable lead annuity trust, with the children as trustees, authorizing the trustees to satisfy the annuity by distributing to the university art objects in kind that can be sold by the university to produce cash to fund the endowment.
12. Closely Held Stock. Facts: Father wishes to transfer future growth in family's C corporation to his children while at the same time benefiting the family's friendly charity. Solution: Create an inter vivos charitable lead annuity trust that will not be subject to Internal Revenue Code section 4943 (restriction on excess business holdings), will be funded with cash and stock, and will be authorized to distribute stock in kind to the charity in satisfaction of the annuity obligation, after which the charity could offer the stock to the corporation for redemption.

13. Double Discounts for Closely Held Stock. Facts: Father wishes to give minority-interest stock in the family's C or S corporation to his children and is willing to postpone their receipt of the shares and to allow the dividends to benefit charity. Solution: Create an inter vivos charitable lead annuity or unitrust (structured as a grantor trust or ESBT if S stock is involved) funded with a certain amount of cash in addition to the stock. For gift tax purposes there are double discounts – first, discounts for minority interest and lack of marketability; and second, for the value of the charitable lead annuity or unitrust interest. The cash in the trust, as augmented by dividends, can be used to pay the charitable lead interest, and the stock at its appreciated value will pass to the children upon termination of the trust.
14. Tax-Exempt Bonds. Facts: Owner of tax-exempt bonds wishes to use these bonds to obtain a current income tax deduction. Solution: Create an inter vivos charitable lead annuity or unitrust structured as a grantor trust that will provide the grantor with a current income tax deduction equal to the annuity or unitrust value and without having taxable income to report in future years.
15. Corporate Lead Trust. Facts: Corporation has “unwanted” appreciated assets that would generate corporate level tax if sold or distributed to shareholders. Solution: Create a charitable lead annuity or unitrust for a term of years and structure trust as a grantor trust if circumstances warrant. Offers opportunities to avoid the General Utilities tax and to shift growth outside the corporation if the remainder interest is assigned to the shareholders.
16. Leverage for Spouse's Poor Health. Facts: Husband and wife wish to create charitable lead trust as part of their gift program. Wife is younger than husband and is in poor health but can be expected to live for more than one year. Solution: Create a charitable lead annuity or unitrust to continue for the wife's life. A larger charitable deduction will be available than if based on husband's life, and the remainder will likely become possessory at a much earlier time.
17. Avoiding Private Foundation Rules. Facts: Childless business owner wishes to give stock in family corporation to a charitable lead trust (for the ultimate benefit of his nephew) that can, without self-dealing, sell all or a portion of the stock back to the company or to the grantor if the nephew decides to leave the business. Solution: Create a nonqualifying lead trust for the nephew, avoiding Internal Revenue Code section 2702. The trust will not

be an Internal Revenue Code section 4947(a)(2) split-interest trust subject to the Internal Revenue Code section 4941 self-dealing rules on any sale of the stock because no gift tax charitable deduction is allowable.

18. Avoiding High State Income Taxes. Facts: Individual lives in a state that has high state income taxes and already has more charitable deductions being carried forward than he can use. Solution: Create a charitable lead annuity or unitrust as a nongrantor trust, thereby removing the income from his returns, both federal and state, and effectively getting a 100 percent deduction and doing the tax authorities out of significant dollars.
19. Cascading Lead Trusts. Facts: An investor with many entrepreneurial investments, and who is otherwise willing to have the investments go to charity, wishes to use zeroed-out GRAT techniques to produce a benefit without transfer tax for his children if one or more of the investments have outstanding growth. Solution: Create a series of charitable lead annuity trusts having staggered or “cascading” termination dates.

V. CHARITABLE REMAINDER TRUSTS.

A. Overview of Charitable Remainder Trusts.

1. The charitable remainder trust is used primarily to provide income security to the noncharitable beneficiary or beneficiaries, while at the same time obtaining a current income tax charitable deduction. It is often used to avoid capital gains tax on appreciated assets that will be sold.
2. **Example.** Jack transfers \$2 million worth of appreciated marketable securities paying little or no dividends to a charitable remainder trust that will pay him a 6% annuity interest for life. The trust can sell the marketable securities without paying capital gains tax and invest the proceeds in income producing property. Jack has used the trust to convert the marketable securities to an income stream of \$120,000 per year. If he had sold the marketable securities directly and paid federal and state capital gains tax of \$300,000, he would have had only \$1,700,000 remaining, and, taking 6% would have given him only \$102,000 per year.
3. Under Internal Revenue Code section 664, a charitable remainder trust is a trust that provides for the distribution of a specified payment at least annually to one or more persons, at least one of which must be a noncharitable beneficiary. The payment period must be for the life or lives of the individual beneficiaries (all of

whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. Upon the termination of the noncharitable interest or interests, the remainder must either be held in a continuing trust for charitable purposes or paid to or for the use of one or more charitable organizations described in Internal Revenue Code section 170(c).

4. For a trust to be a qualified charitable remainder trust, the value of the remainder interest that passes to charity at the end of the term (i.e., the amount of the donor's charitable deduction) must be no less than 10 percent of the initial value of the assets contributed to the trust. With a 3.4 percent AFR, a unitrust cannot be established for the life of an individual under age 27. Also, in the case of the two-life unitrust, if both individual beneficiaries are the same age, a unitrust cannot be established unless the beneficiaries are at least 38 years old with a 3.4 percent AFR.
5. A qualified charitable remainder trust is generally exempt from federal income tax. The grantor is entitled to an income tax charitable deduction and a gift or estate tax charitable deduction based on the present value of the remainder interest ultimately passing to charity. If the noncharitable beneficiary is an individual other than the grantor, the creation of a charitable remainder trust may have gift tax consequences.
6. There are two basic types of charitable remainder trusts under Internal Revenue Code section 664, a charitable remainder annuity trust and a charitable remainder unitrust.
 - a. A charitable remainder annuity trust is required to pay a sum certain annually to one or more beneficiaries, at least one of which is not a charity. The annuity amount must be equal to at least five percent (but not more than 50 percent) of the fair market value of the trust assets valued as of the date the assets are transferred to the trust.
 - b. A charitable remainder unitrust is required to pay a fixed percentage of the net fair market value of the trust assets as revalued annually to one or more beneficiaries, at least one of which is not a charity. The unitrust amount must be equal to at least five percent (but not more than 50 percent) of the net fair market value of the trust assets valued annually.

- c. The amount paid by a unitrust fluctuates with the fair market value of the trust assets, whereas the annual payment from an annuity trust remains constant.
- 7. A unitrust may provide for the payment of the lesser of the fixed percentage or the net income of the trust. This type of unitrust is referred to as a “net income” unitrust. A net income unitrust may have what is called a “makeup” provision. A makeup provision provides that any amount by which the trust income falls short of the fixed percentage is to be paid out in a subsequent year to the extent the trust’s income exceeds the fixed percentage in that subsequent year. A unitrust may also provide for the trust to be a net income trust initially and later convert to a straight unitrust. These types of trusts are often referred to as “flip” unitrusts.

B. Governing Instrument Requirements of Charitable Remainder Trusts.

- 1. In 1989 and 1990 the Internal Revenue Service published a series of Revenue Procedures containing sample governing instruments that can be used in drafting charitable remainder trusts. The sample instruments published by the Internal Revenue Service for annuity trusts and unitrusts, include forms for inter vivos and testamentary trusts and trusts for one or two lives (but not for a term of years).
- 2. These Revenue Procedures provide that a trust will satisfy the requirements of a qualified remainder trust if the trust instrument creates a valid trust under local law, refers to the applicable Revenue Procedure, and is substantially similar to the sample instruments published in the Revenue Procedures.
- 3. The Internal Revenue Service issued new (and improved) sample governing instruments for charitable remainder annuity trusts on August 4, 2003 and for charitable remainder unitrusts on August 19, 2005. These new sample trusts are set forth in a series of Revenue Procedures, as described below, that supersede the earlier 1989 and 1990 sample forms for charitable remainder trusts.
 - a. Revenue Procedure 2003-53 – one life, inter vivos charitable remainder annuity trust.
 - b. Revenue Procedure 2003-54 – term of years, inter vivos charitable remainder annuity trust.
 - c. Revenue Procedure 2003-55 – two lives (consecutive), inter vivos charitable remainder annuity trust.

