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# Reformation of the Charitable Contribution Deduction

## Split Interest Trusts - What Works and What Doesn't*

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# SPLIT INTEREST TRUSTS – WHAT WORKS AND WHAT DOESN'T

Charitable remainder trusts and charitable lead trusts have been with us for over a century. Donors have had a longstanding interest in making a gift and reserving certain critical rights. Although incorrectly credited with creating those structures, the 1969 Tax Reform Act changed their structure dramatically and introduced detailed rules for tax qualification.

This regulatory scheme has evolved over the last 30 years. This paper will discuss the important aspects of those rules and the problems that have become evident in their application. We have not attempted to describe 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 either through statutory amendment or interpretive guidance.

Despite the rhetoric emanating from Washington in the early part of this year about estate tax repeal, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), which the President signed in June, has sustained the estate, gift, and generation-skipping transfer ("GST") taxes. Estate planners continue to be fully employed while clients are more confused than ever. Under the new law, the gift tax is retained, with some modifications. Estate and GST taxes are reduced gradually between 2002 and 2009 and are repealed for the year 2010, but then return in 2011. Few estate planning attorneys believe that the EGTRRA regime will remain unchanged in the coming years when the fog of the tax bill gradually clears and its unwieldy structure emerges and is understood by taxpayers and their elected representatives. Anecdotal evidence suggests that most estate planners do not believe that the current law will be replaced with full repeal of transfer taxes; rather, it is highly likely that some form of the estate, gift, and GST taxes will remain with us indefinitely.

The transfer tax changes have succeeded in raising questions about whether donors will continue to make large charitable gifts. While most thoughtful planners continue to believe that transfer taxes will remain part of the tax landscape, we know for certain that the income tax endures. Even if the maximum income tax rate declines from its present level of 39.6 percent to 35 percent, the incentive to give during lifetime will remain powerful.

## I. CHARITABLE REMAINDER TRUSTS

### A. **Introduction**

Charitable remainder unitrusts and annuity trusts ("CRUT"s and "CRAT"s, 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 consequences of such a trust. Instead, it is the income tax deduction enjoyed by most donors and the opportunity to diversify investments without incurring capital gains on the sale of the contributed property that provides the primary attraction. 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 continuing 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.

## 1. MANY ABUSES HAVE BEEN ELIMINATED

In response to perceived abuses, the IRS implemented several changes to the Code in 1997. First, the value of the remainder interest in a CRT must now equal at least 10 percent of the fair market value of the property transferred to the CRT upon contribution.[1] Second, the annual payout may not exceed 50 percent of the trust's assets.[2] The IRS provides guidance for reforming or voiding a CRT that passes the 50 percent test but fails the 10 percent test.[3] In the case of CRATs, these rules apparently supplemented and did not supplant the pre-existing rule that a gift to a CRAT with more than a 5

[1] I.R.C. §§664(d)(1)(D), (d)(2)(D). This rule is applied with respect to the fair market value of the property even if the donor's deduction is based on his cost basis in the funding asset. It is applied to the initial funding asset for a charitable remainder annuity trust and upon each contribution for a charitable remainder unitrust. If a unitrust initially passes the 10 percent test but fails it at a later date, the CRT will not be disqualified; it can be reformed.

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

[3] See I.R.C. §2055(e)(3)(J)(ii) (reformation permitted in certain circumstances to reduce payout percentage or shorten the trust's term); I.R.C. §2055(e)(3)(J)(i) (if, within a certain period, a court declares a trust void, it can be unwound and the property returned to the donor); I.R.C. §664(d)(4) (if a CRT violates the 10 percent test due to additional contributions made to a CRUT that was established before the effective date of the 1997 Act, such additions will be treated as a separate CRT and will not affect the status of the original trust).

percent chance of exhausting its principal before the trust's termination will not qualify for the income tax charitable deduction.[4] With the new restrictions in place, we believe that the 5 percent exhaustion test is no longer necessary. Also, it is unclear that a statutory basis exists for denial of the deduction for such a CRAT if the remainder interest is ascertainable upon creation, even if only the minimum 10 percent of initial asset value. Another uncertainty in this arena is whether a CRAT that fails the 5 percent exhaustion test will be completely disqualified or merely be ineligible for a charitable deduction. Such doubt is of course unsettling to donors, and we believe unnecessary to the IRS's mission of eliminating abuses. In sum, the 5 percent exhaustion test for CRATs is left over from an era before the newer 10 percent and 50 percent rules routed out some legitimate abuses and today represents nothing more than an artificial limitation on the structure of a CRAT.

Another change adopted in 1997 and fully effective for trusts after December 10, 1998 concerns the timing of payments from CRTs. Former 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). For CRATs or straight percentage CRUTs, however, payments are permitted after the close of the tax year only if either (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.[5] In order to allow non-abusive distributions of cash following the close of a year, the regulations have since been further amended to include two exceptions: there will be no deemed sale if cash is distributed to a beneficiary after the close of the year for which the payout is due and the cash is either (i) cash contributed to the trust for which a deduction was allowable (even if contributed after the close of the taxable year in question), or (ii) return of basis in an asset contributed to the trust for which a deduction was allowable and which was sold during the year for which the distribution is being made.[6]

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

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

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

[6] Treas. Regs. §§1.643(a)-8(b); 1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g).

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.

New regulations also prohibit a donor from postponing recognition of income through 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. Now, 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, there is a deemed sale; the trust is be treated as if it sold a pro-rata portion of the assets in order to make the distribution.[7]

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.[8] 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. While, in the case of a CRUT, this trap may be avoided by establishing a flip trust that converts 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.

### 2. CONTINUING PROBLEMS WITH 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".[9] Typically applied to

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[7] See footnote 6 supra. Note that the IRS has indicated that such a deemed sale will not be considered acquisition indebtedness under I.R.C. §514(c). Prop. Reg. 1.643(a)-8(c), example 1.

