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Reform and Simplification

Areas for Reform: Split Interest and Partial Interest Gifts

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I. INTRODUCTION

Split interest and partial interest gifts have been with us for over a century. Donors have had a long-standing interest in making gifts and reserving certain critical rights with respect to the property given. Although incorrectly credited with creating those structures, the 1969 Tax Reform Act changed their makeup dramatically and introduced detailed rules for tax qualification. This regulatory scheme has evolved over the ensuing 40 years.

This paper will discuss certain important aspects of the split interest and partial interest gift rules and the problems that have become evident in their application. We have not attempted to describe all of the relevant statutes and regulations in detail, assuming that those rules have been well covered elsewhere. Instead, we have focused on areas that need reform through either statutory amendment or interpretive guidance.

Much rhetoric has emanated from Washington regarding the need for estate tax reform. The Tax Relief, Unemployment and Insurance Reauthorization and Job Creation Act Of 2010[1] ("2010 Tax Relief Act"), signed by the President on December 17, 2010, made substantial, albeit temporary, changes to the federal gift, estate and generation skipping transfer ("GST") taxes. The new law was enacted just days before the 10-year phase out and repeal of the estate and GST tax was set to expire, which would have reinstated a $1 million estate/gift tax exemption and 55% maximum rate. The highlights of the new law included an exemption of $5 million and maximum rate of 35% for all three taxes. Of particular significance, the lifetime gift tax exemption increased from $1 million to $5 million beginning in 2011, so a married couple would be able to give away a cumulative total of $10 million free of gift tax. The law also permits a surviving spouse to utilize the unused estate tax exemption of a predeceased spouse. These changes are in effect for just two years, ending December 31, 2012. Consequently, unless Congress acts to make these rules permanent, we will return to the 2001 rules when the calendar turns to 2013.

While few estate planning attorneys are willing to predict the future, none believes that the current transfer tax regime will remain unchanged in the coming years. But only after November's election will there be another real opportunity to adopt more permanent transfer tax reform. Anecdotal evidence suggests that most estate planners do not believe that there is any real likelihood that transfer taxes will be repealed in their entirety; rather, it is likely that some version of the current gift/estate tax regime will remain with us indefinitely.

Regardless of any changes that may be made to the transfer tax rules, donors are likely to continue to make large charitable gifts, including split interest and partial interest gifts. We know for certain that the income tax will endure. Even if the income tax rate does not increase from its current maximum level of 35%, the incentive to give during lifetime will remain powerful. We offer these comments as a contribution to the continuing policy conversation over how best to design legal structures to encourage and appropriately regulate this important and unique class of charitable gifts. Along with introducing new sources and concepts, we draw on certain elements from our previous work – including the recently published Ninth edition of the *Harvard Manual*

[1] Pub. L. No. 111-312, 124 Stat. 3296 (2010).

– *Tax Aspects of Charitable Giving* and our article for this conference in 2001, *Split Interest Trusts – What Works and What Doesn't*.

We begin with a discussion of three areas where major reforms are necessary to align the rules with economic reality and to resolve areas of internal inconsistency. Our primary suggestions are: (1) the reduction of the 5% minimum payout rate for charitable remainder trusts ("CRTs"), (2) the replacement of the Section 7520 present value determination regime affecting all split interest gifts with value rules that more closely approximate actual market conditions, and (3) the rationalization of the marital deduction rules applicable to split interest gifts. Next, we discuss particular issues arising in the context of CRTs, including certain unnecessarily restrictive aspects of the self-dealing rules and unrelated business taxable income (UBTI) rules, practical problems and planning restrictions associated with the CRT reformation, termination, and payout rules, and the indefensible rule against multiple donors. Then, we turn to charitable lead trusts ("CLTs"), commenting on the planning opportunities and complexities CLTs provide, the recent evolution of IRS guidance in this area, and the need for further guidance relating to the possible organization and payment structures permissible under the existing rules. Finally, we include a brief discussion of the difficulties – legislative, regulatory and economic – facing other types of split interest and partial interest gifts, such as gifts of fractional interests in artwork, pooled income funds, and gift annuities. We conclude with a brief commentary on the cyclical nature of regulatory change in the split interest and partial interest gift arena, spurred by both economic conditions and actions taken by planners, and suggest fruitful areas of focus for the current cycle.

II. OVERARCHING AREAS IN NEED OF REFORM

A. **The 5% minimum payout requirement for charitable remainder trusts is too high**

CRTs are subject to a 5% minimum annual payout requirement, a requirement that, when combined in a low-interest rate environment with certain other CRT qualification requirements, severely limits the available applications for CRTs. A CRAT must pay out annually at least 5% of the initial net fair market value of the assets placed in the trust; a CRUT must pay out annually at least 5% of the net fair market value, determined annually, of the trust assets.[2] The actual percentage rate must be fixed in the trust instrument and generally cannot vary – whether up or down - during the trust term.[3] Two permissible variations on the CRUT mitigate the effect of the 5% payout requirement. A net income CRUT (NICRUT) pays the lesser of the specified unitrust amount (of at least 5% of net fair market value of the trust's assets) or the trust's net income; the net income with makeup CRUT (NIMCRUT) also pays the lesser of the specified unitrust amount or the trust's net income, but when the trust's net income is less than the unitrust amount,

[2] I.R.C. §664(d)(1)(A) (CRATs), (d)(2)(A) (CRUTs).

[3] Treas. Reg. § 1.664-3(a)(1)(ii); Rev. Rul. 80-104, 1980-1 C.B. 135 (containing both the general rule and one very limited exception).

the NIMCRUT makes up the shortfall to the income beneficiary in later years, to the extent the trust has sufficient income to do so.[4]

The minimum payout requirement was enacted in 1969 as part of an overhaul of CRTs, private foundations, and other charitable organizations in response to perceived abuses. A minimum payout ensures that the CRT incorporates a significant non-charitable interest, preventing the CRT from being used as a tax-exempt vehicle designed to avoid private foundation status.[5] During the split-interest period, CRTs are subject to certain of the private foundation rules, including most notably the self-dealing rules.[6] However, CRTs are not subject to the 2% tax on investment income to which private foundations are subject,[7] or to the private foundation minimum distribution rules, which require that private foundations distribute 5% of the average fair market value for the previous year of the foundation's investment assets.[8] The CRT minimum payout rule was designed to prevent CRTs "from being used to circumvent the current income distribution requirement imposed on private foundations."[9] Absent such a rule, a CRT "could be established which provided for a minimal payout to the noncharitable income beneficiary (substantially less than the amount of the trust income)," accumulating income without tax yet without substantial present benefit to charity – exactly the type of behavior the 1969 Act sought to curtail in private foundations.[10]

When the 5% rule was put into place in 1969, however, the investment climate was very different than it is today. Recall that the 5% CRT minimum payout rule was imposed as a backstop to the private foundation minimum distribution rules. The 1969 Act generally required private foundations to pay out the greater of all investment income or 6% of investment assets, and authorized the Secretary of the Treasury to adjust the rate from time to time based on "changes in money rates and investment yields using as the standard the 6% rate, given rates and

[4] I.R.C. § 664(d)(1)(3).

[5] Joint Committee on Internal Revenue Taxation, General Explanation of Tax Reform Act of 1969, 91st Cong. 2d Sess. 85, 88-89 (1970).

[6] I.R.C. § 4947(a)(2). Under the statute, split-interest trusts are also technically subject to additional private foundation rules; however, both statutory and regulatory exceptions and practical matters curtail the impact of these rules on CRTs. While the Section 507 private foundation status termination rules apply to split-interest trusts per Section 4947, there is an exception in the regulations that will generally apply to CRTs. Treas. Reg. § 53.4947-1(e). Similarly, CRTs ordinarily enjoy a statutory exception to the excess business holdings and jeopardy investment rules, even though these rules technically apply to CRTs. I.R.C. § 4947(b)(3). The taxable expenditure rules and governing instrument requirements (to the extent applicable to a split-interest trust) also apply, but the CRT requirements of Section 664 generally result in CRTs complying with these rules. Further, even the self-dealing rules do not apply with respect to payments to a noncharitable beneficiary made under the terms of the trust instrument. I.R.C. § 4947(a)(2)(A).

[7] I.R.C. § 4940.

[8] I.R.C. § 4942.

[9] Joint Committee on Internal Revenue Taxation, General Explanation of Tax Reform Act of 1969, 91st Cong. 2d Sess. 85 (1970).

[10] *Id.*

yields for 1969."[11] At the time, it was thought that foundations should be able to earn at least 8% annually on their investments.[12] Whatever the accuracy of that assumption in 1969,[13] in 2012, when long-term Treasury notes are paying 2% or less, the related 5% payout requirement for CRTs no longer reflects the reality of the economic environment. Attached to this outline is a chart prepared by New York University's Stern School of Business showing annual returns on Treasury bills as well as stock and Treasury bond yields from 1928-2011 that clearly illustrates the dramatic decline in the returns offered by secure investments since 2000. In 1970, the 3 month Treasury bill rate was 6.69%, in 1980 11.22%, in 1990 7.55%, in 2000 5.76%, and in 2010 0.13%.[14]

Paul Lee, a noted commentator on the total return trust issue, has discussed the fact that the nature of returns in the capital markets has dramatically changed over the 20 year period, 1982-2002, during which Treasury yields and dividend yields have dropped precipitously. An income trust that had been invested in a 60% stock and 40% bond allocation would have produced the following yields over that 20 year period:[15] Since then, yields have continued to drop further.

Yield of Portfolio:	1982	1992	2002
	8.8%	4.7%	2.9%

Other CRT eligibility requirements related to the minimum value of the charitable remainder place further strictures on the use of CRTs in low-interest environments. In 1977, the IRS ruled that no charitable contribution deduction is allowed for a CRAT if there is more than a 5% chance that the CRAT's assets will be exhausted by the payment of the annuity, with the result that the charitable remainder beneficiaries will receive nothing at the termination of the trust.[16] In 1997, Congress enacted legislation applicable to both CRATs and CRUTs requiring

[11] *Id.* at 37.

[12] *See* K. Martin Worthy, The Tax Reform Act of 1969: Consequences for Private Foundations, 39 *Law & Contemporary Problems* 233, 238 (1975).

[13] *See id.* at 238-42 (discussing the erosion of foundation investment assets resulting from the then-newly imposed minimum distribution requirement).

[14] As we discuss in the next section, these low rates of return on secure investments also affect, sometimes dramatically, the valuation regime used for CRTs and CLTs.

[15] Paul S. Lee (Director, Wealth Management Group, Bernstein Investment Research and Management, New York, New York), Implementing Total Return Trusts, at 5 (2003).

[16] Rev. Rul. 77-374, 1977-2 C.B. 329. It is not clear whether failing the 5 % test disqualifies the CRAT entirely, or only results in the loss of the charitable contribution deduction. Compare Priv. Ltr. Rul. 95-01-004 with Priv. Ltr. Rul. 95-32-006 (permitting a trust to be considered a qualified CRT for income tax purposes, but not for estate tax and generation-skipping transfer tax purposes).

that the value of the remainder interest must be at least 10% of the fair market value of the property transferred to the CRT on the date of contribution.[17]

The charitable remainder in a CRT – and, it follows, the donor's charitable deduction – is determined by assuming the trust will grow at the interest rate prescribed by Section 7520, which is discussed in more detail in the next section.[18] Because of the 5% payout requirement, the value of the net assets of a CRAT paying out 5% of the initial fair market value of its assets will be deemed to decrease over time if the applicable Section 7520 rate is less than 5%, and will be deemed to grow over time if the rate is more than 5%. If the Section 7520 rate falls below a threshold of 1.4%, a twenty-year CRAT (the maximum permissible term of years) that pays the minimum 5% annuity will violate the 5% probability of exhaustion test and the 10% minimum remainder value requirement.[19] For a CRT paying an annuity for life, when the Section 7520 rate is at or below 1.4%, the annuitant must be at least 75 years old when the trust is created, or the CRAT will fail the 5% probability of exhaustion test.[20]

We understand the need for some minimum distribution requirement applicable to the payouts from CRTs so that these trusts will not become vehicles for circumventing the private foundation rules. However, the 5% payout rate was enacted before the 5% probability of exhaustion and 10% minimum remainder tests applied, and before Section 7520 was enacted to pin the initial valuation of a CRT to a specific interest rate in effect at a particular point in time. Moreover, the 5% payout requirement was enacted in an investment climate that was very different from today's.

Whatever congressional expectations were in 1969 about future investment returns, empirical evidence has shown that, with an all-equity portfolio, from the period from 1960 to 1994, a 4% payout generated the highest after-tax income to the current beneficiary (although for a longer term trust an even lower payout may be best). It has been shown that, over time, higher fixed distribution rates lead to lower total return due to greater volatility and because high payouts in the initial years mean that the benefits of compounding and ability to ride out a poor market are diminished. A trustee has a fiduciary obligation to balance the interests of the current and remainder beneficiaries of a CRT. With the current minimum annual payout of 5%, the trustee must focus on investing to produce a yield in line with that amount rather than focusing on the overall return of the assets. This increasingly creates a drag on growth in the portfolio and leads to reduced payouts to both the income and remainder beneficiaries over time. Further, interest rates generally, as reflected in the IRS discount rates, have been historically low in recent

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[17] I.R.C. §664(d)(1)(D) (CRATs), (d)(2)(D) (CRUTs). In the case of a CRAT, the 10% test is applied when the trust is initially funded and is satisfied if the value of the remainder interest is at least 10 % of the initial fair market value of the trust assets. In the case of a CRUT, the test is applied at the time of each separate contribution to the trust.

[18] See Treas. Reg. §1.664-4.

[19] Trent Kiziah, American College of Trusts & Estates Counsel Transfer Tax Study Committee, Charitable Remainder Trust Proposal.

[20] Id.

years, making it that much harder for trustees to keep up with investment performance required to yield at least a 5% return.

Other commentators have noted the need for a modification of the 5% payout requirement to more accurately reflect the current low-interest rate environment and the need for the payout requirement to continue to reflect market conditions over the long run. The Transfer Tax Study Committee of the American College of Trust and Estate Counsel (ACTEC) has put forth a simple and bold proposal: that the minimum payout requirement for both types of CRTs be the lesser of 5% or the applicable Section 7520 rate used to value the remainder interest.

While the bold simplicity of the ACTEC proposal is attractive, it is debatable whether a payout on the order of 1% (the Section 7520 rate published for September 2012) would create a non-charitable interest sufficient to achieve the minimum payout requirement's purpose of preventing CRTs from being used as an end-run around the private foundation rules. Actual investment returns have generally exceeded the recent Section 7520 rates though they have not in recent years regularly reached the 5% benchmark.

We propose a more moderate reevaluation of the minimum payout requirement based on the general shift in trust law toward total return trusts. With the adoption of the Uniform Prudent Investor Act ("UPIA") and the 1997 revised version of the Uniform Principal and Income Act ("UPAIA") in many states, the focus on balancing between the current and remainder beneficiaries has shifted to a focus on total return. Under these reforms, trustees of private trusts now can concentrate on the overall performance of the assets rather than on traditional (sometimes arbitrary) distinctions between income and principal. Further, several states have passed or are currently considering legislation that would redefine income to reflect a unitrust concept, and have selected a unitrust payout amount in the range of 3 to 4 percent.

Trustees have traditionally attempted to maximize income yields while preserving principal value in their administration of trusts, striving for a balance that benefits income and remainder beneficiaries alike. But as trustees have made diversification and preservation of principal rather than income generation their primary goal, income-producing assets often make up a smaller portion of trust portfolios. At the same time, interest rates and dividend payouts have declined, and trustees have struggled to balance the interests of income beneficiaries and remaindermen in an environment where a diversified portfolio of securities may yield only a two to three percent return annually. The bulk of the return in these trust portfolios is attributable to capital appreciation. To prevent income beneficiaries from being unduly disadvantaged by the decline of traditional sources of income such as dividends, interest and rents, states have begun to reconsider the notion of income altogether.

As noted earlier, nearly all states have now adopted some version of the UPAIA, which generally applies to private non-charitable trusts. Most of these states have adopted the UPAIA's provisions directing a trustee to allocate receipts and expenses to income or principal according to certain statutory guidelines (in the absence of direction in the trust instrument regarding allocation) and then permitting the trustee to make adjustments between income and principal to ensure that the trust beneficiaries are treated impartially.[21] In the current investment environment, a trustee would most often transfer certain principal receipts such as all or a portion of realized capital gain to income, increasing the amount available for distribution to the income beneficiaries and allowing them to benefit from part or all of the capital appreciation in the trust's assets. In a period of high interest rates, a trustee might transfer a portion of the interest income received in a trust to principal.

Another legislative approach centers on the unitrust concept that has become familiar in the context of charitable trusts. Under a unitrust statute, trust income of a private non-charitable trust is defined as a percentage of the annual market value of the trust. New York, Maine, and more than a dozen other states have adopted unitrust statutes that also contain equitable adjustment provisions. In the current low-interest-rate environment, the unitrust percentage, which is determined by statute, may often exceed a trust's income yield, and the unitrust allows an income beneficiary to receive a portion of the trust's capital gain in a particular year.

Trustees must consider several factors, including the nature and purpose of the trust, the identity and circumstances of the beneficiaries and the needs for liquidity, regularity of income and preservation and appreciation of capital, in deciding whether to make adjustments or choose a unitrust approach to administration. Many states' UPAIAs limit the trustee's power to adjust or adopt a unitrust payout for a trust in certain circumstances. For example, the statute may prohibit trustees from adjusting amounts that have been permanently set aside for charitable purposes, or, where a trustee is also a beneficiary of a trust, the statute may prohibit the trustee from making any adjustments between income and principal of the trust, even if the adjustments are contrary to the beneficiary's interest. A co-trustee who is not a trust beneficiary, however, generally may make adjustments between income and principal.

The unitrust percentage adopted under UPAIA varies by state. Several states set a flat 4 % unitrust percentage (or a 4% unitrust with smoothing over three years, as in New York), while others permit a range from 3 to 5%. Still others set a default of 4 or 5% but permit divergence within the 3 to 5% range under certain circumstances.[22] This small range between 3 and 5% is no accident. In February 2001, Treasury issued proposed regulations amending the definition of trust income under Section 643, in acknowledgment of the shift in the states toward the total return concept. The proposed regulations provided that if state law permits "reasonable apportionment" between income and remainder beneficiaries of income, capital gains, and unrealized appreciation, allocations in accordance with that state law would be respected for federal income tax purposes.[23] The proposed regulations provided as an example of such

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[21] For information on the UPAIA, including Section 104 (the power to adjust), see the Uniform Law Commission, Acts – Principal and Income Act, http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act. For more detailed information about the extent to which each state has adopted the power to adjust and/or a unitrust statute, see Leimberg.com, TRUs (Total Return Unitrusts), http://www.leimberg.com/freeResources/truStates.html.

[22] *See* Leimberg.com, *supra* note 21. Two states, Missouri and South Dakota, simply set a minimum 3% unitrust percentage, with no maximum, while New Hampshire has set a high 5% unitrust rate.

[23] Treas. Reg. § 1.643(b)-1, as amended 12/30/2003 by T.D. 9102 effective for taxable years of trusts and estates ending after 1/2/2004.

"reasonable apportionment" a state law providing for "a unitrust amount of between 3% and 5%."[24] Soon after these proposed regulations were published, states began enacting unitrust statutes. The regulations were finalized in December 2003, retaining the 3 to 5% range, rejecting requests from two commentators to respect any unitrust percentage permitted by state statute. The preamble to the final regulations explained, "The IRS and the Treasury Department believe that when establishing a unitrust percentage that attempts to yield the equivalent of income over a long period of time that may encompass wide variations in economic conditions, a range of 3% to 5% will be considered a reasonable apportionment of a trust's total return."[25]

The same 3 to 5% assumption would seem to provide a good benchmark for charitable trusts as well, particularly since it has regulatory support as a reasonable range for maintaining a trust's income and principal over time. The IRS's acceptance of this range, with a top amount of 5%, further illustrates that the 5% CRT minimum payout is likely too high to support the same goal of consistent balance between income and principal interests. Whatever comes of the Section 7520 valuation regime, our proposal for which is discussed in the next section, we suggest that the minimum payout requirement be reduced to 3 or 4%, or shifted to permit a range from 3 to 5%, in recognition of the total return and unitrust concepts and the supporting empirical evidence we have discussed. Alternatively, Section 664 should be amended to allow some flexibility to donors in choosing the rate.

Reducing the 5% minimum payout requirement would allow many younger donors, who are currently hindered by the combination of the 5% minimum payout and the 10% remainder requirement, to establish CRTs within the threshold requirements. More generally, such a reform would improve the reflection of economic reality in the CRT valuation and eligibility determination process, reducing distortions in potential donors' incentives. This incentive-naturalizing effect would be further enhanced by adoption of our proposals to reform the Section 7520 valuation framework, discussed next.

B. The Section 7520 rates used for present value determinations no longer reflect actual market conditions, and should be replaced with a new way of thinking about present value determinations.