- d. Revenue Procedure 2003-56 – two lives (concurrent and consecutive), inter vivos charitable remainder annuity trust.
 - e. Revenue Procedure 2003-57 – one life, testamentary charitable remainder annuity trust.
 - f. Revenue Procedure 2003-58 – term of years, testamentary charitable remainder annuity trust.
 - g. Revenue Procedure 2003-59 – two lives (consecutive), testamentary charitable remainder annuity trust.
 - h. Revenue Procedure 2003-60 – two lives (concurrent and consecutive), testamentary charitable remainder annuity trust.
 - i. Revenue Procedure 2005-52 – one life, inter vivos charitable remainder unitrust.
 - j. Revenue Procedure 2005-53 – term of years, inter vivos charitable remainder unitrust.
 - k. Revenue Procedure 2005-54 – two lives (consecutive), inter vivos charitable remainder unitrust.
 - l. Revenue Procedure 2005-55 – two lives (concurrent and consecutive), inter vivos charitable remainder unitrust.
 - m. Revenue Procedure 2005-56 – one life, testamentary charitable remainder unitrust.
 - n. Revenue Procedure 2005-57 – term of years, testamentary charitable remainder unitrust.
 - o. Revenue Procedure 2005-58 – two lives (consecutive), testamentary charitable remainder unitrust.
 - p. Revenue Procedure 2005-59 – two lives (concurrent and consecutive), testamentary charitable remainder unitrust.
4. If a donor wishes to obtain the benefits of the income tax charitable deduction for a contribution to a 50 percent-type organization, the governing instrument must require that the charitable organization qualify under Internal Revenue Code section 170(b)(1)(A). In Revenue Ruling 79-368, 1979-2 C.B. 109, the Internal Revenue Service limited the allowable charitable deduction to 20 percent of adjusted gross income because the remainder interest could have

passed to a 30 percent-type organization even though the document named a 50 percent-type organization. On the other hand, the Internal Revenue Service allowed a deduction based on a gift to a 50 percent-type organization in Revenue Ruling 80-38, 1980-1 C.B. 56 for a charitable remainder trust that provided for the remainder interest to pass to a public university. The instrument provided that if the university was not an organization under Internal Revenue Code section 170(c) the trustee was to select another section 170(c) beneficiary. Although the instrument did not also mention Internal Revenue Code section 170(b)(1)(A), the Internal Revenue Service held the possibility that the remainder would not pass to a 50 percent-type organization to be negligible. Unlike the Internal Revenue Service's 1989 and 1990 sample forms which only referred to Internal Revenue Code section 170(c), the 2003 and 2005 sample forms for charitable remainder trusts address this issue specifically.

5. The Internal Revenue Service requires a special provision for a charitable remainder trust that has a life interest following the grantor's life interest. In Revenue Ruling 82-128, 1982-2 C.B. 71, *mod. Rev. Rul. 72-395*, the Internal Revenue Service ruled that the mere possibility that a death tax could be apportioned against the inter vivos charitable remainder trust under state law disqualified the trust as a charitable remainder trust. Under the Ruling, if the trust agreement has a provision stating that the interest of the second life beneficiary shall not take effect unless the beneficiary furnishes funds with which to pay any death taxes apportioned against the trust on the donor's death for which the trust may be liable, the trust will qualify as a charitable remainder trust. The donor must require that the successor life beneficiary pay any death taxes imposed on the trust out of the life beneficiary's own assets as a condition of receiving distributions from the charitable remainder trust. If the successor life beneficiary fails to do so, the charity's interest takes effect immediately.
6. One of the important optional provisions is the reservation by the donor of the right to revoke or terminate the interest of any noncharitable beneficiary. This power may only be exercisable by will. Reg. § 1.664-2(a)(4) and § 1.664-3(a)(4). If the donor reserves this power, the secondary life interest is revocable and there is no gift at the time of the creation of the trust. By making the life interest revocable, the value of the trust would be included in the donor's estate but partially offset by the charitable deduction for the actuarial value of the charitable remainder interest determined as of the donor's date of death. If the donor is not one of the income beneficiaries, the reservation of a power to revoke

may not accomplish the desired tax goals in certain circumstances. Particular care should be taken in these circumstances.

7. The Internal Revenue Service's sample forms generally do not contain provisions regarding the trustee's powers, right to resign, etc. As a general rule, it is advisable to include these types of provisions in the trust agreement.

C. Noncharitable Beneficiaries of Charitable Remainder Trusts.

1. If the noncharitable interest is for a life or lives (rather than a term of years) the annuity amount or the unitrust amount must be paid to one or more named persons, all of whom must be living when the trust is created. Payments may be made for the use of an individual thus allowing distributions to a guardian of an incompetent beneficiary. Revenue Ruling 76-270 allowed the payment from a charitable remainder trust to an educational trust for the benefit of three minor beneficiaries.
2. In Revenue Ruling 76-270, the income beneficiary of a charitable remainder trust was a trust established for the benefit of a permanently incompetent beneficiary. The trustee of the recipient trust had discretion to use all of the trust assets for the incompetent beneficiary and upon the death of the beneficiary, the trust assets were to be paid to the incompetent's estate. The Internal Revenue Service ruled that this trust was a qualified charitable remainder trust.
3. In Revenue Ruling 2002-20, the Internal Revenue Service ruled that a charitable remainder unitrust may pay the unitrust amounts to a second trust for the life of an individual who is financially disabled as defined in Internal Revenue Code section 6511(b)(2)(A) if the use of the unitrust amounts by the second trust is consistent with the manner in which the individual's own assets would be used, and upon the individual's death, the second trust will distribute the remaining assets either to the individual's estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to the individual's general power of appointment.

D. Contributions to Charitable Remainder Trusts.

1. The rules governing charitable remainder trusts contain no express limitation on the types of property that may be contributed to a charitable remainder trust. Because charitable remainder trusts are tax-exempt entities, frequently charitable remainder trusts are funded with appreciated property.

2. If the grantor wishes to retain the option to make additional contributions to a charitable remainder trust, the grantor must use a charitable remainder unitrust. No additional contributions may be made to a charitable remainder annuity trust after the initial funding. The governing instrument of a charitable remainder unitrust must prohibit additional contributions or provide special rules for determining unitrust payments in the case of additional contributions.
3. A testamentary charitable remainder trust can be used as the beneficiary of retirement plan accounts possibly maximizing family wealth. By having the distribution made to a tax-exempt charitable remainder trust, it is possible to defer paying the income tax and the estate will receive an estate tax charitable deduction. The income taxes will be deferred over the life of the income beneficiary.

E. Trustees of Charitable Remainder Trusts.

1. A grantor may serve as trustee of a charitable remainder trust. If a grantor does serve as trustee, the grantor must not retain any power that would cause the trust to be subject to the grantor trust rules under Internal Revenue Code sections 671 through 679. (For example, the grantor may not have the power as trustee to alter the beneficial enjoyment of the income distributions.)
2. The charity that is the charitable remainder beneficiary may also serve as trustee of a charitable remainder trust assuming the charity is permitted to serve under applicable state law.
3. If the grantor serves as trustee, payment of commissions to the grantor should not constitute self-dealing, if the payments are reasonable and based on the amount ordinarily paid to trustees under state law.
4. Previously, practitioners took the position that the grantor should never be permitted to serve as trustee of a charitable remainder trust that contains assets that are difficult to value, such as real estate or closely held stock. It is questionable in these circumstances whether the charity should serve as trustee as well. Self-dealing concerns in these situations have been resolved in final regulations issued in December 1998 by the Internal Revenue Service as discussed in more detail below.