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

[9] 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 percent interest. I.R.C. §4946(a).

private foundations, these rules also apply to the remainder interest in split-interest trusts such as CRTs,[10] yet do not apply to the unitrust or annuity amount payable under a qualified CRT.[11] 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.

a. 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. 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[12] -- 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.[13] 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.[14]

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

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

[12] Treas. Reg. §1.664-1(a)(7).

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

[14] 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 before the transfer

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.[15] Similarly, in a 1995 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.[16] 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 677of the Code.[17] 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.[18]

We believe the IRS is wrong in its position that the transfer of mortgaged property to a CRT creates a grantor trust.[19] 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

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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).

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

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

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

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

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

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 this case, however, simply because income could be distributed to the donor in satisfaction of the unitrust payout, the Service considered the entire trust to be "owned" by the donor.[20]

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.[21] 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.[22] 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

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

[21] 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.

[22] 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.

recognizing gain at the corporate level if assets have value at liquidation in excess of original basis.[23]

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 accept the bargain sales rules, pay some capital gains upon funding, and then be permitted to continue without tainting an otherwise qualified CRT.

b. 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.[24] 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.[25] This logic forces donors to satisfy their pledges to a given charity through other assets or through the payouts they receive from the CRT.

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, 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,

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[23] 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.

[24] I.R.C. §§4941, 4946.

[25] 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).

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 get around 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.

### 3. PROBLEMS WITH THE UNRELATED BUSINESS INCOME TAX RULES

Even one dollar of unrelated business taxable income can be fatal to a CRT. It will cause 100 percent of the income of the CRT earned that year, including income otherwise exempt from tax, to be treated as taxable income.[26] The rule, under Section 514 of the Code, for many other charitable entities is that only the debt-financed portion of the income is taxable when it is earned. We see no reason why this should not be the rule for CRTs as well.

The current rule discourages the funding of CRTs with partnership assets that may generate UBTI. It also may bar a donor from making gifts of commercial real estate such as an apartment building because modest income from vending machines or laundry facilities may be earned on site and distributed to the trust before the real estate may be sold. This is an unnecessary hindrance to potential donors. Most importantly, the current UBTI rule has a deleterious effect on investment options for the CRT. Many exempt organizations serve as trustees of CRTs of which they are beneficiaries, but this rule prohibits them from commingling the CRT with their endowments, which often are invested in debt-financed real estate and recognize small amounts of UBTI. 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, results in substantial sacrificed investment return. There is no logical reason why the §514 rules should not apply to a CRT as if it were another tax-exempt entity.

New legislation currently before Congress would address this very problem.[27] Under the proposal, UBTI earned by a CRT would be subject to 100 percent excise tax in the year it is earned, but the entire income for the year will not be "tainted" by the presence of the UBTI. Moreover, the legislation provides that the UBTI would be excluded when determining the value of the trust's assets and for the calculation of the

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[26] I.R.C. 664(c); Leila G. Newhall Unitrust v. Commissioner, 104 T.C. 236 (1995), aff'd 97-1 U.S.T.C. ¶ 50, 159 (9th Cir. 1997).

[27] Section 106, H.R. 7, "Community Solutions Act of 2001".

unitrust amount and characterization of the distributions in the hands of the beneficiary. This bill has passed the House and is currently being considered in the Finance Committee in the Senate. This would be a welcome amendment to the existing rule. Although it would result in a tax that is more draconian that that applied to other tax exempt organizations, it is certainly preferable to the existing rules governing UBTI earned in CRTs.

4. PAYOUT ISSUES

CRTs must make payments to the beneficiary at least as often as annually. In all cases, the tier rules determine the characterization of these distributions in the hands of the beneficiaries.[28] However, various payout methods are available when drafting a CRT.

[28] Under the tier 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. A distribution is first taxed as ordinary income, then capital gain (first short term, then long term), then other income (such as tax-exempt income) and finally tax-exempt return of principal. I.R.C. §664(b). This prevents a trustee from taking an ordinary income or capital asset contributed to a CRT, selling it and investing the proceeds in tax-exempt bonds, and then distributing tax-exempt income to the beneficiary. 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; each receives a pro rata share of each tier.

The following example illustrates the tier system:

*Samantha contributes $100,000 worth of stock with a basis of $80,000 to a CRAT that pays out a 6 percent annuity to her. The trustee sells the stock and invests the proceeds in a 7 percent tax-free bond. The trust realizes a capital gain of $20,000 ($100,000 - $80,000). That capital gain will not be taxable to the trust but will be recorded in the historical capital gain account of the trust. Distributions to the donor will be deemed to come from the capital gain account (and thus taxed to the donor as capital gain) until all of the $20,000 gain has been distributed and taxed to the beneficiary:*

| ***Year*** | ***accumulated cap gain*** | ***accumulated tax-exempt income*** | ***distribution*** | ***character of distribution*** |
|---|---|---|---|---|
| *1* | *$20,000* | *$7,000* | *$6,000* | *cap gain* |
| *2* | *$14,000* | *$14,000* | *$6,000* | *cap gain* |
| *3* | *$ 8,000* | *$21,000* | *$6,000* | *cap gain* |
| *4* | *$ 2,000* | *$28,000* | *$6,000* | *2,000 cap gain<br>4,000 t/e inc* |
| *5* | *$ 0* | *$31,000** | *$6,000* | *t/e inc* |

Flexibility in this area has been largely enhanced with the endorsement by the Service of the flip CRUT[29] and the ability to allocate capital gains to income in many circumstances.[30] Nonetheless, several issues remain to be resolved in connection with the payout provisions of the governing regulations, including reformation of defective or poorly administered

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|---|---|---|---|---|---|
| *6* | *$* | *0* | *$32,000*** | *$6,000* | *t/e inc* |

**$28,000 - $4,000 (distributed) + $7,000 earned*
***$31,000 - $6,000 (distributed) + $7,000 earned*

One 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 for trusts funded at death.

[29] <u>See</u> 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 could 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 is 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.