The donor to a CRT established during her lifetime receives an immediate income tax charitable contribution deduction equal to the present value of the remainder interest that will pass eventually to charity; analogously, the donor to a CLT receives a gift or estate tax charitable deduction equal to the present value of the lead annuity or unitrust interest payable to charity.[26] Prior to the enactment of Section 7520 in 1988, the IRS tables used to make these present value determinations were based on a single, static interest rate (and on mortality assumptions established in 1969).[27] The interest rate was changed from time to time in order to reflect then-

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[24] *Id.*

[25] T.D. 9102 (Dec. 30, 2003).

[26] § 2522(c) and 2055 (e).

[27] Ways & Means Committee Report for H.R. 100-795, 1988.

current market rates of interest. Rates varied from for the period from December 3, 1970 through November 30, 1983 during which period the factors were gender specific. From December 1, 1983 through April 30, 1989 a 10% rate was in effect.[28] But the fixed and reactive nature of the regulatory interest rate meant that the designated rate could not keep up with changes in the market interest rate. Section 7520, enacted as part of the Technical & Miscellaneous Revenue Act of 1988, set the valuation interest rate to 120% of the midterm Applicable Federal Rate (AFR), ensuring that the valuation interest rate would fluctuate with market interest rates. The goal in enacting Section 7520 was to update the valuation assumptions used in order to improve the accuracy of valuations, eliminating planning opportunities based on the under- and over-valuations associated with fixed valuation interest rates.[29]

Under the statute, "the value of any annuity, [or] any interest for life or a term of years" – including the annuity or unitrust interest of a CRT or CLT – and the value of "any remainder or reversionary interest" – including the charitable remainder interest in a CRT or the non-charitable remainder interest in a CLT – is determined under unisex mortality tables prescribed by the IRS[30] and "by using an interest rate (rounded to the nearest two tenths of 1%) equal to 120% of the Federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls."[31] Where the property transfer being valued gives rise to a charitable deduction for income, estate, or gift tax purposes, "the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls."[32] Because the Section 7520 rate for each month is published on or about the 21st day of the preceding month, a donor effectively has the choice of four rates. The Federal midterm rate is the AFR determined with reference to the market yield on outstanding Treasury obligations with a remaining term of three to nine years.[33]

The valuation of a guaranteed annuity is highly dependent on the Section 7520 rate. The valuation of a unitrust interest that fluctuates depending on annual investment performance is less dependent on the Section 7520 rate. The lower the rate, the higher will be the gift tax charitable deduction for the annuity interest in a CLAT, and the lower will be the income tax charitable deduction for the remainder interest in a CRT, all other things being equal. Using the

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[28] Treas. Regs. § 20.3021-7A.

[29] In addition to pegging the valuation rate to the AFR, Section 7520 also required the IRS to publish new mortality tables, and to publish updated mortality tables at least every 10 years. § 7520(c)(3). See Leo L. Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedent's Estates: Sixty Six Years of Astigmatism" 40 Tax Law Review, 1, 67 et seq. (1984) in which the author discusses the impact of discount factors on various partial interests.

[30] These tables assume each measuring life will live until age 110. See T.D. 8630, 1996-1 C.B. 339; see also Reg. § 25.7520-3(b)(2).

[31] § 7520(a).

[32] Id.

[33] § 1274(d)(1)(A), (C)(ii). The midterm AFR is determined with semiannual compounding, while the § 7520 rate is determined with annual compounding, so an adjustment is required in addition to multiplying the AFR by 120%.

example of a CLAT, the charitable gift tax deduction for a 5% guaranteed annuity interest over a 20-year term is 90.2% when the Section 7520 rate is 1.0% (the rate for September 2012, the lowest rate since Section 7520 became effective on May 1, 1989) but only 38.3% when the Section 7520 rate is 11.6% (the rate for May 1989, the highest since Section 7520 has been in effect). A 6.2% rate for a 6% annuity would result in a gift tax charitable deduction of 67.7%.[34] For a CRAT, the inverse result obtains: a 20-year, 5% guaranteed annuity interest is impossible when the Section 7520 rate is 1.0%, because it results in a charitable remainder interest of less than 10%, which would disqualify the trust. As described above, as long as the Section 7520 rate is less than 1.4%, a twenty-year CRAT that pays the minimum 5% annuity will violate the 5% probability of exhaustion test and the 10 % minimum remainder value requirement.[35] By contrast, for a 5% CRAT, a Section 7520 rate of 11.6% would result in an income tax charitable deduction of 60.1% for the charitable remainder interest; a rate of 6.2% would result in a deduction of 42.27%.

As demonstrated, while low Section 7520 rates make some CRAT terms impossible to use, CLATs can be useful gift-leveraging devices in an environment of low interest rates. It is possible to create a CLAT under which the value of the remainder interest is "zeroed-out" because the present value of the guaranteed charitable annuity is equal to the entire value of the property transferred to the trust. As the disparity between the Section 7520 rate (measured on a single date) and historically achievable and reasonably conservative rates of return grows wider, the leveraging effect grows more pronounced. In contrast, changes in the Section 7520 rate have little impact on the charitable deduction created by a CLUT. Using the same range of Section 7520 rates above and focusing on a 20-year term, 5% lead unitrust only, the 1.0 % Section 7520 rate creates a 63.8% deduction, versus a 60.0% deduction if the Section 7520 rate is 11.6%.[36]

The Section 7520 rates have varied dramatically over time, with a generally declining trend: the rate, 11.6% in its first month in May 1989, has been less than 9% since April 1995, less than 7% since January 2001, less than 5% since January 2008, and less than 3% since June 2011.[37] To some extent these variations have corresponded to the rise and fall of prevailing investment returns in the overall economy, and to that extent Section 7520 has accomplished its purpose of enabling the statutory formula for present value determinations to vary with market conditions. However, the AFR is not based on investment returns achievable in the market

[34] All calculations assume that the guaranteed annuity or unitrust interest is paid once and at the end of the year. Changes in the frequency and timing of distributions will affect the calculation of the charitable deduction.

[35] Trent Kiziah, American College of Trusts & Estates Counsel Transfer Tax Study Committee, Charitable Remainder Trust Proposal, date & URL]

[36] In fact, the difference in the charitable deduction is attributable entirely to the timing and frequency of the first year's payment in the example, assumed to be once a year and at the end of the year. If the sample trust provided for the 5% unitrust distribution to be made once a year and at the beginning of the year, the deduction would be the same no matter what level the Section 7520 rate.

[37] See Internal Revenue Service, Index of Applicable Federal Rates (AFR) Rulings, http://www.irs.gov/app/picklist/list/federalRates.html?resultsPerPage=200&sortColumn=number&indexOfFirstRow=0&criteria=&value=&isDescending=true (linking to AFRs since January 2000); Leimberg.com, Key Rates/Valuation, http://www.leimberg.com/software/7520rate.html (chart with Section 7520 rates since 1989).

generally, but on one very specific type of investment return: the market yield on U.S. Treasury obligations. Therefore, the AFR will diverge from overall market rates of interest – and from the returns donors can reasonably expect a CRT or CLT will enjoy – when the yield on U.S. Treasury obligations diverges from overall market rates of interest.

There is no sound policy reason in favor of the design restrictions placed on CRTs or the planning opportunities in CLTs created by pegging present value determinations to the AFR instead of to market investment returns. The chief benefit of the AFR is administrative convenience: the same set of rates, published monthly, are used for many purposes throughout the tax code.[38] In proposing an alternative to the Section 7520 rate based on the AFR, then, we have focused on ease of administration as well as accurate reflection of economic conditions.

We believe the rate used for present value determinations should be a rolling average based on the performance of a particular stock index or published measure of institutional investor returns averaged over a three-year period. Using a published measure of performance maintains the relative simplicity of a single rate, while tying valuation to the broader investment market rather than solely to U.S. Treasury obligations as the AFR does. This prevents the distortions that arise when market factors cause the yield of U.S. Treasury obligations to diverge so dramatically from conservative expectations of overall market return. Further, use of a three-year rolling average drastically reduces the distortions caused by the "noise" of short-term fluctuations in rates. This would, incidentally, eliminate any need for the election to use the statutory rate for the previous two months. The stability associated with using a three-year rolling average would reduce opportunistic planning and facilitate deliberate planning.

The Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), approved for enactment by the National Conference of Commissioners on Uniform State laws in 2006, has now been adopted in virtually every state to provide rules for investment of restricted endowment funds held by charitable institutions such as universities. UPMIFA adopts the concept of total return expenditure of endowment assets for programmatic purposes, replacing the old trust law concept that only income such as interest and dividends could be expended from such assets. Section 4(a) of the Act as promulgated by the Commissioners states that the institution "may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established." Seven criteria guide the institution in its annual expenditure decisions, and an optional provision of UPMIFA adopted in many states would create a presumption of prudence for an appropriation for expenditure of an amount less than or equal to 7% of the fair market value of an endowment fund. The total return concept embodied in UPMIFA has now been generally adopted as a substitute for expenditure of annual income.

The fair market value used for these decisions is calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation was made. A similar twelve-quarter average could be applied to an indexed investment return to determine the factor for present value determinations. Replacing the Section 7520 rate with a fair market valuation regime drawn from

[38] See e.g. I.R.C. §§1274, 1288, and 382.

the already familiar UPMIFA twelve-quarter average would rationalize the valuation regime for CRT and CLT interests.

While we generally believe that split-interest charitable gift valuation should be based on economic reality to the extent administratively feasible, and therefore favor exchanging the current Section 7520 regime for a valuation regime tied to modern economic conditions, we recognize that the current regime has created certain planning opportunities that will be less effective in higher valuation rate environments or when present value determination rates reflect more closely expected rates of investment return.[39]

C. **The provisions governing marital deductions vary unnecessarily among types of split-interest gifts, and should be harmonized.**

The gift tax rules include an automatic marital deduction for a gift to the donor's spouse of an interest in a CRT. If there are no non-charitable beneficiaries other than the donor and the donor's spouse, and the donor's spouse is a United States citizen, the spouse's interest will automatically qualify for the unlimited gift tax marital deduction. This applies whether the spouse has a succeeding interest to take effect after the donor's death or whether the spouse's interest takes effect immediately, the donor retaining no interest for herself.[40] There is a parallel automatic marital deduction in the estate tax context. If the only non-charitable beneficiary of a CRT after the donor's death is the donor's spouse, and the spouse is a United States citizen, the spouse's interest automatically qualifies for the unlimited estate tax marital deduction.[41] This basic rule of an automatic marital deduction, without the limitation requiring the spouse to be the sole non-charitable beneficiary, should be extended to other appropriate split-interest gifts, such as contributions to a pooled income fund and contributions of real estate that reserve a life estate for one or both spouses. Both criticisms of the current rules are critiqued in the paragraphs that follow.

First, we do not believe there is any legitimate policy rationale for the statutory rule that no marital deduction is permitted if there is a non-charitable beneficiary of the trust in addition to the donor's spouse, such as a second-tier successor interest in a parent or child. The rule is this: When there is a second non-charitable beneficiary, not only does the spousal interest not qualify for the estate tax or gift tax marital deduction under the automatic rule, it also cannot be elected

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[39] See, e.g., Paul S. Lee, Turney P. Berry, and Martin Hall, Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse, 37 ACTEC L. J. 93 (Summer 2011); Hall & Osteen, *Harvard Manual—Tax Aspects of Charitable Giving*; Lawrence P. Katzenstein, Some Interest-Sensitive Estate Planning Techniques (With an Emphasis on GRATs and QPRTS) and a Look at the Proposed Legislation, ALI-ABA Course of Study April 23 - 27, 2012: Planning Techniques for Large Estates (2012).

[40] I.R.C. § 2523(g); Rev. Proc. 2010-40, 2010-46 I.R.B. 663.

[41] I.R.C. § 2056(b)(8). If the donor's spouse is not a United States citizen, the estate tax marital deduction may be available if the spouse is the only non-charitable beneficiary and the CRT can be treated as a qualified domestic trust. I.R.C. § 2056A. If the donor's spouse is not a United States citizen, no gift tax marital deduction is available. I.R.C. § 2523(i). If the non-citizen spouse's interest is a successor interest, it is critical that the donor retain the right to revoke to avoid making a completed gift. If the non-citizen spouse's interest takes effect immediately, the gift tax consequences may be ameliorated by the enlarged $139,000 annual exclusion available for present interest gifts to non-citizen spouses. I.R.C. § 2523(i)(2).

for the marital deduction under the qualified terminable interest property ("QTIP") rules.[42] There is no apparent policy justification for such a limitation on the marital deduction. The second non-charitable beneficiary's interest can be valued and included in the estate, serving the purpose of the QTIP rules to ensure that amounts do not escape taxation altogether. Moreover, the CRT will still be subject to the general CRT qualification rules of Section 664 – such as the 10% minimum remainder, 5% chance-of-exhaustion, and minimum payout rules – which will prevent any potential abuse of the ability to include multiple non-charitable beneficiaries. Further, taxpayers can already plan around the sole non-charitable beneficiary rule for estate tax purposes, achieving a marital deduction for the spouse's interest, by creating a QTIP trust for the surviving spouse followed by a charitable remainder trust for the second non-charitable beneficiary.[43] The same result should be available under the automatic marital deduction rule for CRT interests.

Second, a spouse's interests in other split-interest gifts, such as an income interest in a pooled income fund ("PIF") or a life estate reserved in a transfer of a residence to charity, should be eligible for the same automatic marital deduction as a spouse's interest in a CRT. Under current law, where an income interest in a pooled income fund ("PIF") is created for the donor's spouse, it will only qualify for the unlimited marital deduction if a QTIP election is made by the donor on a gift tax return.[44] If such an election is made, the property transferred to the PIF is treated as passing to the spouse so that the donor receives a gift tax marital deduction for the total value of the property; thus, the donor does not need a charitable gift tax deduction for the value of the remainder interest.[45] The value of the units attributable to the spouse's interest in the fund will be included in the estate of the spouse at death, but, as noted below, an offsetting charitable deduction will be available to the estate of the spouse for the value of the interest passing to charity. There is a parallel rule for the estate tax: the donor's executor must elect under the QTIP rules to qualify the interest of the surviving spouse for the unlimited marital deduction, which, when the spouse dies, will cause the then-value of the PIF interest to be included in the spouse's estate, offset by a charitable estate tax deduction.[46] A similar regime governs QTIP elections governing a bequest of a remainder interest in a personal residence to charity, reserving a prior life estate for the donor's spouse.[47] No policy justification exists for reserving the automatic marital deduction to interests in CRTs and requiring taxpayers to engage in complex QTIP

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42 Treas. Reg. §§ 20.2056(b)-8(b); § 25.2523(g)-1(b).

43 See Conrad Teitell, Taxwise Giving April 2012, at 5, for a detailed explanation of the mechanism.

44 I.R.C. § 2523(f).

45 See General Explanation of the Economic Recovery Tax Act of 1981, prepared by the Joint Committee on Taxation, at 238 n. 5. Since the enactment of the Technical Corrections Act of 1982, it has been clear that the donor to a PIF cannot claim a gift tax charitable deduction for the remainder interest in addition to the marital deduction for the entire interest. See Section 104(a)(2)(B) of the Technical Corrections Act of 1982, adding I.R.C. § 2523(h).

46 See, e.g., Priv. Ltr. Rul. 94-06-013.

47 Treas. Reg. § 20.2056(b)-6(g) (providing an example of a marital deduction available for this type of split-interest gift involving a personal residence.)

planning – and to comply with QTIP election requirements – for these other types of split-interest gifts.

Further, a complication arises when the surviving spouse's interest in a PIF takes effect after an interest reserved by the donor, or when a married couple transfers a jointly owned personal residence to charity reserving a prior life estate for both members of the couple. In the case of the PIF interest, it remains unclear whether the interest can be qualified by the QTIP election; the intervening interest prevents the spouse from receiving "all of the income" for life.[48] To plan around the problem, if a donor spouse makes a gift to a PIF for the benefit of both spouses, with the donor spouse the primary beneficiary, the donor should reserve the right to revoke the other spouse's interest by will in order to avoid any question of whether the other spouse's interest is a qualifying QTIP interest before it vests.

Similarly, in the case of the transferred personal residence, no lifetime QTIP election for the eventual surviving spouse is available because no person other than the surviving spouse may have an interest in the property during the lifetime of the surviving spouse. Here, if the residence is jointly owned, each spouse has an intervening interest that defeats the lifetime QTIP election for the other spouse; if the residence is owned by one spouse, that donor spouse's life interest intervenes and defeats the lifetime QTIP election for the other spouse. Again, in order to plan around this problem, the sole spouse or both spouses owning the residence must reserve the right to revoke the survivor spouse's interest by will in the deed transferring the property.[49]

As with the rule permitting only a sole non-charitable beneficiary, the absence of an automatic marital deduction for these non-CRT split-interest gifts is not supported by any apparent policy justification. In order to correct both of the statutory flaws we have discussed, we propose that Congress amend Section 2056(b)(8), which provides for the automatic marital deduction for a surviving spouse's interest in a CRT, to eliminate the language requiring that the surviving spouse be the only non-charitable beneficiary of the CRT, and to extend the automatic deduction to a surviving spouse's interest in a PIF or personal residence transferred to a charity. A similar change should be made to the gift tax provision, Section 2523(g).

III. CHARITABLE REMAINDER TRUSTS

A. **Introduction**

Charitable remainder unitrusts and annuity trusts ("CRUT"s and "CRAT"s, and collectively "CRT"s) continue to be planned giving devices popular among donors and charities alike. The primary benefit to an inter vivos CRT does not stem from the gift and estate tax

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[48] See 1981 Act Section 403(d), adding I.R.C. §§ 2056(b)(7)(B)(ii)(I) and 2523(f)(3). Treas. Reg. § 25.2523(f)-1(c)(1) appears to prevent such an election where the spousal interest follows another beneficiary's interest. Thus, a donor giving a deferred-income interest to her spouse should reserve the right to revoke the spousal interest by will.

[49] For a more detailed discussion of the issue and the planning required to work around it, see Teitell, *supra* note 43; ABA Section of Taxation, Letter to The Honorable Max S. Baucus and Orrin G. Hatch, Senate Committee on Finance, and The Honorable Dave Camp and Sander Levin, House Committee on Ways & Means, April 4, 2012 (outlining options for tax reform and simplifications with respect to federal estate, gift and GST taxes).

consequences of such a trust. Instead, the primary attractions are the income tax deduction enjoyed by most donors and the opportunity to diversify investments without incurring an immediate capital gains tax liability on the sale of the contributed property. The Internal Revenue Service ("IRS", also sometimes referred to as "the Service") has provided detailed guidance for establishing and administrating CRTs. The Service has also closed down several abuses, or perceived abuses, associated with CRTs. Having worked out these wrinkles, we believe that it is now time for the IRS to focus on some simple, practical solutions to remaining problems. The issues raised and suggestions outlined in this paper are not intended to alter radically the world of CRTs or to carve out special exceptions to avoid every minor inconvenience. Nor are they designed to place the IRS or the charitable beneficiaries of such a trust in a disadvantaged position. The proposals discussed below are aimed at highlighting some of the ongoing frustrations and inefficiencies with the rules in this area and some potential solutions or compromises that we believe could and should be adopted to address them.

B. **Brief Summary of Abuses Eliminated**

Historically, Congress and the IRS have been concerned about the potential use of the CRT structure for abusive transactions. In response to perceived abuse, Congress enacted several changes to the Code in 1997. As a result, CRTs are subject to two maximum payout rules: first, the value of the remainder interest in a CRT must equal at least 10% of the fair market value of the property transferred to the CRT upon contribution;[50] and second, the annual payout may not exceed 50% of the trust's assets.[51] These rules supplement rather than supplant the pre-existing rule that a gift to a CRAT with more than a 5% chance of exhaustion of its principal before the trust's termination will not qualify for the income tax charitable deduction.[52] With the 10% and 50% restrictions in place, the 5% exhaustion test is no longer necessary, and merely creates additional confusion for donors.

Another change adopted in 1997 and fully effective for trusts created after December 10, 1998 concerns the timing of payments from CRTs. Out-of-date rules, still applicable to net income CRUTs, permit payments to be made not only by year-end but also within a reasonable period after year-end (basically before the trustee is required to file the trust's tax return for the particular year, including extensions); however this may not be a matter of real significance in light of the rarity of net income CRUTS in the present low income environment. For CRATs or straight percentage CRUTs, however, payments are permitted after the close of the tax year <u>only</u> if (i) the payout is treated as income under the tier rules rather than a distribution of principal, or (ii) the trustee makes an in-kind distribution and elects to treat any income generated by the distribution as having occurred on the last day of the year for which the payment was due; or (iii) the trustee pays the annuity or unitrust amount by distributing cash that was contributed to the

[50] I.R.C. §§664(d)(1)(D), (d)(2)(D).

[51] I.R.C. §§664(d)(1)(A), (d)(2)(A). According to the legislative history of the 1997 Act, a CRT failing the 50% test will be taxed as a complex trust.

