What You Should Know About Charitable Remainder Trusts

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What You Should Know About Charitable Remainder Trusts

DISCLAIMER: The following is a brief, perhaps over-simplistic, overview of some of the more frequently asked questions concerning charitable remainder trusts, a subclass in the family of charitable split-interest trusts, where there are charitable and noncharitable beneficiary-donees. This memorandum should not be relied upon in any given situation without first consulting your tax advisor. The law in this area changes frequently, and I have not necessarily undertaken to keep this memo current, since that would be a full-time job.

This memorandum covers charitable remainder trusts (CRTs). It does not treat pooled income funds (PIFs) or charitable lead trusts (CLTs).

What Is A Split Interest Trust? A split interest trust is a trust that has both charitable and noncharitable beneficiaries. In order to qualify for favorable tax treatment where a both charitable and noncharitable beneficiaries have a beneficial interest, the trust must either qualify as a charitable remainder trust (CRT) or as a charitable lead trust (CLT). Split interest trusts are subject to detailed technical requirements in order to qualify for favorable tax treatment.

What Is A Charitable Lead Trust? The subject of this memo is the charitable remainder trust, or CRT. The CRT may be contrasted with the charitable lead trust, or CLT. In a CLT, the income interest (an annuity or unitrust interest) is owned by a charity, and at the conclusion of the charitable term, the interest either reverts to the grantor or to a noncharitable beneficiary chosen by the grantor. In a CLT, the charitable interest “leads,” or comes in front of the noncharitable interest.

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1Technically, a Pooled Income Fund is not a trust, but for purposes of this memo it will sometimes be referred to as a trust for convenience.

WHAT IS A CHARITABLE REMAINDER TRUST?

A charitable remainder trust (CRT) is the opposite of a charitable lead trust (CLT). In the case of a CRT, charity owns the remainder and an individual who is not a charity owns the income interest.

More specifically, a charitable remainder trust (CRT) is a trust that provides for either annual annuity or unitrust payments to one or more persons (at least one of whom is not a charity), with the remainder passing to or for the use of a charitable organization described in IRC §170(c), and which meets the requirements set forth in IRC §664 and the §664 regulations.

Where the income interest is owned by noncharitable beneficiaries, and the remainder interest belongs to a charity, the trust (CRT) must take one of three qualifying forms: a charitable remainder annuity trust (a CRAT), a charitable remainder unitrust (a CRUT), or a pooled income fund (PIF).

These requirements are illustrated in Rev. Rul. 72-395 as modified by Rev. Rul. 80-123, Rev. Rul. 82-128, and Rev. Rul. 88-81.

DOES A CRT PAY INCOME TAX?

No. Unlike a charitable lead trust, a charitable remainder trust is a tax exempt entity. It pays no income tax (unless it has UBTI). This means that it does not recognize capital gains tax on the sale of appreciated property contributed to the trust, and does not pay ordinary income tax on items of ordinary income earned by the trust. The beneficiary of the trust does, however, recognize income on distributions from the trust, under a complex tiered system of income recognition (basically, worst in, first out) to be explained later.

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3Known as an IRC3 §170(c) organization.
51980-1 C.B. 205.
61982-2 C.B. 71.
71988-2 C.B. 127.
| **WHAT REQUIREMENTS APPLY TO BOTH ANNUITY TRUSTS AND UNITRUSTS?** | Both annuity trusts and unitrusts require that a specified sum be payable to (or for the use of) one or more persons for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals. At least one of the income beneficiaries must not be a charity (i.e., must not be an organization described in section 170(c)). If the noncharitable beneficiary is an individual, the individual must be living at the time of the creation of the trust. Other than the specified sums required to be paid to the income beneficiaries, no amount may be paid to or for the use of a noncharitable organization. |
| **WHAT IS THE ANNUAL PAYMENT REQUIRED OF A CHARITABLE REMAINDER ANNUITY TRUST?** | In the case of a CRAT, the annual payment must be a sum certain, which does not vary from year to year. This fixed sum cannot be less than 5%, nor more than 50%, of the initial net fair market value of all property placed in trust. |
| **ARE THERE ANY MINIMUM RESTRICTIONS ON THE SIZE OF THE REMAINDER PASSING TO CHARITY?** | Section 1089(b) of the 1997 Taxpayer Relief Act added a last minute change to the law that now requires that the anticipated charitable remainder amount be at least 10% of the amount transferred.9 |
| **WILL THE CRAT ANNUAL PAYMENT VARY FROM YEAR TO YEAR?** | No. Unlike a CRUT, the annuity under a CRAT is fixed when the trust is funded, and it will remain the same throughout the term. That is perhaps one of the reasons that additional contributions to a CRAT are not allowed. (Additional amounts may be contributed to a CRUT.) |
| **WHAT IS THE ANNUAL PAYMENT REQUIRED OF A CHARITABLE REMAINDER UNITRUST?** | In the case of a CRUT, the annual payment must be a fixed percentage (which is not less than 5% nor more than 50%) of the net fair market value of its assets, valued annually. There in an exception in the case of a NICRUT, a NIMCRUT and a FLIP-Unitrust, discussed below. |

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9 IRC §664(d)(1)(D) and (d)(2)(D).
WHAT IS A NICRUT?
It is permissible for a CRUT to provide that the annual payment will be the lesser of (i) trust accounting income, or (ii) the unitrust percentage amount. This is sometimes referred to as a “net income only unitrust” or a NICRUT.

WHAT IS A NIMCRUT?
A NIMCRUT is just a NICRUT with a make-up provision, so that if the net income has been less than the fixed percentage unitrust amount in the past, but exceeds the fixed percentage unitrust amount at some point in the future, then the trustee can pay the excess to the income beneficiary, to the extent that the aggregate of the amounts paid in prior years was less than the aggregate of the fixed amounts (by reason of the net income only feature).

This is called a net income only unitrust with make-up provision, or NIMCRUT, and it offers a number of special tax planning advantages.

WILL THE CRUT ANNUAL PAYMENT VARY FROM YEAR TO YEAR?
Whether the trust is a normal CRUT, a NICRUT or a NIMCRUT, it should be expected that the annual payments will fluctuate each year with the value of the assets, or, in the case of a NICRUT or NIMCRUT, with the fiduciary accounting income generated.

WHY WOULD ANYONE WANT TO USE A NICRUT OR NIMCRUT?
If the asset contributed to the CRUT initially will not produce enough income to pay the unitrust amount without resort to corpus, and if the corpus is not readily marketable, it may be inconvenient to come up with sufficient liquid funds to make the unitrust payment. Knowing this, the donor might structure the CRUT so that annual payments only have to be made when the trust has sufficient income.

This technique can also be used to defer payments until a later date when the donor is more likely to need the money.

WHAT IS “NET INCOME” UNDER A NICRUT OR NIMCRUT?
Generally, “net income” means “fiduciary accounting income,” net of expenses of administration, as further defined by state law and the terms of the governing instrument and by reference to IRC §643(b), which provides:

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10 Regs. Section 1.642(c)-5(a)(5)(i). See Section 643(b).
(b) **Income.** For purposes of this subpart and subparts B, C, and D, the term “income”, when not preceded by the words “taxable”, “distributable net”, “undistributed net”, or “gross”, means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

- **CAN CAPITAL GAINS BE TREATED AS INCOME UNDER A NICRUT OR NIMCRUT?**
  - PLR 9442017 approved a definition of income that included capital gains, holding that since “income,” under IRC 643(b), is whatever state law and the governing instrument says it is, it can include capital gain under appropriate circumstances.\(^\text{12}\)
  - Note, however, that two other letter rulings held that if capital gains were income, then the fair market value of the assets on which the income is determined must be reduced by the lesser of the prior years’ deficiency or the unrealized gain.\(^\text{13}\)

- **IS A CHARITABLE REMAINDER TRUST SUBJECT TO INCOME TAXES?**
  - Not usually. A principal advantage of a CRT is that it is not subject to income taxes during any year, unless it has unrelated business taxable income (UBTI) within the meaning of IRC §512, or debt financed income within the meaning of IRC §514.
  - If the CRT has any UBTI,\(^\text{14}\) the entire trust is taxed as a complex trust.\(^\text{15}\)

- **WHAT IS UNRELATED BUSINESS TAXABLE INCOME (UBTI)?**
  - Unrelated business taxable income is income from an unrelated trade or business (regularly carried on) that is not substantially related to the performance of a tax exempt organization’s exempt purposes.
  - This would not ordinarily include dividends on stock, interest on bonds, etc., but would include income from an unrelated business that is not conducted in corporate form. As a rule-of-thumb, look for cases where a business has not been subjected to at least one level of tax.

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\(^\text{12}\)PLR 9442017.

\(^\text{13}\) PLRs 951107 and 9511029.

\(^\text{14}\) Note that if there are deductible expenses, that offset the unrelated business income, the unrelated business taxable income may be zero. Occasionally, this fact can save the day.

\(^\text{15}\) IRC §664(c).
HOW IS AN UNRELATED TRADE OR BUSINESS DEFINED UNDER THE IRC?

IRC §512(a) provides:

Except as otherwise provided in this subsection, the term “unrelated business taxable income” means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

WHAT IS AN UNRELATED TRADE OR BUSINESS?

IRC §513(a) provides:

The term “unrelated trade or business” means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 501(c)(3)), except that such term does not include any trade or business—

WHAT IS NOT UBTI?

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.
### IS UNRELATED DEBT-FINANCED INCOME UBTI?

**Yes.** The income from debt financed property gives rise to UBTI under IRC §514.

### WHAT IS THE MOST COMMON SOURCE OF UNPLANNED FOR UBTI?

UBTI or debt financed income can arise if the trust borrows money\(^{16}\) or holds mortgaged property.\(^{17}\) This is often overlooked until noticed by the tax preparer at tax time.

### IS THERE AN EXCEPTION FROM UBTI FOR CERTAIN MORTGAGES?

There is an important exception where a mortgage is placed on the property more than 5 years prior to the transfer to the charity and where the transferor owned the property for more than 5 years. This exception will apply for 10 years after the transfer.

Where property subject to a mortgage is acquired by an organization by bequest or devise, the indebtedness secured by the mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of the acquisition. If an organization acquires property by gift subject to a mortgage which was placed on the property more than 5 years before the gift, which property was held by the donor more than 5 years before the gift, the indebtedness secured by such mortgage shall not be treated as acquisition indebtedness during a period of 10 years following the date of such gift. This subparagraph shall not apply if the organization, in order to acquire the equity in the property by bequest, devise, or gift, assumes and agrees to pay the indebtedness secured by the mortgage, or if the organization makes any payment for the equity in the property owned by the decedent or the donor.\(^{18}\)

### WHAT ARE SOME OTHER EXAMPLES OF HOW UBTI MIGHT ARISE?

Unrelated business taxable income can arise if the CRT is involved in a business or holds an interest in a partnership, including a limited partnership, or has debt financed income.