[30] 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.

trusts, payout limitations in connection with CRATs, and the inability of the parties to reduce the payout amount by agreement.

a. Reformation

Section 2055(e)(3) allows permanent reformation of a defective instrument but is itself quite complex.[31] 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 percent of the actuarial value of the unreformed interest.[32] 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.[33] These restrictions are difficult to achieve and cumbersome to administer.

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 a recent 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.[34] 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 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.

b. Variable Payout for Annuity Trusts

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[31] 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.

[32] I.R.C. §2055(e)(3)(B)(i)

[33] I.R.C. §2055(e)(3)(B)(ii)-(iii).

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

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 Section II 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.[35] 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. As long as, taking the graduated annuity payments into account, the trust passes the 5 percent exhaustion test (if retained), the 10 percent remainder test and the 50 percent maximum payout rule, 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.

c. 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 if they desired. We understand the prohibition on the parties ability to raise the percentage payout – after all, income and gift tax deductions would have been based on the higher figure. We see no reason, however, why the parties should not be permitted to agree to a reduction in the percentage amount if they desired. Under the current rules, a beneficiary who is no longer in need of the income produced by a CRT and who would like to accelerate the remainder interest with respect to a portion of the trust has several options, yet none 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 is cumbersome to the beneficiary in that it would require 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. 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.[36] Thereafter, the trust would pay the same percentage amount each year, but the amount would be calculated based on a smaller pool of assets. Thus each of the latter two options have the desired effect of reducing the amount

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

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

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, and in the third option the pool of assets upon which to generate that return is reduced. Many beneficiaries do not want the pool of assets reduced but rather want to reduce the payout so as to preserve those assets both for their benefit and the benefit of the remainder beneficiaries.

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 §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 percent minimum and 50 percent maximum payout restrictions, and the 10 percent remainder interest test (and the unnecessary 5 percent exhaustion test for CRATs). The IRS currently considers such an attempted revision as a disqualifying act.[37]

### 5. DRAFTING COMPLEXITIES

There is a lack of current guidance from the IRS on several drafting issues in connection with CRTs. We are hopeful that this will soon be corrected because the IRS requested comments before embarking on a new forms project.[38] Some areas in which we would like to see clarification are provisions relating to incompetent beneficiaries, provisions permitting the testamentary revocation of a beneficiary's interest, and provisions relating to the release and assignment of interests.

#### a. Incapacitated Beneficiaries

The need often arises to make distributions from a CRT to an incapacitated beneficiary. While the Service has endorsed a payout to a trust for such a beneficiary if he was legally incompetent from a trust's creation, it otherwise limits payments to a trust for a beneficiary to a term of years.[39] This was the case even when the trust beneficiary of the CRT was a grantor trust.[40] The IRS's rationale is apparently that a trust cannot be a

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[37] 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).

[38] IRS Notice 2000-37, 2000-29 I.R.B. 118.

[39] Rev. Rul. 76-270, 1976-2 C.B. 194; Priv. Ltr. Ruls. 79-53-029; 91-43-030; but see Priv. Ltr. Rul. 93-39-018 (trustee permitted to make distributions for a unitrust beneficiary's support if the beneficiary becomes disabled).

[40] Priv. Ltr. Rul. 97-10-008 (withdrawing earlier ruling that would have permitted such payments to a trust for any CRT beneficiary)

measuring life, coupled with the requirement that the measuring life of a CRT must be a beneficiary of the trust.[41] When the beneficiary is living at the creation of the CRT and is treated as the owner of the trust for income tax purposes or the trust will terminate at the beneficiary's death, we see no reason for this distinction. In these cases, the IRS should not be concerned that the payouts are made to a trust rather than to the individual directly. It is curious that the Service has taken such a hard line in this circumstance and is seemingly unconcerned about the disconnect between the beneficiary and the measuring life in others, such as the situation discussed below.

b. Testamentary Revocation of Beneficiary's Interest

If a donor creates an inter-vivos CRT for a beneficiary other than the donor or her spouse, she may be making a taxable gift, subject to gift tax. In order to avoid making a completed gift for gift tax purposes, the CRT could provide that the donor retains the right to revoke the interest of a beneficiary in the donor's will. This will accomplish the desired gift tax result – it will prevent the gift from being a completed taxable gift – and will instead mean that the trust assets are included in the donor's estate for estate tax purposes.[42] This structure raises the question of whether the retention of such a power violates the rule that a CRT be measured by either a term of years or the life of a trust beneficiary.[43] 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 IRS appears to approve this structure.[44] It would be helpful if the IRS clarified the rule in this connection. If a donor wishes to delay the taxes associated with the gift (and pay estate rather than gift tax on the transfer), she should be permitted to do so without concern about violating the CRT's qualification. We suspect that this will be an increasingly popular structure as donors become reluctant to incur gift tax in light of the new tax law's rising exemption from estate tax and cap on the gift tax exemption, as well as the possibility of the elimination of the estate tax altogether. As noted above, the IRS appears to sanction the retention of this right, but more specific guidance would be helpful.

c. Release and Assignment of Interests

Guidance is also needed on the tax consequences of the release of an interest in a CRT. Donors frequently find that they want to use a CRT as a means of making a present

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[41] Priv. Ltr. Ruls. 97-18-030, 97-10-008, 97-10-009, 97-10-010 (citing Treas. Reg. §1.664-3(a)(5)(i)).

[42] I.R.C. §2038.

[43] <u>See</u> Treas. Reg. §§1.664-2(a)(5), 1.664-3(a)(5); Priv. Ltr. Rul. 89-49-061.

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

gift to the designated charitable remainder beneficiary. It is possible to release a fractional undivided interest e.g. a one-third interest, which allows the trustee to peel off one-third of the trust principal and distribute it to the remainderman. Generally the donor may deduct for income tax purposes the present value of the income interest released.