[52] Rev. Rul. 77-374, 1977-2 C.B. 329.

trust or that was received as a return of basis in any asset that was contributed to the trust and sold by the trust during the year for which the amount is due.[53]

These restrictions have succeeded in undermining the so-called "accelerated CRT". In this scheme, a short-term, high-payout, straight percentage CRT was created and no distributions were made during the first year of the trust. In the second year, the assets were sold and the distribution for the first year was made before the tax return was filed for that initial year. The payout, generally a very high percentage of asset value, significantly diminished the trust assets. Little or no income was received by the trust during the first year, so the distribution for that year was treated as carrying out little or no income under the tier rules. The gain arising in year two when the assets were sold to make the distribution was not carried back and treated as a taxable event for year one. The regulations also prohibit a donor from postponing recognition of income through the use of other means – including pre-paid forward contracts and borrowing – that do not produce current income but permit sale or diversification of the trust portfolio. If the CRT makes a distribution that is not treated as income to the beneficiary because it represents proceeds from a forward sale or borrowing arrangement, the trust is treated as if it sold a pro-rata portion of the assets in order to make the distribution, and the beneficiary is taxed accordingly.[54]

While these reforms may have addressed specific abuses, they have had a tangential negative impact on non-abusive transactions. For example, the timing rules make it difficult to administer a straight CRUT or CRAT funded in the last weeks of the year. If the first, short-year payment is made after year-end, it can be made in cash only if enough cash is contributed to the trust either as part of the first year's contribution, or as part of a subsequent contribution, or if the funding assets are partially liquidated prior to year-end and the distribution is made from the proceeds of sale.[55] If no cash is contributed, or if it is not feasible to make a sale before year-end, a post year-end payment can only be made by an in-kind distribution of trust assets accompanied by an election to treat those assets as having been sold during the prior year. This creates a true trap for the unwary. In the case of a CRUT, this trap may be avoided by establishing a flip CRT, one that is created to pay the lesser of net income or straight percentage amount at the outset, converting to a straight CRUT immediately after the first short year; this solution requires too high a degree of sophistication to be a panacea and is not available for a year-end CRAT. We would suggest at the very least that the Service expand its election back rules to apply where sales are made in the trust after year-end and cash distributed so that a trust does not face inappropriate disqualification.

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[53] Treas. Regs. §§1.664-2(a)(1)(i) and 1.664-3(a)(1)(i)(g).

[54] Treas. Regs. §§ 1.643(a)-8(b); 1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g). Note that the IRS has indicated that such a deemed sale will not be considered acquisition indebtedness under I.R.C. §514(c). Reg. 1.643(a)-8(c), example 1.

[55] Treas. Reg. §§1.664-2(a)(1), 1.664-3(a)(1).

C. Continuing Problems with Gifts of Real Estate and the Self-Dealing Rules

Section 4941 of the Code imposes a two-tier excise tax on acts of "self-dealing" between certain charitable entities and their "disqualified persons".[56] Typically applied to private foundations, these rules also apply to the remainder interest in split-interest trusts such as CRTs,[57] yet do not apply to the unitrust or annuity amount payable under a qualified CRT.[58] Two areas in which the self-dealing rules frequently apply to CRTs and often hinder otherwise non-abusive transactions are the areas of gifts of real estate to a CRT and the satisfaction of a charitable pledge through a CRT.

1. Issues of Funding a CRT with Real Estate

Real estate continues to be a popular asset with which to fund a CRT. If the real estate is the donor's personal residence, however, the gift is often thwarted by the Code's requirement that a CRT cannot even rent a personal residence back to the donor (or a family member) on an arms-length basis.[59] For the donor who wishes to continue to occupy the property for even just a short period before it is sold in the CRT, this may prove an insurmountable barrier. It is difficult to understand why an arms-length lease for a limited period should not be permitted. If the rental amount had to be determined by a qualified appraiser – which could be part of the qualified appraisal process necessary to substantiate the charitable deduction[60] – and if there was a maximum rental period to "disqualified persons" of, say, two years from the funding date, it would appear that the potential for abuse could be avoided.

Funding a trust with mortgaged property also raises several problems. First, if real estate is contributed subject to a mortgage, the bargain sale rules under Section 1011 apply, with the amount of the indebtedness treated as proceeds from the bargain sale. The donor is required to pay capital gains on these "proceeds", whether or not she retains an interest in the trust itself.[61] We believe that the donor should be able to accept the bargain sale rules and pay the capital gains tax on the deemed proceeds from the sale generated to the extent that she is relieved of the debt, but by this technique she should be able to avoid adverse consequences to the CRT itself.[62]

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[56] Disqualified persons in relation to a CRT include the donor, her family and any entity in which the donor, the trustee or their families own more than a 35% interest I.R.C. §4946(a).

[57] I.R.C. §4947(a)(2); Treas. Reg. §53.4947-1(b)(1)(2), example 2.

[58] I.R.C. §4947(a)(2)(A); Treas. Reg. §53.4947-1(c)(2)(ii), example 1.

[59] I.R.C. §4941(d)(1)(A).

[60] Treas. Reg. §1.664-1(a)(7).

[61] I.R.C. §1011(b) and Treas. Reg. §1011-2(a); Priv. Ltr. Ruls. 78-08-016; 79-03-075.

[62] One problem that remains with this approach is that, under the bargain sale analysis, the transfer of mortgaged property to a CRT after its initial funding could be considered self-dealing by the donor. This will be true even if the CRT does not assume the mortgage, provided that the mortgage was placed on the property less than ten years prior to the transfer of the real estate into the trust. I.R.C. §4941(d)(2)(A). Note that if the property was not owned by the donor for more than five years or the mortgage was placed on the property less than five years

Another problem with contributing mortgaged property to a CRT arose in a 1990 ruling, in which the IRS concluded – without addressing the bargain sale issue discussed above or the payment by the donor of income tax attributable to capital gains – that the contribution of mortgaged property to a CRT created a grantor trust for income tax purposes and therefore disqualified the CRT.[63] Similarly, in a 1995 Private Letter Ruling, the Service concluded, based on a violation of the partial interest rule, that a trust would not qualify as a CRT if a donor funded it in part with an option to purchase encumbered real estate and in part with unencumbered real estate (it was expected that the trustee would later sell its option to a third party for a price that reflected the difference between the fair market value of the property at that time and exercise price), reasoning that, because no charitable income tax deduction was allowed and the gift was not a completed gift for gift tax purposes (because under local law the option was not binding on the donor), the trust could not function as a CRT from the beginning and should instead be taxed as a grantor trust.[64] The IRS concluded that, because income could be paid to the donor to satisfy the payout requirements, the trust will be considered a grantor trust under Section 677 of the Code.[65] The Service also stated that if no tax deduction was allowed for a contribution to a purported CRT, the trust would be used only as a means to avoid taxation of the gain from the sale of the contributed assets, which it could not allow.[66]

We believe the IRS is wrong in its position that the transfer of mortgaged property to a CRT creates a grantor trust.[67] Such a transfer should not disqualify the CRT and therefore the grantor trust rules should never come into effect. Rather than a means to avoid restrictions on donating mortgaged property to a CRT, the option described in the 1995 letter ruling should be viewed as akin to an interest in real estate, but with no value until the option is exercised. The grantor trust rules were intended to cause the donor to be taxed on income from property over which she has retained effective control. In a CRT, the donor does not retain such control because, even if the donor is acting as his own trustee, he lacks discretion whether to make distributions to himself. In the 1995 letter Ruling, however, simply because income could be

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before the transfer to a CRT or the CRT has assumed or agreed to pay the mortgage, the CRT will be treated as having realized debt-financed income upon the sale of the property, which is unrelated business income ("UBTI") and will cause all of the trust income in the year of the sale to be taxable. I.R.C. §664(c); Treas. Reg. §1.664-1(c). However, an exception exists if the mortgage was placed on the property more than five years before the transfer, the donor owned the property for more than those five years and the CRT did not assume or agree to pay the mortgage. In these circumstances, the CRT will be exempt from the UBTI rules for ten years; if the trust does not dispose of the property in those ten years; however, it loses this exemption and is subject to UBTI in the year of the sale. I.R.C. §514(c)(2)(B).

[63] Priv. Ltr. Rul. 90-15-049; I.R.C. §675.

[64] Priv. Ltr. Rul. 95-01-004.

[65] Priv. Ltr. Rul. 95-01-004.

[66] Priv. Ltr. Rul. 95-01-004.

[67] See I.R.C. §674(d) and Reg. §1.664-1(a)(4).

distributed to the donor in satisfaction of the unitrust payout, the Service considered the entire trust to be "owned" by the donor.[68]

One possible solution to the problems associated with contributing mortgaged property to a CRT is a hold-harmless agreement executed by the donor, coupled with a limited transfer of an undivided fractional interest in the real estate (which would be no greater than the donor's equity in the real estate). This would leave the trust holding an asset that is unencumbered from an economic standpoint and arguably not debt-financed from a tax standpoint.[69] This solution, although we believe it to be reasonable, has yet to be tested. It is conceivable that the IRS would view this too as creating a grantor trust. If the agreement were accompanied by a pledge or security interest in some other assets, however, this argument would be difficult to sustain because it is virtually certain that the trust assets would never be called upon to discharge the donor's obligation in connection with the property. Another risk is that the IRS would consider any agreement between the donor and trustee in connection with the later sale of the property to be self-dealing.

A second possibility for dealing with the contribution of mortgaged property to a CRT would be the use of an option, such as has been sanctioned in connection with the contribution of other undivided fractional interests to a CRT, such as contributions of closely held stock. It appears that the IRS will allow such a transaction if the donor first establishes a partnership or gives an option without the creation of a partnership or other special arrangements, but will not permit a straight donation of such an interest.[70] Yet another possibility is to incorporate the property before it is contributed to the trust; this approach has been approved by the IRS in at least one letter ruling. This final approach has the disadvantage of causing the trust to have to liquidate the corporation and recognize gain at the corporate level if assets have value at liquidation in excess of original basis.[71]

While these strategies may have worked in some situations, and the hold-harmless agreement may be sanctioned by the Service at some point, we believe the best solution is for the donor of mortgaged property to a CRT to make a bargain sale of the real estate to the CRT

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[68] Priv. Ltr. Rul. 95-01-004.

[69] In Rev. Rul. 76-95, 1976-1, C.B. 172, an exempt organization acquired an undivided interest in rental property subject to a mortgage and prepaid its proportionate share of the liability, receiving releases from co-owners: The organization was found to have no acquisition indebtedness even though the entire property remained subject to the mortgage. Similarly, the CRT might prepay its share of the mortgage and receive a release enabling it to sell without UBTI.

[70] Treas. Reg. §53.4941(e)-1(c)(7)(ii); see also Priv. Ltr. Ruls. 97-26-006; 97-16-023; 96-51-037; 96-33-007-013; 95-33-014; 95-33-041.

[71] See I.R.C. §337. A letter ruling in 1991 appears to have sanctioned another complicated approach to a similar situation. In that ruling, the donor established a partnership to hold the property, contributed a partnership interest to the CRT, and then delegated authority over the sale to the trustee. Priv. Ltr. Rul. 91-14-025. This approach may have succeeded in pointing the way to make a contribution of a partial interest, but it does not solve the mortgage issues discussed above, nor does it avoid the problems arising with the UBTI generated by the sale in the year the property is sold.

(while taking care to avoid self-dealing rules), and pay capital gains tax on the sale element, in order to avoid tainting an otherwise qualified CRT.

2. Funding a CRT in Satisfaction of a Charitable Pledge

Although charitable pledges, when made in exchange for some action by the charity receiving the pledge, are generally enforceable, satisfying those pledges through a split-interest trust (or a private foundation) presents a problem. If a charitable organization is designated as the remainder beneficiary in a CRT in satisfaction of a pledge by the donor or a family member, the IRS is likely to consider such a transaction as an act of self-dealing between the CRT and a disqualified person.[72] The rationale would be that the CRT was being used to relieve the disqualified person of a legal obligation (whether or not the pledge is enforceable under state law) and therefore was being used "for the benefit of" such person.[73] This logic forces donors to satisfy their pledges to a given charity through other assets or through the payouts they receive from the CRT. This issue occurs frequently because, for example, members of a charity's board of directors are asked to commit to give a certain amount to the charity. If the board member attempts to satisfy his commitment using an existing CRT, he would run afoul of the self-dealing rules.

These hurdles are unnecessary and cumbersome. In this circumstance, it seems that the IRS's application of the self-dealing rules is excessive. Reading the regulations narrowly, it may follow that a CRT's satisfaction of a pledge "benefits" the donor (because the donor does not have to satisfy the pledge with her other assets), but it provides far more benefit to the charity. We believe that the IRS should not be concerned whether a donor contributes to a charity – either by direct gift, distribution from a foundation or through a CRT – in satisfaction of a pledge to the charity or as a new transaction. In either case, the key beneficiary is the charity and the donor's funds are used to make the gift. Rather than encouraging more donors to make charitable pledges, the threat of self-dealing may intimidate them. It also may discourage an otherwise ideal potential donor from entering into a CRT arrangement for fear of subjecting himself (and possibly the trustee) to harsh penalties. Finally, it should be easy enough to circumnavigate this rule by the donor revoking an existing pledge before establishing a CRT that will "replace" it. These complications seem unnecessary and beyond the scope of the legitimate self-dealing conflicts with which the IRS should be concerned. We are hopeful that the law in this area will become less restrictive soon.

D. **Problems with the Unrelated Business Income Tax Rules**

1. Prior Law

Prior to 2007, a CRT that had even one dollar of unrelated business taxable income ("UBTI") was subject to tax on 100% of the income of the CRT earned that year, including

[72] I.R.C. §§4941, 4946. See Priv. Ltr. Rul. 97-14-010.

[73] Priv. Ltr. Rul. 97-03-020; Priv. Ltr. Rul. 96-10-032; Priv. Ltr. Rul. 81-28-072. GCM 38103; 39644. See also Treas. Reg. §53.4941(d)-2(f)(1).

income otherwise exempt from tax (such as income earned from municipal bond investments).[74] This rule was much harsher than the general rule, which taxes charitable organizations only on the net UBTI that they earn.[75] This former rule discouraged the funding of CRTs with partnership assets that may have generated UBTI. It also discouraged donors from making gifts of commercial real estate such as an apartment building, because modest income from vending machines or laundry facilities that may have been earned on site and distributed to the trust before the real estate was sold would have subjected the entire income of the trust to tax. This rule was an unnecessary hindrance to potential donors, and most importantly, had a deleterious effect on investment options for CRTs. Many exempt organizations serve as trustees of CRTs of which they are beneficiaries, and would like to invest these CRTs along with their endowments in order to maximize the return from the investment and to save money on administration of the CRTs. However, endowments often are invested in debt-financed real estate and therefore recognize small amounts of UBTI. Therefore, the CRT rule prevented exempt organizations from commingling CRTs with their endowments in order to avoid the possibility of subjecting the entire CRT income to taxation. Charities are not crippled by a small amount of taxable income generated by their endowments' investments. A CRT's inability to join these investment pools, on the other hand, resulted in substantial sacrificed investment return.

2. Partial Resolution

The Tax Relief and Health Care Act of 2006[76] (TRHCA) partially resolved the problems associated with the treatment of CRTs with UBTI under prior law. Now, UBTI earned by a CRT is subject to a 100% excise tax in the year it is earned, but the rest of the trust income is still exempt from taxation.[77] This rule represents an improvement over prior law, because the entire income for the year is not "tainted" by the presence of the UBTI. However, the TRHCA introduced new problems with the treatment of UBTI earned by CRTs. The excise tax is treated as paid from principal of the CRT. However, for the purposes of determining the character of distributions made to the individual beneficiary, UBTI remains trust income subject to the tier system of Section 664(b).[78] Therefore, the CRT's UBTI is subject to additional tax in the hands of the individual beneficiary—possibly up to 35%. The amount of income is not diminished by the amount of tax paid;[79] therefore, there is the possibility of up to a 135% tax imposed on any UBTI earned by a CRT. This tax is draconian compared to the treatment of UBTI earned by other tax exempt organizations.

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[74] Leila G. Newhall Unitrust v. Commissioner, 104 T.C. 236 (1995), aff'd 97-1 U.S.T.C. ¶ 50, 159 (9th Cir. 1997).

[75] I.R.C. § 511.

[76] Pub. L. No. 109-432, § 424.

[77] I.R.C. § 664(c)(2).

[78] Treas. Reg. § 1.664-1(c)(1).

[79] Treas. Reg. § 1.664-1(c)(1).

3. Suggested Reform

It is not clear that Congress understood the implication of the structure that the legislative history implied, leading to the potential for a tax greater than 100%. Because a CRT benefits taxable beneficiaries in addition to the ultimate charitable beneficiaries, it is not surprising that Congress and the IRS are more worried about UBTI earned by a CRT than about UBTI earned by other tax-exempt organizations. However, there is no reason for the Treasury to take more in tax than the taxable income that is earned—doing so is harmful not only to the individual beneficiary but also to the ultimate charitable remainder beneficiary. CRTs are intended to serve as a way to encourage charitable giving and to benefit the charitable organizations that serve as their remainder beneficiaries. However, the current UBTI rule instead penalizes the use of CRTs. This problem could easily be resolved by the issuance of a Treasury Regulation indicating that the excise tax paid on UBTI is allocated to income rather than corpus, thereby permitting a deduction against the UBTI earned when determining the character of distributions to be made to the income beneficiaries.

E. **Payout Issues**

CRTs are plagued by multiple issues regarding the payout of income to the income beneficiaries. First, the historic tier system is overly complicated and leads to unfair results when a CRT is funded with an asset that constitutes an item of income in respect of a decedent. Further, the amount of the payout from a CRT is subject to both minimum and maximum payout requirements. As discussed in Part II of this paper, there are significant problems with the 5% minimum payout requirement for CRTs. CRTs are also subject to maximum payout restraints: a trust will not qualify as a CRT if the annual payout percentage exceeds 50%[80] or if the value of the remainder interest is less than 10% of the fair market value of the property transferred to the CRT on the date of contribution.[81] These restrictions create a trap for the unwary, and have led to a need for relief provisions for trusts that aim to meet the CRT requirements but fall short. The reformation procedures permitted in the Code are helpful, but these procedures should be simplified. In addition, while flexibility in payout methods has been enhanced with the endorsement by the Service of the flip CRUT[82] and by the introduction of the ability to allocate

[80] I.R.C. § 664(d)(1)(A), (d)(2)(A).

[81] I.R.C. § 664(d)(1)(D), (d)(2)(D).

[82] See Treas. Reg. §1.664-3(a)(1)(i)(c)(1). With the rise in popularity of the flip CRUT, we are seeing an increasing number of contributions of illiquid assets to a CRT, such as real estate or unmarketable securities. The flip structure can also be used in a trust funded with marketable assets. This provides enormous flexibility for donors interested in maintaining some control over the timing of the payouts from a CRT. If a donor establishing a CRT with unmarketable assets does not want a flip trust, he may contribute cash or marketable securities sufficient to meet the payout requirements of a straight CRUT until the funding assets are sold. The risk with this approach, of course, is that the funding asset may not be sold before the additional contribution has been depleted and the trustee will be forced to return a fraction of the funding asset to the donor in satisfaction of the unitrust payment, which is likely not the donor's goal when he contributed the property to the trust in the first place. In this case, the trust is deemed to realize gain when the asset is distributed and the beneficiary takes as her tax basis the fair market value of the asset on the date of distribution. Treas. Reg. §1.664-1(d)(5). The flip trust option is a simple, reasonable solution to this unfortunate situation.

capital gains to income in many circumstances,83 additional flexibility should be introduced. We suggest that it should be permissible to vary the payout for annuity trusts and to reduce the payout rates for CRUTs by agreement of the relevant parties.

1. The Tier System

CRTs must make payments to the income beneficiary at least annually. In all cases, the tier rules determine the characterization of these distributions in the hands of the beneficiaries.[84] Under the tier or category rules, the distributions to a beneficiary of a CRT are characterized for income tax purposes according to the historic income of the trust since its inception. This system generally provides for a worst-in, first-out rule. The historic tier system prevents a trustee from manipulating the CRT structure by selling an ordinary income or capital asset that was contributed to a CRT and investing the proceeds in tax-exempt bonds, and then distributing tax-exempt income to the beneficiary. Because of the tier system, the distributions will be tax-exempt only after all of the income (or capital gains) earned from the sale of the funding asset have been depleted. Moreover, it is not possible to allocate all of the income from one tier to one beneficiary of a CRT, while permitting the other beneficiary to report income from another tier; rather, each must receive a pro rata share of each tier.