F. Valuation of Unmarketable Assets.

1. The legislative history to Internal Revenue Code section 664 has often been referred to for the proposition that a donor could not serve as trustee of a charitable remainder trust unless an independent trustee appraised the trust assets.
2. To clarify this issue, the final regulations provide that if a charitable remainder trust holds unmarketable assets and the trustee is the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or noncharitable beneficiary within the meaning of Internal Revenue Code section 672(c), the trustee may use a qualified appraisal from a qualified appraiser (within the meaning of Regulation section 1.170A-13(c)(3) and (5)) to value the unmarketable assets if there is not an independent trustee.
3. This change permits the grantor, a noncharitable beneficiary, or a related or subordinate party to serve as sole trustee of a charitable remainder trust funded with unmarketable assets.
4. This provision is effective for trusts created on or after December 10, 1998.

G. Income Taxation of a Charitable Remainder Trust.

1. If the charitable remainder trust has no unrelated business income, the trust is exempt from all federal income taxes.
2. Changes made by the Tax Relief and Health Care Act of 2006 removed the harsh rule that a charitable remainder trust would lose its exempt status for any year in which it had even one dollar of unrelated business taxable income. The new law imposes a 100 percent excise tax on unrelated business income of a charitable remainder trust, and the payment of this tax is treated as having been made from corpus. But, unrelated business income is considered income of the trust for purposes of determining the taxation of the income to the noncharitable beneficiary.

H. Payments to Noncharitable Beneficiaries.

1. A charitable remainder annuity trust must pay at least annually a sum certain to one or more noncharitable beneficiaries. The payment must be for the life of the noncharitable beneficiary or for a term of years not to exceed 20 years. The sum certain may be stated as an absolute dollar amount or as a fraction or percentage of initial net fair market value of the property placed in the trust.

Subject to certain exceptions, the stated annuity amount may not be less than five percent nor more than 50 percent of the initial net fair market value of the trust property. There are special rules where the sum certain is expressed as a fraction or percentage and the initial fair market value of the trust property is valued incorrectly.

2. A charitable remainder unitrust must pay at least annually a fixed percentage of the net fair market value of the trust assets, as revalued each year, to noncharitable beneficiaries. The payments must be for the life of the noncharitable beneficiaries or for a term of years not to exceed 20 years. Subject to certain exceptions, the fixed unitrust percentage for a charitable remainder unitrust may not be less than five percent nor more than 50 percent of the initial fair market value of the trust property. Similar to the charitable remainder annuity trust, there are special rules when the net fair market value of the unitrust assets is determined incorrectly.
3. The primary difference between a charitable remainder unitrust and annuity trust is that the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, while the amount of the unitrust payment will fluctuate from year to year, depending upon the value of the trust principal. A unitrust will result in increasingly greater payments to the income beneficiaries if the trust assets appreciate. Because the amount of the annuity payment is fixed at the time the charitable remainder annuity trust is created, the amount the noncharitable beneficiaries receive will not vary and may be preferable for noncharitable beneficiaries who do not want investment or market risk.
4. There are four types of unitrusts: a standard unitrust, a net income only unitrust, a net income unitrust with a makeup provision, and a “flip” unitrust.
 - a. A standard unitrust pays the recipient a fixed percentage of the net fair market value of the trust assets as revalued annually.
 - b. A net income unitrust pays the noncharitable beneficiary the lesser of the trust's net income or the stated percentage.
 - c. The net income unitrust with a makeup provision pays the noncharitable beneficiary the lesser of the trust's net income or the stated percentage and, if the income in any year exceeds the unitrust amount for the year, the excess is

paid out to the extent necessary to make up for any shortfalls in prior years.

- d. “Flip” unitrusts are discussed in more detail below.
5. The minimum amount rule will not be violated where the governing instrument of the annuity trust or unitrust provides for a reduction of the stated amount or fixed percentage upon the death of a noncharitable beneficiary upon the expiration of the term of years provided that a distribution of principal is made to a charitable organization at the same time. The total amount payable by the annuity trust after a distribution to the charity may not be less than the dollar amount that bears the same ratio to the total annuity amount before the reduction as the net fair market value of the trust assets immediately after the distribution bears to the net fair market value of the trust immediately before the distribution and for a unitrust the total percentage of the trust assets payable must be at least five percent.
6. The governing instrument of an annuity trust or unitrust must provide that in the case of a short taxable year other than the final year, the annuity or unitrust amount otherwise payable is prorated for the actual number of days in the short taxable year.

I. Period of Payment to Noncharitable Beneficiary.

1. The governing instrument of a qualified charitable remainder trust must require payment of the annuity or unitrust amount for a period that begins with the first year of the charitable remainder trust and continues for the life or lives of a named individual or individuals living at the creation of the trust or for a term of years not to exceed 20 years. Only an individual or section 170(c) organization may receive the annuity or unitrust amounts for the life of an individual. If payments are made to a noncharitable entity such as a partnership, corporation, or trust, the period of payment must be measured by a term of years not to exceed 20 years.
2. If an individual receives an amount for life, it must be payable solely for the life of that individual. An interest based on the life of another individual is not permissible.
3. Where payments are to be made for a term of years, it is permissible for payments to be made to the beneficiary's estate for the duration of the term. The Internal Revenue Service ruled in Revenue Ruling 74-39 that the following payment provision was acceptable: a payment to an individual for a term of 20 years and

if the individual died before the expiration of the 20-year term, payments were made to a second individual for the balance of the period and if this individual also died, payments were made to that individual's heirs-at-law for the remainder of the 20-year period. The Internal Revenue Service ruled this was a permissible payment provision because the trust term cannot last longer than 20 years.

4. It is permissible to tack a period measured by the life of an individual onto a period measured by a term of years, provided the individual is living on the date of the creation of the trust. It is not permissible to tack a period measured by a term of years onto a period measured by the life of an individual. (The durational limit must be either a term of years not to exceed 20 years or the life of the individual beneficiary.)
5. Internal Revenue Code section 664(f) allows noncharitable annuity or unitrust payments to end upon the occurrence of a qualified contingency which will accelerate the charitable remainder interest. A qualified contingency must not extend the duration of the otherwise allowable term.

J. The Net Income Charitable Remainder Unitrust.

1. A unitrust with a net income only option limits the amount paid out to the noncharitable beneficiary to the income earned by the trust if that is less than the unitrust amount. The limitation does not affect the donor's charitable contribution deduction.
2. If the unitrust has the net income only option, it may be advantageous to include a makeup provision. With a makeup provision, any deficits between the calculated unitrust amount and the actual income available for payments in a year are made up in future years where the trust income exceeds the unitrust percentage. Normally, there is no reason not to include a makeup provision in a net income unitrust.
3. Use of an "income only" limitation offers the ability to build a substantial retirement fund for the noncharitable beneficiary (often the donor or his spouse). During the pre-retirement years, the trust assets can be invested for growth, with a shift over to current yield investments after retirement. The deficit make-up provisions could result in a substantial credit owned the beneficiary from the trust to boost the post-retirement payout.
 - a. **Example.** An individual creates a net income with makeup charitable remainder unitrust at age 50. The trust provides for a unitrust payment to the individual of 5%, or if less, the

income earned by the trust. The individual funds the trust with \$100,000, which is invested in common stocks yielding about 1% per year. At the end of 15 years, the trust fund is worth \$197,993 because of the appreciation of the common stock, and the net income limitation has created a payout deficiency of \$64,736. The individual retires, and the trust shifts its investments to bonds and notes yielding about 8%. The unitrust amount at this time is about \$9,900 (5% of 197,893), but the trust will pay all its \$15,840 of income (8% of \$197,893) to the individual to make the payout deficit from the first 15 years. This increased payout will last for about 11 years.