One problem with the assignment of a beneficiary's interest arises when a donor who is also an income beneficiary of a net income CRUT in which there are successive beneficial interests wants to assign her interest. Because of the partial interest rules – that generally deny a gift tax charitable deduction for a transfer of an interest that is less than one's entire interest in property or an undivided fraction thereof – such an assignment is arguably a taxable gift. If a current and successive beneficiary of a net income trust both assign their interests to the remainder beneficiaries, the secondary beneficiary is entitled to a gift tax charitable deduction because he is giving up his entire interest in the trust. The primary beneficiary, however, has already given a portion of the property to the secondary beneficiary when the trust was created and is now, arguably, giving neither her entire interest nor an undivided fractional interest therein. The beneficiary therefore risks denial of the gift tax charitable deduction in this context even though the assigned property is clearly being distributed to the remainder beneficiary, which by definition must be a qualified charity.[45]

Moreover (unless the CRT is for a term of years and is payable to an estate if all the beneficiaries predecease the term so that the non-charitable term is guaranteed), it is impossible to determine the value of the interest the beneficiary is releasing. Reliance on the mortality tables alone may be insufficient. We would like to see a standard provision relating to this issue so that, when permitted by state law, CRT beneficiaries could more easily and confidently release their interests in favor of one or more of the remainder beneficiaries. In addition, the assignment of an interest in a CRT to another individual should be permitted in some circumstances for the individual's lifetime. Currently, such an assignment would violate the rule that the measuring life of a CRT also be its beneficiary.[46] A simple solution to this would be to permit such an assignment if the interest is assigned to an individual with the same or a shorter life expectancy, or for a term of years.[47] On the other hand, maybe such a limitation need not be required because

[45] A few private letter rulings have suggested that if the secondary beneficiary disclaims his interest in the trust before the assignment, the gift tax charitable deduction will be available to the donor in this context. Priv. Ltr. Rul. 95-29-039; Priv. Ltr. Rul. 95-50-026. One problem with this approach is that an income tax deduction is available only to the donor; the secondary beneficiary may not claim an income tax deduction due to the disclaimer.

[46] I.R.C. §§664(d)(1)(A), (d)(2)(a)

[47] There does not appear to be a prohibition on the assignment of an interest for a term of years, although express guidance on this point would be welcome as well.

in any event the assigned interest can only last as long as the beneficiary's interest in the CRT – the lifetime of the beneficiary or a term of years.

### 6. OTHER AREAS RIPE FOR REFORM

A few final areas in which we would like to see some changes include the following:

#### a. Multiple Donors

In 1995, the IRS concluded that a trust with multiple inter vivos donors did not qualify as a CRT; it was considered a taxable association instead.[48] As such, the IRS would deny the donors' income, gift and/or estate tax deduction and would tax both the association on income or gains earned by it and the beneficiaries' upon distributions therefrom. We believe that the IRS's position in this ruling is simply wrong. It unnecessarily limits the class of persons able to take advantage of the CRT rules and there is no logical basis for such an opinion. The ruling attempts to distinguish a business entity from a CRT based on the purposes behind the entity. 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. Again it appears that the IRS's concern about donors circumventing the rules has unnecessarily complicated and hindered the creation of CRTs and 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.

#### b. Reexamination of 5 Percent Payout Rule

In an environment of total return trusts, we believe it may be time to reconsider the continued usefulness of the 5 percent minimum payout rule now applicable to all CRTs. A trustee has a fiduciary obligation to balance the interests of the current and remainder beneficiaries of a CRT. With the current payouts at a minimum of 5 percent, 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. With the adoption of the Prudent Investor Act and the Uniform Principal and Income Act in many states, the individual focus on current vs. remainder beneficiaries is beginning to shift to one of total return. Trustees of private trusts now can concentrate on the overall performance of the assets rather than on (sometimes arbitrary) distinctions

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

between income and principal. We believe it may be time for CRTs to catch up with these changes.

We understand the need for some minimum distribution requirement for the payouts from CRTs so that these trusts will not become a vehicle for circumventing the private foundation rules. When the 5 percent rule was put into place in the late 1960s, however, the investment climate was very different than it is today. At the time, it may have been thought that a 5 percent payout was akin to the type of return an income beneficiary could expect to receive from a private trust. In contrast, empirical evidence has shown that, with an all equity portfolio, from the period from 1960 to 1994, a 4 percent payout generated the highest after-tax income to the current beneficiary (although for a longer term trust an even lower payout may be best).[49] 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.[50]

As further evidence of the tide shifting toward the total return concept, several states have passed or are currently considering legislation that would redefine income to reflect a unitrust concept, and have tied the amount to a 3 or 4 percentage return.[51] This would seem to provide a good benchmark for charitable trusts as well. Finally, interest rates generally, and as reflected in the IRS discount rates,[52] have been historically low in recent months (as have overall investment returns in 2000 and 2001), making it that much harder for trustees to keep up with investment performance required to yield at least a 5 percent return. We believe it is time to reexamine the 5 percent minimum payout rule and suggest the Service apply empirical evidence to its re-evaluation of the requirement, with an eye toward possibly lowering the minimum distribution requirement. This would also allow many younger donors, who are currently hindered by the combination of the 5

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[49] Robert B. Wolf and Stephan R. Leimberg, *Total Return Unitrusts: The TRU Shape of Things to Come!*, 13, 1999 ABA Tax Section Conference Materials.

[50] Id. at 9.

[51] 2001 N.Y. Laws A09050, September 4, 2001. It is also interesting to note that a net income CRT governed by such state law would likely not qualify as a CRT under the 5 percent minimum payout rule. It appears the IRS would require that income for purposes of the net income CRT rule under the governing instrument and local law cannot be defined as a fixed percentage; the CRT would have to provide its own definition of income in such a case. Prop. Reg. §1.664-3 (a)(1)(i)(b).