Under the tier system, amounts distributed to the income beneficiary are first treated as distributed from the CRT's current and historic ordinary income. To the extent that the amount distributed to the income beneficiary exceeds current and past undistributed ordinary income, the distribution next consists of accumulated capital gain from the current year and prior years (with short-term gains being distributed first). If the amount distributed to the beneficiary exceeds both distributable ordinary income and capital gain income for current and prior years, the distribution is next treated as other income (to the extent that there is such other income for both the current and prior years). This other income includes federally tax-exempt interest income. Finally, to the extent that the distribution exceeds tiers one, two and three, it is deemed to consist of a tax-free distribution of principal.[85]

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[83] Some of the IRS's rulings in this area focus on the gains realized on "unproductive assets", which do not produce a reasonable level of income in the hands of the trustee, and upon the sale of which many states permit an allocation of some of the gain to income. Priv. Ltr. Ruls. 96-43-014; 94-42-017; Uniform Principal and Income Act (1962), §12. The rules, however, do not appear to limit the permissible allocation to these assets. The regulations do limit the allocation to appreciation occurring after the assets are contributed to the trust. Treas. Reg. §1.664-3(a)(1)(i)(b)(4); Priv. Ltr. Ruls. 97-11-013; 95-11-007; 95-11-029. Other limitations include a permissible allocation of gains to income only if the allocation does not "depart fundamentally from concepts of local law." Treas. Reg. §1.643(b)-(1). One advantage to this allocation of gain to income is seen in the year in which the conversion date occurs in a flip trust. Once a trust "flips" from a net income trust to a straight unitrust, any deficiency amount accumulated during the initial period is forfeited. Treas. Reg. §1.664-3(a)(1)(c)(3). If capital gains are considered income in that final year of the net income trust, a larger amount of the make-up account will be distributable to the beneficiary before it is forfeited.

[84] Treas. Reg. § 1.644.1(d).

[85] I.R.C. §664(b).

Within the first two tiers or categories, the regulations require that the income be broken down into different classes.[86] The classes are determined with reference to the highest income tax rate that applies currently to the particular class of income. Accordingly, within the ordinary income category, interest and rents (potentially subject to a maximum tax of 35%) are treated as one class, while qualifying dividends (subject currently to a maximum rate of 15%) are treated as another. Similarly, within the capital gains category, short-term capital gains, 28% long-term capital gains attributable to collectibles, 25% long-term capital gains attributed to depreciation recapture from real estate, and 15% long-term capital gains, each constitutes a separate class. The regulations then provide that within each category the highest-tax class of income is deemed to be distributed first.

The system now contains one significant exception to the basic worst-in, first-out rule. Although qualifying dividends (subject to a 15% maximum tax rate) are not treated as distributed until all other classes of category-one ordinary income are exhausted, they are nevertheless treated as distributed before short-term capital gains, long-term capital gains on collectibles, and unrecaptured gain on the sale of real property, even though all three of these items are subject to potentially higher maximum marginal tax rates. This exception is because the latter items fall into category two. The tier system is excessively complicated and widely misunderstood; however, much of the complexity, it must be acknowledged, comes from the many different ordinary income and capital gains tax rates currently in effect.

A further criticism of the tier system is that it forces out income generated in the trust even if that income may have been earned in earlier years. Thus, arguably the tier system has the effect of discriminating against beneficiaries of CRTs funded with certain types of assets that are all ordinary income, such as retirement plans or other items of income in respect of a decedent (IRD) for trusts funded at death. If a CRT is funded at death with an asset that constitutes an item of IRD—for example, a retirement plan distribution, individual retirement account (IRA), deferred compensation, nonqualified stock options, or U.S. savings bonds—the asset, like any other, will be considered principal for fiduciary accounting purposes when received by the trustee. However, for purposes of the CRT's tier system, the nature of the asset as ordinary taxable income is preserved.[87] No matter how the trust is subsequently invested, all trust distributions will be taxed to the beneficiary as ordinary income until the entire amount of the funding that constitutes IRD and all subsequently earned ordinary income is treated as distributed.

If a deduction is available under Code Section 691 for estate tax attributable to the item of IRD, the deduction belongs to the trust and reduces the amount of ordinary income in the first tier (in effect, treating the amount equal to the deduction as principal).[88] Income tax deductions that are directly attributable to items of income or principal in a particular tier are allocated to that tier in determining the net amount of tier income. All deductions not directly attributable are allocated proportionately, based on the gross amount of each type of income (after allocation of

[86] *Id.*

[87] See Priv. Ltr. Ruls. 99-01-023, 96-34-019, and 92-37-020.

[88] Priv. Ltr. Rul. 99-01-023.

directly attributable deductions). In all events, deductions cannot exceed the amount of income in the particular category for the year. If any taxes are imposed on the trust, taxes must be allocated to principal. Certain deductions cannot be used in any event to reduce income.[89] Private Letter Ruling 92-37-020 holds that distributions from an IRA payable to a CRT as the beneficiary will have the same character in the hands of the trust as they would have had in the hands of the participant. One would have thought, therefore, that any Section 691(c) deduction would remain available to the beneficiary of the CRT to the extent distributions from the CRT were deemed to consist of the IRD. Private Letter Ruling 1999-01-023 takes a different approach, however. It holds that the IRD is "first tier" income to the CRT, and that the Section 691(c) deduction reduces the amount of this income to the trust rather than being directly available to the beneficiary. As a result, it is exceedingly unlikely that the beneficiary would ever obtain any benefit from the Section 691(c) deduction. A fairer result would be to allow the Section 691(c) deduction to pass through to the income beneficiary.

2. Reformation of Defective CRTs

Section 2055(e)(3) allows permanent reformation of a defective instrument but is itself quite complex.[90] For example, the Code requires that the difference between the actuarial value of the reformed interest and the actuarial value of the unreformed interest cannot exceed 5% of the actuarial value of the unreformed interest.[91] Also, the duration of the reformed and unreformed interests must be the same, unless a term of years that exceeds 20 years is scaled back to 20 years.[92] These restrictions are difficult to achieve and cumbersome to administer, which in turn means that the reformation procedures are not particularly useful for many trusts that failed to comply with the initial CRT requirements. In order for the reformation procedures to meet the need that they are designed to satisfy, they must be simplified and expanded in their scope.

There is also a need for corrective procedures or voluntary compliance for trusts that are not defective by their terms but which have been out of compliance in practice. In one Tax Court case, the charitable deduction was denied because a CRAT, although drafted in compliance with the Code, was not administered in accordance with the trust's terms.[93] Specifically, the annuity payments were not made to the donor during her lifetime, and the trustees allowed death taxes occasioned by the donor's death to be paid from the trust assets, in direct conflict with the provisions of the trust. It is interesting that the Court focused not only on the payment of taxes from the CRT – a clear violation of the Code and the intent of Section 664 – but also faulted the trustee for failing to make annuity payments, even though such a failure

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[89] Treas. Reg. § 1.664-1(d)(2).

[90] A defective instrument is one that fails to express the payout as either a unitrust or a fixed annuity amount, or one that includes a power to invade principal for the benefit of a non-charitable beneficiary.

[91] I.R.C. §2055(e)(3)(B)(i).

[92] I.R.C. §2055(e)(3)(B)(ii)-(iii).

[93] Atkinson v. Commissioner, 115 T.C. 26 (2000).

benefited the charity. Of course, the failure also meant that the annuitant did not receive the taxable income to which she was entitled.

Section 664 is designed to protect against abuses favoring individual beneficiaries at the expense of charitable remaindermen and to assure that a donor's income tax deduction does not exceed the amount actually going to the charity at the trust's termination. No such abuses are possible when the annuity payments are not made. A mechanism for correcting such errors of administration would be a welcome addition to the regulations in this area.

3. Variable Payout for Annuity Trusts

As in the context of charitable lead annuity trusts or charitable gift annuities, we believe the CRAT regulations should permit a step-up or graduated annuity payout. In the context of a charitable lead trust (as discussed in Part IV of this paper), the guaranteed annuity amount need not be the same throughout the trust's term; as long as the payments are determinable from the beginning, the annuity amount can vary.[94] We see no reason why this rule should not apply to CRATs as well. As with lead trusts, we believe a CRAT should be permitted to include provisions that allow the annuity amount to increase in pre-determined steps over a number of years, or to change all at once after a certain term of years. The charitable deduction available to the donor upon establishing the CRAT would of course be adjusted accordingly.

With the recent low interest rates, as discussed in Part II of this paper, philanthropists and their advisors have sought more creative ways to structure charitable giving in order to maximize the beneficial use of their assets. In particular, donors may not need income at the time the CRAT is created but may anticipate needing income at a specific future date, such as the date they expect to retire or the date they expect their children to attend college. The CRAT structure should be flexible enough to allow donors to contribute their assets to a CRAT now and build up the value of the principal for the benefit the charitable beneficiary, while still allowing the income beneficiary access to the trust's income later on. There is no reason for the law to require the income beneficiary to take a higher payout early on only because he or she anticipates needing the income later. As long as the trust passes the 5% exhaustion test (if retained), the 10% remainder test and the 50% maximum payout rule, taking the graduated annuity payments into account, such a structure would not be abusive. Instead, it would permit donors to structure a CRAT with payments that tried to keep pace with inflation, or that responded to the donor's need for an increased, but stable, level of income in the later years of her life.

4. Modification of Unitrust Payout Rate

On a similar note, it would be helpful if the parties to a CRT could, by agreement, vary the payout rate for a particular trust. We understand the prohibition on the parties' ability to raise the percentage payout – after all, income and gift tax deductions were already given to the donor based on the expectation that a higher amount would be available for charity. We see no reason, however, why the parties should not be permitted to agree to a reduction in the percentage amount if they desire to do so. Given the recent dramatic reduction in interest rates, many

[94] Treas. Reg. §§20.2055-2(e)(2)(vi); 25.2522(c)-3(c)(2)(vi).

beneficiaries would like to reduce the percentage payout they receive from a CRT in order to avoid quickly depleting trust assets, for their benefit and for the benefit of the remainder beneficiaries. There is no way to achieve this goal under existing law unless the beneficiary chooses to make an immediate gift of a fractional undivided interest in her unitrust or annuity amount to the charitable remainder beneficiary. Even then, the beneficiary's options are limited.

A simple solution to this dilemma would be to permit the amendment of a CRT for the narrow purpose of reducing the percentage payout upon agreement by all of the interested parties. The reformation rules under Section 2055 could easily be expanded to include such a provision. The trust as amended would of course have to meet all of the governing instrument requirements and limitations imposed by the Code, such as the 5% minimum and 50% maximum payout restrictions, and the 10% remainder interest test (and the unnecessary 5% exhaustion test for CRATs). The IRS currently considers such an attempted revision to be a disqualifying act, causing the trust to become taxable and any gift to it non-deductible.[95]

F. **Drafting Complexities**

The IRS published its most recent model CRAT[96] and CRUT[97] documents in 2003 and 2005, respectively. These sample documents answered many questions practitioners previously had with respect to CRT drafting issues, but the documents themselves have multiple deficiencies that the IRS ought to address. In addition, the sample documents did not resolve many difficult drafting issues. Some areas in which we would like to see clarification are provisions relating to incompetent beneficiaries, provisions permitting the revocation of an income beneficiary’s interest, and provisions relating to the release and assignment of interests in the trust.

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[95] See Priv. Ltr. Rul. 95-06-015 (amending a CRT to change the payment amount or the means of determining the property payout would disqualify the trust).

[96] Rev. Proc. 2003-53, 2003-2 C.B. 230 (inter vivos CRAT for one measuring life); Rev. Proc. 2003-54, 2003-2 C.B. 236 (inter vivos CRAT with term of years annuity period); Rev. Proc. 2003-55, 2003-2 C.B. 242 (inter vivos CRAT with consecutive interests for two measuring lives); Rev. Proc. 2003-56, 2003-2 C.B. 249 (inter vivos CRAT with concurrent and consecutive interests for two measuring lives); Rev. Proc. 2003-57, 2003-2 C.B. 257 (testamentary CRAT for one measuring life); Rev. Proc. 2003-58, 2003-2 C.B. 262 (testamentary CRAT with term of years annuity period); Rev. Proc. 2003-59, 2003-2 C.B. 268 (testamentary CRAT with consecutive interests for two measuring lives); Rev. Proc. 2003-60, 2003-2 C.B. 274 (testamentary CRAT with concurrent and consecutive interests for two measuring lives).

[97] Rev. Proc. 2005-52, 2005-2 C.B. 326 (inter vivos CRUT for one measuring life); Rev. Proc. 2005-53, 2005-2 C.B. 339 (inter vivos CRUT with term of years unitrust period); Rev. Proc. 2005-54, 2005-2 C.B. 353 (inter vivos CRUT with consecutive interests for two measuring lives); Rev. Proc. 2005-55, 2005-2 C.B. 367 (inter vivos CRUT with concurrent and consecutive interests for two measuring lives); Rev. Proc. 2005-56, 2005-2 C.B. 383 (testamentary CRUT for one measuring life); Rev. Proc. 2005-57, 2005-2 C.B. 392 (testamentary CRUT with term of years unitrust period); Rev. Proc. 2005-58, 2005-2 C.B. 402 (testamentary CRUT with consecutive interests for two measuring lives); Rev. Proc. 2005-59, 2005-2 C.B. 412 (testamentary CRUT with concurrent and consecutive interests for two measuring lives).

1. Deficiencies in Model Documents

The IRS model documents serve as a useful drafting guide; however, they could still be improved. The IRS has stated that any document incorporating language *substantially similar* to that in the sample documents qualifies as a CRT.[98] Care is required, however, in relying on the sample documents because they are deficient in several areas. Their primary deficiencies are:

i Trustee powers are not described.

ii There is no state law provision. State law can have a significant impact on how the trust is administered.

iii The remainder interest is committed irrevocably to charitable organizations that qualify under Code Section 170(c) without a further limitation to organizations described by Section 170(b)(1)(A)(i)-(viii). This reference includes private foundations. Arguably, since potential charitable remainder beneficiaries are not limited to public charities, the charitable contribution income tax deduction generated by a transfer to the trust is limited by the rules applicable to private foundation gifts.

iv There is no right to revoke by will the interest of a successor income beneficiary. This omission could result in a federal gift tax liability on the creation of a CRT where the donor provides for the income interest to be distributed first to herself and then to a successor.

v There is no right to permit the donor or any other individual to change the charitable remainder beneficiary. This reduces the flexibility of the trust arrangement.

vi All forms of testamentary CRUTs prohibit additional contributions after the initial contribution from the donor's estate. This prohibition is not required.

vii The sample trusts all provide for the income interest to be paid in quarterly installments, which can result in a smaller deduction for the donor than if paid less frequently. The CRUT documents also provide that assets be valued on the first day of the taxable year, rather than the first business day.

viii The sample documents are silent on the issue of the identity of the trustee, the resignation or removal of trustees, a mechanism for appointing successor or additional trustees, limitations or qualifications on the liability of trustees and the fees that may be charged by a trustee.

Given the complexity involved in drafting declarations of trust for CRTs, the IRS-issued sample documents are of particular importance. The sample documents should provide the

[98] The IRS will not ordinarily rule on the qualification of standard CRTs. See Rev. Proc. 2011-3, 2011-1 I.R.B.111, and Rev. Proc. 90-33, 1990-1 C.B. 551.

maximum amount of flexibility in order to encourage charitable giving and to facilitate administration of the trusts (thereby leaving additional funds to be eventually transferred to charity). Until the IRS sample documents are improved, we recommend that practitioners obtain model documents from other sources.[99]

2. Incapacitated Beneficiaries

The need often arises to make distributions from a CRT to an incapacitated beneficiary. For a number of years, the IRS required a CRT with a trust as an income beneficiary to be set up for a term of years rather than the life of the beneficiary of the second trust; technically, the CRT was treated as having no individual beneficiary and consequently could only last for a fixed term.[100] In 2002, the IRS ruled that a CRT may make payments over an individual's lifetime to a trust for the benefit of that individual if the individual is unable to manage his personal financial affairs as described in Section 6511(h)(2)(A) and if the recipient trust will distribute any of its assets remaining upon the individual's death to either the individual's estate or, after reimbursing the state for any Medicaid benefits provided to the individual, subject to his general power of appointment.[101]

While the 2002 guidance is an improvement over the IRS's previous hard line, the IRS position on this issue is still unnecessarily restrictive. When the beneficiary of the recipient trust is living at the creation of the CRT and is treated as the owner of the recipient trust for income tax purposes or the recipient trust will terminate at the beneficiary’s death, we see no reason for distinguishing between an individual beneficiary and a trust administered for the same individual's benefit. In these cases, the IRS should not be concerned that the payouts are made to a trust rather than to the individual directly. It should not matter for these purposes how the beneficiary's estate is disposed of or, for that matter, whether the beneficiary is incapacitated. It is curious that the Service has taken such a hard line in this circumstance, but is seemingly unconcerned about the disassociation between the beneficiary and the measuring life in others, such as the ability to retain a testamentary right to revoke the interest of an income beneficiary, discussed below.

3. Revocation of an Income Interest

If a donor creates an inter-vivos CRT for a beneficiary other than herself or her spouse, she will want to avoid making a completed gift for gift tax purposes. The CRT may provide that the donor retains the right to revoke the interest of a beneficiary in the donor’s will. This power will prevent the creation of the CRT from being a completed gift and will therefore avoid the gift tax, and will instead mean that the trust assets are included in the donor’s estate for estate tax purposes.[102] This structure raises the question of whether the retention of such a power violates

[99] We note that sample documents that address these deficiencies are provided in the recently issued Ninth edition of *Harvard Manual—Tax Aspects of Charitable Giving*, Hall and Osteen (2011).

[100] *See, e.g.*, Rev. Rul. 76-270, 1976-2 C.B. 194.

[101] Rev. Rul. 2002-20, 2002-1 C.B. 794 (superseding Rev. Rul. 76-270, 1976-2 C.B. 194). See also Priv. Ltr. Rul. 98-39-024.

[102] I.R.C. §2038.

the rule that the income interest in a CRT must be measured by either a term of years or the life of a trust beneficiary.[103] Arguably a CRT subject to the donor's right to revoke a beneficiary's interest is measured by the lifetime of the donor rather than of the beneficiary, yet the regulations and IRS guidance permit this structure.[104]

On the other hand, an inter vivos right to revoke an income interest will apparently disqualify a CRT.[105] There is no logical reason why an inter vivos right to revoke should be treated differently from a testamentary right to revoke. In each case the donor retains the right to avoid gift tax and to maintain flexibility in the event of divorce or other unanticipated eventuality. It would be helpful if the regulations could be clarified in this connection. If a donor wishes to have the assets included in her estate for estate tax purposes instead of paying gift tax on the transfer, she should be permitted to do so without concern about violating the CRT's qualification.

We applaud the IRS for sanctioning the retention of a testamentary right to revoke an income beneficiary's interest, and encourage the IRS to expressly approve the retention of an inter vivos right to revoke as well. Either way, more specific guidance from the IRS in this area would be helpful.

G. Reduction in Payout or Early Termination of a Charitable Remainder Trust

1. Termination of the Trust upon Assignment

A donor or income beneficiary of a CRT may want to assign all or a portion of his income interest to the charitable remainder beneficiary to allow an acceleration of that interest. If the entire income interest in the CRT is assigned to charity and the charity is the sole remainder beneficiary and sole trustee of the trust, the trust will generally terminate under the doctrine of merger of interests and the trust property will be distributed outright to the charity. (In some instances, however, state law may prohibit termination at any time before the end of the trust term.) The termination will not affect the trust's qualification as a CRT in the year in which the assignment occurs.[106]

In the unfortunate event that a CRAT is forced by market conditions to terminate because its assets have disappeared, no donor or charitable remainder beneficiary is allowed to add assets to the CRAT to permit its continued existence since such a trust may not by the terms of Section 664 of the Code accept additions. Such an addition should be permitted and the donor allowed an income gift or estate tax deduction for the present value of the charitable interest in that circumstance.

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[103] See Treas. Reg. §§1.664-2(a)(5), 1.664-3(a)(5); Priv. Ltr. Rul. 89-49-061.

[104] Treas. Reg. §1.664-2(a)(4); Treas. Reg. §1.664-3(a)(4); Treas. Reg. § 25.2511-2(c); Priv. Ltr. Rul. 79-29-056; Priv. Ltr. Rul. 81-20-056.

[105] See Priv. Ltr. Rul. 84-30-006.

[106] Treas. Reg. § 1.664-3(a)(4); see also Priv. Ltr. Ruls. 2008-08-018, 2001-40-027, and 86-02-011.

2. Reduction in Payout or Partial Termination

A number of donors to high payout CRTs found in recent years that the value of the principal had been dramatically eroded by market conditions and searched for ways to reduce their payout without reducing CRT assets. For example, a donor to a CRUT paying 8% of fair market value might seek to amend the CRUT to pay only 5% of the trust principal. However, such an amendment or modification does not meet the requirement that any transfer of a partial interest be either a fractional undivided interest or a guaranteed annuity or unitrust interest. Such a modification or amendment, whether made with court approval or not, would be a taxable transfer for gift tax purposes and would not be deductible for income tax purposes.