- b. The IRS stated in one its agent training manuals that the use of a NIMCRUT in the manner described in the example above may violate the self-dealing rules under Internal Revenue Code section 4941.
 - (1) The manual states that an asset manipulation (i.e., not selling stock of a non-income producing company in the early years and then investing in high yielding assets later on) intended to provide an economic benefit to the NIMCRUT's income beneficiary may be self-dealing if the beneficiary is a disqualified person. The manual asks how holding an asset off the market could adversely affect a charitable remainder interest. It answers the question by saying that it is possible that the M stock will not appreciate as fast as the general market. Having made this point, the manual goes on to say that in the end it does not matter whether the charitable remainder trust is better off as a result of the investment strategy.
 - (2) This characterization as self-dealing may be overreaching by the IRS.
- 4. The 1998 final regulations authorize the use of "flip" unitrusts in certain circumstances and if certain requirements are met. In many situations where a net income charitable remainder trust (with or without a makeup provision) may have been appropriate in the past, the flip charitable remainder unitrust will serve the donor's objectives more effectively and eliminate certain concerns.

K. “Flip” Charitable Remainder Unitrusts.

1. The final regulations issued in 1998 allow the creation of a net income charitable remainder unitrust (whether with or without a makeup provision) that converts to a straight percentage charitable remainder unitrust upon the occurrence of a specified event. Under these rules, a net income charitable remainder unitrust may convert to a straight percentage unitrust (using the same percentage) if the governing instrument of the charitable remainder unitrust meets the following requirements:
 - a. The change from a net income unitrust to a straight unitrust must be triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person (referred to as the “triggering event”).
 - b. The change from a net income unitrust to a straight unitrust must occur at the beginning of the taxable year of the unitrust that immediately follows the taxable year during which the triggering event occurs. Under this rule, if the triggering event occurs on July 1, 2009, the conversion of the unitrust to a straight unitrust must occur on January 1, 2010.
 - c. Following the conversion in the case of a net income unitrust with a makeup provision, the unitrust’s governing instrument must provide that any makeup amount not paid as of the conversion date is forfeited.
2. These new flip unitrust rules are extremely broad and significantly enhance the planning opportunities available when establishing a charitable remainder unitrust for a donor. These rules generally apply to charitable remainder unitrusts established on or after December 10, 1998.

L. Allocation of Capital Gain to Income.

1. Many trusts now providing for a makeup provision allocate capital gains to income which is permitted if so provided in the governing instrument under most state’s principal and income acts.
2. The Internal Revenue Service had expressed concern that abuses could occur if the pre-contribution gain is allocable to income.
3. The 1998 regulations provide that the proceeds from the sale of a net income unitrust’s assets, at least to the extent of the fair market

value of the asset when contributed to the trust, must be allocated to principal.

4. This provision is effective for sales or exchanges occurring after April 18, 1997.
5. The preamble to the 1998 regulations further provides that the makeup amount does not have to be treated as a liability to the extent of post-contribution appreciation in the assets for purposes of valuing the unitrust and determining the annual unitrust amount (contrary to the position of the Internal Revenue Service in earlier letter rulings).

M. Taxation of Payments to the Noncharitable Beneficiary.

1. Internal Revenue Code section 664(b) sets forth the rules for determining the taxability of distributions from a charitable remainder trust to the noncharitable beneficiary. Payments to the noncharitable beneficiary are deemed to be made first from ordinary income, second from capital gains, third from other income (which is usually tax-exempt income), and last from trust principal.
2. Distributions to noncharitable beneficiaries consist first of ordinary income to the extent of the trust's ordinary income for the taxable year of the distribution and the trust's ordinary income for prior years not deemed to have been previously distributed. After all current year and prior year's undistributed ordinary income has been exhausted, the distribution to noncharitable beneficiaries is deemed to be composed of capital gain income to the extent of the trust's capital gain income for the year and undistributed capital gain income from earlier years. In determining the amount of capital gain distributed, long-term gains are netted against long-term losses, and short-term gains are netted against short-term losses. The short-term capital gains are deemed distributed before long-term capital gains. If capital losses exceed capital gains, excess losses are carried forward to succeeding taxable years. Losses are never carried back.
3. After capital gain income is exhausted, distributions to a noncharitable beneficiary are deemed to come from other income. Other income includes income that is excluded from gross income, which is usually tax-exempt income.
4. After the three categories of ordinary income, capital gains, and other income have been exhausted, remaining distributions to

noncharitable beneficiaries are considered to have been made from trust principal.

5. In response to tax law changes creating a lower 15% tax rate for qualifying dividends and capital gains, the Internal Revenue Service issued final regulations on March 16, 2005 regarding the characterization and treatment of the dividends and gains under the four-tier distribution scheme applicable to charitable remainder trusts.
 - a. Pursuant to these final regulations, within a designated class, income will be treated as distributed first from those items within the class subject to the highest federal income tax rate and ending with the items subject to the lowest federal income tax rate. Thus, within the ordinary income category, interest income would be distributed before qualifying dividend income.
 - b. A charitable remainder trust may have significant accumulated capital gain from past sales of assets. Unless that gain falls within a special category (such as the 28% rate for gains from collectibles or the 25% rate for unrecaptured section 1250 gain), that gain will fall into the 15% category. This is the case even if it was realized in a sale that occurred when the capital gains rate was higher.
6. The payment to a noncharitable beneficiary is deemed to have occurred on the last day of the trust's taxable year in which the amount is required to be distributed, even if the annuity or unitrust amount is not actually distributed until after the close of the trust's taxable year. Reg. § 1.664-1(d)(4)(i).

N. Timing of Payment of Unitrust and Annuity Amount.

1. Previously under the regulations, a trustee was permitted to pay the annuity or unitrust amount within a reasonable period of time following the close of the trust's taxable year.
2. This was previously deemed to be by the due date of the trust's tax returns. This provision was originally intended as an administrative convenience for trustees of net income unitrusts.
3. To remedy concerns about accelerated charitable remainder trusts as described in Notice 94-78, the 1998 regulations make certain changes to the rules regarding the timing of the payment of the annuity amount or the unitrust amount.

4. For charitable remainder annuity trusts and straight charitable remainder unitrusts, the annuity or unitrust amount may be paid within a reasonable time after the close of the taxable year in which it is due if:
 - a. The character of the annuity or unitrust amount in the recipient's hands is income under Internal Revenue Code section 664(b); or
 - b. The trust distributes property (other than cash) that it owned as of the close of the taxable year in satisfaction of the annuity or unitrust 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 annuity or unitrust amount is due.
5. For charitable remainder annuity trusts and straight charitable remainder unitrusts that were 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 if the percentage used to calculate the annuity or unitrust amount is 15 percent or less.
6. Other charitable remainder trusts will be required to distribute the annuity or unitrust amount by the end of the year for which it is payable. The trusts covered by this rule include:
 - a. Any trust for which some portion of the unitrust or annuity trust amount will be characterized as corpus under the four-tier tax system applicable to distributions from charitable remainder trusts.
 - b. Any annuity trusts or straight unitrusts created before December 10, 1998 with a payout rate greater than 15 percent.
7. Net income unitrusts continue to operate under the prior rule and thus have a reasonable period of time after the end of the taxable year to pay the unitrust amount.

O. Miscellaneous.

1. The governing instrument must contain a provision addressing the incorrect valuation of the net fair market value of trust assets. If the trustee incorrectly determines the net fair market value of the trust assets and the payment is expressed as a fraction or a percentage of the net fair market of the trust property, the incorrect

valuation will affect the amount payable to the noncharitable beneficiary. When this occurs, the trustee must pay to the beneficiary in the case of an undervaluation, or the beneficiary must pay the trustee in the case of an overvaluation, an amount equal to the difference between the amount the trustee paid the beneficiary and the correct payment amount. The payments or repayments must be made within a reasonable period after the final determination of the value of the trust assets.