I have been told that the genesis for the UBTI tax was when New York University went into the spaghetti business. Other people in the same business complained that they were at a competitive disadvantage, because they were conducting the same business, and yet they were subject to tax. If NYU held stock in a for-profit company in the spaghetti business, no one would complain, even though the dividends would be tax-free to NYU.

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\(^{16}\)See IRC §§512-513 and Treas. Reg. §1.664-1(c).

\(^{17}\)IRC §514(c)(2)(A).

\(^{18}\)IRC §514(c)(2)(B).
**WHAT HAPPENS IF A CRT RECEIVES UNRELATED BUSINESS TAXABLE INCOME (UBTI)?**

When a charitable organization receives UBTI, it is merely taxed on it. However, **it bears repeating that if a CRT has any UBTI, the entire trust is taxed as a complex trust.**

**ARE THERE EVER OCCASIONS WHEN ONE MIGHT WANT A CRT TO HAVE UBTI FOR A YEAR?**

Believe it or not, it is occasionally desirable for a CRT to be taxed as a complex trust.

**DOES THE TWO-YEAR HOLDING PERIOD REQUIREMENT APPLY TO A CONTRIBUTION OF APPRECIATED PROPERTY TO A CRT?**

No. **As a general rule, neither the grantor nor the CRT will be taxed on the sale of appreciated property contributed to the trust.** However, in the case of other trusts, IRC §644 has a special rule that requires the grantor to recognize gain if appreciated property contributed to a trust is sold during the two year period following the transfer. Fortunately, this rule does not apply to a CRT.

**DO THE GRANTOR TRUST RULES AND THE THROWBACK RULES APPLY TO A CRT?**

Neither the grantor trust rules of §§671-678 nor the throwback rules of §§665-668, apply to a CRT.

If the trust is a “grantor trust” under §671-678, it cannot be a CRT.

**CAN ADDITIONAL CONTRIBUTIONS BE MADE TO A CRT AFTER INITIAL FUNDING?**

Additional contributions to a CRAT are not allowed after initial funding. However, additional contributions to a CRUT are allowed after initial funding. The governing instrument of a CRT is required to address this issue.

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19Note that if there are deductible expenses, that offset the unrelated business income, the unrelated business taxable income may be zero. Occasionally, this fact can save the day.

20IRC §664(c).

21IRC §644(e)(3).


23Treas. Regs. §1.664-2(b).

24Treas. Regs. §1.664-3(b).
IS THE INCOME BENEFICIARY TAXED ON DISTRIBUTIONS FROM A CRT?

The income beneficiary of a CRT is taxed on distributions under the rules prescribed in IRC §664(b) as follows:

(b) **Character of distributions.** Amounts distributed by a charitable remainder annuity trust or by a charitable remainder unitrust shall be considered as having the following characteristics in the hands of a beneficiary to whom is paid the annuity described in subsection (d)(1)(A) or the payment described in subsection (d)(2)(A):

1. First, as amounts of income (other than gains, and amounts treated as gains, from the sale or other disposition of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;

2. Second, as a capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain of the trust for prior years;

3. Third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and

4. Fourth, as a distribution of trust corpus.

For purposes of this section, the trust shall determine the amount of its undistributed capital gain on a cumulative net basis.

IS THE GRANTOR OF A CRT ENTITLED TO AN ESTATE, GIFT OR INCOME TAX DEDUCTION WITH RESPECT TO THE PROPERTY CONTRIBUTED TO THE TRUST?

Usually. Within limits, the grantor of a CRT is usually entitled to estate, gift and income tax deductions for the present value of the remainder interest that is designated to pass to charity.

IS A CRT REQUIRED TO BE IN ANY SPECIAL FORM?

The IRS has a number of strict governing instrument requirements. If even one of these requirements is accidentally omitted from the terms of a CRT, the CRT may be disqualified.

25Treas. Reg. §§1.664-2(b) and 1.664-3(b).
Can the Trustee’s Investment Authority Be Restricted?

A trust will be disqualified as a CRT if it “restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.” ²⁶

Has the IRS Provided Any Special Governing Instrument Forms?

The IRS has issued a number of safe harbor forms found in a jillion Revenue Procedures. ²⁷

Will the IRS Rule that a CRT Complies with Applicable Law?

The IRS will not give a private letter ruling on the qualification of a trust as a CRT if the terms of the trust are substantially similar to the forms found in the Revenue Procedures, because there is no need. The IRS will rule on a trust that is not substantially similar to the promulgated forms, but this is an expensive procedure and the application fee alone is several thousand dollars.

Are There Any Disadvantages to Using the IRS Forms?

Unfortunately, the IRS forms are limited in a number of respects.

- There is no form if more than two lives are involved or if a charitable beneficiary is to receive a portion of the income interest.
- The forms do not provide for a term certain feature.
- There is no provision in the forms that would allow the donor to revoke or change the interest of the noncharitable beneficiary.
- The IRS forms incorporate all of the private foundation rules, even though two of those rules do not apply.

Can the Payment Features of a CRAT Be Combined With a CRUT?

The trust must be either an annuity trust or a unitrust. If the features are combined, the trust will be disqualified. ²⁸


CAN A CRT INVEST IN S-CORPORATION STOCK?

A CRT cannot qualify as a “qualified Subchapter S Trust” (a QSST) under IRC §1331 because of the requirement that a QSST distribute all of its income, and because a CRT cannot be a grantor trust.

CAN THE GRANTOR AFFECT THE INTEREST OF THE NONCHARITABLE INCOME BENEFICIARY?

The grantor cannot revoke, alter or amend the interest of the noncharitable income beneficiary except in one instance (not addressed in the IRS forms). A grantor may retain a testamentary power to revoke or terminate the noncharitable beneficiary’s life income interest.29

CAN THE CORPUS OF A TRUST INTENDED TO BE A CRT BE RETURNED IF THE TRUST IS NOT QUALIFIED?

The IRS will disqualify a trust as a CRT if it contains a provision allowing for the return of trust assets if the trust is found not to be qualified.30

CAN A CRT BE AMENDED?

It is permissible, and indeed desirable, to include a provision allowing the trust to be amended to ensure qualification as a CRT under IRC §664. Such language is found in the IRS sample trust forms.31

MAY THE GRANTOR SERVE AS TRUSTEE OF HIS OWN CRT?

A feature of a CRT that is very attractive to potential grantors, is that, within limits, a grantor may serve as trustee of a CRT he created.32

If the grantor is also serving as trustee, it is crucial that the grantor not retain any powers that would trigger application of the grantor trust rules under IRC §§671-677.33


32PLR 7730015.


Treas. Reg. §1.664-1(a)(4) provides:

(4) Requirement that trust must meet definition of and function exclusively as a charitable remainder trust from its creation. In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.
What You Should Know About Charitable Remainder Trusts

By Noel C. Ice

IF THE GRANTOR IS TRUSTEE WILL AN INDEPENDENT APPRAISAL OF THE ASSETS CONTRIBUTED BE REQUIRED FOR VALUATION PURPOSES?

The Committee Reports indicate that a trust is not to qualify as a CRUT if the grantor is the trustee and if the trust is funded with assets that do not have an objective ascertainable fair value. Therefore, an independent trustee may be necessary. (This rule may not be applicable in the case of a CRAT.)

MAY A GRANTOR TRUSTEE RECEIVE COMPENSATION FOR ACTING AS TRUSTEE?

Numerous private letter rulings have authorized the payment of reasonable commissions to grantor trustees if not excessive and if consistent with amounts ordinarily paid fiduciaries under state law. The commissions should not be paid out of the annuity or unitrust amount, however, or the trust will be disqualified.

MUST A TRUST BE EXCLUSIVELY A CRT FROM ITS INCEPTION IN ORDER TO BE QUALIFIED?

It is essential that the trust be a CRT from the date of its formation. Under the regulations to §664, however, the trust will be deemed created at the earliest time that the grantor trust rules (IRC §§671-678) do not apply to the entire trust (but in no event earlier than the time property is first transferred to the trust).

HOW CAN A CRT NOT BE A GRANTOR TRUST, IF THE GRANTOR IS A BENEFICIARY?

If the grantor or the grantor’s spouse is a beneficiary of a trust, the trust will almost invariably be treated as a grantor trust under the grantor trust rules (IRC §§671-678). So, if the trust benefits the grantor, how can it ever qualify as a CRT? The answer, I think, is in Treas. Reg. §1.664-1(a)(4), which provides that, for purposes of this rule, neither the grantor nor the grantor’s spouse will be treated as the owner of the trust under the grantor trust rules merely because the grantor or his spouse is named as a recipient:

But Treas. Reg. §1.664-1(d)(1)(ii) last sentence provides, “[t]he provisions of subparts D and E, part 1, subchapter J, chapter 1, subtitle A of the Code are not applicable with respect to a charitable remainder trust (regardless of whether the trust is exempt).”

35PLRs 8033026, 8035078.
36PLRs 7807096, 7828006.
(4) Requirement that trust must meet definition of and function exclusively as a charitable remainder trust from its creation. In order for a trust to be a charitable remainder trust, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust. Solely for the purposes of section 664 and the regulations thereunder, the trust will be deemed to be created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under subpart E, part 1, subchapter J, subtitle A of the Code (relating to grantors and others treated as substantial owners), but in no event prior to the time property is first transferred to the trust. For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient. See examples 1 through 3 of subparagraph (6) of this paragraph for illustrations of the foregoing rule.38

**IS IT TRUE THAT IF A TRUST IS A CRT, THE GRANTOR TRUST RULES DO NOT APPLY?**

Yes. In a nice piece of circular reasoning, Treas. Reg. §1.664-1(d)(1)(ii) last sentence provides, “[t]he provisions of subparts D and E, part 1, subchapter J, chapter 1, subtitle A of the Code are not applicable with respect to a charitable remainder trust (regardless of whether the trust is exempt).”

So, (a) a trust cannot be a CRT if it is a grantor trust, and (b) if it is CRT the grantor trust rules don’t apply. In order to get out of this circle it may help to recall Treas. Reg. §1.664-1(a)(4), quoted above, to the effect that the grantor trust rules will not apply merely because the grantor or the grantor’s spouse is a beneficiary.

**WILL A TRUST BE DISQUALIFIED AS A CRT IF THE INCOME CAN BE USED TO DISCHARGE A LEGAL OBLIGATION OF THE GRANTOR?**

A trust will not qualify as a CRT if the income is, or in the discretion of a nonadverse party may be, applied to discharge a legal obligation of the grantor.39 This rule can prevent the transfer of mortgaged property to a trust intended to qualify as a CRT where the grantor remains liable on the mortgage.

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**Can a Testamentary CRT Qualify if It Subject to Debts, Expenses and Estate Taxes?**

Since a trust will not qualify as a CRT if the income is, or in the discretion of a nonadverse party may be, applied to discharge a legal obligation of the grantor, a testamentary trust will be disqualified from CRT treatment if the trust is not a CRT from date of death, which would be the case, for example, if the trust were responsible for estate administration expenses or debts of the decedent. On the other hand (in what may seem a distinction without a difference), the trust will not be disqualified if debts and expenses are paid by the residuary estate prior to funding the CRT.