[52] I.R.C. §7520 requires the IRS to issue a monthly adjusted discount rate based on 120 percent of certain federal midterm bond rates.

percent minimum payout and the 10 percent remainder requirement, to establish CRTs within the threshold requirements.

c. Marital Deduction

Finally, there is a strong need for modification to the marital deduction provisions of §2056(b)(8) in connection with CRTs. Under the current rules, as long as the donor's spouse is the only beneficiary of a CRT (other than the donor) and is a United States citizen, the spouse's interest will qualify for the unlimited gift or estate tax marital deduction.[53] If, however, the spouse is not the only beneficiary of a CRT – for example, if a child has a successor interest in the trust – the marital deduction will not apply.[54] The present value of the entire non-charitable interests in the trust will be taxable upon creation (if there is a completed gift) or at the donor's death (if the donor is the primary beneficiary of the trust) even if the secondary interest, which caused the marital deduction to fail, never comes to be because the secondary beneficiary does not survive the spouse. This is an unnecessary restriction that forces donors to either choose among beneficiaries or create several CRTs. A reasonable solution to this problem would be to allow the marital deduction to be applied here to protect the interest passing to the spouse so that the present value of the successor beneficiary's interest would be included in the surviving spouse's estate rather than the initial decedent's estate.[55] This would permit a donor to establish a CRT for the benefit of a spouse and then children while delaying transfer taxes until the second death, and then only tax the then-present value of such interest, if any successive beneficiaries survive.

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[53] I.R.C. §2523(g). Note that if the donor's spouse is not a United States citizen, no gift tax marital deduction is available, but the $100,000 annual exclusion amount applies. Id. §2523(i).

[54] Treas. Reg. §25.2523(g)-1(b).

[55] Under the current system, there is no Qualified Terminable Interest Property ("QTIP") involved (because the spouse is not entitled to all of the trust income), so none of the property is includable in the spouse's estate.

## II. CHARITABLE LEAD TRUSTS

### A. **Introduction**

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. 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[56] or a unitrust interest[57] for a term of years,[58] a measuring life or lives, or both.[59] 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.

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

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[56] 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).

[57] 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.

[58] 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.

[59] 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).

to give 50 percent of his estate to charity and 50 percent (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 2001 with $2 million.

If Joe gives $1 million to charity and $1 million outright to his children, his children will receive $450,000 after estate taxes. If that sum is invested for 10 years, with an income yield of 2 percent taxed at 39.6 percent[60] and capital appreciation of 6 percent (with a 33 percent turnover and a capital gains tax rate on realized gains of 20 percent), after 10 years the children will have a fund equal to $870,000.

Assume instead that Joe funds a 10-year term CLAT. At his death, the lowest applicable Section 7520 rate is 6 percent. Joe's estate pays the same estate taxes ($550,000), and $1,450,000 is used to fund the CLAT. To achieve the desired charitable deduction, the CLAT pays a guaranteed annuity of 9.36 percent of the value of the funding assets as of the day of their contribution, once at the end of the year. Assuming the same rates of return and investment turnover, after 10 years Joe's children will have $1,165,000, and $1,360,000 will have been distributed to Joe's charities. The children's situation is improved by approximately 33 percent.

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 1996, Sam, who was then 60 years old, established a CLUT with an 8 percent unitrust interest to last for his life. His health was questionable at the time, although there was less than a 50 percent probability that he would die within one year. The trust was funded with $1,000,000 and was to

[60] Under EGTRRA, income tax rates are gradually reduced between 2001 and 2006, when the top rate is scheduled to level off at 35 percent. Because of the uncertainty regarding EGTRRA's staying power, however, the pre-EGTRRA top rate of 39.6 percent is assumed in this example for simplicity.

> terminate in favor of his granddaughter, Alice. The Section 7520 rate at the time the trust was funded was 6.8 percent.
>
> Of the $1,000,000 gift, $719,480 was eligible for the gift tax charitable deduction. With regard to the $280,520 taxable gift, Sam used unified credit so that no gift tax was due. He also allocated $280,520 of GST exemption to the trust.
>
> In 2001, Sam died, and the trust terminated. During the five years that the trust was in existence, it had an average rate of return of 8 percent per annum. Upon termination, Alice received $1 million 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 responded from time to time by issuing laws and regulations that address specific abuses, actual or perceived, in the use of CLTs by taxpayers and their advisors. For example, final regulations issued earlier this year addressed the use of the so-called "vulture trust," where a perfectly healthy donor would establish a CLT using as the measuring life an unrelated individual who was seriously, but not terminally, ill. As Example 2 illustrates, this scheme provides gift tax and possibly GST-tax leveraging. The new rules, applicable to transfers made on or after April 4, 2000 to inter-vivos CLTs and to transfers made under the wills of persons who die on or after that date, limit measuring lives to the donor, the donor's spouse and an individual who is either a lineal ancestor or the spouse of a lineal ancestor with respect to all the non-charitable remainder beneficiaries[61].

The vulture trust regulations are perfectly sensible in and of themselves, but they unwittingly illustrate what we believe is a problem with the way Congress and the Service have provided CLT-related guidance over the past several years. As far as we have been able to determine in conversations with estate planners and planned-giving officers throughout the country, vulture trusts were extremely uncommon before being prohibited. The Service, it seems, spent a great deal of time and effort creating comprehensive regulations to put a stop to a problem that was never widespread. We would argue that in focusing its efforts on ferreting out some small, sick trees in the CLT forest, the Service is

[61] Treas. Reg. §§1.170A-6(e), 20-2055-2(e)(3)(iii) and 25.2522(c)-3(e). 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 percent 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.

ignoring maladies that afflict the forest as a whole. In the rest of this paper, we will discuss the "forest-wide" problems with which drafters of lead trusts grapple, and propose ideas for addressing them.

### B. **Income Tax Deduction Available To Donor On Funding Only If The CLT Is A Grantor Trust**

Donations 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.[62] The taxation of the CLT itself depends on its treatment as a grantor or non-grantor trust. If a grantor trust, the donor is taxed on all the trust income during the 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 any 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

[62] I.R.C. §170(f)(2)(B).