2. A trust is not a charitable remainder trust if any person has the power to alter the amount to be paid to any named person other than an organization described in section 170(c) if such power would cause any person to be treated as the owner of a trust if the grantor trust rules were applicable to the trust. For example, the governing instrument may not grant the trustee the power to allocate the fixed percentage among members of the class unless this power falls within one of the exceptions to Internal Revenue Code section 674(a).
3. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in section 170(c). The grantor may retain the power exercisable by will to revoke or terminate the interest of any recipient other than an organization described in section 170(c).

P. Planning with “Flip” Charitable Remainder Unitrusts.

In the past, the use of a charitable remainder trust as a charitable gift technique had become fairly routine without much consideration given to planning opportunities presented beyond the immediate income tax benefits. Typically, the only decisions required were whether to use a charitable remainder annuity trust or a charitable remainder unitrust, the amount of the payout to the noncharitable beneficiary, and the timing of the payments to the noncharitable beneficiary. If a charitable remainder unitrust was selected, it was necessary to decide whether the unitrust should provide for payment of a straight percentage or the lesser of the net income or the set percentage. If a net income charitable remainder unitrust was selected, it was also necessary to decide whether to include a makeup provision. Because the options were somewhat limited, establishment of the charitable remainder trust and preparation of the trust agreement were fairly straightforward, and reliance on forms was the norm.

1. With the advent of the flip unitrust, traditional approaches to the establishment of a charitable remainder trust no longer work. Planned giving officers, lawyers, and other advisors to individuals desiring to establish charitable remainder trusts must now explore

more fully the estate planning objectives and goals of the donor. Depending upon these objectives and goals, more attention must also be given to the drafting of the actual terms of the charitable remainder trust agreement. But, the charitable remainder unitrust is now a much more flexible estate planning tool. While there are certain obvious uses for a flip unitrust, there are also a myriad of circumstances for using flip unitrusts to accomplish the unique objectives and goals of the donor that are not so obvious.

2. The wide range of planning opportunities associated with a flip unitrust arises from the broad definition of a “triggering event” under the final regulations. It is the triggering event that causes the flip unitrust to convert from a net income charitable remainder unitrust (whether with or without a makeup provision) to a straight charitable remainder unitrust. The actual conversion to a straight charitable remainder unitrust will occur on January 1 of the first taxable year after the year in which the triggering event occurs.
 - a. The final regulations offer a number of examples of permissible triggering events. A specific date is a permissible triggering event.
 - b. A single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person is a permissible triggering event.
 - c. The sale of an unmarketable asset or the marriage, divorce, death, or birth of a child with respect to any individual are permissible triggering events. Unmarketable assets include real estate, closely held stock, or unregistered securities for which there is no available exemption permitting public sale under the rules of the Securities and Exchange Commission.
 - d. The regulations also set forth a number of examples that illustrate the breadth of the definition of a permissible triggering event. Permissible triggering events under these examples include the sale of a personal residence, the attainment of a certain age by the noncharitable beneficiary of the flip unitrust, the marriage or divorce of the noncharitable beneficiary, the birth of the first child of the noncharitable beneficiary, and the death of the noncharitable beneficiary’s father.

3. Use of Flip Unitrust for Unmarketable Assets.
- a. The most obvious use of a flip unitrust is in connection with a gift of an illiquid or unmarketable asset, such as real estate or closely held stock. In the past, charitable remainder trusts funded with these types of assets were typically structured as net income (either with or without a makeup provision) charitable remainder unitrusts. This approach was necessary to enable the charitable remainder unitrust to satisfy the payout requirements to the noncharitable beneficiary during the time before the unmarketable asset was sold. Under recent market conditions, however, the sale of the unmarketable asset did not usually result in payment of the full straight percentage to the noncharitable beneficiary following the sale without an investment approach that favored the generation of income. This type of investment approach often conflicted with the long-term objective of growth, which would have resulted not only in benefits to the charitable remainderman, but also to the noncharitable beneficiary in the form of higher payouts over time.
 - b. Use of a flip unitrust when dealing with an unmarketable asset, with the triggering event defined as the sale of the unmarketable asset, will avoid problems associated with a net income unitrust and allow the assets of the unitrust to be invested for total return following the sale of the unmarketable asset. The flip unitrust enables the initial problems associated with funding a charitable remainder trust with unmarketable assets to be handled during the period before the unmarketable asset is sold, but has solved the long-term problem associated in the past with net income charitable remainder unitrusts and an investment strategy designed to produce income. Now, if a flip unitrust is used, the trust assets can be invested for growth or total return following the sale of the unmarketable asset to the ultimate benefit of not only the charitable remainderman, but also the noncharitable beneficiary of the charitable remainder unitrust.
 - c. If the flip unitrust is structured initially as a net income with a makeup provision and post-contribution appreciation is allocated to income under the terms of the trust agreement, it may also be possible to ensure that the noncharitable beneficiary receives some of the unitrust amount accrued while the unitrust owned the unmarketable asset before this amount is forfeited following the

conversion to a straight unitrust on January 1 of the year following the year in which the triggering event occurs.

- d. **Example.** Donor establishes a flip unitrust and funds the unitrust with unimproved real estate on January 1, 2008. The flip unitrust provides that the Donor is to receive the lesser of the net income of the unitrust or six percent of the value of the trust's assets as valued each year until the year following the year in which the real estate contributed to the unitrust is sold. The flip unitrust also provides that post-contribution appreciation is to be included in income or purposes of determining the payments to the Donor before the conversion of the unitrust to a straight unitrust. At the time the flip unitrust is funded the real estate is valued at \$100,000. The real estate is sold on December 30, 2010 for \$150,000. The accrued unitrust amount through 2010 is \$18,000. Because post-contribution appreciation is allocated to income, the trustee has \$50,000 of income in 2010, which amount can be used to pay the Donor the accrued unitrust amount of \$18,000. Beginning on January 1, 2011, the unitrust will pay the Donor six percent of the fair market value of the trust assets as revalued each year.
- e. Because of the unique benefits of the flip unitrust when dealing with unmarketable assets, it is likely that the flip unitrust will supplant the net income charitable remainder unitrust and become more widely used. Of course, there may still be situations where the donor may prefer a net income charitable remainder unitrust instead of a flip unitrust, particularly if income is defined to include post-contribution appreciation as now permitted under the final regulations. For these reasons, it will be necessary for the donor's advisors to review the possible choices with the donor in greater detail to insure that the form of charitable remainder unitrust chosen meets the donor's objectives and goals.

4. Use of Flip Unitrusts for Retirement Planning.

- a. Another significant planning opportunity associated with the flip unitrust is in connection with planning for the donor's retirement. In the past, net income charitable remainder unitrusts have been promoted as an effective technique for retirement planning in conjunction with a charitable gift. Under this technique, the donor would contribute assets to a net income charitable remainder

unitrust during a year when the donor's income was high, thereby obtaining an immediate income tax charitable deduction to reduce the donor's income taxes. Then, through a choice of an investment strategy designed to minimize income and maximize growth while the donor was still earning significant income, the income received from the net income charitable remainder unitrust during the employment years was limited. Upon the donor's retirement, the investment strategy of the charitable remainder unitrust would be changed so as to favor income in the years following retirement. While this technique could work in certain circumstances, its success depended in part upon market conditions, which are not always predictable. There have also been concerns in the past that the manipulation of the investments to favor the donor's income needs could be considered self-dealing under Internal Revenue Code section 4941.

- b. The flip unitrust is an excellent alternative to the net income unitrust in connection with retirement planning for the donor. The triggering event in the flip unitrust would be either a set date or the date upon which the donor attains a certain age, such as age 65. Before that time, the unitrust would be invested for growth or total return and the donor would receive the actual income earned by the charitable remainder unitrust under the net income limitation. Upon the conversion of the flip unitrust to a straight charitable remainder unitrust, the donor will begin receiving a straight percentage of the value of the trust assets as revalued each year. Thus, the donor's retirement objectives have been met without having to alter the unitrust's investment strategy to achieve these goals. The investment of the trust assets for total return throughout the donor's lifetime should also have the added advantage of generating a higher unitrust amount in later years assuming the assets increase in value during the term of the unitrust.
- c. The use of a flip unitrust for retirement planning again illustrates the need for the donor's advisors to explore the donor's objectives when establishing the unitrust. In the case of a donor who is still working, the advisors should point out the potential benefits associated with the use of a flip unitrust tied to the donor's anticipated retirement date. (Note that the triggering event should not be defined as the donor's retirement as this could be deemed to be an event that is discretionary with the donor. Instead, the triggering

event should be defined as a specific date or the date upon which the donor attains a certain age.)