**Where Can One Find the Special Rules Governing the Delayed Funding of a Testamentary CRT?**

There are a number of special rules that govern the delayed funding of a testamentary CRT. These rules can be found, *inter alia*, in Treas. Reg. §§1.664-1(a)(5)(i) 1.664-1(a)(6), Ex. (4), and in Rev. Rul. 80-123, 1980-1 C.B. 205.

**Can a Split Interest Trust That Does Not Qualify for CRT Treatment Be Reformed?**

In some cases, a split interest trust that does not qualify for CRT treatment can be reformed.

**How is Income From a CRT Determined?**

“Income” is determined under the terms of the governing trust instrument and applicable local law. See IRC §643(b), quoted above under the NIMCRUT discussion.

**When Must the CRT Payments Be Paid?**

CRT payments must be timely paid. In the case of a calendar year trust requiring annual payments, payment is due no later than the due date for filing Form 5227. If payment is not made within a reasonable time, the trust will be disqualified, the trust will have unrelated business taxable income, and the trustee will have engaged in a prohibited transaction, among other problems.

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40 Treas. Reg. §1.677(a)-1(d). PLR 9015038.
41 Treas. Reg. §1.664-1(a)(6), Ex. (3).
43 Treas. Reg. §1.664-1(a)(6), Ex. (5).
WHAT IS A FORM 5227?

Form 5227 is a tax reporting form for CRTs that is ordinarily due by April 15. A Form 1041-A may also be due. Form 4720 is also due if there are any excise taxes due under Ch. 42 of the IRC.

MUST THE INCOME BE PAID TO OR FOR THE BENEFIT OF THE INDIVIDUAL WHOSE LIFE EXPECTANCY IS BEING USED?

If the income payment is based upon the life expectancy of an individual (rather than for a term of years that does not exceed 20) the income must be paid to or for the benefit of the individual whose life expectancy is being used. Therefore, if a noncharitable entity is a beneficiary (e.g., a corporation), a term of years (not to exceed 20) must be used.

CAN AN INCOME INTEREST FOR THE LIFE OF AN INDIVIDUAL BE PAID TO A TRUST FOR THE BENEFIT OF AN INDIVIDUAL?

It is permissible to pay an income interest on the life of an individual to a trust for the benefit of the individual under some circumstances.

TACKING—CAN A CRT COMBINE A LIFE TERM WITH A TERM OF YEARS?

A CRT cannot last longer than the longer of life of a person living at the time the trust is established, or 20 years. This rule would be violated if a CRT were allowed to measure the noncharitable income interest by the life of an individual plus a term of years, and so is not permitted.

However, it is permissible for the term to be for the shorter of life or a term of years. Further, it is possible for the income interest to be for a term of years, plus the life of someone who is living at the time the trust is established.

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49IRC §§664(d)(1)((A) and 664(d)(2)((A).

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Prior to 1984 there were no events other than the death of the beneficiary or the expiration of the term of years that could terminate the income payments under a CRT. For transfers after 1978, IRC §664(f) allows certain “qualified contingencies” to terminate the income interest.

Under IRC §664(f)(3) “[t]he term ‘qualified contingency’ means any provision of a trust which provides that, upon the happening of a contingency, the [annuity or unitrust] payments . . . will terminate not later than such payments would otherwise terminate under the trust.” [Emphases added.]

Thus, it is now permissible for the annuity or unitrust payments to cease, and for the charitable remainder interest to be accelerated, upon the happening of an express contingency: death of a third party or remarriage of the beneficiary, for example.

IRC §664(f)(2) is explicit that “[f]or purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency shall not be taken into account.”

The governing instrument must contain specific provisions, detailed in the regulations, to correct the incorrect valuation of any assets contributed to a CRT.53

Although a testamentary CRT is deemed created at date of death, the regulations allow a reasonable period to pass before the trust must be funded. However, in that case, the CRT must contain specific and detailed provisions to calculate any missed payments with interest.54


WHAT HAPPENS IN AN INTER-VIVOS CRT IF THE ANNUITY PAYMENT IS LESS THAN 5% BECAUSE OF AN INCORRECT VALUATION?

In the case of an inter-vivos (but not a testamentary) trust, if an incorrect valuation results in an annuity payment that is less than 5% of the initial fair market value, the regulations provide for a corrective mechanism if the undervaluation was made in good faith, and provided further, that the grantor agrees to value the property at 20 times the stated annuity for charitable deduction purposes.  

MUST THE GOVERNING INSTRUMENT REQUIRE THE ESTABLISHMENT OF A DEPRECIATION RESERVE, IF THE CRT CAN INVEST IN DEPRECIABLE PROPERTY?

In the case of a net income only unitrust and a pooled income fund (and perhaps the other types of CRTs), the governing instrument must require the establishment of a depreciation reserve, if the CRT can invest in depreciable property.  

CAN A PET BE A BENEFICIARY OF A CRT?

Surprisingly, the issue of whether or not a pet can be a beneficiary of a CRT has come up several times and in each case the IRS has ruled that the answer is “no,” in case you were wondering.  

CAN A TRUST OR OTHER ENTITY BE AN INCOME BENEFICIARY OF A CRT?

In order to qualify as a CRT, an annuity or unitrust amount must be payable to at least one “person” (i.e., an individual, trust, estate, association, company, corporation and partnership) who is not a charity (i.e., who is not an IRC §170(c) organization).  

The noncharitable beneficiaries are probably entitled to a depreciation deduction.  

57Treas. Reg. §1.167-1(b). PLRs 8610067, 8931019, 8931020, 8931023, 9030041, and 9030042
59IRC §7701(a)(1). PLR 9419021.
**CAN THE GRANTOR OR ANY OTHER PERSON HAVE THE POWER TO ALTER THE AMOUNT PAID TO THE NON-CHARITABLE BENEFICIARY?**

No one may have the power to alter the amount to be paid to the income beneficiary if to do so would subject the trust to the grantor trust rules of IRC §§671-678. This means, for example, that the power to sprinkle income among a class of beneficiaries cannot be held by the grantor or the grantor’s spouse, and can only be held by certain other parties under certain conditions.  

Suffice it to say that these rules are very technical and generally beyond the scope of this memo.

**CAN THE GRANTOR RETAIN A POWER TO REVOKE THE INTEREST OF THE NONCHARITABLE INCOME BENEFICIARY?**

The grantor cannot retain the power to revoke or terminate the interest of the noncharitable beneficiary, unless the power is a testamentary power (i.e., a power exercisable solely by will).

**CAN A PORTION OF THE ANNUITY OR UNITRUST INTEREST BE PAYABLE TO CHARITY?**

A CRT may allow or require that a portion of the annuity or unitrust interest be paid to charity (a §170(c) organization) as long as there is at least one noncharitable person to receive at least a portion of the income. If assets are to be paid to the §170(c) organization, the governing instrument must contain special additional provisions. Such a provision will not result in an additional income or estate tax deduction, however.

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621.664-2(a)(5)(i), 1.664-3(a)(5)(i).

63IRC §674(c) & (d).


WHAT HAPPENS TO THE REMAINDER FOLLOWING THE TERMINATION OF THE ANNUITY OR UNITRUST INTEREST?

“Following the termination of the . . . [annuity or unitrust interest], the remainder interest in the trust is to be transferred to, or for the use of, an organization described in §170(c) [i.e., a charitable organization] or is to be retained by the trust for such a use.”

Thus, the permissible forms of distribution include (1) outright to charity, (2) in a new trust for charity, and (3) in continued trust for charity.

DOES THE FORM OF DISPOSITION OF THE REMAINDER AFFECT THE TAX DEDUCTION?

Whether the remainder interest passes (1) outright to charity, (2) in a new trust for charity, or (3) in continued trust for charity, will not affect the gift or estate tax deduction, but it can limit the income tax deduction.

ARE THE ORGANIZATIONS THAT QUALIFY FOR THE INCOME, ESTATE AND GIFT TAX DEDUCTIONS ALL THE SAME.

Unfortunately, there are one or two types of §170(c) organizations (charities for income tax purposes) that do not qualify for the §2055(a) estate tax deduction or the §2522(a) gift tax deduction. The example most frequently cited is that of certain nonprofit cemeteries. On the other hand, some organizations qualify for the estate tax deduction but not the income tax deduction; e.g., foreign charities qualify under §2055(a) but not §170(c).

CAN MORE THAN ONE CHARITY BE DESIGNATED TO RECEIVE THE REMAINDER IN SUCCESSION?

More than one charity can be designated to receive the remainder following the termination of the annuity or unitrust interest, either concurrently or in succession.

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68IRC §664(d)(1)(C) & (2)(C). See Treas. Reg. §§1.664-2(a)(6)(i) and 1.664-3(a)(6)(i) for governing instrument requirements to this same effect.


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MUST THE INSTRUMENT PROVIDE FOR AN ALTERNATIVE CHARITY IN THE EVENT THE PRIMARY REMAINDERMAN DOES NOT QUALIFY?

The governing instrument (i.e., the trust document) of a CRT must provide for the appointment of an alternative qualifying charity in the event the designated charity does not qualify as a §170(c) organization at the termination of annuity or unitrust interest.71

To be assured of a gift or estate tax deduction as well as an income tax deduction, the instrument should provide that any alternative charity will qualify under §2055(a) and §2522(a) in addition to §170(c). To be assured of the higher income tax percentage deduction, the instrument should also require that the alternative charity qualify under §170(b)(1)(A).72

CAN A GRANTOR REMOVE A CHARITABLE REMAINDERMAN AND SUBSTITUTE ANOTHER?

The grantor may retain the right to remove a designated charity and replace it with another without disqualifying the CRT.73 Further, the income beneficiary of a testamentary CRT may exercise a nongeneral power of appointment to designate a qualified charitable organization as a substitute remainderman.74

HOW IS THE ANNUITY OR UNITRUST BENEFICIARY TAXED ON DISTRIBUTIONS FROM A CRT

The rules governing the taxation of distributions from a CRT are described in the tier distribution system of IRC §664(b). These rules supersede all other provisions of the IRC.75

All distributions from a CRT are treated as being made first from any ordinary income of the trust, second from capital gains, third from any other income (such as tax exempt income) and lastly from corpus.76

Income or gain from the current year and undistributed income of the trust for prior years is used up first in each tier before proceeding to the next category.77

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73 Rev. Rul. 76-8, 1976-1 C.B. 179. See PLRs 9331043 and 9445010.
75 Treas. Reg. §1.664-1(d)(1).
76 IRC §664.
Net operating loss deductions\(^{78}\) are not considered.\(^{79}\) However, ordinary income is offset by ordinary losses from the sale or exchange of property that is not a capital asset. Excess ordinary losses are carried back first, and the excess is carried forward indefinitely.\(^{80}\)

After all current and accumulated income has been distributed, current and accumulated capital gains are deemed distributed\(^{81}\) on a cumulative net basis,\(^{82}\) without regard to the §1212 carryback and carryover rules. Net short term gains are treated as distributed before net long term gains. Net capital losses are carried forward, but never carried back.