Under the current rules, an income beneficiary who would like to reduce his or her payout from a CRT has several options, but none of them is completely satisfactory. First, the beneficiary may, of course, accept the income and then turn around and donate some or all of it to charity. This approach is cumbersome for the beneficiary in that it requires documentation and reporting with each additional gift, and uncertain for the charity because the donations would be made on an ad hoc basis. Second, a beneficiary may—if the governing instrument and state law permit—assign a portion of her income to the charitable remainder beneficiary.[107] Thereafter, the trust would pay the same percentage amount each year, with a portion going to the beneficiary and a portion going to the assignee. Third, the beneficiary may—again if the trust and state law permit—assign all of his rights to a certain portion of the trust to the remainder beneficiaries and terminate the trust with respect to that portion.[108] Thereafter, the trust would pay the same percentage amount each year, but the amount would be calculated based on a smaller pool of assets. Both of the latter two options have the desired effect of reducing the amount received by the beneficiary. Neither, however, relieves the trustee of the fiduciary obligation to invest the assets in such a way as to produce a rate of return in line with the percentage payout of the trust. In the third option, the pool of assets upon which to generate that return is reduced.

3. Commutation

There has been considerable interest in the division of CRT assets between income and remainder beneficiaries which is characterized as a sale by the income beneficiary to the remainder beneficiary. As with the assignment of the income interest, state law and the terms of the trust document must be taken into account. For the income beneficiary, the exchange of the income interest in a CRUT or CRAT for an actuarial share of assets is a sale of a capital asset.[109] Gain will be recognized to the extent of value received in excess of basis. In an exception to the uniform basis rules of Code Sections 1001 and 1014, no basis is allocated to an income interest

[107] In certain states, an assignment is flatly prohibited by law or is only permitted if the donor expressly granted the beneficiary or retained as beneficiary the right to transfer her interest. *See* Sue S. Stewart, Jon L. Schumacher and Patrick D. Martin, *Charitable Giving and Solicitation*, ¶ 23,098 (1996); N.Y. E.P.T.L. § 7-1.5.

[108] See Priv. Ltr. Ruls. 2001-24-010; 94-42-017; 91-38-024.

[109] See Rev. Rul. 72-243. 72-1 C.B. 233; McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), *cert denied*, 330 U.S. 826 (1947).

in a trust.[110] As a result, the entire proceeds received by the income beneficiary are treated as realized capital gain.[111] The Internal Revenue Service has recently reaffirmed its position that it will not rule on such transactions.[112]

The self dealing rules discussed in section III.C impose a flat prohibition on sales or similar transactions between a CRT and a disqualified person regardless of whether the transaction results in benefit to a disqualified person or detriment to the CRT.[113] In egregious circumstances, the private foundation termination tax under Section 507 of the Code may apply when an entity ceases to be a CRT. Neither rule is applicable, nor will any penalty tax apply, to CRT distributions that are or are treated as "amounts payable" in accordance with terms of trust, and are not discretionary with trustee. To constitute "amounts payable" for this purpose, the CRT assets must be divided based on the Section 7520 rate in effect at the time of commutation, utilizing the methodology for calculating remainder interests under Treasury Regulation Section 1.664-4. In addition, early termination must not result in a greater allocation of trust assets to the income beneficiary, to the detriment of the charitable remainder beneficiary, than would otherwise occur upon the termination directed in the instrument.[114]

The Section 7520 calculation must take into account the CRT's net income limitation, if any; that limitation cannot be ignored as it is when a donor's deduction is determined at a trust's inception.[115] One method for valuing an income interest subject to a net income limitation is by using the lesser of (i) the fixed percentage and (ii) the Section 7520 rate in effect on date of commutation.[116] Since the net income limitation is not considered in valuing a NIMCRUT's remainder interest when the trust is created, nor was it considered in earlier private letter rulings addressing commutation, there have been calls for clarification regarding this issue.[117]

When reviewing early terminations of charitable remainder trusts, the IRS is often concerned with whether, because of the income beneficiary's specific health concerns, his *actuarial* life expectancy is significantly greater than his *actual* life expectancy. Such a scenario could result in the income beneficiary receiving a larger lump-sum payment than is warranted.

[110] I.R.C. § 1001(e)(1).

[111] See, e.g., Priv. Ltr. Rulings 2001-27-023, 2003-14-021, 2004-41-024, 2007-33-014, 2007-39-004, 2008-27-009, 2008-33-012.

[112] See Internal Revenue Service's "No Ruling" position on commutation of interests in CRTs described in Rev. Proc. 2011-3, 2011-1 I.R.B. 111.

[113] I.R.C. §§ 4947(a)(2); 4941(d)(1).

[114] See Priv. Ltr. Rul. 2002-08-039.

[115] See Priv. Ltr. Ruls. 2007-25-044, 2007-33-014, 2008-09-044, 2008-16-032, 2008-16-033, 2008-17-039, 2008-27-009, 2008-33-012, 2009-12-036.

[116] See Priv. Ltr. Ruls. 2007-25-044, 2007-33-014, 2008-09-044, 2008-16-032, 2008-16-033, 2008-17-039, 2008-27-009, 2008-33-012, 2009-12-036.

[117] New York City Bar Association letter to IRS dated April 8, 2008.

To guard against this outcome, the IRS has often required documentation from the income beneficiary's physician regarding the state of his health. [118] The holder of the income interest should therefore supply an affidavit or certification from his doctor stating that he has no condition that would shorten his normal life expectancy.

It is clear that the identity of the remainder beneficiary affects the self-dealing analysis, although the exact limits of the IRS's acceptance of commutation is still uncertain. If the remainder beneficiary is a public charity, including a donor-advised fund or supporting organization, commutation has been permitted.[119] In a 2005 private letter ruling, the IRS approved the early termination of a CRT whereby the assets of the CRT were distributed to the original donors (husband and wife) and their private foundation, which was the remainder charitable beneficiary of the CRT.[120] Among the favorable rulings issued by the IRS was that the termination would not result in an act of self-dealing under Section 4941, an issue that arises because the donors were disqualified persons with respect to the private foundation. In a subsequently issued private ruling, however, the IRS revoked the 2005 ruling and stated that taxpayers may not continue to rely on it.[121]

The question the IRS has been wrestling with is whether the transaction should be viewed as a sale of the income interest by the noncharitable beneficiary to the charitable remainder beneficiary for purposes of Code Section 4941. If it is, then the transaction would be considered an act of self-dealing. The noncharitable beneficiary is treated as having sold his interest for income tax purposes (which results in capital gain treatment) and, in those rulings that have considered the issue, the IRS has, in fact, indicated that the sale is considered as having been made to the remainder charity. The revocation of the 2005 ruling strongly suggests that there should be no such commutation transaction where the remainder beneficiary is a private foundation and the noncharitable beneficiary receiving payments on the termination of the CRT is a disqualified person.[122]

4. Sale of Trust Interests in a CRT

An alternative method of early termination of a CRT is for the income and remainder beneficiaries to enter into separate agreements with a third party to sell their respective interests in the CRT. The third party acquires all interests in the CRT and through the doctrine of merger takes title to the trust assets. By this technique the income beneficiary hopes to avoid the provision of Section 1001(e) that would deny the income interest any share of basis in the transferred property. The technique is designed to utilize the exception of Section 1001(e)(3), saying that the no basis allocation rule does not apply to a transaction in which all interests are

[118] See, e.g., Priv. Ltr. Ruls. 2002-52-092, 2003-24-035, 2007-25-044, 2007-33-014, 2008-09-044, 2008-16-032, 2008-16-033, 2008-27-009, 2008-33-012, 2008-41-040, 2009-12-036.

[119] See Priv. Ltr. Ruls. 2006-16-035, 2007-39-004, and 2008-46-037.

[120] See Priv. Ltr. Rul. 2005-25-014.

[121] See Priv. Ltr. Rul. 2006-14-032.

[122] See Fox, *Charitable Giving: Taxation Planning and Strategies*, Section 25.84.

transferred to a third party. The income beneficiary treats the sale of her interest as a disposition of a capital asset and claims a share of the trust's uniform basis in the trust assets.[123]

Certain financial institutions have promoted this technique: the sale of both the income and remainder interests in a CRT to the financial institution, as an unrelated third party, in an effort to take advantage of the provision of Section 1001(e)(3), allowing proportional allocation of basis to income and remainder interests when they are both sold to the third party. The technique assumes that the donor/income beneficiary has contributed appreciated assets to the CRT which have been sold and the proceeds reinvested. Since the CRT is tax-exempt, that sale generated no tax.

In Notice 2008-99, the IRS identified as a "transaction of interest" a transaction where the donor of a CRT and the charitable remainder beneficiary join together in the sale of their respective interests to an independent third party equal to the value of the trust's assets. The Notice described the transaction as designed to allow the donor of the CRT to obtain the present value of her annuity or unitrust interest while claiming to recognize little or no taxable gain. This is contrary to the result in the case of a sale of an annuity or unitrust interest, separate and apart from the remainder interest, where the recognized gain is equal to the total amount of the sale proceeds, as no tax basis may be claimed for purposes of determining gain.

The Notice indicated that the IRS and the Treasury Department believe this transaction has the potential for tax avoidance or evasion, but lacked enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. By identifying the transaction and substantially similar transactions as "transactions of interest," the Notice mandates that persons entering into these transactions after November 2, 2006 must report them on Form 8886, Reportable Transaction Disclosure Statement, or be subject to penalties under Code Section 6707A for failing to do so.[124]

Where a trust was funded with cash or assets that have not appreciated, Notice 2008-99 should not apply. Some sale transactions are justified and are not tax avoidance schemes. There have been some proposals to close the loophole offered by Section 1001(e)(3) without prohibiting sales of CRT interests. In other words, the same principles would apply as in the commutation of CRT interests. The solution could treat the sale as a distribution that carries out taxable income from tiers of historic ledger in accordance with Section 664. Alternatively, the income beneficiary's basis might be deemed to be a pro rata share of the CRT's basis reduced by a pro rata share any undistributed capital gain in the CRT's historic ledger.

The self-dealing rules, discussed earlier, apply to transactions between a disqualified person and a CRT; however, in this case the transaction is between the disqualified person (income interest holder) and an unrelated third party purchaser. Even if the transaction is recast as between the CRT and an unrelated purchaser, there should be no self-dealing since the purchaser is not a disqualified person and does not become a disqualified person by virtue of the

[123] I.R.C. § 1001(e)(3); Treasury Regulation § 1.1001-1(f)(3) (applicable where sale of income interest is part of transaction in which entire interest in property is sold).

[124] See Fox, *Charitable Giving: Taxation, Planning and Strategies*, Section 25.82.

transaction. Must the charitable remainder beneficiary receive a portion of trust property determined under Section 664 methodology? Because the parties are unrelated and there is no self-dealing, the charity and the buyer should be able to negotiate a sales price; however, the charity needs to undertake the transaction only after careful due diligence. In some cases, it may also be prudent to seek approval of the state Attorney General before terminating a CRT in this manner.

Notice 2008-99 has had a significant chilling effect on such sale transactions. Nevertheless, there may be old and cold CRTs where a sale of all interests is justified, particularly where there has been an unforeseen change of circumstances and no pre-conceived plan.

H. **Multiple Donors**

In 1995, the IRS concluded that a trust with multiple *inter vivos* donors did not qualify as a CRT, reasoning that because it had both associates and a business purpose, it was considered a taxable association instead.[125] In another private ruling, an S corporation proposed to create a CRT that would pay the unitrust amount to the corporation for nineteen years and thereafter to the corporation's sole shareholder and his spouse for their lives; the IRS concluded that both the corporation and its sole shareholder were grantors of the proposed trust and that it did not qualify as a trust for federal income tax purposes because it had two grantors, the trustee could vary the investment of trust assets, and the grantors would share in the profits derived from the joint investment of their assets. As a result, the trust did not qualify as a CRT under Code Section 664.[126]

Based on these rulings, it appears that the IRS will not permit a trust with multiple donors, other than two spouses, to qualify as a CRT. As a result, the IRS denies potential donors an income, gift and/or estate tax deduction and taxes both the association on income or gains earned by it and the beneficiaries upon distributions therefrom. This result has been described as "shocking,"[127] a sentiment shared by the authors, and contradicts many prior private letter rulings involving multiple donors contributing to a CRT. In light of this ruling, nonspousal multiple donor trusts should be avoided.

We believe that the IRS's position in these rulings is simply wrong and illogical. It unnecessarily limits the class of persons able to take advantage of the CRT rules. The rulings

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[125] Priv. Ltr. Rul. 95-47-004.

[126] See Priv. Ltr. Rul. 2002-03-034. The proposed arrangement provided that if the corporation were liquidated during the nineteen-year term, the unitrust payments otherwise payable to the corporation were to be made to its shareholders. In its analysis of the arrangement, the IRS stated that, under Treas. Reg. § 1.671-2(e)(4), the gratuitous transfer by the corporation to the trust, which was not made for the corporation's business purposes, should be treated as a constructive distribution to the shareholders and a transfer of those assets by the shareholders to the trust. The amount of the constructive distribution was determined to be equal to the sum of the present values of the unitrust interests of the shareholder and his spouse and a proportional share of the charitable remainder interest.

[127] See Conrad Teitell, *Taxwise Giving*, Volume 34, No. 6 at p.3 (February 1996).

attempt to distinguish a business entity from a CRT based on the purposes behind the entity, but they assume that any entity to which multiple grantors contribute must have an impermissible business purpose. Clearly a CRT that is drafted and administered in compliance with the Code and regulations could only have the purposes set forth in and sanctioned by those rules, regardless of the number of donors or beneficiaries associated with the trust.

Since it is permissible for a single grantor to use the CRT structure to benefit from the investment of assets, the remainder of which will be donated to charity, it makes no sense to disallow this benefit when multiple donors would like to pool their assets. Rather, allowing potential donors to pool their assets might create efficiencies in administration that would generate higher remainder amounts available for the charitable remainder beneficiaries. Once again, it appears that the IRS's concern about donors circumventing the rules has unnecessarily complicated and hindered the creation of CRTs in a way that is not justified by the existing statutory or regulatory structure. Joint CRTs established by spouses are routine and regularly accepted by the Service. We see no reason why a trust established by two or more individuals not related in this way should cause such alarm.

IV. CHARITABLE LEAD TRUSTS

A. **Introduction to CLTs**

Because of the likely staying power of the transfer tax system, and because the interest rates prescribed in Section 7520 continue to be low relative to historically achievable rates of investment returns, charitable lead trusts (CLTs) continue to be very relevant and potentially powerful estate planning tools. Our reform suggested in II, B above that would result in a Section 7520 rate more accurately reflecting current investment return, would reduce the advantage offered by CLTs to some extent.

In a lead trust, a donor transfers assets irrevocably to a trustee. The trustee makes payments to charity in the form of an annuity interest[128] or a unitrust interest[129] for a term of years,[130] a measuring life or lives, or both.[131] On termination, the remaining trust assets, if any, are distributed to non-charitable beneficiaries. These beneficiaries may be anyone, but most often are the children or other lineal descendants of the donor.

[128] A lead annuity interest is a fixed-dollar amount distributed at least as often as annually. The CLAT need not specify the actual dollar amount; a guaranteed annuity can be determined by formula, provided the amount of the annuity is ascertainable at the date of transfer. Treas. Reg. §§20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi).

[129] A lead unitrust interest is a payment equal to a fixed percentage of the net fair market value of the trust property, determined annually and distributed not less often than once a year.

[130] The Code and Treasury Regulations do not prescribe a maximum limit to the term of years for a CLT, but if state law provides for a rule against perpetuities, the CLT must not extend beyond the period permitted under that rule.

[131] Treasury Regulations allow a term of years to be tacked on to a measuring life. Treas. Reg. §§20.2055-2(e)(2)(vi)(a), 20.2055-2(e)(2)(vii)(a), 25.2522(c)-3(c)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vii)(a).

In an environment of low interest rates, CLTs offer donors the possibility of making meaningful contributions over a number of years to charity while also transferring significant sums free of transfer tax to their descendants at the end of the lead term. Of course, the ultimate benefit to the non-charitable remaindermen will depend on the trust's investment return, which cannot be foreseen with certainty on the date of funding. Nevertheless, for a wealthy client whose offspring's basic needs have been met with assets other than those that would be used to fund the lead trust, CLTs can be a highly productive component of an estate plan. Consider the following examples:

Example 1: Charitable Lead Annuity Trust ("CLAT")

Joe has made significant lifetime gifts to his children. He is in the top gift and estate tax bracket. At death, he wants to give 50% of his estate to charity and 50% (reduced by estate taxes) to his children. As a result of the lifetime gifts from their father and their own employment, Joe's children are all well-off, and they would invest any assets they receive at their father's death. Assume Joe dies in 2012 with $20 million.

If Joe gives $10 million to charity and $10 million outright to his children, his children will receive $6,500,000 after estate taxes. If that sum is invested for 10 years, with an income yield of 2%, income taxes at 35% and capital appreciation of 5% (with a 33% turnover and a capital gains tax rate on realized gains of 15%), after 10 years the children will have a fund equal to $11,358,000.

Assume instead that Joe funds a 10-year term CLAT. At his death, the lowest applicable Section 7520 rate is 1%. Joe's estate pays federal estate tax of $2,280,250, and $17,719,750 is used to fund the CLAT. To achieve the desired charitable deduction, the CLAT pays a guaranteed annuity of 8.03% of the value of the funding assets as of the date of their contribution, once at the end of each year. After 10 years Joe's children will have $15,186,000 and $14,237,750 ($10,000,000 in present dollars, assuming a 1% discount rate) will have been distributed to Joe's charities. The children's situation is improved by approximately 30%.

Although CLATs offer the most powerful opportunities for gift-leveraging, CLUTs can, under certain circumstances, also provide significant transfer tax savings.

Example 2: Charitable Lead Unitrust ("CLUT")

In 2012, Sam, who was then 60 years old, established a CLUT with a 6% unitrust interest to last for his life. His health was questionable at the time, although there was less than a 50% probability that he would die within one year. The trust was funded with $10,000,000 and was to terminate in favor of his granddaughter, Alice. The Section 7520 rate at the time the trust was funded was 1%.

Of the $10,000,000 gift, $6,791,300 was eligible for the gift tax charitable deduction. With regard to the $3,208,700 taxable gift, Sam used unified credit so that no gift tax was due. (He also allocated sufficient GST exemption to the trust.)

In 2017, Sam died, and the trust terminated. During the five years that the trust was in existence, it had an average rate of return of 7% per annum. Upon termination, Alice received $10,615,250 from the trust. There was no estate or GST tax liability associated with this transfer.

Congress and the Service have long been aware of the opportunities for transfer-tax planning that CLTs offer, and have historically responded by issuing laws and regulations from time to time that address specific abuses, actual or perceived, in the use of CLTs by taxpayers and their advisors. [132] However, in 2007 and 2008 the IRS published four revenue procedures (the "Revenue Procedures") that gave the first broad guidance on CLTs, including creating "safe harbor" model forms of CLTs, complete with annotations to the forms, and additional guidance on alternative provisions to the samples.[133] While the existence of comprehensive guidance is extremely helpful for practitioners, there remain a variety of details relating to the structure and function of CLTs that would benefit from further guidance, as well as areas in which we believe the IRS should reconsider its current positions. In the rest of this section, we will discuss several problems with which drafters of lead trusts still grapple, and propose ideas for addressing them.

B. Income Tax Deduction Available to Donor on Funding Only if the CLT is a Grantor Trust

Gifts to qualified lead trusts entitle the donor to a gift or estate tax charitable deduction, but unlike most other split-gift techniques that involve charities, transfers made to qualified CLTs do not in general entitle the donor to an income tax charitable deduction. An income tax deduction is available only if the donor is treated as the owner of the deductible interest under the grantor trust rules.[134] The taxation of the CLT itself depends on its treatment as a grantor or non-grantor trust. With a grantor trust, the donor is taxed on all the trust income during the

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[132] For example, final regulations applicable to transfers made on or after April 4, 2000 addressed the use of the so-called "vulture trust," where a healthy donor would establish a CLT using as the measuring life an unrelated individual who was seriously, but not terminally, ill. As Example 2 above illustrates, this scheme provides gift tax and possibly GST-tax leveraging. These rules, applicable to transfers to inter-vivos and testamentary CLTs made on or after that date, limit measuring lives to the donor, the donor's spouse or an individual who is either a lineal ancestor or the spouse of a lineal ancestor with respect to all the non-charitable remainder beneficiaries. A lead trust satisfies the requirement that all non-charitable remainder beneficiaries be lineal descendants of the measuring life if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust principal. Certain limited exceptions to the April 4, 2000 date are included in the regulations. Treas. Reg. §§1.170A-6(e), 20-2055-2(e)(3)(iii) and 25.2522(c)-3(e).

[133] Rev. Procs. 2007-45, 2007-29 I.R.B. 89, 2007-46, 2007-29 I.R.B. 103, 2008-15, 2008-30 I.R.B. 224, and 2008-46, 2008-30 I.R.B. 238.

[134] I.R.C. §170(f)(2)(B).

charitable lead term. If a non-grantor trust, a qualified CLT is subject to the normal rules of Subchapter J of the Code regarding complex trusts.