5. Use of Flip Unitrust to Meet Estate Planning and Income Objectives. Because of the broad range of possible triggering events, there is a greater need to explore the donor's particular objectives when establishing a charitable remainder unitrust, even if the trust is funded with marketable assets or the donor is not concerned about retirement. There are any number of circumstances where the flip unitrust may be advisable or prudent for the donor. Planning with the flip unitrust will require a great deal of attention to the specific circumstances of the donor and greater creativity when structuring a charitable remainder unitrust to meet the objectives and goals dictated by the donor's unique circumstances. Examples of the types of situations where a flip unitrust may be useful or advisable include:
 - a. Planning for Surviving Spouse. Many donors are not concerned about their income needs while they are living, but instead worry that their spouses may need greater income following their deaths. In these circumstances, the donor should consider a flip unitrust, with the surviving spouse as a noncharitable beneficiary and the triggering event defined as the donor's death.
 - b. Planning for a Child. Many donors worry that their children may not have the necessary financial resources in the event of certain occurrences during their children's lives, such as divorce or birth of a child. In these circumstances, the donor may consider a flip unitrust, with the child as a noncharitable beneficiary and the triggering event defined as the child's divorce or the birth of the child's first child. Other possibilities would include defining the triggering event as the death of the donor or the death of the child's spouse to ensure that the child is adequately provided for following the donor's death or the death of the child's spouse.
 - c. Planning for Education. Many donors have provided funds for grandchildren's education under favorable gift tax provisions. Often, there are younger grandchildren who are not yet of school age. If the donor is concerned that he may not be living when the grandchild reaches school age, the donor may consider a flip unitrust for a term of years with the triggering event defined as the date the grandchild reaches a certain age. Particular care should be taken to

examine the transfer tax ramifications upon the creation of the trust.

- d. Planning for Uncertainty. Many donors do not have a current need for income but worry about a possible need for income in the future. In these circumstances, a flip unitrust may be advisable with a triggering event tied to an event such as involuntary termination of employment or total disability. The examples under the final regulations also make it clear that it is permissible to use a triggering event tied to the sale of an unmarketable asset even when other assets of the unitrust consist of marketable assets. Because it may not be possible to plan for an unknown event, some flexibility could be created by funding a flip unitrust with marketable assets and one unmarketable asset, such as real estate or a share of closely held stock and defining the triggering event as the sale of the unmarketable asset. If the donor had a need for greater income in the future, the trustee could then sell the unmarketable asset to trigger a conversion of the unitrust from a net income charitable remainder unitrust to a straight charitable remainder unitrust.

Q. Planning Considerations with Gifts of Appreciated Property

1. If the grantor owns low-dividend-paying appreciated securities, the use of such securities to fund a charitable remainder trust results in a charitable deduction for the remainder interest based on fair market value of the securities transferred. The trust can then sell the securities without tax and invest in higher income securities, the income from which will fund a higher payout to the grantor than his previous dividend payouts. The result is that the grantor has realized a benefit from the appreciation by using it (without paying a capital gain tax) to obtain a higher yield and also has obtained a charitable deduction for the remainder portion of the appreciation without paying a capital gain tax.
2. **Example.** In 2009, an individual, age 60, transfers \$100,000 of low-tax basis securities percent income annually to a charitable remainder annuity trust. The current interest rate in the Treasury tables is 8%. The trust provides that an \$8,000 annuity be paid to the individual for his life. The trustee of the trust sells the securities and invests in bonds yielding 8 percent income. The trust does not pay any tax on the capital gain resulting from the sale. The individual receives a \$28,380 income tax deduction in the year of the transfer, which will save about \$9,930 in income taxes (assuming a 35% tax rate). In addition, the individual

receives over two and one-half times the income that he previously received from the securities.

3. The use of a charitable remainder trust allows the individual to retain all of the proceeds from the sale of the appreciated stock for reinvestment. If the individual had sold the stock directly, he would have only the after-tax proceeds available for investment.
4. Ultimate Payment of Capital Gains Tax. Because of the tier system for the taxation of distributions to beneficiaries of charitable remainder trusts, any capital gains resulting from the sale may ultimately be distributed and taxed to the beneficiary. If the unitrust or annuity payment exceeds the trust's ordinary income in a given year, capital gain will be carried out in an amount equal to that excess until all of the deferred gain has been fully distributed. Despite this, the beneficiary still is financially better off because the actual tax payments are deferred and spread over a many-year period.
5. Contract for Sale of Stock in Place Before Gift Made. Many donors begin thinking about a gift of appreciated assets to a charitable remainder trust (or other charity) only after a contract for the sale of the appreciated assets is in place. The IRS will impute gain to the donor when such a transaction is already in place.
6. Donation and Redemption. Shareholders of a closely-held corporation often donate stock to a charity. The shareholder gets a charitable deduction. The corporation then redeems the stock from the charity. This allows corporate earnings and profits to be paid out without incurring dividend income. The redemption also will reduce the total number of outstanding shares, and thus may increase the value of stock held by younger generation family members (assuming that a more senior family member donated the stock to charity).
 - a. In *Palmer v. Comm'r*, 62 T.C. 684 (1974), a donor had voting control of both a closely-held corporation and a private foundation. The donor contributed stock of the closely-held corporation to the foundation, and the corporation then redeemed the stock. The IRS argued that, in fact, the corporation redeemed the stock from the donor, and the donor then contributed the proceeds to the foundation. The Tax Court, however, respected the transaction, primarily on the basis that the foundation was not obliged to go through with the transaction.

- b. As a result of *Palmer*, the IRS issued Rev. Rul. 78-197, 1978-1 C.B. 83, which states that “the Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee [the charity] is legally bound or can be compelled by the corporation, to surrender the shares for redemption.”
 - c. In *Blake v. Comm’r*, 697 F.2d 473 (2d Cir. 1982), the Court of Appeals went further and said that a mere understanding between the donor and the charity is sufficient for the imputation of gain to the donor.
 - d. These same rules should apply to arrangements between a donor and the trustee of a charitable remainder trust. Thus, it should be clear from the outset that there is no understanding or requirement between the donor and the trustee prior to the gift that the corporation will redeem the stock. In addition, the corporation should have complete discretion after the transaction as to whether it will redeem the stock from the trustee of the charitable remainder trust.
7. Liquidating Corporations. The test for imputing gain to a donor is whether the gift occurs before or after the liquidation plan becomes final. If the liquidation plan is final prior to the gift of stock, then the gain realized upon liquidation of the corporation will be imputed to the donor.
- a. Courts have taken differing views on when a liquidation plan became final. In two early cases, all necessary steps for liquidation had to be taken before the plan was final. In one case, the plan of liquidation was not final until consents of all shareholders were received. *Winton v. Kelm*, 122 F. Supp. 649 (D. Minn. 1954). In another, even though the liquidation plan was adopted, no gain was imputed to the donor since the gift was made before declaration of a liquidating dividend. *Jacobs v. United States*, 390 F.2d 877 (6th Cir. 1968).
 - b. Courts now apply a facts and circumstances test, which is less favorable to donors. For example:
 - (1) When the gift was made after the liquidation plan was formally adopted by the board of directors and the shareholders, the gain was imputed to the donor. *Hudspeth v. United States*, 471 F.2d 275 (8th Cir. 1972).