The third tier is made up of “other income.” Other income includes income excluded under IRC §§101-136.\(^{83}\) This would include life insurance and tax exempt bond income, but, in addition, includes gifts and inheritances. Thus, a pour over distribution to a CRT from an estate is probably tier three “other income” rather than tier four corpus. Other income losses are carried back first, and any excess is carried forward.\(^{84}\)

It has been suggested by some that a technical reading of §664 leads to the conclusion that the tier system does not apply to an income only unitrust.\(^{85}\) The issue arises from the fact that §664(b) states that the tier system applies to income in the hands of a beneficiary receiving a unitrust payment under §664(d)(2)(A) (the normal unitrust rules), and fails to cross reference §664(d)(3) (the income only unitrust exception). The regulations, however, do not support this reading, indicating instead that the unitrust amount includes the payment of income only.\(^{86}\)

\(^{78}\)IRC §§172 and 642(d).

\(^{79}\)Treas. Reg. §1.664-1(d)(1)(a).

\(^{80}\)Treas. Reg. §1.664-1(d)(1)(a).

\(^{81}\)IRC §664(b)(2); Treas. Reg. §1.664-1(d)(1)(i)(b).

\(^{82}\)Treas. Reg. §1.664-1(d)(1)(i)(b).

\(^{83}\)Treas. Reg. §1.664-1(d)(1)(i)(c).

\(^{84}\)Treas. Reg. §1.664-1(d)(1)(i)(c).


\(^{86}\)Treas. Reg. §1.664-3(a)(1)(i)(b).
These rules apply even if the trust loses its exemption because it has unrelated business taxable income (UBTI). Moreover, the beneficiary receives no credit for the tax on UBTI paid at the trust level. The UBTI is simply ignored for purposes of the tax applied under the §664(b) tier rules.

Further, the beneficiary is taxed even if incapacitated and even if payments are made for the benefit of instead of directly to the beneficiary.

HOW ARE DEDUCTIONS ALLOCATED? Many deductions available to ordinary trusts under IRC §642 are not available to CRTs. However, a CRT is not subject to the 2% floor for ordinary deductions.

HOW ARE EXCISE TAXES AND TAXES ON UBTI ALLOCATED? UBTI and excise taxes are allocated to corpus.

HOW ARE DISTRIBUTIONS TO CHARITY TAXED? The tier system applies in reverse, in the case of distributions to a §170(c) organization of amounts other than the unitrust or annuity. The tier rules do apply, however, if the distribution to charity is out of the annuity or unitrust amounts.

Ordinarily, the trust will not recognize gain or loss on an in-kind distribution of property to charity, unless the trust is relieved of an obligation in the nature of a debt, such as where the charity has the right to a pecuniary sum or to property other than that being distributed.
IS INCOME RECEIVED ON ACCOUNT OF A PRECEDING TAXABLE YEAR INCLUDIBLE IN THE YEAR OF RECEIPT?

Income received by a beneficiary on account of a taxable year of the trust is includible in the beneficiary’s income in the beneficiary’s year that includes the last day of the tax year of the trust, even if the income is not actually paid until after the close of the trust year. 95 Thus, if income is required to be paid annually, and a calendar year trust makes a distribution in January on account of the preceding year, the beneficiary will recognize the income in that prior year.

WHAT IS THE TAX YEAR END OF A CRT?

TRA ‘86 required all CRTs to adopt a calendar year end for taxable years beginning after calendar 1986. 96

ARE THERE OTHER SPECIAL RULES THAT APPLY TO THE TIMING OF INCLUSION IN INCOME BY THE BENEFICIARY?

There are special timing inclusion and deduction rules that apply to the receipt of income by a noncharitable beneficiary from a CRT in the case of death 97 and upon the correction of an incorrect asset valuation. 98

IS THE CRT TAXED IF IT MAKES A DISTRIBUTION IN-KIND?

If a unitrust or annuity distribution is made in-kind (i.e., using property other than cash), in a year in which it has no UBTI 99 (and thus, is otherwise exempt) the distribution will be treated as a sale by the CRT and the trust will recognize gain or loss accordingly. (However, that gain will ordinarily be exempt from tax under the usual rules.) The recipient will receive a basis in the distributed property equal to its fair market date of distribution value. 100

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95 Treas. Reg. §1.664-1(d)(4)(i).
96 IRC §645(a).
99 PLR 8834039.
100 Treas. Reg. §1.664-1(d)(5).
When Might the Grantor Be Taxed on a Contribution of Appreciated Property to a CRT?

As a general rule, the grantor does not realize gain or loss on the contribution of property to a CRT. This is one of the primary tax advantages of making a gift to a CRT.

The rule is otherwise, however, if the property is subject to a debt in excess of basis, or if the transfer is made as a part of an exchange.\(^{101}\) The bargain sale rules will apply if the property transferred is subject to debt, regardless of whether the CRT assumes it.\(^{102}\)

Of course, the CRT can become disqualified if it discharges a legal obligation of the grantor, as might be the case if the grantor transfers property to the CRT subject to a mortgage that the CRT pays.

Will the Grantor Be Taxed on the Sale by a CRT of Tax Exempt Securities?

If the trustee is under an express or implied obligation to sell transferred property and to reinvest it in tax exempt securities, the grantor will be taxable on any gain realized.\(^{103}\)

Is a CRT Subject to Income Tax?

A CRT is exempt from income tax in any year that it does not have UBTI (unrelated business taxable income) or debt financed income.\(^{104}\) This is one of the primary tax factors motivating donors to establish CRTs.

Will a Trust Lose Its Tax Exemption as a CRT For a Given Year if it Has Unrelated Business Taxable Income or Debt Financed Income?

The presence of UBTI or debt financed income will cause the trust to lose its exemption for the year.\(^{105}\) This can easily happen if the trust borrows money\(^{106}\) or holds mortgaged property.\(^{107}\)

There is an important exception for lifetime gifts where the mortgage was placed on the property more than 5 years prior to the transfer where the transferor owned the property for more than 5 years. This exception will apply for 10 years after the transfer.\(^{108}\)

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104IRC §664(c); Treas. Reg. §1.664-1(a)(1)(i).
105Treas. Reg. §1.664-1(c).
106See IRC §§512-513 and Treas. Reg. §1.664-1(c).
107IRC §514(c)(2)(A).
108IRC §514(c)(2)(B).
WILL A TRUST loose its tax exemption as a CRT for a given year if it fails to make the required unitrust or annuity payment?

A trust will not qualify as a CRT in any year in which it fails to make the required annuity or unitrust payment to a noncharitable beneficiary by the extended due date of the Form 5227.109

WILL A TRUST lose its tax exemption as a CRT for a given year if it fails to pay property taxes?

A trust will not qualify as a CRT in any year in which it fails to timely pay any real property taxes or assessments.110

WILL A TRUST lose its tax exemption as a CRT if used primarily for tax avoidance purposes?

The IRS, in a particularly ominous Notice, has stated that a trust will lack an exempt purpose and therefore, not qualify as a CRT, if it is used primarily for tax avoidance purposes.111

HOW IS A TRUST TAXED IF IT LOSES ITS CRT TAX EXEMPTION?

Subject to a number of important exceptions, a trust that fails to qualify as a CRT in any year is generally taxed as a complex trust under the normal rules of Subchapter J of the IRC §§641-644 and 661-664. However, the grantor trust rules do not apply, despite the loss of exemption;112 nor do the throwback rules of §§665-668 apply.113 Further, the tier rules continue to apply to the beneficiaries.114

(The charitable set aside deduction is generally not available to a split interest trust.115)

Nonexempt trusts must make estimated tax payments.116

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110IRC §514(c)(2)(C).
112Treas. Reg. §1.664-1(c), 1.664-1(d)(1)(i).
1131.664-1(d)(1)(ii).
115IRC §642(c)(2).
WHAT TAX AND REPORTING FORMS MUST BE FILED BY A CRT ANNUALLY?

A CRT is required to file certain returns each year. Since all CRTs are now on the calendar year, the returns are generally due April 15 (the 15th day of the fourth month following the last day of the tax year of the trust), unless extended.

A CRT is required to file a Form 5227. Further, a CRT is required to file a Form 1041-A annually unless all of the net income for the year is required to be distributed currently. The exception would apply to a net income only unitrust where the income is less than the percentage amount.

As indicated by the instructions to the Form 5227, a CRT must distribute a Schedule K-1 (Form 1041) to the unitrust or annuity trust beneficiary each year, showing the income and deductions that the beneficiary is required to report.

If the CRT has any UBTI, the trust must file a Form 1041, in addition to the Forms 1041-A and 5227. In that case the estimated payment rules may require the filing of Form 1041-ES.

ARE THERE ANY SPECIAL RULES THAT APPLY TO AN ESTATE THAT FUNDS A TESTAMENTARY CRT?

As a general rule, the normal Subchapter J distribution rules apply to an estate that makes distributions to fund a CRT.

CAN THE ANNUITY OR UNITRUST INTEREST BE PAID BY THE ESTATE DURING THE PERIOD OF ADMINISTRATION?

The regulations permit a decedent’s estate to pay the annuity or unitrust interest directly to the beneficiary during the period of administration, pending the physical funding of the CRT.

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116IRC §6654(l).
118Treas. Reg. §1.6034-1(c).
119IRC §6034(a) & (b).
120Treas. Reg. §1.664-1(a)(5)(iii).
HOW ARE DISTRIBUTIONS FROM A DECEDENT’S ESTATE TAXED TO THE RECIPIENT? The noncharitable beneficiary is taxed on annuity or unitrust distributions from the estate to the extent the distribution is composed of distributable net income (DNI).

Distributions from the estate to the CRT itself are exempt, even if DNI is carried out. For this purpose the CRT is exempt from tax immediately upon partial funding.

IS A DECEDENT’S ESTATE ENTITLED TO A DISTRIBUTION DEDUCTION FOR PAYMENTS TO A CRT’S NONCHARITABLE BENEFICIARIES? A decedent’s estate is entitled to a distribution deduction for payment of the unitrust or annuity interest during administration, to the extent of its distributable net income (DNI), as in the case of any other distribution that carries out DNI.

IS A DECEDENT’S ESTATE ENTITLED TO A DISTRIBUTION DEDUCTION FOR PAYMENTS MADE TO FUND A CRT? A distribution to a CRT carries out distributable net income (DNI) to the same extent as any other distribution of a similar nature. As a general rule, a distribution from the residuary estate or a distribution in satisfaction of a formula pecuniary gift carries out DNI, whereas a gift of specific property or of a specific sum of money does not carry out DNI.

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122 Treas. Reg. §1.664-1(a)(6), Ex. 5.

123 TAM 8810006; GCM 39707.

124 Treas. Reg. 1.663(a)-1(b)(2).

125 Treas. Reg. §1.663(a)-1(b)(1).

126 IRC §663(a)(1).
WILL THE DECEDENT’S ESTATE RECOGNIZE GAIN ON FUNDING A CRT WITH PROPERTY OTHER THAN CASH?

Whether or not an estate will recognize gain on the funding of a CRT with property other than cash depends upon the nature of the bequest.