This fact poses a dilemma for donors and their advisors. On the one hand, because a primary goal of most donors who establish CLTs is to transfer assets to children or more remote descendants at a reduced transfer tax cost, it is imperative that such donors not retain powers that would prevent a completed gift or that would cause inclusion of the CLT property in their estate. Nevertheless, having the trust taxed as a grantor trust for income tax purposes could be advantageous for such individuals, not only because of the up-front income tax deduction, but also because the annual payment of income taxes by the donor could benefit the remainder beneficiaries. This advantage is illustrated in the following example:

Example 3:

Assume a CLT with an annual annuity payout of $100,000 has taxable income of $200,000 in Year 2. If the trust is a grantor trust, the donor will pay income tax on the $200,000. $100,000 of the trust's income will be paid out to charity and the other $100,000 will be retained in the trust and invested, possibly benefiting the non-charitable remaindermen at the end of the lead term. By contrast, if the trust is not a grantor trust, the $100,000 that is not paid out to charity will be taxable to the trust, and an amount substantially less than $100,000 will be available for investment after payment of the tax due.[135]

C. **Defective lead trust treatment**

Because of these advantages of grantor-trust status, a practitioner might want to structure a CLT as a so-called intentionally defective grantor trust by making the donor the effective owner of the deductible interest under the income tax grantor trust rules while not making the donor the owner of that interest for transfer tax purposes. Grantor trust status is most easily achieved by the donor retaining a reversionary interest worth more than 5% of the trust property at the beginning of the trust term.[136] For this purpose, a remainder to the donor's spouse is treated as a reversion retained by the donor.[137] However, the existence of a reversion to the donor or remainder in the donor's spouse will produce adverse estate tax consequences to the donor or her spouse.

Several options for straddling the line and achieving both results are available, each, however, not without risk.

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[135] In the past, the IRS had suggested that if a donor pays income tax on trust income that is taxable to the donor under the grantor trust rules, the donor would be treated as making an additional gift to the trust. <u>See</u>, e.g., Priv. Ltr. Ruls. 95-19-029 and 94-44-033; <u>but</u> <u>see</u> Priv. Ltr. Rul. 95-43-049 (inconclusive result). This position seemed to be without foundation, since the donor is discharging an obligation placed on the donor by federal income tax laws. The IRS corrected the earlier confusion with a 2004 Revenue Ruling that clearly states that the payment of tax on trust income by a donor who is liable for the taxes is not a gift to the trust's beneficiaries for federal gift tax purposes. Rev. Rul. 2004-64, 2004 C.B. 7.

[136]I.R.C. § 673.

[137]I.R.C. § 672(e).

First, under Code Section 675(4), the donor is treated as the owner of the trust property under the grantor-trust rules if a person, acting in a non-fiduciary capacity, has the power, without consent of the trustees, to reacquire the trust corpus by substituting other property of equivalent value. In the CLT context, such a power should not be retained by the donor. It would appear to violate the self-dealing rules and would be negated by the governing instrument requirement prohibiting acts of self-dealing.[138] The Revenue Procedures use Section 675(4) in the sample forms for both grantor CLATs and CLUTs.[139] The forms provide that the substitution power be held, in a non-fiduciary capacity, by someone other than the donor, the trustee, or a disqualified person as defined in Section 4946(a)(1) of the Code, expressly recognizing that the power can have self-dealing consequences. The Revenue Procedures confirm the IRS position that the reacquisition power does not create a *per se* grantor trust; instead the determination of whether the power is exercisable in a non-fiduciary capacity is a question of fact to be considered upon review of the "circumstances surrounding the administration" of the CLT.[140] Interestingly, however, the IRS had no difficulty concluding that a person could "reacquire" assets even if they had never owned them.

Other options available for creating the “defective” grantor trust status include (i) giving a disinterested trustee the power to add remainder beneficiaries;[141] (ii) giving a trustee who is “related or subordinate” to the donor or who is the donor’s spouse a spray power to distribute the principal of the trust among a class of beneficiaries when the trust terminates;[142] (iii) giving the trustees a power to purchase life insurance on the life of the donor or the donor’s spouse;[143] (iv) giving a non-adverse trustee the power to distribute income or accumulate income for future

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[138]The retention of such a power by the donor would not cause inclusion of the trust property in the donor's estate under I.R.C. § 2038(a). See *Estate of Jordahl*, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1; Priv. Ltr. Ruls. 95-48-013 and 92-27-013.

[139] See Rev. Proc. 2007-45, §§ 7.11 and 8.09; Rev. Proc. 2008-45, §§ 7.11 and 8.09. This is not entirely surprising, given that several earlier rulings suggested that a Section 675(4) power given to an individual who was not a disqualified person was a safe choice to create grantor trust status and not jeopardize the qualification of the lead trust or the donor's transfer tax objective. See, e.g., Priv. Ltr. Ruls. 92-24029 and 92-47024.

[140] See Rev. Proc. 2008-45, § 8.09; Rev. Proc. 2007-45, § 8.09. See Treas. Reg. § 1.675-1(b)(4); See Priv. Ltr. Ruls. 94-07-014, 96-42-039 and 97-13-017.

[141] I.R.C. §674(c); Treas. Reg. §1.674(d)-2(b). A technical concern with this route is that it does not create a grantor trust for all purposes. Since it only affects the eventual distribution of the trust principal, this method creates a grantor trust only with respect to capital gains or some amount of ordinary income that might be accumulated. A broader concern is that the donor may be reluctant to grant such a power, although it can be fettered by extending only to the spouses of the original individual beneficiaries or even charitable organizations.

[142] I.R.C. §674(c). Reliance on this power is again subject to the concern that the trust will not be treated completely as a grantor trust and also runs into potential problems if the trustee resigns or the third party is not available to act.

[143] IR.C. §677(a)(3). While the mere existence of such a power appears to make the trust a grantor trust under the statute, there is case law to the effect that the grantor will be taxed on the trust income and capital gains only if the power is in fact exercised, and possibly only to the extent that income and principal are used to purchase the insurance. G.F. Moore v. Comm’r, 39 B.T.A. 808 (1939) (trustees were empowered to use the trust income for payment of premiums on insurance policies on the donor’s life; since no such policies were purchased and premiums paid, the court concluded that the trust income was not taxable to the donor).

distribution to the donor or the donor's spouse;[144] and (v) making the trust a foreign trust by, for example, appointing a foreign trustee, provided there are United States remainder beneficiaries.[145] None of the options for straddling the ownership line is without risk, however, and the process of evaluating the various options and drafting the intentionally defective trust document tends to be burdensome for practitioners and expensive for clients.

A legitimate question may be raised about the benefit of forcing a donor seeking an income tax deduction for the contribution to a CLT to deal with the complexity, uncertainty and expense inherent in establishing an intentionally defective grantor trust. The Service's basic interest in structuring income tax deduction rules for CLTs is to ensure that only one deduction be available for any particular transfer. The two income tax regimes applicable to CLTs (grantor treatment and non-grantor treatment) both respect this interest. With a grantor CLT, the donor gets an up-front income tax deduction for the present value of the entire gift to charity, but neither the donor nor the trust receives any further deduction. With a non-grantor CLT, the trust, which is a taxable entity separate from the donor, is permitted to take deductions stemming from the funding dollars, so it is reasonable that no other taxpayer – including the donor – be permitted to take deductions for those same dollars.

Because the Service's interests are protected under both systems of CLT taxation, we suggest that donors be allowed to choose for themselves one system or the other using a simple, check-the-box procedure. This would allow a donor to evaluate her own needs and decide whether she prefers an up-front income tax deduction, and ongoing liability for the payment of the trust's income tax with no offsetting deduction available, or to take no up-front income tax deduction, but have the trust treated as a separate taxpayer with a Section 642(c) deduction available for amounts paid to charity. Such a system would avoid entirely the need for donors and their advisors to have to spend time and money adding artificial provisions to CLT documents in order to achieve a straightforward income tax result.

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[144] I.R.C. §677. This provision could be invoked by requiring that the lead interest be payable from principal and that the income be accumulated for future distribution to the donor's spouse. However, this is cumbersome, and undermines part of the transfer tax leverage by bringing the accumulated income back into the ownership or the estate of the donor's spouse.

[145] I.R.C §679. The risk in this approach is potential exposure to tax under I.R.C. § 684, which treats the transfer of appreciated property by a U.S. person to a foreign trust as a sale and imposes a capital gains tax on the difference between the fair market value of the property transferred and the donor's adjusted basis. While an exception under § 684(b) eliminates this problem when the CLT is first established, the tax could be a problem when grantor trust status ceases. To minimize the risk of a tax under I.R.C. § 684, foreign trust status may be terminated before the end of the lead term. For example, assume that a 10-year term lead trust is established with a foreign trustee. The trust is a grantor trust by virtue of its foreign character, but also includes other powers and discretions that arguably constitute it as a grantor trust. Shortly before the end of the term, the foreign trustee resigns, leaving only U.S. resident trustees and foreign status ends. Continuing grantor-trust treatment is asserted because of the other powers. Even if the trust lost its grantor-trust status, the position that the § 684 tax should be applied would seem even more tenuous, since foreign-trust status terminates before grantor-trust status. See Priv. Ltr. Rul. 2003-38-015 (supporting the notion that the domestication of a foreign trust does not trigger the § 684 tax).

A check-the-box system of income taxation would also benefit charities by making CLTs more understandable and flexible, and thus more attractive to potential donors. We have found that it can be difficult even for sophisticated donors to understand the intricacies and implications of the grantor trust rules. Someone thinking about creating a CLT might be concerned that his trust will inadvertently be drafted incorrectly, and that unfavorable income tax results will ensue. Allowing donors to take matters into their own hands would provide a level of comfort and security that could encourage the use of CLTs by wealthy donors, to the great benefit of charitable organizations.

D. **"Shark-Fin CLAT"**

The CLAT regulations permit a great deal of flexibility in structuring the annuity payments over the life of the CLAT. Not only are there no minimum or maximum payout requirements, but the regulations allow for the annuity to be either a fixed dollar amount or a fixed percentage of the initial value of assets in the trust, as long as the annual payment amount is ascertainable when the trust is funded.[146] The recent Revenue Procedures even permit the CLAT to have an annuity amount that increases during the annuity period, something that is not allowed in the case of a CRAT.[147] Structuring a CLAT with payments that increase over time may be advantageous for a variety of reasons, including allowing for funding with low-liquidity assets and minimizing the amount of trust assets that leave the trust in the first years after the trust is funded (thereby allowing for more asset appreciation within the trust). This has the potential to increase the amount of funds available for distribution to the non-charitable beneficiaries at the end of the trust term.[148]

Aside from the requirement that the value of each annuity payment be ascertainable at the time that the trust is funded, the Revenue Procedures and Treasury regulations give no guidance to practitioners who are structuring these increasing annuity CLATs. An extreme example of a varied annuity payment is the “shark-fin” or “balloon” CLAT, which pays a small, equal payment for the majority of the trust term with one large payment in the final year.[149]We believe

[146] Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi) and 25.2522(c)-3(c)(2)(vi). The regulations specify that while the amount may change in some ways, it “may not be redetermined by reference to a fluctuating index such as the cost of living index.” One Private Letter Ruling did approve an annuity amount that varied from year to year; however, the amounts of each payment were laid out in the trust instrument. Since no additional information was given concerning this variation, it is difficult to generalize as to its effect. Priv. Ltr. Rul. 91-12-009.

[147] Rev. Prov. 2007-45, § 5.02(2); Rev.Proc. 2007-46, § 5.02(2). The Treasury Regulations governing CRATs, however, require that the “sum certain” required by statute means “a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year,” meaning that no variation in the annual payment is permitted. Treas. Reg. § 1.664-2(a)(1)(ii).

[148] See Paul S. Lee, TurneyP. Berry, and Martin Hall, Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse, 37 ACTEC L. J. 93 (Summer 2011).

[149] See Lee, et al., supra note 39. The terms ‘shark-fin’ and ‘balloon’ come from the appearance these structures create when the annuity stream is graphed. Interestingly, the authors show that “the Shark-Fin structure actually results in a smaller remainder than both the 120% and 150% back-loaded CLATs over the same period of time. The highest probabilities of success (defined as the probability of a remainder greater than zero) and the highest remainder values peak with 150% back-loaded annuities.” *Id*. at 105.

that the IRS should clarify the extent to which variation in annuity streams is permitted for CLATs, particularly in light of the fact that some have argued that the shark-fin style payment may not be available in a valid CLAT.[150] Since keeping more funding assets in the trust in the early years may lead to more wealth transfer to the non-charitable beneficiaries, as well as decreasing the likelihood that the trust assets will be entirely consumed before the charity has received the full amount intended by the trust instrument, we recommend that the IRS permit donors to structure the annuity payments in any way they choose.

E. **Lead Trusts Are Taxable Entities**

Donors often fund CLTs with a single asset (or a very small group of assets). Trustees, then, often face the immediate need to sell at least part of the funding assets in order to diversify the trust's holdings. The duty to diversify has long been a fundamental duty of trustees, and this duty is made explicit in the prudent-investor statutes of the many states that have adopted laws based on the Uniform Prudent Investor Act ("UPIA").[151]

In the context of a CLT, the duty to diversify often places the trustee in a difficult position. On the one hand, the trustee wants to diversify, both for the long-term economic welfare of the trust and for his own protection. On the other hand, diversification can have a deleterious effect on the trust. If, as is often the case, the assets used to fund a CLT have a low basis in the hands of the donor relative to their fair market value at the time of transfer, the sale of the assets by the trustee will produce a significant amount of taxable income. This income will not likely be entirely offset by the unlimited income tax charitable deduction available to the trust. While it is true that under the modern prudent investor statutes, tax consequences are an important element to be considered by a trustee in deciding whether to make a particular investment decision most trustees would choose to diversity a large concentrated holding in spite of the imposition of tax.

The dilemma encountered by trustees who face a duty to diversify a single, low-basis asset is illustrated in the following example:

Example 4:

Lawrence establishes a non-grantor lead annuity trust in 2012. He funds the CLAT with stock of Experiment, Inc. having a fair market value of $1 million. Lawrence's basis in the stock, which pays no dividend, is $100,000. The required annual payout to Charity is $60,000.

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[150] See Richard L. Fox & Mark A. Teitelbaum, Validity of Shark-Fin CLATs remains in Doubt Despite IRS Guidance, 37 Est. Plan. 3 (2010).

[151] See UPIA, §3 ("A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." See also Restatement (Third) of Trusts, §227(b) and §227, Comment g. To date, 44 states have adopted some form of the UPIA.

Experiment, Inc.'s stock has been volatile, and the trustee of the CLAT wants to sell 75% of it right away. If the trustee sells $750,000 worth of stock, the trust will recognize gain of $675,000. The required annuity payment of $60,000 will be made from this amount and an income tax deduction for that payment will be available under Section 642(c). That still leaves $615,000 that is subject to tax. Assuming that that entire amount consists of long-term gain taxed at 15%, the trust will owe $92,250 in income tax. Thus, in 2012, the trust loses over 9% of its initial value due to its income tax liability.

Furthermore, the problem of excess income in a lead trust generally cannot be mitigated by the special election provision of Section 642(c). The basic rule under Section 642(c) is that if a taxable trust makes a payment to Charity in Year 1 from income earned in 2012, and the payment is made pursuant to the terms of the governing instrument, then the amount contributed to Charity is deductible from the trust's 2012 taxable income. Section 642(c) goes on to say that if a taxable trust makes a contribution to Charity in 2013 from income that was earned in 2012, the trustee may elect to treat that contribution as having been made in 2012 so that it would be deductible from the trust's taxable income in 2012. The difficulty in using this election provision in the context of a CLT is that the payment deemed to have been made in 2012 can be deducted from 2012 income only if the payment was made pursuant to the terms of the governing instrument. It is generally not possible for a lead trust to satisfy this requirement. This dilemma is illustrated in the following example.

Example 5:

The facts are the same as in Example 4, above. In 2013, the trust's income is only $20,000. The trustee makes the annuity payment of $60,000 in 2013, as is required by the governing document. $20,000 of this payment is made from 2013 income, and the other $40,000 from 2012 income.

Clearly, a $20,000 deduction is available for the trust's 2013 income. With regard to the $40,000 that was paid from 2012's income, can the trustee make an election under Section 642(c) to have that $40,000 treated as having been paid in 2012? If so, then another $40,000 could be deducted from 2012 income, and the taxable income for that year would be reduced from $615,000 to $575,000.

Unfortunately, this is not possible. The governing document authorizes $60,000 per year to be paid from the trust – no more, and no less. $60,000 was paid in 2012, and there is no authority in the governing document to pay an additional $40,000 in 2012. Thus, no additional deduction is available for 2012. Furthermore, the $40,000 of charitable deduction that the trustee was unable to use in 2013 due to the trust's insufficient income in 2013 is lost; there is no carryforward to subsequent years of the unused deduction amount.[152]

[152] I.R.C. §642(c); Treas. Reg. §1.642(c)-(1)(b). See also Rebecca K. Crown Income Charitable Trust Fund v. Comm'r, 98 T.C. 327 (1992), aff'd on appeal, 8 F.3d. 571 (7th Cir. 1993) (amounts in excess of the annuity specified in the trust instrument are not deductible under I.R.C. §642(c), even though the amounts are not in commutation of future amounts and are within the overall annuity obligation when considered in the aggregate).

The problem in meeting the requirement that a payment deemed to have been made in a prior year be made "pursuant to the terms of the governing instrument" could be solved through a commutation clause requiring the trustee to pay out any income of the CLT in excess of the annuity or unitrust amount in commutation of the lead interest. The Tax Court has suggested on at least one occasion that payments made pursuant to such a commutation clause would be made pursuant to the terms of the governing instrument for purposes of the Section 642(c) deduction if, as a matter of law, commutation were permissible.[153] As will be discussed in Section F below, however, it is not currently possible as a matter of law to include a commutation clause in a lead trust, as such inclusion will disqualify the CLT entirely.

Nor can the problem of excess income be solved through a so-called split-interest lead trust, which provides for part of the lead interest to pass to charity and part to non-charitable beneficiaries in an effort to mitigate the tax burdens resulting from the excess income. Treasury Regulations provide that generally a CLT cannot make payments to a non-charitable beneficiary before the end of the lead term, with two exceptions. First, non-charitable interests may be paid if they take the form of a guaranteed annuity or unitrust interest and the trust requires that no priority be given to the non-charitable annuity or unitrust interest over the charitable annuity or unitrust interest; second, non-charitable payments may be made from trust assets that are segregated and administered exclusively for non-charitable purposes.[154] These Regulations limit the utility of the split-interest lead trust, because, under the first exception, no flexibility is created that would allow the fiduciaries to adjust for excess income. Neither does the second exception provide a solution, since, if separate "accounts" must be maintained, excess income cannot be transferred from the charitable to the non-charitable account, and the build-up problem in the non-charitable account will continue.[155]

While it is true that in the context of a CLAT, the charity's fixed interest is unlikely to be affected by the tax consequences discussed in this section, the situation is different with a CLUT. In a CLUT, the charity's interest is directly affected by fluctuations in the value of the trust property. If a trust is significantly diminished due to a tax liability brought about by the trustee's need to sell low-basis assets in order to diversify (as was the case in Example 4), the aggregate payment to charity over the remaining life of the trust will be significantly less than it would have been under a kinder tax regime.

Furthermore, the current tax rules often produce adverse consequences to donors. If a donor has paid estate or gift tax upon the transfer of assets to a CLT, or has used unified credit or

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[153] Rebecca K. Crown, supra note 152, at 336. The Tax Court explicitly expressed no opinion regarding whether the payment of a charitable lead interest may be accelerated consistent with the requirement of Section 2522(c)(2)(B) that the charitable interest be in the form of a guaranteed annuity. Id.

[154] Treas. Reg. §§20.2055-2(e)(2)(vi)(f), 20.2055-2(e)(2)(vii)(e), 25.2522(c)-3(c)(2)(vi)(f), and 25.2522(c)-3(c)(2)(vii)(e); Rev. Proc. 2007-45, §§ 5.02(8) and 8.02(8); Rev. Proc. 2007-46, § 5.02(8); Rev. Proc. 2008-45, §§ 5.02(8) and 8.02(8); Rev. Proc. 2008-46, § 5.02(8).

[155] The Tax Court has, however, invalidated the estate tax version of this regulation in a case where a private unitrust interest was created first and, after the measuring life died, the unitrust amount was split between charitable and private purposes. Estate of Minnie L. Boeshore v. Comm'r, 78 T.C. 523 (1982), acq. 1987-2 C.B. 1.

allocated GST exemption, the benefit of the tax paid, credit used, or allocation made is lost to the extent that the trust assets are diminished by the tax liability.

One could argue that the problems brought about by the trustee's duty to diversify a low-basis funding asset would not arise if donors simply funded CLTs with assets that were not significantly appreciated. This "solution", however, would not work in the real world, since it ignores the fact that the opportunity to avoid or defer significant amounts of capital gains tax is a very powerful incentive to many donors. The widespread popularity of outright donations of appreciated securities (where capital gains taxes are avoided entirely), charitable remainder trusts (where beneficiaries pay capital gains tax only as unitrust or annuity distributions are made to them) and charitable gift annuities (where a donor can in some circumstances spread out capital gains liability over her lifetime) is strong evidence of the practical importance of capital gains issues to charitable giving. In order to encourage further philanthropy among wealthy individuals, the tax regime needs to be structured so that donating low-basis assets to a charitable lead trust is an economically viable and sensible option.