- (2) When a board member made a charitable gift of stock after the board approved a plan of liquidation, but several weeks before shareholder approval, there was no imputation of gain, since shareholder approval was still necessary and, since the board members owned a minority of the shares outstanding, approval was uncertain. P.L.R. 9117002 (Sept. 26, 1990).
8. Sale of donated property by charity to buyer with whom the donor had previously negotiated. An old case shows the problem that can arise. In this case, the donor negotiated with a prospective purchaser of stock in his closely held corporation. While negotiating, the donor told his attorney to prepare a charitable remainder trust. The donor transferred his stock to the charitable remainder trust. Two days later, the trustees (donor and his lawyer) sold the stock to the buyer with whom the donor had previously negotiated. The court found that the trust was not legally obligated to sell the stock. Therefore, the gain could not be imputed to the donor. *Martin v. Machiz*, 251 F. Supp. 381 (D. Md. 1966); *see also Sheppard v. United States*, 361 F.2d 972 (Ct. Cl. 1966). However, if the trust was legally obligated to sell the stock, then the gain would be imputed to the donor.
9. Avoid making cash gifts to charity. Many commentators recommend the use of long-term appreciated securities when a donor is considering a cash gift. The donor gives the securities to charity and uses the cash to buy the same securities on the open market. If the securities rise in value, the donor will have less taxable gain on a future sale because of the higher basis. If the securities decline in value, the sale will produce a loss, instead of the gain that may have been produced on a sale of the original securities.
10. **Example.** Donor has \$100,000 of cash and \$100,000 of stock with a basis of \$0. If donor gives the cash to the charity, he receives income tax savings of \$35,000 if he is in the 35% tax bracket. Two years later he sells the stock when it is worth \$150,000. The capital gains tax on this sale is \$22,500 (\$150,000 gain x 15%). Thus, his net gain after paying tax is \$127,500. If, instead, donor donates the stock to charity, he receives income tax savings of \$35,000. He uses the \$100,000 cash to replace the stock he has donated to charity. Two years later, he sells the stock for \$150,000. The capital gains tax is \$7,500 (\$50,000 gain x 15%). Thus, the donor nets \$142,500. This is \$15,000 more than if the

donor gave cash. In both cases, the donor receives the same income tax savings of \$35,000.

R. Early Termination of Charitable Remainder Trusts.

1. During the booming stock market of the 1990s, many people took advantage of the opportunity afforded by charitable remainder trusts ("CRT") to make tax-deductible contributions to charity while at the same time reserving substantial future income on the donated property. The expectations of these CRT donors have not been realized recently as the stock markets subsequently fell dramatically. The disappointment has been particularly sharp for those who established charitable remainder unitrusts (a "CRUT"), or a variation on a CRUT in which distributions each year are limited to the income realized by the CRUT during that year. Although capital gains deriving from post-contribution appreciation of assets may be included in that "income," recent experience shows that in years when the stock market is down that may not provide much help. Careful harvesting of gains, while avoiding sales that realize losses, may also be of some assistance, but such techniques will not necessarily create sufficient income to fund fully the payments that the donor otherwise would receive.
2. Even for CRUTs that are not limited in their distributions to income, the precipitous decline in the stock market has, for many donors, meant that the actual cash flow (both from the CRUT and from other assets) may be substantially less than had been anticipated. As a result, an increasing number of donors have considered terminating their CRTs by paying the current value of the remainder interest to the charitable beneficiary and returning the remaining assets to the donor. Since CRTs are often designed to leave charity the minimum 10% charitable remainder value, terminations of these trusts can result in the bulk of the assets being returned to the donor.
3. Federal Tax Law Aspects of Early Termination.
 - a. Self-Dealing.
 - (1) CRTs are subject to certain of the rules in the Internal Revenue Code governing private foundations, including the self-dealing rules that prohibit most transactions between the foundation and a disqualified person. Under these rules, a donor to a CRT is a disqualified person. However, since the private foundation rules are not applicable

with respect to amounts payable by a CRT to a non-charitable beneficiary, the periodic unitrust payments to the income beneficiary do not violate the self-dealing rules. The IRS has recently ruled that the terminating payment to an income beneficiary upon the early termination of the CRT is also protected under this exception, provided certain conditions are met.

- (2) In Private Letter Ruling 200208039 (November 29, 2001), the IRS considered the proposed early termination of a CRUT that paid the donor the lesser of the 8% unitrust amount and the net income of the trust for the year in question. The ruling does not reveal whether the CRUT in question contained a “make up” provision, as permitted by Internal Revenue Code section 664(d)(3)(b), that would allow for payments to the donor of excess income in future years to make up for shortfalls in prior years. The facts recited included that the payout to the income beneficiary had averaged less than 3% in recent years. The ruling notes that the trust would be terminated in accordance with applicable state law and that the income beneficiary did not have a medical condition that could lead to a shorter life expectancy than that assumed in the IRS actuarial tables. Based on those representations, the private letter ruling approved a termination of the CRUT whereby the income beneficiary received the actuarial value of an 8% unitrust interest and the charity received the residue.
- (3) The letter ruling states that whether the self-dealing rules apply depends on whether the allocation of trust assets to the income beneficiary may properly be considered as “payable under the terms of such trust” and “directed by the terms of the governing instrument of the trust and not discretionary with the trustee” under section 53.4947-1(e) of the regulations. According to the IRS, this question reduces to “... whether early termination may be expected to result in a greater allocation of the trust assets to the income beneficiary, to the detriment of the charitable beneficiary, than a non-early termination.”

- (4) The letter ruling accepted the method proposed by the taxpayer for determining the amounts payable upon the early termination: determine the present values of the income and remainder interests effective on the date of termination, using the discount rate in effect under section 7520 on the date of termination, and using the methodology under section 1.664-4 of the regulations for valuing interests in CRTs. It is noteworthy that, even though the trust was a CRUT that paid the lesser of the income and the unitrust amount, the IRS permitted the donor to value the unitrust interest based on the full 8% payout called for in the trust instrument.

b. Income Tax Consequences.

- (1) In Private Letter Ruling 200127023 (April 4, 2001), the IRS also addressed income tax consequences of an early termination of a CRT. The Service ruled that the property received by the income beneficiary upon termination is not an annuity or unitrust payment and is therefore not governed by the "tier system" of Internal Revenue Code section 664(b). Under the tier system, the annuity or unitrust payments to the income beneficiary are characterized in the hands of the recipient first as ordinary income, second as capital gain, third as other income, and fourth as trust corpus.
- (2) However, in the case of an early termination, the letter ruling concludes that since the income beneficiary is disposing of his or her interest in the trust in exchange for money or property, the transaction is governed by Internal Revenue Code section 1001, which provides that the gain from the disposition of property is the excess of the amount realized over the adjusted basis of the property. Where, as here, the property disposed of is a term interest, such as an income interest in a trust, the portion of the adjusted basis determined under Internal Revenue Code section 1015, which contains rules for determining the basis of a transfer in trust, shall be disregarded unless the entire interest in property is transferred to a person or persons.

- (3) The letter ruling takes the position that the entire interest in property would not be transferred to a third party upon the termination of the trust. Thus the income beneficiary's basis in his or her interest in the trust is disregarded, and the income beneficiary must realize the full amount received as gain. The sale of an income interest in a trust is treated as the sale of a capital asset whose holding period commences on the date the beneficiary first held the interest. Thus, the income beneficiary must recognize the entire amount received upon termination of the trust as either long-term or short term capital gain, depending on the amount of time that has elapsed since the property was contributed to the trust.
- (4) In Private Letter Ruling 200127023, the IRS expressly based its conclusions on the fact that any distribution of assets in kind would be made in a pro rata manner. The Service did not explain why this should be necessary, but it may derive from a concern that the assets would not be divided fairly if any of them were nonmarketable and, therefore, difficult to value. It is difficult to see that there should be any income tax concerns resulting from a non-pro rata distribution, however. Even if the IRS were to treat each party as having received a pro rata share of each asset followed by a deemed sale between the parties to reach the non pro rata holdings, the income beneficiary would have a basis equal to the then fair market value of the assets. Thus no additional tax would be owed.