When property other than cash is used to satisfy a pecuniary bequest, a taxable sale or exchange occurs, resulting in gain or loss to the estate, with a corresponding step up or step down in basis to the beneficiary, because it is a payment in satisfaction of an ascertainable fixed dollar amount, if a date of distribution values are used in satisfying the legacy (“true worth” funding).127

If true worth funding is used, only the assets distributed in satisfaction of the bequest need be revalued at the time of funding. The recipient of the gift will receive assets equal to the dollar value of the bequest, and will receive a basis equal to the date of distribution values.

A normal distribution from the residuary estate to the heirs entitled to the property under a will or trust will ordinarily not be considered a taxable sale or exchange (although it would carry out DNI), since the beneficiaries “acquired the property from the decedent” and, in effect, own or are treated as owning the residuary estate from date of death.128 This is implied in IRC §643(e). However, IRC §643(e)(3) now gives the executor an election whether or not to recognize gain or loss on such distributions. In fact, it may be that the election described in §643(e)(3) only applies to distributions out of the residuary estate which would otherwise not trigger sale or exchange treatment.


If there is more than one residuary beneficiary, and the distributions are made on a pro rata basis, the principles remain the same as with any other residuary distribution, and gain or loss should not be recognized or realized.129

Beneficiaries having equal shares of the residuary estate are generally entitled to a prorata share of each asset, in the absence of a direction in the will to the contrary. It is often more practical, however, to make nonprorata division. For example, if A is a CRT and B is not, and if each are 50% beneficiaries of the residuary estate, the executor may decide that instead of giving A and B an undivided one-half interest in Universal Widgets, Inc., and Blackacre, both being assets of the residuary estate, A and B may prefer that A gets all of the stock in Universal Widgets, Inc., and B gets all of Blackacre, with any difference in value being made up with other residuary assets. However, such a nonprorata partition has all of the attributes of a sale or exchange between A and B, each exchanging his undivided one-half interest in the one asset for the other's one-half interest in the remaining asset.

According to Rev. Rul. 69-486, 1969-2 C.B. 159, a nonprorata distribution out of the residuary estate will ordinarily be treated as a taxable sale between or among the beneficiaries. However, Rev. Rul 69-486 implied that if the will authorizes a nonprorata distribution, such a distribution would not result in sale or exchange treatment for tax purposes. This has been confirmed by two private letter rulings (which of course, have no precedential value).130

IN THE CASE OF A TESTAMENTARY CRT, MAY THE TRUSTEE OF A CRT DELAY MAKING UNITRUST OR ANNUITY PAYMENTS UNTIL THE TRUST IS FULLY FUNDED?

The trustee may, and perhaps must be allowed the option to delay payments to the noncharitable income beneficiaries until a testamentary CRT has been fully funded.131


130PLR 8119040 and PLR 8029054.

131Rev. Rul. 80-123, 1980-1 C.B. 205
IS A DECEDENT’S ESTATE ENTITLED TO A CHARITABLE SET-ASIDE DEDUCTION IF IT EARMARKS INCOME FOR DISTRIBUTION TO A CRT?

Although IRC §642(c) grants an unlimited income tax charitable deduction to an estate that is required to distribute income to a §170(c) charitable organization, or which irrevocably sets such income aside for such distribution, a CRT is not itself a §170(c) organization because it has noncharitable beneficiaries that may be entitled to corpus.132

On the other hand, the noncharitable beneficiary of an income only unitrust will never receive corpus, and therefore a set-aside deduction just might be available in that case.

According to the regulations, the set-aside deduction is available if the possibility that the amount set aside will go to a noncharitable beneficiary is so remote as to be negligible.133

The IRS has indicated, rather ambiguously, that a set-aside deduction might be available where the partially funded CRT currently pays the annuity or unitrust amount or where the estate sets such amounts for payment in the future, with interest.134

IS IT GENERALLY DESIRABLE TO PARTIALLY FUND A TESTAMENTARY CRT EACH YEAR TO THE EXTENT OF THE ESTATE’S DNI?

It should be obvious that there may be an income tax advantage in making partial distributions to a testamentary CRT of income as to which a distribution deduction is available, if that income would otherwise be taxed in the estate or in the hands of the noncharitable beneficiaries. The reason is that the CRT is tax exempt.

132Treas. Reg. §1.642(c)-2(a) & (d).
133Treas. Reg. §1.642(c)-2(d).
134Compare TAM 8341001 with GCM 39249.
DO THE PRIVATE FOUNDATION RULES APPLY TO CRTS?

A CRT can be a private foundation. Moreover, even if a CRT is not a private foundation, it will be treated as if they were for many purposes.\(^{135}\)

The termination tax of §507 can apply to a CRT, but this would be unusual.

The governing instrument requirements of §508(e) apply to a CRT.

The self-dealing restrictions of IRC §4941 applicable to private foundations apply to CRTs. This statute prohibits and taxes acts of self-dealing between a private foundation and a “disqualified person” (as defined in IRC §4946).

WHO IS A DISQUALIFIED PERSON?

The definition of a disqualified person with respect to a private foundation is defined in IRC §4946(a)(1). The donor of a CRT is a disqualified person, because the donor would be a substantial contributor (in addition to being a foundation manager, if the donor is also a trustee). The full statutory definition is as follows. Note that it includes relatives of the donor.

Sec. 4946(a)(1) Definitions and special rules.

(1) In general.

For purposes of this subchapter, the term “disqualified person” means, with respect to a private foundation, a person who is --

(A) a substantial contributor to the foundation,

(B) a foundation manager (within the meaning of subsection (b)(1)),

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\(^{135}\)IRC §4947(a)(2) provides, with certain exceptions, that in the case of split interest trusts, “507 (relating to termination of private foundation status), section 508(e) (relating to governing instruments) to the extent applicable to a trust described in this paragraph, section 4941 (relating to taxes on self-dealing), section 4943 (relating to taxes on excess business holdings) except as provided in subsection (b)(3), section 4944 (relating to investments which jeopardize charitable purpose) except as provided in subsection (b)(3), and section 4945 (relating to taxes on taxable expenditures) shall apply as if such trust were a private foundation.”
(C) an owner of more than 20 percent of --

(i) the total combined voting power of a corporation,

(ii) the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise,

which is a substantial contributor to the foundation,

(D) a member of the family (as defined in subsection (d)) of any individual described in subparagraph (A), (B), or (C),

(E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,

(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,

(G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest,

(H) only for purposes of section 4943, a private foundation --

(i) which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or

(ii) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A), (B), or (C), or members of their families (within the meaning of subsection (d)), who made (directly or indirectly) substantially all of the contributions to the private foundation in question, and

(I) only for purposes of section 4941, a government official (as defined in subsection (c)).
WHO IS A FOUNDATION MANAGER?

The trustee of a CRT is treated as a foundation manager. IRC §4946(b) defines a foundation manager as follows:

(b) Foundation manager. For purposes of this subchapter, the term “foundation manager” means, with respect to any private foundation --

(1) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and

(2) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act).

WHAT ACTS OF SELF-DEALING ARE PROHIBITED BETWEEN A GRANTOR OR OTHER DISQUALIFIED PERSON AND A CRT?

Acts of self dealing under IRC §4941(d)(1) include, with some exceptions,136 “any direct or indirect—

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

136IRC §4941(d)(2).
IS A SALE OF ASSETS OWNED BY A CRT TO A PERSON WHO IS NOT A DISQUALIFIED PERSON AN ACT OF SELF DEALING IF THE SALE INDIRECTLY BENEFITS THE GRANTOR?

It is the position of the IRS that a sale by a CRT to a third party (who is not a disqualified person) can be an act of self-dealing, if the sale was intended to benefit a disqualified person.137

CAN A CRT BE SUBJECT TO EXCISE TAX FOR EXCESS BUSINESS HOLDINGS?

Some, but not all, CRTs are subject to the excise tax described in IRC §4943 prohibiting “excess business holdings.” Generally, this rule will not apply unless there is a charitable income beneficiary. Nevertheless, the IRS form contains a prohibition against investing in excess business holdings for all trusts using that form.

A private foundation, together with all disqualified persons with respect to it, is prohibited from holding more than 20% of the voting interests of a business. If the business is acquired by testamentary or intervivos gift, the foundation is given a 5 year grace period in which to dispose of the excess business holdings.

WHAT ARE EXCESS BUSINESS HOLDINGS IN THE WORDS OF THE STATUTE?

IRC §4943 is actually quite complex, and full of special exceptions and rules:

(c) Excess business holdings. For purposes of this section —

(1) In general. The term “excess business holdings” means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

(2) Permitted holdings in a corporation.

(A) In general. The permitted holdings of any private foundation in an incorporated business enterprise are—

(i) 20 percent of the voting stock, reduced by

(ii) the percentage of the voting stock owned by all disqualified persons.

In any case in which all disqualified persons together do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings.

(B) 35 percent rule where third person has effective control of enterprise. If—

(i) the private foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and

(ii) it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation,

then subparagraph (A) shall be applied by substituting 35 percent for 20 percent.

(C) 2 percent de minimis rule. A private foundation shall not be treated as having excess business holdings in any corporation in which it (together with all other private foundations which are described in section 4946(a)(1)(H) ) owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock.
(3) **Permitted holdings in partnerships, etc.** The permitted holdings of a private foundation in any business enterprise which is not incorporated shall be determined under regulations prescribed by the Secretary. Such regulations shall be consistent in principle with paragraphs (2) and (4), except that—

(A) in the case of a partnership or joint venture, “profits interest” shall be substituted for “voting stock”, and “capital interest” shall be substituted for “nonvoting stock”,

(B) in the case of a proprietorship, there shall be no permitted holdings, and

(C) in any other case, “beneficial interest” shall be substituted for “voting stock”.

(4) Present holdings.

(A)

(i) In applying this section with respect to the holdings of any private foundation in a business enterprise, if such foundation and all disqualified persons together have holdings in such enterprise in excess of 20 percent of the voting stock on May 26, 1969, the percentage of such holdings shall be substituted for “20 percent,” and for “35 percent” (if the percentage of such holdings is greater than 35 percent), wherever it appears in paragraph (2), but in no event shall the percentage so substituted be more than 50 percent.
(ii) If the percentage of the holdings of any private foundation and all disqualified persons together in a business enterprise (or if the percentage of the holdings of the private foundation in such enterprise) decreases for any reason, clause (i) and subparagraph (D) shall, except as provided in the next sentence, be applied for all periods after such decrease by substituting such decreased percentage for the percentage held on May 26, 1969, but in no event shall the percentage substituted be less than 20 percent. For purposes of the preceding sentence, any decrease in percentage holdings attributable to issuances of stock (or to issuances of stock coupled with redemptions of stock) shall be disregarded so long as—

(I) the net percentage decrease disregarded under this sentence does not exceed 2 percent, and

(II) the number of shares held by the foundation is not affected by any such issuance or redemption.