> substantially less than $100,000 will be available for investment after payment of the tax due.[63]

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 avoiding making the donor the owner of that interest for transfer tax purposes. There are several options that could legitimately be used under current law and regulation to achieve this goal, including: (i) Giving a disinterested trustee the power to add remainder beneficiaries;[64] (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;[65] (iii) Giving someone other than the donor and other than a trustee the power, in a non-fiduciary capacity, and without requiring the consent of the trustees, to "reacquire the trust corpus by substituting other property of equivalent value";[66] (iv) Giving the trustees a power to purchase life insurance

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[63] The IRS has suggested from time to time that if a donor pays income tax on trust income that is taxable to the donor under the grantor trust rules, the donor is 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 see</u> Priv. Ltr. Rul. 95-43-049 (inconclusive result). This position would seem to be without foundation; the donor is discharging an obligation placed on the donor by federal income tax laws.

[64] I.R.C. §674(c); Treas. Reg. §1.674(d)-2(b). A technical concern with this route is that it creates a grantor trust with respect to capital gains or some amount of ordinary income that might be accumulated, since it only affects the eventual distribution of the trust principal; it does not create a grantor trust for all purposes. 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.

[65] 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.

[66] I.R.C. §675(4). Such a power could not be retained by the donor because it would likely violate the self dealing rules; it would not, however, cause inclusion of the trust property in the donor's estate under I.R.C. §2038(a). *Estate of Jordahl*, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1. Several Private Letter Rulings have undermined the usefulness of the reacquisition power. Priv. Ltr. Ruls. 94-07-014, 96-42-039 and 97-13-017. In each, the IRS, relying on Treas. Reg. §1.675-1(b)(4), concluded that the existence of the power did not create a *per se* grantor trust. Instead, it was a question of fact whether the power was exercised by the holder in a non-fiduciary capacity, that could only be answered after examination of the trust income tax returns. Although not raised in any of these rulings, it is also difficult to see (as a technical matter) how a person other than the donor can have a power to "reacquire" assets.

on the life of the donor or the donor's spouse;[67] (v) Giving a non-adverse trustee the power to distribute income or accumulate income for future distribution to the donor or the donor's spouse;[68] and (vi) Making the trust a foreign trust by, for example, appointing a foreign trustee, provided there are United States remainder beneficiaries.[69] 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.

One wonders if anyone's interests are served by forcing donors who simply want an income tax deduction for their contribution to a CLT to deal with the complexity, uncertainty and expense inherent in establishing an intentionally defective grantor trust. The Government's basic interest in structuring income tax deduction rules for CLTs is to ensure that only one deduction be available for any given set of dollars. 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 government's interests are protected under both systems of CLT taxation, we see no reason why donors should not be allowed to choose for themselves one system or the other using a simple, check-the-box procedure. This would allow donors to evaluate their own needs and decide whether they prefer to take an up-front income tax deduction, and be personally liable for the payment of the trust's subsequent income taxes with no further deduction available, or to take no up-front income tax deduction, but have the trust's income tax liability borne by the trust (with deductions available for amounts paid to charity). Such a system would avoid entirely the need for

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[67] I.R.C. §677(a)(3). 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. 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).

[68] 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.

[69] I.R.C. §679. The risk in this approach is potential exposure to tax under Code Section 684 when grantor trust status ceases.

donors and their advisors to have to spend time and money adding artificial provisions to CLT documents just to achieve a simple, straightforward income tax result.

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 or her trust will inadvertently be drafted incorrectly, and that extremely 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.

### C. **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").[70]

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 may not 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 one element that trustees should consider in deciding whether to make a particular investment decision, it is unlikely that a trustee of a CLT would ever determine that tax considerations were sufficient to justify a decision not to diversify the trust's holdings.

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

Example 4:

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[70] 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, 35 states have adopted some form of the UPIA.

Lawrence establishes a non-grantor lead annuity trust in Year 1. 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.

Experiment, Inc.'s stock has been volatile, and the trustee of the CLAT wants to sell 75 percent 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 20 percent, the trust will owe $123,000 in income tax. Thus, in Year 1, the trust loses over 12 percent 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 Year 1, 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 Year 1 taxable income. Section 642(c) goes on to say that if a taxable trust makes a contribution to Charity in Year 2 from income that was earned in Year 1, the trustee may elect to treat that contribution as having been made in Year 1 so that it would be deductible from the trust's taxable income in Year 1. The difficulty in using this election provision in the context of a CLT is that the payment deemed to have been made in Year 1 can be deducted from Year 1 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 Year 2, the trust's income is only $20,000. The trustee makes the annuity payment of $60,000 in Year 2, as is required by the governing document. $20,000 of this payment is made from Year 2 income, and the other $40,000 from Year 1 income.

Clearly, a $20,000 deduction is available for the trust's Year 2 income. With regard to the $40,000 that was paid

> from Year 1's income, can the trustee make an election under Section 642(c) to have that $40,000 treated as having been paid in Year 1? If so, then another $40,000 could be deducted from Year 1 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 Year 1, and there is no authority in the governing document to pay an additional $40,000 in Year 1. Thus, no additional deduction is available for Year 1. Furthermore, the $40,000 of charitable deduction that the trustee was unable to use in Year 2 due to the trust's insufficient income in Year 2 is lost; there is no carryforward to subsequent years of the unused deduction amount.[71]

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.[72] As will be discussed in Section E 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

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[71] 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).

[72] Rebecca K. Crown, supra note 16, 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.

income. Treasury Regulations provide that a CLT cannot make payments to a non-charitable beneficiary before the end of the lead term unless the non-charitable payments are to be made from trust assets that are segregated and administered exclusively for non-charitable purposes.[73] These Regulations cast into doubt the utility of the split-interest lead trust, because 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.[74]

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 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.

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[73] I.R.C. §§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).