We believe that if the value of the charity's lead interest is above a certain threshold level, the trustee of a CLT should have the option of spreading the recognition of capital gains over a period of years. This simple modification of current law would greatly mitigate the problem of the large, up-front depletion of trust property illustrated in Example 4 and the problem of excess income in the year of sale (and insufficient income in subsequent years) illustrated in Example 5. Trustees would be able to diversify the trust property appropriately without having the specter of Draconian income tax consequences hanging over their heads. The requirement that the value of the lead interest be substantial, perhaps at least 50% or 60% of the total trust value, in order for the trust to qualify for delayed recognition of gain would eliminate the possibility that the system of delayed recognition could be abused. The establishment of a limited period of time over which the recognition of gain could be spread, for example five years, would also strike a reasonable balance between the interests of the donor and the trust on one hand and the interests of the government on the other.

F. **Commutation**

A provision in a charitable lead trust allowing the trustee to pre-pay the lead interest could be very useful. For example, if a trustee were required in the governing document to pay out any income in excess of the annuity or unitrust amount in commutation of the lead interest, the trust would be able to take its full deduction under Section 642(c), and the problems related to excess income discussed in Section E above would be solved. In addition, a commutation provision would lend flexibility to the irrevocable lead trust, allowing the distribution of the remainder interest to be accelerated if the remainder beneficiaries developed economic needs that were not anticipated at the time the trust was created.

Unfortunately, the Service takes the position that the existence of a commutation provision results in the disqualification of the lead interest for the gift or estate tax charitable deduction, and the Revenue Procedures reflect this view.[156] The Service has argued in a

[156] See Rev. Proc. 2007-45, § § 5.02(1) and 8.02(1) and Rev. Proc. 2007-46, § 5.02(1) (each confirming this position with the statement that "a charitable lead annuity interest is not a guaranteed annuity interest if the trustee

published revenue ruling[157] that since Treasury Regulations applying to guaranteed annuity interests[158] require that the annuity must represent the right to receive periodic payments over a specified period of time and that the exact *amount* (rather than the present value) payable under the annuity must be determinable at the outset of the trust, the Regulations prohibit any amount of pre-payment at a date after the date of transfer. If commutation were permitted, the argument continues, the amount of the charitable interest would not represent the right to receive periodic payments over a specified period because the number of payments would be a function of whether and to what extent the trustee decided to pre-pay. Similarly, the exact amount could not be determined as of the date of the gift, because the amount of each payment is dependent on the trustee's decision whether or not to commute. The IRS has subsequently applied this rationale and holding to lead unitrust interests[159] and has concluded that an estate tax charitable deduction would not be available for a distribution made by a trustee in commutation of a lead unitrust interest, where that distribution was to occur as of the date of establishment of a testamentary trust.

In the context of lead annuity trusts, the Service's objection to pre-payment provisions is clearly unwarranted. The concern of the IRS is apparently that a prepayment provision will permit the trustee "to manipulate the payments to the respective interests in the trust and thus to affect the real values of the charitable and non-charitable interests."[160] This concern would seem unfounded in connection with guaranteed annuities as long as the commutation is performed at the discount rate mandated by the IRS at the time the commutation occurs and requires the consent of the charity. While the unfortunate use of the word "amount" in the regulations may provide a basis for the position of the IRS, there is nothing in the statute or the legislative history that justifies the approach with respect to an annuity interest.[161]

There is a stronger argument against allowing a commutation provision in a lead unitrust, but that argument is not insurmountable. Under current valuation regulations, while it is possible to fix a value at any given time to a lead unitrust interest, that value assumes that the trust assets will not appreciate and thereby in economic terms tends to undervalue the unitrust interest. Although one could use this fact to argue against allowing the commutation of a lead unitrust

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has the discretion to commute *and* prepay the charitable interest prior to the termination of the annuity period") (emphasis added).

[157] Rev. Rul. 88-27, 1988-1 C.B. 331.

[158] Treas. Reg. §25.2522(c)-3(c)(2)(vi)(a).

[159] Priv. Ltr. Rul. 97-34-057.

[160] TAM 87-45-002.

[161] The 1969 Act was designed to ensure that the value received by charities from split-interest trusts was readily determinable; there was nothing in that Act that requires the amount to be readily determinable. As long as the discount rate used to determine the commutation is economically reasonable (e.g., the mandated IRS rate), the value received by the charity will be the same as if the commutation payment was not made and, as long as the charity is required to approve the commutation, there is little if any chance for the kind of "manipulation" feared by the IRS. Thus, the authors submit that there is no policy justification for prohibiting commutation of annuity interests.

interest, we think that one could argue that the problem is not commutation, but valuation. The regulations on valuation could instead be refined to include provisions whereby a trustee could at any given time fix a value of a lead unitrust interest that the Service would consider economically reasonable. As is the case with lead annuity trusts, as long as any commutation of a lead unitrust interest is performed pursuant to standardized valuation rules promulgated by the Service and requires the consent of the charity, the possibility that a party could use commutation to manipulate trust payments to the detriment of the charity would be remote.

A non-tax objection that could be raised with respect to allowing commutation clauses in lead trusts is that such clauses could have the effect of transferring part or all of the remainder interest to the "wrong" beneficiary. A remainderman's interest in a CLT is a contingent remainder interest, the contingency being survival to the end of the lead term. A commutation clause could have the effect of transferring property to a beneficiary who does not meet the contingency, as illustrated in the following example.

Example 6:

Harry establishes a 15-year CLAT. Charity is the sole beneficiary of the lead interest. Under the terms of the trust, after the lead interest terminates, the trust property is to pass to Harry's daughter, Jeanne, if she is then living, or if she is not then living, equally to Harry's two young nephews, Will and Michael. Assume commutation clauses are permitted by the IRS, and a broad commutation provision is included in the governing document. Seven years after the creation of the trust, all interested parties agree to pre-pay the lead interest and terminate the trust. Jeanne takes the remainder interest. Two years later, she dies, leaving her estate to her husband, Sam.

If the trust had run its full, fifteen-year term, Will and Michael would have taken the remainder. Arguably, because of the commutation, the "wrong" beneficiary (i.e. Jeanne and, ultimately, Sam) has received the benefit of the trust.

The solution to this problem would simply be to leave it up to the donor to decide whether to add a provision to the CLT document prohibiting commutation if early termination might have the effect of paying the lead interest to someone other than the person who would take if the trust were allowed to live out its full life. Language could easily be included in a trust document stating explicitly the donor's intent regarding the disposition of the remainder interest in the event of a commutation. If allowing commutation becomes a default rule, as we think it should, this rule should apply only to trusts drafted after the rule goes into effect, as donors who have created CLTs under the current rules have drafted under the assumption that commutation is not permitted.

G. **Tier System of Income Distribution**

While it was always clear that absent any specific instructions in the governing instrument, amounts paid out to the charity will be deemed to include a proportionate amount of each class of income (for example ordinary income, capital gains and unrelated business taxable income ("UBTI"),[162]the position of the Service with regard to ordering provisions was a longstanding area of uncertainty. This position was clarified by recently finalized regulations (originally proposed in June of 2008) which state that ordering provisions will only be controlling for federal tax purposes to the extent that the provision has "economic effect independent of income tax consequences."[163] An example in one of the regulations indicates that ordering provisions in charitable lead trusts do not have the necessary economic effect "because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid."[164] It is virtually impossible to structure a lead trust in which an income ordering would have substantial economic effect. Since the Service will not follow the ordering provision in the trust instrument, the distributions will be "deemed to consist of the same proportion of each class of the items of income…as the total of each class bears to the total of all classes."[165] Arguments may however be made that an income-ordering provision has substantial economic effect. In Rev. Rul. 78-183[166] the Service recognized that a trust paying the greater of 2% of the fair market value of trust assets or trust income would yield a smaller contribution value than a trust paying a fixed 2% of value annually. Since payments of trust income in excess of the 2% amount would reduce trust principal, the charity's interest would be reduced. For that reason, income-ordering provisions that tend to protect the value of a lead trust's assets by minimizing tax have substantial economic effect.[167]

Rather than continuing to use the proportionate income distribution described in the regulations, we believe that the Service should endorse a distribution of payments to charity in the following order:

i ordinary income, including short-term capital gains, but excluding UBTI;

ii 50 % of UBTI;

iii capital gains other than short-term gains;

iv the balance of UBTI;

v tax-exempt income; and

[162] A lead trust is not technically subject to tax on UBTI since it is not subject to the provisions of I.R.C. §§ 511-514; however, I.R.C. § 681 disallows a taxable trust's charitable deductions under I.R.C. § 642(c) to the extent allocable to trust income which would be UBTI if the trust were tax exempt.

[163] Treas. Reg. §§ 1.642(c)-3 and 1.643(a)-5.

[164] Treas. Reg. § 1.642(c)-3, ex. 1.

[165] Treas. Reg. § 1.642(c)-3(b)(2).

[166] 1978-1 C.B 306.

[167] See comments on Proposed Lead Trust Regulations submitted by Conrad Teitell on behalf of American Council on Gift Annuities and the National Committee on Planned Giving, September 12, 2008. See also Notice 2011-39 and Internal Revenue Service and Treasury 2011-2012 Priority Guidance Plan.

vi principal.

The reason for this order is that category (i) represents income that, unless distributed, is fully taxable to the trust at the highest income tax rates and that can, if distributed, be fully deducted by the trust. Category (ii) represents the portion of UBTI that the trust may deduct. Since UBTI will almost always be taxed at ordinary income rates, it makes sense to distribute the deductible portion before distributing capital gains other than short-term gains (category (iii)).[168]

We believe that the tier system outlined above should be endorsed by the IRS and furthermore should be the default system for income distributions from CLTs. We realize that under such a regime, it would be possible for a CLT's distribution of a unitrust or an annuity amount to be composed entirely of deductible ordinary income, even when other kinds of income were earned by the trust, but we do not think such a result is inappropriate since it is consistent with the deduction regime for individuals. When an individual makes a contribution to charity in a particular tax year, the Service does not require that he apportion his income tax deduction among the different types of income he earned that year. Rather, the Service effectively allows the individual to use the deduction to offset his ordinary income to the greatest possible extent; only when ordinary income is no longer available would the deduction be used to offset capital gains. The tier system in a CLT, then, would simply translate the system endorsed by the Code for individuals into the context of a lead trust. If the Service believes that this system has economic significance for individuals, we see no reason why it should not find similar economic significance for lead trusts. The pro rata allocation currently advocated by the IRS is a far more artificial construct, and we see no legal or policy justification for it.

H. Recapture of income tax deduction if grantor dies during trust term

If the donor to a grantor lead trust dies during the trust's term (or otherwise ceases to be treated as the owner under the grantor trust rules), all or part of the charitable income tax deduction allowed to the donor upon funding the CLT will be recaptured.[169] Upon termination of grantor trust status, the donor is treated as receiving an amount of income equal to the difference between the total deduction the donor received when the trust was created and the discounted value of all amounts of income earned by the trust and taxable to the donor before the grantor trust status ceased.[170] The recapture amount is characterized differently by Treasury regulations, which calculate the recapture amount by reference to the difference between the initial deduction and the discounted value of all amounts that were required to be and were actually paid under the terms of the trust to charity before grantor trust status ceased.[171] This approach leads to the possibility that, if the aggregate value of the discounted lead payments exceeds the up-front income tax deduction, no recapture will occur even if minimal trust income has been taxable to

[168] Within the category of capital gains, an ordering provision should, distinguish between those non-short-term gains taxed at higher rates under Section 1(h) of the Code - e.g., capital gains attributable to the sale of collectibles.

[169] I.R.C. § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(4).

[170] I.R.C. § 170(f)(2)(B); Rev. Proc. 2007-45, § 8.02(5); Rev. Proc. 2008-45, § 8.02(5).

[171] Treas. Reg. §§ 1.170A-6(c)(4), 1.170A-6(c)(5), ex. 3.

the grantor.[172] Regardless of the method of determining the amount of recapture, the maximum amount that would be included on the donor's return would be the original deduction amount.

This recapture requirement leads to an uncertainty in the treatment of a grantor lead trust that terminates at the donor's death. Under Treasury regulations, recapture applies if "for any reason the donor of an income interest in property ceases at any time *before the termination of such interest* to be treated as the owner of such interest for purposes of applying Section 671, as for example, where he dies *before the termination of such interest*…."[173]The possibility that the lead interest in a CLT that terminates upon the death of the donor will be considered to have continued after the donor's death is particularly problematic in the case of a CLT that has back-end loaded annuity payments, such as the shark fin CLT discussed above.[174] In such a situation, the recapture payment is likely to be considerably larger than in a typical evenly disbursed annuity structure, since the early charitable payments are likely to be minimal. This would be of even greater concern to a CLT that is structured with a large final balloon payment that will be funded by a life insurance policy on the donor's death, meaning that donor will always die prior to the major charitable payment from the trust.

I. Distribution of appreciated property is taxable

Income earned by a grantor lead trust is fully taxable to the donor. Although all, or a significant portion, of the income will be paid to the charity, there is no offsetting charitable deduction. The recent Revenue Procedures make clear that the taxation of income to the grantor also applies in the case of distributions of appreciated property in satisfaction of the annuity payment. [175] While a donor who owned appreciated assets outright would not be required to realize capital gains upon the donation of those assets to a public charity, and would nevertheless be entitled to a charitable income tax deduction based on the full value of the assets, a distribution of appreciated property from a grantor lead trust is a realization event to the grantor. Although this is an inconsistent result, the IRS has drawn a distinction between the two situations and enforced the position in a recent private ruling, determining that the annuity payment from

[172] The variance is explained in a Technical Memorandum, which concludes that "…a literal reading of the statute would be illogical because there is no necessary correlation between the charitable contributions deduction previously allowed to the donor and the amount paid to charity. … It is recognized [however] that [the] approach [taken by the proposed regulation] is not clearly supportable under the language of section 170(f)(2)(B)." "Technical Memoranda: Notice of proposed rule making – Amendment of Income Tax Regulations to conform them to section 201 (a) and (f) of the Tax Reform Act of 1969, relating to charitable contributions", available at 1970 TM Lexis 26, *8-9 (Dec. 10, 1970) (not published in the Federal Register); see also Charitable Contributions Deduction, 36 Fed. Reg. 6082 (proposed Apr. 2, 1971) (to be codified at 26. C.F.R. pt. 1).

[173] Treas. Reg. § 1.170A-6(c)(4) (emphasis added).

[174] The IRS does not seem to have considered the possibility of triggering the recapture rules in this context. Several commentators have expressed the view that a grantor trust term measured by the grantor's life can be a solution to the recapture problem. See, e.g., Peter Melcher and Matthew Zuengler, Maximinizing the Benefits of Estate Planning Bet-To-Die Strategies: CLATS and Private Annuities, 7 Marq. Elder's Advisor 203, 218 (2006); Carlyn S. McCaffrey, The Charitable Lead Trusts-Estate Planning for the Philanthropic Optimist, SG093 ALI-ABA 271 (2002).

[175] Rev. Proc. 2007-45; § 8.02(2); Rev. proc. 2008-45, § 8.02(2)

the trust was taxable because it was in satisfaction of a debt to the charity, rather than being the completion of a mere pledge, as would be the case when an individual made a donation of appreciated property that was owned outright.[176]

V. OTHER SPLIT-INTEREST AND PARTIAL-INTEREST GIFT ISSUES

A. **Fractional Interests in Artwork**

1. Fractional interest gifts under prior law

Prior to the adoption of the Pension Protection Act of 2006 (PPA), a charitable deduction was allowed for a gift of an undivided fractional portion of a donor's entire interest in tangible personal property. The partial interest rule of section 170(f) expressly permits a deduction for such an interest.[177] If it were reasonable to anticipate that the gift would be used in a manner related to the exempt purposes of the charity, and if the property would generate long-term capital gain upon its sale, the income tax deduction could be based on the relevant fraction of the entire fair market value of the property at the time of the contribution.[178] If the charity's use were unrelated, the deductible amount was limited to the relevant fraction of the donor's basis in the property. Several very important changes were made under the PPA, effective for gifts made after August 17, 2006, with the result that fractional interest giving is much less common than it was prior to the PPA.

2. All interests must be owned either by the donor or the donee

No income tax deduction is available for a contribution of an undivided interest in tangible personal property unless immediately before the contribution, all interests in the property were owned by the donor or by the donor and the donee charity.[179] In other words, there can be no other fractional interest owner (including for this purpose another charitable organization). The authors urge the IRS to exercise its authority to issue regulations that will permit separate donors who own undivided interests in the same item (for example, three siblings who inherited artwork as co-tenants) to make simultaneous proportionate contributions of such property to the same charity.[180] The limitation on owners applies for gift as well as income tax purposes.[181]

[176] Priv. Ltr. Rul. 2009-20-031.

[177] I.R.C Sections 170(f)(3)(B)(ii), 2055(e)(2) and 2522(c)(2).

[178] I.R.C Section 170(e)(1)(B)(i).

[179] I.R.C Section 170(o)(1)(A).

[180] I.R.C Section 170(o)(1)(B).

[181] I.R.C Section 2522(e)(1).

3. Deduction for additional gifts of undivided interests in the same property

If the use of the property is related to the charity's exempt purpose, and the deduction is based on the fair market value of the property, there is a special limit on the amount of deduction generated by gifts to the same charitable donee of additional undivided interests in the same property. In that situation, the fair market value of an additional contribution is determined by using the lesser of (1) the property's fair market value at the time of the initial fractional contribution or (2) the property's fair market value at the time of the additional contribution.[182] Therefore, no deduction is allowed for increases in the fair market value of the entire property after the time of the initial fractional gift. This provision is a dramatic change from the earlier treatment of fractional-interest gifts, which allowed the donor to continue to benefit if the property increased in value while still partially owned by the donor. This provision should be returned to its prior status to allow each donation to accurately reflect the fair market value of the property, or at a minimum, be modified; if the intent is for consistency of treatment across the time period of the donation, the deduction should not be adjusted downwards if the property goes down in value after the initial gift.

4. Recapture of deduction and recapture penalty

If the prior change were not a sufficient disincentive to make gifts of undivided interests in tangible personal property, the PPA also provides for the recapture of both the income and gift tax (but not estate tax) charitable deductions in certain circumstances. First, if the donor makes an initial contribution and then fails to contribute all of the remaining interest in the property to the original charitable donee (or if the donee is no longer in existence, to another charitable organization) before the earlier of the 10th anniversary of the initial gift and the donor's death, there is recapture of the deductions permitted for all prior contributions. Secondly, there is also recapture where the charitable donee fails to take substantial physical possession of the property, or fails to use the property in a use related to the organization's exempt function during the period beginning with the date of the initial fractional contribution and ending on the earlier of the 10th anniversary of the initial contribution and the donor's death.[183] The recapture takes the form of taxing the amount of the recaptured deductions in the year in which the recapture is triggered, and paying interest on any additional tax running from the due date of the tax that would have been paid earlier if the deduction had not been claimed. Furthermore, if a deduction is recaptured, there is an additional tax of 10 % of the amount recaptured.[184]

There is a significant question as to whether the recapture provision would apply to a gift of jointly held property owned by husband and wife with right of survivorship in the event that one joint owner dies and the survivor inherits the decedent's fractional interest. If the survivor completes the gift within the requested 10-year period, the recapture provision arguably should not apply, but technically the gift may not comply with requirement of Section 170(o)(3)(A)(i)

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[182] I.R.C Section 170(o)(2).

[183] I.R.C Sections 170(o)(3) and 2522(e)(3).

[184] I.R.C Section 170(o)(3)(B) and 2522(e)(3)(B).

that the donor must complete the transfer of the remaining interests to the donee by the date of his death.

5. The future of fractional interest gifts

There has been considerable ink spilled on this subject given that it has largely shut down fractional interest gift planning in this area. See Stephanie Strom's article in the New York Times, December 10, 2006, entitled "The Man Museums Love To Hate," focusing on Senator Grassley, the former chairman of the Senate Finance Committee who was largely responsible for initiating the PPA reforms. In 2009, Senator Charles Schumer introduced S. 1605, which was later re-introduced as S. 931, that would have walked back several of the PPA reforms, including extending the period during which the donation must be completed from 10 years to 20 years and again allowing donors to claim an increased deduction on subsequent gifts of the value of the art increased after the first fractional interest donation. These amendments to the PPA reforms should be made to encourage donors to make fractional interest gifts of valuable art works for the benefit of museums and the art-loving public.

B. Pooled Income Funds

A pooled income fund ("PIF") is a trust maintained by a charity to which several donors make gifts, retaining income interests for themselves or their designated beneficiaries and naming the charity as the remainder beneficiary. A PIF is governed by Section 642(c)(5) and functions very much like a mutual fund for the commingling and investment of retained life-income gifts. All the income earned by the PIF is paid out on a current basis to the income beneficiaries. On the death of the last income beneficiary of a particular gift, the corpus attributable to that gift is severed from the PIF and transferred to or for the use of the charity.