(iii) The percentage substituted under clause (i), and any percentage substituted under subparagraph (D), shall be applied both with respect to the voting stock and, separately, with respect to the value of all outstanding shares of all classes of stock.

(iv) In the case of any merger, recapitalization, or other reorganization involving one or more business enterprises, the application of clauses (i), (ii), and (iii) shall be determined under regulations prescribed by the Secretary.
(B) Any interest in a business enterprise which a private foundation holds on May 26, 1969, if the private foundation on such date has excess business holding, shall (while held by the foundation) be treated as held by a disqualified person (rather than by the private foundation)—

(i) during the 20-year period beginning on such date, if the private foundation and all disqualified persons have more than a 95 percent voting stock interest on such date,

(ii) except as provided in clause (i), during the 15-year period beginning on such date, if the foundation and all disqualified persons have more than a 75 percent voting stock interest (or more than a 75 percent profits or beneficial interest in the case of any unincorporated enterprise) on such date or more than a 75 percent interest in the value of all outstanding shares of all classes of stock (or more than a 75 percent capital interest in the case of a partnership or joint venture) on such date, or

(iii) during the 10-year period beginning on such date, in any other case.

(C) The 20-year, 15-year, and 10-year periods described in subparagraph (B) for the disposition of excess business holdings shall be suspended during the pendency of any judicial proceeding by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument (as in effect on May 26, 1969) in order to allow disposition of such holdings.
(D) 

(i) If, at any time during the second phase, all disqualified persons together have holdings in a business enterprise in excess of 2 percent of the voting stock of such enterprise, then subparagraph (A)(i) shall be applied by substituting for “50 percent” the following: “50 percent, of which not more than 25 percent shall be voting stock held by the private foundation”.

(ii) If, immediately before the close of the second phase, clause (i) of this subparagraph did not apply with respect to a business enterprise, then for all periods after the close of the second phase subparagraph (A)(i) shall be applied by substituting for “50 percent” the following: “35 percent, or if at any time after the close of the second phase all disqualified persons together have had holdings in such enterprise which exceed 2 percent of the voting stock, 35 percent, of which not more than 25 percent shall be voting stock held by the private foundation”.

(iii) For purposes of this subparagraph, the term “second phase” means the 15-year period immediately following the 20-year, 15-year, or 10-year period described in subparagraph (B), whichever applies, as modified by subparagraph (C).

(E) Clause (ii) of subparagraph (B) shall not apply with respect to any business enterprise if before January 1, 1971, one or more individuals who are substantial contributors (or members of the family (within the meaning of section 4946(d) ) of one or more substantial contributors) to the private foundation and who on May 26, 1969, held more than 15 percent of the voting stock of the enterprise elect, in such manner as the Secretary may by regulations prescribe, not to have such clause (ii) apply with respect to such enterprise.
(5) Holdings acquired by trust or will. Paragraph (4) (other than subparagraph (B)(i) ) shall apply to any interest in a business enterprise which a private foundation acquires under the terms of a trust which was irrevocable on May 26, 1969, or under the terms of a will executed on or before such date, which are in effect on such date and at all times thereafter, as if such interest were held on May 26, 1969, except that the 15-year and 10-year periods prescribed in clauses (ii) and (iii) of paragraph (4)(B) shall commence with respect to such interest on the date of distribution under the trust or will in lieu of May 26, 1969.

(6) 5-year period to dispose of gifts, bequests, etc. Except as provided in paragraph (5) , if, after May 26, 1969, there is a change in the holdings in a business enterprise (other than by purchase by the private foundation or by a disqualified person) which causes the private foundation to have—

(A) excess business holdings in such enterprise, the interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than by the foundation) during the 5-year period beginning on the date of such change in holdings; or

(B) an increase in excess business holdings in such enterprise (determined without regard to subparagraph (A) ), subparagraph (A) shall apply, except that the excess holdings immediately preceding the increase therein shall not be treated, solely because of such increase, as held by a disqualified person (rather than by the foundation).

In any case where an acquisition by a disqualified person would result in a substitution under clause (i) or (ii) of subparagraph (D) of paragraph (4) , the preceding sentence shall be applied with respect to such acquisition as if it did not contain the phrase “or by a disqualified person” in the material preceding subparagraph (A).
(7) 5-year extension of period to dispose of certain large gifts and bequests.

The Secretary may extend for an additional 5-year period the period under paragraph (6) for disposing of excess business holdings in the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures if—

(A) the foundation establishes that—

   (i) diligent efforts to dispose of such holdings have been made within the initial 5-year period, and

   (ii) disposition within the initial 5-year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of such holdings,

(B) before the close of the initial 5-year period—

   (i) the private foundation submits to the Secretary a plan for disposing of all of the excess business holdings involved in the extension, and

   (ii) the private foundation submits the plan described in clause (i) to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the foundation's disposition of the excess business holdings involved and submits to the Secretary any response received by the private foundation from the Attorney General (or other appropriate State official) to such plan during such 5-year period, and

(C) the Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period.
IS A CRT PROHIBITED FROM HOLDING ASSETS THAT COULD JEOPARDIZE THE CARRYING OUT OF ITS EXEMPT PURPOSE?

Some, but not all, CRTs are subject to the IRC §4944 prohibition against investing foundation funds in a manner that could jeopardize the conduct of its exempt purpose. Nevertheless, the IRS form contains a prohibition against jeopardy investments for all trusts using that form.

The regulations cite the following as examples of investments that could jeopardize the carrying out of the foundation’s exempt purpose—

Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of 'puts,' 'calls,' and 'straddles,' the purchase of warrants and of selling short.138

CAN A CRT BE SUBJECTED TO AN EXCISE TAX ON TAXABLE EXPENDITURES?

A “taxable expenditure” made by a private foundation is subject to an excise tax under IRC §4945.

For purposes of IRC §4945, the term “taxable expenditure” means, with some exceptions, any amount paid or incurred by a private foundation—

(1) to carry on propaganda, or otherwise to attempt, to influence legislation;

(2) to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive;

(3) as a grant to an individual for travel, study, or other similar purposes by such individual;

(4) as a grant to an organization unless -- (A) such organization is a public charity described in paragraph (1), (2), or (3) of IRC §509(a) or is an exempt operating foundation (as defined in § 4940(d)(2)), or (B) the private foundation exercises expenditure responsibility with respect to such grant; or

(5) for any purpose other than one specified in IRC §170(c)(2)(B).

ARE THERE ANY SPECIAL EXEMPTIONS FROM THE PRIVATE FOUNDATION RULES AVAILABLE TO CRTs?

IRC §4947(a)(2)(A) excepts from private foundation treatment, amounts for which no income, estate or gift tax deduction was taken. This describes the income interest payable to the noncharitable beneficiaries of the CRT. Therefore, payment of the annuity or unitrust interest does not constitute an act of self dealing.

This means, for example, that an in kind distribution of trust corpus in satisfaction of a unitrust amount is not considered a self-dealing transaction.\(^\text{139}\)

Certain segregated amounts, earmarked exclusively for noncharitable purposes and separately accounted for, may qualify for exemption under IRC §4947(a)(2)(B).\(^\text{140}\)

IRC §4947(a)(2)(C) grandfathers from application of the private foundation rules any amounts transferred in trust before May 27, 1969.

ARE THERE ANY SPECIAL EXCEPTIONS TO THE JEOPARDY INVESTMENT AND EXCESS BUSINESS HOLDINGS RULES?

IRC §4947(b)(3) exempts most CRTs from the application of the jeopardy investment and excess business holdings restrictions of IRC §§4943 and 4944. The specific requirements for the exemption are that—

(A) all the income interest (and none of the remainder interest) of such trust is devoted solely to [charitable purposes] . . . , and all amounts in such trust for which a deduction was allowed . . . have an aggregate value not more than 60 percent of the aggregate fair market value of all amounts in such trusts, or

(B) a [charitable] deduction was allowed . . . for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary.”

Thus, if the CRT has no charitable income beneficiaries, neither §4943 (excess business holdings) nor 4944 (jeopardy investments) will apply.\(^\text{141}\) (Even if part of the annuity or unitrust interest is payable to charity, a deduction is not ordinarily allowed for such portion, in which case IRC §4947(b)(3)(B) offers a separate exemption from §§4943 and 4944.) Nevertheless, the IRS form contains a prohibition against jeopardy investments and excess business holdings for all trusts using that form.

\(^{139}\)PLR 8846058

\(^{140}\)Treas. Reg. §53.4947-1(c)(3).

\(^{141}\)Treas. Reg. §53.4947-2(b)(1).
**WHAT HAPPENS IF A SPLIT INTEREST TRUST BECOMES A CHARITABLE TRUST?**

When a split interest trust is considered terminated under Treas. Reg. §1.641(b)-3(b), it is treated as a charitable trust under IRC §4947(a)(1) until all of its assets have been distributed to charity. All of the private foundation rules apply to §4947(a)(1) unless it qualifies as a “supporting organization” under §509(a)(3).

If the last noncharitable interest in a CRT has ended, and the trust continues to hold the assets “for the benefit of” charity, the trust will be treated as a CRT during a “reasonable period of settlement,” after which it will be treated as a charitable trust under IRC §4947(a)(1).

This treatment is somewhat inconsistent with the §664 regulations.

**HOW DOES ONE CLAIM A DEDUCTION FOR A CONTRIBUTION TO A CRT?**

In order to claim a deduction, the taxpayer is required to attach a statement to the return showing how the deduction was computed. Note, however, that neither a gift, estate nor an income tax deduction is allowed for a contribution to a charitable remainder trust that does not qualify under §664.

**HOW IS THE PRESENT VALUE OF A SPLIT INTEREST DETERMINED?**

In general, actuarial factors used to determine the present value of an annuity, a life estate, or a remainder interest, are based on two components: life expectancy (mortality) and the assumed rate of return (interest rate). If a term certain is involved, a term of years component is substituted for the life expectancy factor.

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146Treas. Reg. §§1.664-2(d), 1.664-4(c), 1.170A-13, 20.2055-1(c), 25-2522(a)-1(c).


149*Id.*
TAMRA added IRC §7520 to the Internal Revenue Code. IRC §7520 modifies Treas. Reg. §20.2031-7 by mandating that value of annuities and other temporal split interests be determined by using an interest rate (rounded to the nearest 2/10ths of 1 percent\textsuperscript{150}) equal to \textbf{120 percent of the Federal midterm rate (compounded annually)} in effect under IRC §1274(d)(1) for the month in which the valuation date falls.

The IRC and the regulations permit the taxpayer to elect, as an alternative, the rate in effect for either of the 2 months preceding the month in which the transfer is made.\textsuperscript{151}

IRC §7520(c)(3) requires the Secretary of the Treasury to revise the mortality table used in valuing temporal split interests at least once every 10 years to take into account the most recent mortality experience available. \textbf{Notice 89-60}\textsuperscript{152} contains the new mortality tables by substituting Table R(1) Single Life Remainder Factors (set forth in the ruling) for the Table A found in §20.2031-7(f). This table only has interest rate assumptions for interest rates between 8.2 and 12 percent.