4. State Law Procedural Matters.

a. Consensual Termination Without Court Proceedings.

- (1) When the settlor of a trust does not reserve the power to amend or revoke the trust, the trust cannot ordinarily be terminated prior to the time designated for termination, if any, in the trust instrument. In certain circumstances, however, an irrevocable trust may be modified or terminated. The Restatement (Third) of Trusts (the "Restatement") sets forth several limited circumstances in which an irrevocable trust may be prematurely terminated.

Among these are (i) where it become impossible or illegal to accomplish the purposes of the trust, and the terms of the trust make no provision for the situation; and (ii) where changed circumstances are such that the purposes of the trust can no longer be accomplished.

- (2) Even where the purposes of the trust have not been frustrated, it may still be possible to terminate the trust by agreement of the appropriate parties. For example, where all beneficiaries of the trust agree to terminate the trust, and the purposes of the trust have been essentially accomplished, the trust may be terminated. Or, where the settlor and all the beneficiaries agree to terminate the trust, regardless of whether the purposes of the trust have been accomplished, the trust may be terminated.

Specifically, Restatement § 65(2) states:

If termination or modification of the trust under Subsection (1) [termination or modification by consent of all the beneficiaries] would be inconsistent with a material purpose of the trust, the beneficiaries cannot compel its modification or termination except with the consent of the settler

- (3) It is clear that, as stated in the commentary to the corresponding rule in Restatement (Second) of Trusts (“Restatement (Second)”), this rule “is applicable where the settlor and the beneficiaries consent to a reconveyance of the trust property to the settlor and also where they consent to the conveyance of the trust property to the beneficiaries or to a third person. It is applicable whether or not the settlor is one of the beneficiaries.” Furthermore, it is applicable “although the settlor does not reserve a power of revocation, and even though it is provided in specific words by the terms of the trust that the trust shall be irrevocable.” Of particular importance, the commentary under Restatement (Second) states that:

If by the terms of the trust it is provided that the trust shall not terminate until a certain time, or until the happening of a certain event, and the sole beneficiary, or if there

are several beneficiaries, all of the beneficiaries, none of them being under an incapacity, desire to terminate the trust, and the settlor consents to its termination, the trust will be terminated, although the specified time has not arrived or the specified event has not happened, and the beneficiary without the consent of the settlor could not compel the termination of the trust.

- (4) Section 65 of the Restatement thus states rules whereby an irrevocable trust can be modified or terminated by agreement of the appropriate parties. These rules are likely to be recognized in most, if not all, states, but, of course, the law of the relevant jurisdiction should always be confirmed before proceeding with the termination of any CRT.
- (5) It will be clear in most jurisdictions that the settlor and all of the beneficiaries (as long as the beneficiaries are all competent and there are no contingent beneficiaries) may modify or terminate an irrevocable trust, even though the purposes of the trust have not been accomplished. Since this is a common law rule, however, it is stated in judicial decisions, which necessarily arise from court proceedings. This circumstance might raise a question whether court action is necessary to effect such a termination.
- (6) Not only does common sense suggest that a judicial proceeding will not ordinarily be necessary, the Restatement, in an advancement over Restatement (Second), explicitly recognizes that the modification or termination of a trust can be achieved by agreement of the appropriate parties without the authorization of a court. Thus, a private agreement between the settlor and all the beneficiaries will be sufficient to terminate a trust, even though all the material purposes of the trust have not been accomplished.

b. Attorney General Involvement.

- (1) In the two recent private letter rulings in which the IRS has approved early termination of a CRT, it made a point of the fact that the state attorney general consented to the termination. In particular, Private Letter Ruling 200127023, specifically based its favorable ruling on the "assumption" that the state attorney general was a party to the proceeding that resulted in the termination.
- (2) One of the roles of the attorney general in most, if not all, state jurisdictions is to protect charitable trusts within the state. In view of the concern expressed by the IRS that "gamesmanship" could be exercised with respect to CRTs where the income beneficiary has a shortened life expectancy due to health conditions, it is understandable that the IRS would take comfort from the participation of the state attorney general.
- (3) However, in the other area where gamesmanship could be played, involving income-only CRTs where the expected income is far below the amount that otherwise would be payable under the trust, the IRS has expressed no concern. Indeed, it specifically approved termination using the actuarial tables in Private Letter Ruling 200208039, where an 8% unitrust was able to pay out only 3% because of that lower level of income on the CRT's investments. Arguably, the IRS could have required that the value of the charitable remainder interest be computed using an assumed 3% payout rate rather than 8%.
- (4) While it is possible that the IRS did not take that position because of the participation of the state attorney general and the consent of the charitable organization, the absence of any discussion of that point suggests that it is more likely that the IRS simply had made the determination, at least with respect to that private letter ruling, that application of the actuarial tables in the same way as they apply for purposes of determining the charitable deduction when a donation is made to an income-only CRT is also appropriate when the trust is being terminated.

Certainly, there is an element of fairness in that approach that gives it merit.

- (5) The participation of the state attorney general might also be important in situations where the CRT owns difficult to value assets or the income beneficiary has a controlling relationship with the charitable organization suggesting that the charitable organization does not act independently. However, in the absence of those factors, and assuming that the trust assets are valued fairly and the actuarial tables are applied with scrupulous fairness, it does not appear that failure to get prior consent from the state attorney general should change the logic which resulted in a ruling in favor of the transaction in the private letter rulings discussed in this article. Moreover, although the law of the applicable jurisdiction would have to be carefully reviewed, a private agreement to terminate a CRT under these circumstances should not require the prior approval of the state attorney general under state law.

5. Variations.

- a. As discussed above, the IRS takes the position is that the income beneficiary will owe capital gains tax on the full value of the interest payable to him or her upon termination of the trust. It may be possible to defer (or possibly avoid) this tax by having the assets otherwise distributable to the income beneficiary instead be distributed to another CRT. If the second CRT has a higher payout rate than the original CRT, or has the same rate but no income-only limitation, this may be sufficient to permit the CRT to meet the beneficiary's cash flow needs.
- b. It appears that this could be accomplished through a two-step process. First, the income beneficiary would assign all of his or her right to future payments from the CRT to the new CRT. (The original CRT would have to permit assignments of interests for this to be possible – it cannot be a spendthrift trust). The new CRT would then negotiate an early termination of the old CRT with the charitable remainder beneficiary. The lump sum payment from the first CRT would then be paid into the second CRT. This transfer would not be subject to capital gains tax. Although this admittedly requires that a portion of the assets be permanently transferred to charity (so that a smaller amount

of money is “working for” the income beneficiary in the new CRT), this might nevertheless be entirely consistent with the income beneficiary’s charitable objectives while at the same time providing a more predictable or higher payout from the new CRT.

- c. It might also be possible to do a partial termination of a CRT. With respect to a CRUT, no additional changes in the trust instrument should be required since the payout is based on a percentage of the value of the trust assets (although there may need to be an adjustment made for any payments due during the year of termination if the termination does not occur at the beginning of the taxable year). If a charitable remainder annuity trust were to be partially terminated, some further amendment of the trust instrument would be necessary since the original annuity would be a fixed dollar amount, which should presumably be reduced proportionately by the percentage of the trust terminated. Since the Restatement sections cited earlier allow for modification of a trust as well as termination, it would seem that a charitable remainder annuity trust could be modified to permit this.

- d. One of the things that makes a CRT popular for some donors is that it provides a budgeting mechanism. It is viewed as a way of putting principal out of reach, while providing a steady flow of income to a beneficiary. For those find CRTs attractive for this reason, the opportunity of accomplishing an early termination may not be a welcome one. On the other hand, those who are disappointed by the results of their CRTs, either because market performance is below their expectations or because of a change in circumstances, may find this to be an important planning opportunity. In any event, the recent private letter rulings are a welcome development, and the possibility of terminating a CRT early if all parties agree might even encourage more individuals to create them in the first place.