[74] 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

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 out 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 dire income tax consequences hanging over their heads. The requirement that the value of the lead interest be substantial, perhaps at least 50 percent or 60 percent 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.

## D. **Tier System For Income Distribution**

A longstanding area of uncertainty for drafters of CLTs is the position of the Service with regard to ordering provisions for income distributions. It is 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").[75] Many practitioners agree that under a reasonable interpretation of relevant Code sections and Treasury Regulations, the charitable deduction can be maximized in a regular lead trust by requiring the payments to charity to be made in the following order:

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

ii. 50 percent of UBTI;

iii. capital gains other than short-term gains;

iv. the balance of UBTI;

v. tax-exempt income; and

vi. principal.

[75] 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.

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)).[76]

The uncertainty regarding the validity of such ordering provisions arose in a 1983 General Counsel Memorandum interpreting regulations under Code Section 681.[77] In that Memorandum, the IRS determined that an ordering provision of the type described above will be ignored in favor of a *pro rata* allocation, unless the provision (allocating away from UBTI) had "economic substance independent of its tax consequences."[78] This position is questionable, however. The regulations under Section 681 provide that the amount of a charitable distribution that is allocable to UBTI will be determined on the basis of the ratio of the amount of UBTI to the total taxable income of the trust "unless the facts clearly indicate to the contrary."[79] Under a reasonable interpretation of this regulation, a designation of priorities in a trust instrument constitutes "facts" which clearly indicate that a pro rata allocation is not to be used. The General Counsel's Office believes that provisions in the trust instrument are not facts, relying on examples cited in the Treasury Regulations that indicate that specific allocation is required only when the allocation has independent economic significance. That argument, however, begs the question because there is no indication in the Regulation examples that the trust instrument contained any specific allocation, nor does there appear to be any statutory support for ignoring a designation of priorities explicitly contained in the trust instrument.[80]

The IRS has reached a similar conclusion with respect to sourcing provisions for purposes of Code Section 642(c) in a series of private letter rulings.[81] These rulings seem

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[76] 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.

[77] Section 681 limits the amount of the charitable deduction otherwise allowable under Section 642(c) with respect to income which is allocable to a trust's unrelated business income.

[78] Gen. Couns. Mem. 39161.

[79] Treas. Reg. §1.681(a)-2(b)(2).

[80] On the other hand, the position of the General Counsel is consistent with the approach taken under I.R.C. §704(b) regarding partnership allocations.

[81] See, e.g., Priv. Ltr. Rul. 97-50-020, 1999-08-002, and 1999-03-045.

to rest on even more dubious grounds. The regulations under Section 642(c) provide that, in determining whether income paid by a trust includes particular items not included in gross income, the governing instrument controls with respect to sourcing if it "specifically provides as to the source out of which amounts are to be paid."[82] A pro rata allocation applies "in the absence of specific provisions in the governing instrument."[83] Noting the difference in the Regulations under Sections 642 and 681, and specifically the absence of any requirement in the former that an allocation provision in the trust instrument must have economic effect, the IRS read in such a requirement and concluded that a specific allocation is allowed only when the trust provisions have an economic effect independent of tax consequences.[84] It is difficult to understand what the IRS might require. Arguably, to have independent economic effect, the nature and amount of income generated by the CLT would have to have a direct impact on the payout. The payout, however, is guaranteed and is not dependent on the nature and amount of income.

We believe that the tier system outlined in this section should be endorsed explicitly 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, simply translates the system endorsed by the Service 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.

Making the tier system the default system would not only be consistent with the tax regime currently in place for individuals, but would also create equity among CLT donors. CLTs are rare, and many attorneys have little or no experience drafting them. Practitioners who are experienced at drafting under the current CLT regime know that it

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[82] Treas. Reg. §1.642(c)-3(b)(2).

[83] Id.

[84] Priv. Ltr. Rul. 97-50-020

is often worth the risk to include an ordering provision in a document despite the IRS' stated position.[85] The practitioner who very rarely encounters lead trusts might well be unfamiliar with this issue, however. We do not think that donors or their advisors should have to opt into what is a reasonable, favorable system of taxation, or face the prospect of adverse tax consequences if they inadvertently fail to do so.

### E. **Commutation Clauses**

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 C 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 needs that were not foreseen at the time the trust was created.

Unfortunately, the IRS 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. The Service has argued in a published revenue ruling[86] that since Treasury Regulations applying to guaranteed annuity interests[87] 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 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 since applied this rationale and holding to lead unitrust interests[88] and has concluded that an estate tax charitable deduction would not be available for a distribution made by a

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[85] Such a provision which may be contrary to the Service's stated position may raise issues of disclosure on the trust's tax returns.

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

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

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

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."[89] 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.

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 interest, we think that one could use it more persuasively to argue that the problem is not commutation, but valuation. The regulations on valuation could and should 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

[89] TAM 87-45-002

> 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.
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> 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.

### F. **GST Tax**

The uncertainty donors face when allocating GST exemption to a lead annuity trust is an ongoing concern that needs to be addressed. In the context of lead unitrusts, knowing how much GST exemption to allocate to the trust to guarantee that the trust (or payments therefrom) will not be subject to GST tax at the termination of the lead interest is not a problem. One simply determines the fair market value of the assets used to fund the CLUT on the date of funding, subtracts the present value of the charitable lead interest, and allocates an equal amount of GST exemption.[90] Put more technically, the GST tax liability of the trust or a payment from the trust depends on the trust's "inclusion ratio." As a general rule, a trust's GST inclusion ratio is determined by deducting from one the "applicable fraction" for the trust. The applicable fraction is a fraction, the numerator of which is the amount of GST exemption allocated to the trust and the denominator of which is the value of the property transferred to the trust less, inter alia, any charitable deduction allowed under Code Sections 2055 or 2522 with respect to such property.

[90] I.R.C. §2642(a)(2).