Further, Table R(1) of Notice 89-60, unlike Treas. Reg. §§20.2031-7, does not contain annuity factors. It only shows the remainder factors. The Table R(1) annuity factor can be obtained by first obtaining the income factor (life estate factor). The income factor is simply 1 minus the remainder factor. \textbf{The annuity factor may then be obtained by dividing the income factor by the applicable interest rate under IRC §7520.}

\begin{flushleft}
\textbf{An easier way to obtain the annuity factor is to refer to Table S in Pub. 1457, Actuarial Values-Alpha Volume.} See also Publication 1458, Actuarial Values Beta Volume. These tables give the annuity factors from 2.2 percent to 26 percent through age 109. Publication 1457 can be purchased from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.
\end{flushleft}

\textsuperscript{150}That is, an even number will be in the first and only decimal place, if the number is expressed as a percent. E.g., 11.2%, 11.4%, 11.6% etc.

\textsuperscript{151}IRC §7520(a) (flush language); Treas. Reg. §§ 1.7520-2(a)(2), 20.7520-2(a)(2), and 25.7520-2(a)(2).

The procedure for making the election can be found in Treas. Reg. §§ 1.7520-2(a)(4), (b); 20.7520-2(a)(4), (b); and 25.7520-2(a)(4), (b). Cf., Treas. Reg. §§ 1.7520-2(c), 20.7520-2(c), and 25.7520-2(c).

Incidentally, the regulations under §7520 are helpful in understanding these principles. See, for example, Treas. Reg. §20.7520-1(c). An outstanding and straightforward explanation of these concepts can be found in “The Mathematics of Partial Interests in Property,” by Jerome J. Caulfield, Probate and Property, Vol. 6, No. 6, November/December 1992 beginning at page 44, published by the American Bar Association.

**SPECIFICALLY, HOW IS A CRAT VALUED?**

For gift, estate and income tax purposes, the fair market value (FMV) of the remainder interest of a charitable remainder annuity trust is the net fair market value (as of the appropriate valuation date) of the property placed in trust less the present value of the annuity.\(^{153}\) In general, the valuation date is the date on which the property is transferred to the trust by the donor, regardless of when the trust is created. In the case of a testamentary trust, this would either be the date of death or the alternate valuation date under IRC §2032, if elected.

After April 30, 1989, FMV is determined by reference to IRC §7520, which prescribes the mortality tables to be used and the rate of interest (the 7520 rate). The §7520 rate is 120% of the applicable federal mid-term rate (which changes monthly) under Section 1274(d), compounded annually and rounded to the nearest two-tenths of one percent. A Revenue Ruling is issued each month setting the appropriate rate.

As in the case of a CRUT, the IRC and the regulations permit the taxpayer to elect, as an alternative, the rate in effect for either of the 2 months preceding the month in which the transfer is made.\(^{154}\)

**ARE THERE ANY IRS PUBLISHED TABLES THAT CAN ASSIST IN DETERMINING THE VALUE OF THE REMAINDER INTEREST?**

In Notice 89-24\(^{155}\) the IRS published guidelines for determining values under §7520. However, for transfers after 4/30/94, the final regulations should be consulted.\(^{156}\)

Notice 89-24 is still useful, as it contains a formula for determining values based upon a term of years, though not for life interests.

In order to compute the value of a life interest in a split interest trust, Notice 89-60 may be consulted.\(^{157}\)

\(^{153}\)Treas. Reg. §1.664-2(c).

\(^{154}\)IRC §7520(a) (flush language); Treas. Reg. §§ 1.7520-2(a)(2), 20.7520-2(a)(2), and 25.7520-2(a)(2).

The procedure for making the election can be found in Treas. Reg. §§ 1.7520-2(a)(4), (b); 20.7520-2(a)(4), (b); and 25.7520-2(a)(4), (b). Cf., Treas. Reg. §§ 1.7520-2(c), 20.7520-2(c), and 25.7520-2(c).

\(^{155}\)Notice 89-24, 1989-1 C.B. 660.

\(^{156}\)Treas. Reg. §§1.7520-4(a), 20.7520-4(a), and 25.7520-4(a).

\(^{157}\)Notice 89-60, 1989-1 C.B. 700.
**WHAT HAPPENS IF THE VALUE OF AN ANNUITY INTEREST IS INCORRECTLY VALUED, WITH THE RESULT THAT THE INTEREST IS WORTH LESS THAN 5% OF THE INITIAL FMV OF THE TRUST CORPUS?**

The regulations provide a procedure for correcting a situation where an incorrect value of the annuity interest results in that interest being less than the 5% minimum required under §664. Basically, the grantor must agree to limit the FMV of the trust property to 20 times the annuity, for purposes of computing the charitable deduction, which deduction will then equal an agreed figure.\(^\text{158}\)

**HOW IS THE VALUE OF THE REMAINDER INTEREST IN A CRUT OBTAINED?**

Calculating the value of the remainder interest in a CRUT is more involved than in the case of a CRAT. The procedures are set forth in Treas. Reg. 1.664-4. The first step is to determine the “adjusted payout rate” (APR) and following the procedures outlined in Treas. Reg. §1.664-4(e)(3) and (4). This rate is determined differently, depending upon whether the CRUT income interest is based upon a term of years or the life of an individual.

TAMRA added IRC §7520 to the Internal Revenue Code. IRC §7520 mandates that the value of annuities and other temporal split interests be determined by using an interest rate (rounded to the nearest 2/10ths of 1 percent\(^\text{159}\)) equal to **120 percent of the Federal midterm rate** (compounded annually) in effect under section 1274(d)(1) for the month in which the valuation date falls. Further, IRC §7520(c)(3) requires the Secretary of the Treasury to revise the mortality table used in valuing temporal split interests at least once every 10 years, to take into account the most recent mortality experience available.

For transfers made after April 30, 1989, the interest rate is the §7520 rate, and the APR is determined by multiplying the unitrust fixed percentage provided in the instrument by a “payout factor” contained in Table F\(^\text{160}\) under Treas. Reg. § 1.664-4(e)(6).\(^\text{161}\)

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\(^{159}\)That is, an even number will be in the first and only decimal place, if the number is expressed as a percent. E.g., 11.2%, 11.4%, 11.6% etc.

\(^{160}\)Table F uses the new mortality tables required by §7520.

\(^{161}\)For transfers made after November 30, 1983 and before May 1, 1989, use Table F(1) in Regs. Section 1.664-4A(d)(6) to compute the APR.
After determining the payout rate from Table F, a “valuation factor” is determined under either Table D, in the case of a term of years CRUT, or Table U(1), in the case of a CRUT for the life of one individual, by matching the APR with the applicable measuring life or term of years, as the case may be.

The age used for the measuring life is the age of the individual at his birthday nearest the date of the transfer.

If the exact payout rate cannot be determined from the tables, then an interpolated factor must be computed.

The present value of the remainder interest is simply the net fair market value of the assets times the valuation factor obtained from the table (either Table D or U(1), as the case may be).

**How is the Value of the Remainder Interest in a CRUT Obtained if More than One Life is Involved?**

If there is more than one measuring life in a two life unitrust, the valuation factor must be obtained from Table U(2) found in IRS Publication 1458.

**Do the Tables Cover All Cases?**

There are no tables if more than two lives are involved, or if the payout is other than monthly, quarterly, semiannually, or annually.

In such cases, a ruling can be obtained from the IRS.

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163 Treas. Reg. § 1.664-4(e)(5).

164 Treas. Reg. § 1.664-4(e)(5).

165 Treas. Reg. § 1.664-4(e)(4) and (5).

166 Treas. Reg. § 1.664-4(b).
**What Other Factors Must Be Taken into Account to Determine the Size of the Charitable Income Tax Deduction Available?**

The donor must take into account the percentage limitations found in IRC §170. These limitations are affected by the nature of the charitable remainderman, and the size of the donor’s “contribution base.”

**What is the Contribution Base?**

A donor's contribution base is his adjusted gross income for the year, determined by disregarding net operating loss carrybacks.¹⁶⁷

**What Are the Percentage Limits?**

The size of the deduction is based upon a percentage of the donor’s contribution base for the year.

In the case of an individual, there is a 50% limit, a 30% limit and a 20% limit. Which limit applies is determined by reference to (1) the type of property contributed to the CRT, (2) the nature of the charity and (3) the terms of the gift.

The **50%** limit applies to gifts “to” 50% charities, of property other than qualified long term capital gain property.

The **30%** limit applies to gifts to charities other than 50% charities, and to gifts “for the use of” 50% charities, or for gifts of qualified long term capital gain property.

The **20%** limit applies to gifts to charities other than 50% charities of certain appreciated marketable securities.

To the extent that the gift exceeds the deduction limit allowed for a given year, the excess can be carried forward for up to five years.

There are other rules that can reduce the amount of the contribution, depending on the nature of the charity and the property donated.

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¹⁶⁷IRC §170(b)(1)(F).
HOW ARE THE DEDUCTION LIMITATIONS AFFECTED BY THE NATURE OF THE PROPERTY CONTRIBUTED?

In the case of a gift of property to a 50% charity, where the property is not qualified long term capital gain property or ordinary income property, the donor can take a deduction for the full fair market value of the property, up to 50% of the donor’s contribution base.

In the case of a gift of ordinary income property to a 50% charity, the donor’s deduction for the fair market value of the property is reduced by 100% of the built in ordinary income gain, up to 50% of the donor’s contribution base.

WHAT ARE 50% CHARITIES?

Organizations described in IRC §170(b)(1)(A) are “50% charities.” These include certain—

(a) Churches.168
(b) Schools.169
(c) Hospitals.170
(d) Governmental Units.171
(e) Publicly Supported Organizations.172 This very important class of charitable organization includes organizations that normally receive a substantial part of its support from the general public or a governmental unit. Typical examples are museums, libraries, organizations providing facilities for the performing arts, the Red Cross, etc.
(f) Operating Private Foundations.173
(g) Two Types of Nonoperating Private Foundations:174 Private Distributing Foundations,175 Private Foundations Maintaining a Common Fund.176
(h) Private Foundations that Qualify Under IRC §509(a)(2) (meeting the “one-third support test”) or Under IRC §509(a)(3) (qualifying as supporting organizations).177

168IRC §170(b)(1)(A)(i).
169IRC §170(b)(1)(A)(ii).
170IRC §170(b)(1)(A)(iii).
171IRC §170(b)(1)(A)(v).
WHAT SPECIAL LIMITS APPLY TO THE CONTRIBUTION OF APPRECIATED LONG TERM CAPITAL GAIN PROPERTY?

Long term capital gain property is **property held for more than one year** (or more than six months if acquired prior to January 1, 1988).

If the recipient of the gift is a 50% charity (a public charity), the donor can take a deduction equal to the full fair market value of the property, but only up to 30% (rather than 50%) of the donor’s contribution base. If the 30% limit is exceeded, the excess can be carried forward for **5 years**.