1. Multiple Remaindermen

A PIF must be "maintained" by the charitable organization to which the remainder interest is given.[185] This requirement means, in effect, that a PIF can have only a single charity as a remainderman. Regulations provide a limited exception that allows a national organization carrying out its purposes through local organizations, chapters, or auxiliary bodies with which it has an identity of aims and purposes to maintain a PIF in which donors can designate either the national organization or one or more of the local organizations as the remaindermen.[186]

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[185] I.R.C. § 642(c)(5)(E).

[186] Treas. Reg. § 1.642(c)-5(b)(5). See also Rev. Rul. 92-107, 1992-2 C.B. 120. In that ruling, the national organization generally controlled and supervised the local organizations, and only those local organizations that expressly consented to participation in the PIF were to be included in the PIF. The PIF's governing instrument provided that (1) a designated local organization could not sever its interest in the PIF prior to the death of the income beneficiary and (2) if the designated local organization was no longer affiliated with the national organization at the time the remainder interest was transferred, the remainder interest would be transferred either to the national organization or to another affiliated local organization chosen by the national organization. The ruling, limited to this set of facts, provided very little guidance for national organizations wishing to establish a PIF because many such organizations are structured with looser relationships between the parent and subsidiaries than the organization profiled in the ruling. The ruling did not address the feasibility of PIFs for national organizations that

In Revenue Ruling 96-38,[187] the Service considered whether a PIF maintained by a community trust satisfied the maintenance requirement.[188] The IRS concluded that the maintenance requirement for PIFs would be satisfied if either (i) the trustee of the community trust has discretion to determine the charitable beneficiary of the remainder interest, or (ii) the donor is permitted to request or require that the remainder interest be placed in a component fund of the community trust designated to benefit a specific charitable organization. However, the donor may not require that the funds be transferred to the specified organization except in a case of emergency; rather, only income may be transferred to the specified organization, but principal must remain in the community trust. Revenue Ruling 96-38 has discouraged many donors who would like to give to a PIF maintained by a community trust in order to benefit a small charity. The donor would like to request that the community trust distribute the fund outright at the death of the income beneficiary to the designated charity, since many such gifts are modest in size, typically under $50,000, but such an outright distribution is not possible under the PIF rules.

The single-remainderman requirement was apparently intended to ensure that the charity would have a sufficient interest in the trust to prevent the trustee from manipulating the investment policy against the interest of the charitable remainderman. This is a laudable goal, but choosing to achieve this goal by limiting the remainderman to a single charity denies most small charities any access to a PIF as a deferred-giving vehicle. While a PIF can be established quickly and cheaply, it is expensive to operate. Unless a PIF can accumulate assets of more than $500,000 rather quickly, it is probably not wise to start one, and thus the PIF is out of reach of most small charitable organizations. Permitting a community trust to maintain a joint PIF for multiple small charities would allow these organizations to take advantage of this efficient giving structure, leaving more of the donor's funds available for the ultimate charitable beneficiary.

2. Unitrust Payments for Pooled Income Funds

As discussed in Part II of this article, investment returns have decreased significantly in recent years. In addition, the proportion of increased value attributable to interest and dividends has diminished and has been replaced by capital gain. Because most PIFs are not permitted to allocate capital gains to income for trust accounting purposes, the "net income" amount permitted as a distribution from a PIF has declined as a %age of total investment return. As a

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are controlled from the "bottom up" (that is, when local organizations control the national organization) or for more loosely structured groups of affiliated organizations. See also Priv. Ltr. Rul. 95-03-018, in which the IRS ruled that a PIF established by an affiliate of a state organization satisfied the maintenance requirement.

[187]See 1996-2 C.B. 44

[188]This issue was previously addressed in Rev. Rul. 92-108, withdrawn in February 1993, which involved a PIF maintained by a community trust (sometimes referred to as a community foundation), which permitted the donor either to specify by name the charitable organization to receive the ultimate distributions of the remainder interest or to grant to the community trust the right to determine the charitable organizations that ultimately would benefit from the remainder interest. Because of requirements applicable to community trusts, the trustees of the community trust retained discretion over so-called donor-advised and donor-designated funds. Nevertheless, Rev. Rul. 92-108 concluded that if the donor were permitted to designate by name the charitable organization ultimately to receive the remainder interest, the fund would not meet the requirements of a pooled income fund under Section 642(c). After receiving pressure from community foundations, the Service revoked Rev. Rul. 92-108.

result, the usefulness of PIFs as planned gift vehicles has decreased dramatically. It has been suggested that one solution to this dilemma is to follow the model of charitable remainder trusts ("CRTs"), which may now be commingled by the exempt remainder beneficiary with its endowment. Such an arrangement would provide the PIF with a unitrust payment from the charity's endowment, which it could in turn pay out to its beneficiaries.

Allowing the charitable beneficiary of a PIF to commingle its assets with the charity's endowment would result in greater economics of scale in the management of the charity's planned or deferred gifts, a potentially higher and more stable investment return for the PIF, and greater diversification of the PIF's investments. The PIF could participate in the charity's endowment using the unit method, which the IRS has specifically approved in the context of investment of "split interest" assets held by certain CRTs.[189] The unit method assigns units of participation to all investors in the endowment, and entitles the holder of a unit to a proportional amount of the endowment's income. The PIF would be entitled to receive periodic payments from the endowment based on the number of units owned and the payout rate, and would thereby be able to receive an investment return equal to that of the endowment.

This type of arrangement would allow the PIF to receive payments on the units held by it based on the payout rate the charity has established for units in the endowment, with payouts made at least quarterly. The donors to the PIF would retain an income interest in the PIF, equal to the payout rate described above, for the life of one or more beneficiaries.[190] The payouts would be treated as ordinary income, regardless of the character of the underlying income of the endowment (whether capital gain, ordinary income, or return of capital). Any redemptions of units (over and above receipt of the payout amount) would be treated as generating long or short term capital gain (or loss), depending on the holding period of the redeemed units. Of course, it would be unusual for the PIF to redeem units once purchased because the income distribution to the PIF beneficiaries would represent each beneficiary's entire respective share of the PIF income.

For example, if the PIF has a value of $10,000 at the beginning of the tax year, it will be required to pay out to the income beneficiaries the beneficiaries' allocable share of income for the year. Assuming that the payout rate established by the charity for its endowment units is 4 %, a payout of $400 would be made to the PIF by the charity and would be treated as ordinary income. The total payout to the income beneficiaries would also be $400 and would be treated entirely as ordinary income.

Such an arrangement would not seem to be inconsistent with the Code's requirements for PIFs.[191] However, this arrangement has not received IRS approval at the current time. Given that the IRS has approved the use of a comparable transaction in the CRT context, the authors see no reason why the IRS should not bless this structure for PIFs as well.

[189] See Priv. Ltr. Rul. 2003-52-017 (October 3, 2003).

[190] Code Section 642(c)(5)(A).

[191] See Code Section 642(c)(5).

C. **Gift Annuities in the Current Economic Climate**

Unlike the other split interest vehicles discussed in this paper, the charitable gift annuity is not technically a "deferred gift," but a "bargain sale" transaction. In a gift annuity, the donor transfers cash or other property to a charitable organization in exchange for a charity's promise, backed by its general assets, to make annuity payments to one or two individuals for their lifetime. Gift annuities have traditionally been popular and desirable because of their simplicity and security: gift annuity contracts are short documents, and the charity's obligation is not dependent upon the limited assets of a trust. However, given the current economic climate, gift annuities have become substantially less attractive, making split-interest giving even more challenging for donors with smaller amounts to give.

The donor of a gift annuity is entitled to an income tax charitable deduction equal to the difference between the value of the property contributed to the charity and the present value of the annuity,[192] determined by using the Section 7520 rate to discount the value of the annuity payments to be received in the future. Because the amount of the donor's deduction can vary significantly based on the interest rate used, the tax treatment cushions the impact of the monthly changes to the discount rates on charitable transfers. Code Section 7520(a) permits a donor who makes a transfer of property with respect to which a charitable income, estate, or gift tax deduction is allowable in whole or in part to elect to use the applicable rate for the month in which the transfer is made, or either of the two months preceding the month of the transfer. Since the applicable rate for any particular month is normally published on or about the 20th day of the preceding month, a donor making a gift near the end of any month can, in effect, select among four potential rates simply by deferring the gift until the following month.[193]

The current low Section 7520 rate means that the annuity the donor receives is valued highly and the deduction the donor receives is correspondingly small. For example, a $500 annuity for a 70-year-old person has a value of $6,516 using the September, 2012, rate of 1.0%, but a value of $4,746 if the discount rate used is 5.0%. If the annuity was funded with a gift of $10,000, the donor's deduction is $5,254 if the discount rate is 5.0% but only $3,484 if the discount rate is 1.0%. Given the historically large fluctuations in interest rates described in Part II of this paper, the disparity in these valuations seems out of proportion to the actual difference in value between the two annuities. Using such a low interest rate, even though the interest rate is likely to increase during the course of the annuity, makes gift annuities unnecessarily unattractive, leading donors to use methods of giving that are less efficient—or in the case of many potential donors of small gifts, to forgo their charitable gift entirely.

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[192] Treas. Reg. § 1.170A-1(d)(1).

[193] However, for a gift being made in December, the donor is, from a practical standpoint, limited to a choice of three rates, since deferral of the gift until the following month will defer the deduction for a year.

VI. CONCLUSION

Charitable giving by individuals will continue to be important to our society. Our tax structure has and will continue to respond to political pressures which in recent times have been directed toward estate and gift taxes. Regardless of those changes, charitable remainder and lead trusts, gift annuities and possibly even pooled income funds will remain important tools in the charitable gift structure. The rules governing those arrangements must be adapted to reflect current investment realities and changes in the law of trusts. Investment market realities require recognition that the Section 7520 rate based on federal bond rates is no longer an accurate measure of investment return. Furthermore, the changed definitions of principal and income adopted by many states should lead to changes in the CRT payout requirements.

The narrow interpretation of grantor trust and bargain sale rules which prevents transfers of debt-financed property to CRTs could easily be modified. A CRT with multiple donors is currently prohibited in spite of the fact that such an arrangement is logical and reasonable when, for example, members of a single family or of a single college class want to create such a trust to benefit a family member or class member and a charity of common interest to all donors. The self-dealing rules have been interpreted in an unnecessarily narrow fashion to prevent the use of CRTs, CLTs and private foundations to meet a pledge originally given by the donor. These rules need a somewhat more flexible and rational interpretation because, as currently interpreted, they discourage many significant philanthropic efforts. Simultaneously, the limitations on modification of a unitrust payout, preventing a reduction in the payout to protect the principal of the trust and to decrease the payout to the individual CRT beneficiary are counter to the interest of protecting and increasing the value of charitable remainder. Also, commutation of interests in both CRTs and CLTs should be permitted under appropriate circumstances. Such commutation can accelerate interests to charity and may be advantageous if handled properly.

Trustees of charitable lead trusts need to be permitted and encouraged to diversify trust assets. The need to diversify creates the need to rationalize the tax burden on such a trust. In addition, the current game playing in the CLT area where a so-called super lead trust or defective lead trust may be structured as a grantor trust for income tax purposes but as a completed gift and outside the donor’s estate for gift and estate tax purposes could be ended with a simple check-the-box technique.

The recently finalized regulations that recognize income ordering provisions in a CLT only when such provisions have economic effect independent of income tax consequences add a further level of unnecessary complexity and unreasonable tax treatment to the already confusing area of imposition of income tax on CLTs. A donor to a CLT should be able to prescribe how distributions will be ordered, and the treatment should be consistent with the general tax treatment of individuals and trusts: deductions offset the highest level of income first.

Fractional gifts of artwork have drastically diminished as a result of adverse rules changes in the 2006 PPA. Many of those changes are unnecessary and represent an overreaction to a perception of abuse in an area where little abuse actually existed.

Pooled income funds are destined for extinction unless the requirement to pay out net income may be reinterpreted to mean a unitrust amount. It is vital to move away from the narrow definition of income as exclusively interest, dividends, rents and royalties. Such traditional income sources typically are earned at a rate well below actual investment return. As a result, a gift to a PIF is extremely unattractive. Similarly, gift annuities are not likely to enjoy much use so long as current Section 7520 rates remain at low levels. The importance of gift annuities to modest donors underscores the importance of adapting the Section 7520 rates to a more realistic level.

Annual Returns on Stock, T.Bonds and T.Bills: 1928 - Current

The raw data for treasury bond and bill returns is obtained from the Federal Reserve database in St. Louis (FRED). The treasury bill rate is a 3-month rate and the trreasury bond is the constant maturity 10-year bond, but the treasury bond return includes coupon and price appreciation. It will not match the treasury bond rate each period. For more details, download the excel spreadsheet that contains the same data.

	Annual Returns on			Compounded Value of $ 100		
Year	*Stocks*	*T.Bills*	*T.Bonds*	Stocks	T.Bills	T.Bonds
1928	43.81%	3.08%	0.84%	$143.81	$103.08	$100.84
1929	-8.30%	3.16%	4.20%	$131.88	$106.34	$105.07
1930	-25.12%	4.55%	4.54%	$98.75	$111.18	$109.85
1931	-43.84%	2.31%	-2.56%	$55.46	$113.74	$107.03
1932	-8.64%	1.07%	8.79%	$50.66	$114.96	$116.44
1933	49.98%	0.96%	1.86%	$75.99	$116.06	$118.60
1934	-1.19%	0.32%	7.96%	$75.09	$116.44	$128.05
1935	46.74%	0.18%	4.47%	$110.18	$116.64	$133.78
1936	31.94%	0.17%	5.02%	$145.38	$116.84	$140.49
1937	-35.34%	0.30%	1.38%	$94.00	$117.19	$142.43
1938	29.28%	0.08%	4.21%	$121.53	$117.29	$148.43
1939	-1.10%	0.04%	4.41%	$120.20	$117.33	$154.98
1940	-10.67%	0.03%	5.40%	$107.37	$117.36	$163.35
1941	-12.77%	0.08%	-2.02%	$93.66	$117.46	$160.04
1942	19.17%	0.34%	2.29%	$111.61	$117.85	$163.72
1943	25.06%	0.38%	2.49%	$139.59	$118.30	$167.79
1944	19.03%	0.38%	2.58%	$166.15	$118.75	$172.12
1945	35.82%	0.38%	3.80%	$225.67	$119.20	$178.67
1946	-8.43%	0.38%	3.13%	$206.65	$119.65	$184.26
1947	5.20%	0.57%	0.92%	$217.39	$120.33	$185.95
1948	5.70%	1.02%	1.95%	$229.79	$121.56	$189.58
1949	18.30%	1.10%	4.66%	$271.85	$122.90	$198.42
1950	30.81%	1.17%	0.43%	$355.60	$124.34	$199.27
1951	23.68%	1.48%	-0.30%	$439.80	$126.18	$198.68
1952	18.15%	1.67%	2.27%	$519.62	$128.29	$203.19
1953	-1.21%	1.89%	4.14%	$513.35	$130.72	$211.61
1954	52.56%	0.96%	3.29%	$783.18	$131.98	$218.57
1955	32.60%	1.66%	-1.34%	$1,038.47	$134.17	$215.65
1956	7.44%	2.56%	-2.26%	$1,115.73	$137.60	$210.79
1957	-10.46%	3.23%	6.80%	$999.05	$142.04	$225.11
1958	43.72%	1.78%	-2.10%	$1,435.84	$144.57	$220.39
1959	12.06%	3.26%	-2.65%	$1,608.95	$149.27	$214.56
1960	0.34%	3.05%	11.64%	$1,614.37	$153.82	$239.53
1961	26.64%	2.27%	2.06%	$2,044.40	$157.30	$244.46
1962	-8.81%	2.78%	5.69%	$1,864.26	$161.67	$258.38
1963	22.61%	3.11%	1.68%	$2,285.80	$166.70	$262.74
1964	16.42%	3.51%	3.73%	$2,661.02	$172.54	$272.53
1965	12.40%	3.90%	0.72%	$2,990.97	$179.28	$274.49
1966	-9.97%	4.84%	2.91%	$2,692.74	$187.95	$282.47
1967	23.80%	4.33%	-1.58%	$3,333.69	$196.10	$278.01
1968	10.81%	5.26%	3.27%	$3,694.23	$206.41	$287.11
1969	-8.24%	6.56%	-5.01%	$3,389.77	$219.96	$272.71
1970	3.56%	6.69%	16.75%	$3,510.49	$234.66	$318.41
1971	14.22%	4.54%	9.79%	$4,009.72	$245.32	$349.57
1972	18.76%	3.95%	2.82%	$4,761.76	$255.01	$359.42
1973	-14.31%	6.73%	3.66%	$4,080.44	$272.16	$372.57
1974	-25.90%	7.78%	1.99%	$3,023.54	$293.33	$379.98
1975	37.00%	5.99%	3.61%	$4,142.10	$310.90	$393.68
1976	23.83%	4.97%	15.98%	$5,129.20	$326.35	$456.61
1977	-6.98%	5.13%	1.29%	$4,771.20	$343.09	$462.50
1978	6.51%	6.93%	-0.78%	$5,081.77	$366.87	$458.90
1979	18.52%	9.94%	0.67%	$6,022.89	$403.33	$461.98
1980	31.74%	11.22%	-2.99%	$7,934.26	$448.58	$448.17
1981	-4.70%	14.30%	8.20%	$7,561.16	$512.73	$484.91
1982	20.42%	11.01%	32.81%	$9,105.08	$569.18	$644.04
1983	22.34%	8.45%	3.20%	$11,138.90	$617.26	$664.65
1984	6.15%	9.61%	13.73%	$11,823.51	$676.60	$755.92

1985	31.24%	7.49%	25.71%	$15,516.60	$727.26	$950.29
1986	18.49%	6.04%	24.28%	$18,386.33	$771.15	$1,181.06
1987	5.81%	5.72%	-4.96%	$19,455.08	$815.27	$1,122.47
1988	16.54%	6.45%	8.22%	$22,672.40	$867.86	$1,214.78
1989	31.48%	8.11%	17.69%	$29,808.58	$938.24	$1,429.72
1990	-3.06%	7.55%	6.24%	$28,895.11	$1,009.08	$1,518.87
1991	30.23%	5.61%	15.00%	$37,631.51	$1,065.69	$1,746.77
1992	7.49%	3.41%	9.36%	$40,451.51	$1,101.98	$1,910.30
1993	9.97%	2.98%	14.21%	$44,483.33	$1,134.84	$2,181.77
1994	1.33%	3.99%	-8.04%	$45,073.14	$1,180.07	$2,006.43
1995	37.20%	5.52%	23.48%	$61,838.19	$1,245.15	$2,477.55
1996	23.82%	5.02%	1.43%	$76,566.48	$1,307.68	$2,512.94
1997	31.86%	5.05%	9.94%	$100,958.71	$1,373.76	$2,762.71
1998	28.34%	4.73%	14.92%	$129,568.35	$1,438.70	$3,174.95
1999	20.89%	4.51%	-8.25%	$156,629.15	$1,503.58	$2,912.88
2000	-9.03%	5.76%	16.66%	$142,482.69	$1,590.23	$3,398.03
2001	-11.85%	3.67%	5.57%	$125,598.83	$1,648.63	$3,587.37
2002	-21.97%	1.66%	15.12%	$98,009.73	$1,675.96	$4,129.65
2003	28.36%	1.03%	0.38%	$125,801.18	$1,693.22	$4,145.15
2004	10.74%	1.23%	4.49%	$139,315.72	$1,714.00	$4,331.30
2005	4.83%	3.01%	2.87%	$146,050.90	$1,765.59	$4,455.50
2006	15.61%	4.68%	1.96%	$168,853.19	$1,848.18	$4,542.87
2007	5.48%	4.64%	10.21%	$178,114.34	$1,933.98	$5,006.69
2008	-36.55%	1.59%	20.10%	$113,009.37	$1,964.64	$6,013.10
2009	25.94%	0.14%	-11.12%	$142,318.62	$1,967.29	$5,344.65
2010	14.82%	0.13%	8.46%	$163,411.79	$1,969.84	$5,796.96
2011	2.07%	0.03%	16.04%	$166,787.51	$1,970.44	$6,726.52

Arithmetic Average

				Risk Premium Stocks - T.Bills	Stocks - T.Bonds
1928-2011	11.20%	3.66%	5.41%	7.55%	5.79%
1962-2011	10.60%	5.22%	7.24%	5.38%	3.36%
2002-2011	4.93%	1.81%	6.85%	3.12%	-1.92%

Geometric Average

				Risk Premium Stocks - T.Bills	Stocks - T.Bonds
1928-2011	9.23%	3.61%	5.14%	5.62%	4.10%
1962-2011	9.20%	5.19%	6.85%	4.02%	2.35%
2002-2011	2.88%	1.80%	6.49%	1.08%	-3.61%

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[1]
Aswath Damodaran:
ST: Short term (Treasury bill)
LT: Long term (Treasury bond)

[2]
Aswath Damodaran:
The risk premium will be computed from this year to the current year.

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