Of course, it is the lead annuity trust rather than the lead unitrust that offers the donor the possibility of leveraging the GST exemption so as to transfer significant assets to grandchildren free of GST tax. Responding to this leveraging possibility, Congress in 1988 adopted a special rule regarding the allocation of GST exemption to CLATs which takes a wait-and-see approach.[91] Although GST exemption may be allocated as of the time of transfer, the inclusion ratio is not determined until the lead annuity interest terminates. Specifically, the applicable fraction is a fraction, the numerator of which is the "adjusted GST exemption" and the denominator of which is the value of all the property in the trust immediately after the termination of the charitable lead annuity. The adjusted GST exemption is further defined as an amount equal to the GST exemption allocated to the trust increased by interest determined at the rate used in determining the deduction for the charitable lead annuity and for the actual period of the annuity.[92]

This provision creates great uncertainty for donors because it prevents them from knowing the applicable fraction (and, accordingly, the extent to which distributions from the CLT may be subject to the GST tax) until the trust terminates. It also reduces the power of leveraging because, if the trust property grows faster than the Section 7520 rate, this faster growth will increase the denominator but not be reflected in the numerator and will thereby reduce the applicable fraction. If the trust property grows more slowly than expected, this slower growth is also detrimental to the donor because any excess GST exemption that was allocated to the trust is wasted and cannot be recovered.[93]

The special rules regarding the allocation of GST exemption to CLATs are illustrated in the following example:

Example 7:

> Sam establishes a 20-year term CLAT during his lifetime, terminating in favor of his three grandchildren. The Section 7520 rate is 6.8 percent. The guaranteed annuity is 8 percent. Sam gets a charitable deduction of approximately 86¢ for every dollar transferred to the CLAT. Sam funds the CLAT with $1 million and allocates $139,140 of GST exemption at the time of transfer. The GST results at

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[91] I.R.C. § 2642(e).

[92] I.R.C. § 2642(e)(2).

[93] Although a living donor might be able to make additions to the trust at the time of termination that will result in the trust property having a value equal to the then adjusted GST exemption.

termination of the trust are dependent on the growth-rate of the trust assets.

If the trust assets grow at 6.8 percent per annum (identical to the Section 7520 rate), the value of the trust principal at the end of the lead term is $518,665. The adjusted GST exemption ($139,140 compounded at the initial 6.8 percent Section 7520 rate) is $518,665. The inclusion ratio is 1-($518,665/$518,665), or zero. There is no GST tax payable when the CLAT terminates, because the trust property grew in line with IRS assumptions.

If, by contrast, the trust assets grow at 8 percent per annum (1.2 percent in excess of the Section 7520 rate), the value of the trust principal at the end of the lead term is $1,000,000. The adjusted GST exemption is $518,665, as it was in the previous example. The inclusion ratio is 1-($518,665/$1,000,000), or .48135. In this situation, when the trust terminates, GST tax is payable. The tax is $1,000,000 x .48135 x 55 percent, or $264,741, for an effective GST tax rate of 26.474 percent. To prevent this result, Sam would have to have allocated $214,548 of GST exemption when the trust was established (the amount of GST exemption which, when compounded at 6.8 percent, will result in an adjusted GST exemption at the end of year 20 of $1,000,000). Alternatively, if Sam was alive at the end of year 20 and had sufficient GST exemption remaining, he could allocate additional exemption at that time to reduce or eliminate GST tax liability (an additional allocation of $481,335 would be required to produce a zero inclusion ratio).

We believe that this special method of allocating GST exemption is essentially an admission, although perhaps unwitting, by the Service that its general valuation principles relating to lead trusts are flawed. In Example 7 above, at the time Sam funds his CLAT, he receives a charitable deduction of about 86 percent of the value of the funding assets. Although the Service retains the right to re-assess this value in the context of one applicable transfer tax (the GST tax), it treats this value as final for purposes of the other applicable transfer tax (the gift tax). We see no economic or policy justification for ascribing two different transfer-tax values to the same transfer. If the current system would, absent the adjustment provisions of Section 2642(e), undervalue the remainder interest for GST purposes, then by definition the system undervalues the remainder interest for gift or estate tax purposes. Conversely, if the current system correctly values the remainder interest for gift and estate tax purposes, then the adjustment provisions of Section 2642(e) are unwarranted and unfair.

Unless and until the Service revises its valuation principles in light of the disparity outlined above, we would argue that the reasonable and economically correct valuation of a remainder interest in a lead annuity trust is the one that is fixed for gift or estate tax purposes at the time the trust is established. The imposition of an alternate valuation regime for GST purposes seems to us to be little more than a "sour grapes" provision – the government's way of saying that it is annoyed that the trust's investment performance did better than it thought it would. But when a donor establishes a CLT with a very low remainder value in the hope that the trust's assets will grow at a rate above the Section 7520 rate, the donor is taking a genuine economic risk. Any careful practitioner will point out to his or her client that a remainder at or near zero might not only reflect the IRS calculation of present value, but also what is transferred to the family at the end of the lead term. CLATs can hardly be branded as tax shelters. Furthermore, the special allocation rules of Section 2642(e) have nothing to do with safeguarding the charitable interest, which is (or should be) the driving policy force behind any CLT provisions in the Code and the Regulations. As long as the charity gets the full value of the lead interest it was promised at the creation of the CLAT, it should not be of concern to the Service that the remainder beneficiaries, as a result of the good luck and/or sound investing of the trustees, receive a larger benefit than was anticipated. Penalizing good fortune in this context seems inappropriate and unwarranted.

## 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, the charitable remainder and lead trust will remain important tools in the charitable gift structure. The rules governing those trusts must be adapted to reflect current investment realities and changes in the law of trusts. The changed definitions of principal and income adopted by many states may require changes in the CRT payout requirements. The need to diversify CLTs creates the need to rationalize the tax burden on such a trust. 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 narrow interpretation of grantor trust and bargain sale rules which prevents transfers of debt-financed property to CRTs could easily be modified as could the interpretation which prevents several donors from funding a single CRT. 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.