If the gift is to a charity that is not a 50% charity, the deduction with respect to long term capital gain property is subject to the reduction rules of IRC §170(e). The reduction rules require that the long term capital gain, that would have been realized had the property been sold, be reduced by the appreciation attributable to the remainder interest. (Between July 19, 1984 and December 31, 1995, there existed an exception for gifts of certain marketable securities.)

The reduced amount is also subject to a 20% deduction limit.

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175 IRC §170(b)(1)(E)(ii).
176 IRC §170(b)(1)(E)(iii).
177 IRC §170(b)(1)(A)(viii).
178 IRC §170(b)(1)(C)(i).
179 IRC §170(b)(1)(C)(ii).
180 IRC §170(c)(1)(B)(ii).
181 IRC §170(c)(5).
182 IRC §170(b)(1)(D).
Does Basis Need to Be Allocated Between the Charitable and Noncharitable Interests When Long Term Capital Gain Property Subject to the 170(e) Reduction Rules Is Contributed to a CRT That Has a Private Foundation as the Remainderman?

If a donor contributes long term capital gain property subject to the reduction rules to a CRT that has a private foundation as the remainderman, an allocation of basis must be made between the charitable and noncharitable interests.183

Under the regulations, the basis allocated to the charitable remainder interest is the portion of the total that bears the same ratio as the fair market value of the interest contributed to the charity bears to the fair market value of the entire property.

Is It Disadvantageous to Fund a CRT With Appreciated Property, If the Remainderman Is a Private Foundation?

As the above rules indicate, funding a CRT with appreciated property results in a lower income tax deduction because of the application of both the IRC §170(e) reduction rules and the IRC §170(b)(1)(D) percentage limitations.

Can a Donor Elect to Have the 50% Ceiling Apply Where the Remainderman Is a 30% Public Charity?

A donor may elect to have the 50% limit apply, instead of the 30% ceiling, in the case of a gift of appreciated property to a 30% public charity.184

However, if this election is made, the 170(e) reduction rules operate to reduce the contribution for deduction purposes by 100% of the long term capital gain attributable to the remainder.185

The trade off is that the charitable deduction for the reduced amount is increased from 30% to 50% of the taxpayer donor’s contribution base.

183IRC §170(e)(2); Treas. Reg. § 1.170A-4(c)(1).
184IRC §170(b)(1)(C)(iii).
185IRC §170(e)(1)(B).
WHAT SPECIAL DEDUCTION RULES APPLY WITH RESPECT TO CONTRIBUTIONS OF ORDINARY INCOME PROPERTY TO A CRT?

Ordinary income property is property that would generate income at least some of which would not be long term capital gain if sold for fair market value.\(^{186}\)

The deduction for ordinary income property contributed to a CRT is reduced by the amount of built in gain that would not have been long term capital gain if the property had been sold for fair market value.

IS THE SIZE OF THE INCOME TAX DEDUCTION REDUCED IF THE REMAINDER INTEREST IS TO PASS “FOR THE USE OF” (RATHER THAN OUTRIGHT TO) CHARITY?

The income tax deduction for a gift “for the use of charity” is limited to 30% of the donor’s contribution base.\(^{187}\) If the charitable remainderman is a public charity and if the gift is of qualifying property, (e.g., not appreciated long term capital gain property), then the donor is ordinarily entitled to a deduction for up to 50% of the donor’s contribution base, if the charity will take the property outright upon the termination of the annuity or unitrust interest. However, if the property will continue to be held in trust “for the use of” charity, the 50% limit is reduced to 30%.\(^{188}\)

HOW DO THE 50%, 30% AND 20% LIMITS INTERACT WITH THE 5 YEAR CARRY FORWARD PERIOD?

The 50%, 30% and 20% limits are separate but inclusive limitations. The 30% and 20% limits are not in addition to the 50% limit.

Where the limitations are exceeded and the excess is carried over, subsequent gifts are taken into account first when applying the 50% limit. The limitations in succeeding years are applied in the following order—

1. current gifts of 50% property;
2. carryover gifts of 50% property (oldest first);
3. current gifts of 30% property;
4. carryover gifts of 30% property (oldest first);
5. current gifts of 20% property; and
6. carryover gifts of 20% property (oldest first).\(^{189}\)

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\(^{187}\)IRC §170(b)(1)(B).

\(^{188}\)Treas. Reg. § 1.170A-8(a)(2).

\(^{189}\)IRC §170(b)(1)(C)(ii), (D)(ii), and (d)(1).
DOES THE ALTERNATIVE MINIMUM TAX APPLY TO GIFTS TO A CRT?

At the present time, deductions taken for contributions to a CRT by noncorporate taxpayers are not a tax preference item for purposes of the alternative minimum tax (AMT).

IS THE INCOME TAX DEDUCTION AFFECTED IF THE CHARITABLE REMARKEDMAN CAN BE CHANGED?

The grantor, trustee or someone else can be given the power to change the remainderman to another charity, but the deduction will be limited depending upon whether the permissible appointees include 30% charities, unless the possibility of adverse exercise is so remote as to be negligible.190

IS AN ESTATE OR GIFT DEDUCTION AVAILABLE IF THERE IS A MORE THAN 5% CHANCE THAT THE CHARITY WILL RECEIVE NOTHING?

If there is a greater than 5% chance that the gift to charity will be defeated because the remainder interest in a CRT will be totally exhausted upon termination of the income interest, then the regulations provide that no charitable gift or estate tax deduction will be allowed.191

It may be that this rule only applies in the case of a CRAT.

WHAT SPECIAL INCOME TAX CONCERNS ARE ASSOCIATED WITH THE CONTRIBUTION OF TANGIBLE PERSONAL PROPERTY TO A CRT?

It is possible that the charitable income tax deduction will be both limited and postponed if the property contributed to the CRT is tangible personal property.192 IRC 170(a)(3) specifically postpones the income tax deduction for a contribution of tangible personal property until the time when all intervening noncharitable interests have either expired or are held by persons other than the donor or those standing in a relationship to the donor described in IRC §§267(b) or 707(b).

Recall further, that for purposes of the income tax deduction, the value of appreciated tangible personal property must be reduced by 100% of the long term capital gain, unless the property is related to the organization's exempt purpose or function.193

192IRC §§170(a)(3), 267(b) and 707(b); Treas. Reg. § 1.664-2(d); Rev. Rul. 73-610 1973-2 C.B. 213; Rev. Rul. 69-63, 1969-1 C.B. 63. PLRs 7908038, 7850068.
How and When is the Gift Tax Applied to a Transfer to a CRT?

The donor makes an adjusted taxable gift if someone other than the owner or charity has a beneficial interest in the CRT. The regulations specify how the value of the gift of an annuity is computed. The value of the gift of a unitrust interest is computed by subtracting the present value of the remainder interest from the value of the property placed in trust.

Is the $10,000 Per Donor Per Donee Annual Exclusion Under IRC §2503(b) Available with Respect to the Annuity or Unitrust Interest of an Individual?

A vested immediate gift of a unitrust or annuity interest in a CRT directly to a beneficiary is a present interest for purposes of the IRC §2503(b) $10,000 per year annual exclusion. The exclusion would not be available if the income interest begins in the future, as it would if the interest were successive, as in a two life nonconcurrent CRT.

Is a Gift Tax Marital Deduction Allowed for a Unitrust or Annuity Trust Interest in a Surviving Spouse?

IRC §2523(g) allows a gift tax marital deduction for an annuity or unitrust interest (but not an income interest in a pooled income fund) of a surviving spouse if the spouse is the sole noncharitable beneficiary other than the donor. But for §2523(g), the spouse’s interest would be a nondeductible terminable interest for marital deduction purposes.

IRC §2523(f) allows a gift tax marital deduction where a spouse is given a qualifying income interest for life in property (generally all of the net fiduciary accounting income from a trust), however a unitrust or annuity trust interest does not qualify.

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195 Treas. Reg. §§ 25.2522(c)-3(d)(2)(i) and 1.664-2(c).
197 Treas. Reg. § 25.2503-3(c), Ex. 5. PLR 8637084.
199 IRC §§2523(f)(2)(B) and 2056(b)(7)(B)(ii).
IF THE GRANTOR RETAINS THE TESTAMENTARY RIGHT TO REVOKE THE ANNUITY OR UNITRUST INTEREST OF THE NONCHARITABLE INTEREST, WILL THE GIFT BE INCOMPLETE?

It is permissible for the grantor of a unitrust or annuity trust interest to retain the testamentary right to revoke the income interest of a noncharitable beneficiary.200 If the grantor retains this right, the gift will be incomplete for gift tax purposes.201 Of course, in that event, the transfer would be subject to estate taxation on the donor’s death.202 A completed gift will take place, however, in each year of the grantor’s life that a distribution is made to the noncharitable beneficiary.

If the donor is the first beneficiary and another noncharitable person is the successive beneficiary, retaining a testamentary power to revoke may be a useful technique for postponing the gift tax.

IS A GIFT TAX DEDUCTION ALLOWED FOR THE GIFT OF THE REMAINDER INTEREST TO CHARITY?

A gift tax deduction is allowed for the gift of the remainder interest to charity,203 but in the case of a split interest gift, only if the gift is to a qualifying annuity trust, unitrust or pooled income fund.204 Unlike the case with the income tax deduction, there is no percentage limitation.

The gift is not complete, however, if the donor retains the powers to alter it or to name new charitable or noncharitable beneficiaries.205

MUST THE VALUE OF THE REMAINDER INTEREST BE PRESENTLY ASCERTAINABLE AND SEVERABLE FROM THE NONCHARITABLE INTEREST?

The regulations disallow a charitable deduction for a remainder interest unless it is presently ascertainable and severable from the noncharitable interest.206

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202IRC §2036(a) and 2038(a).
203IRC §2522(a).
204IRC §2522(c)(2)(A).
205PLRs 8102104, 7948024.
MUST THE CHARITY QUALIFY UNDER BOTH IRC §170(C) AND §2422(A) IN ORDER FOR THE GIFT TAX DEDUCTION TO APPLY?

In order to qualify for the charitable gift tax deduction, the charitable remainderman must qualify under both IRC §§2522(a) and §170(c). Most charities qualify under both charities, but there are a couple of odd exceptions (e.g., cemetery organizations qualify for the income tax but not the estate or gift tax deduction).

IF A CHARITY RECEIVES A PORTION OF THE ANNUITY OR UNITRUST AMOUNT, IS A CHARITABLE GIFT TAX DEDUCTION FOR THIS PORTION ALLOWED?

If the charitable remainderman also is to receive a portion of the annuity or unitrust interest, no estate or gift tax deduction is allowed with respect to that interest.

CAN THE INCOME BENEFICIARY RECEIVE A GIFT TAX DEDUCTION IF SHE ASSIGN HER INTEREST TO CHARITY?

The IRS has allowed a gift tax charitable deduction for the value of an annuity or unitrust interest assigned to charity under certain conditions.

IS AN ESTATE TAX DEDUCTION ALLOWED FOR THE GIFT OF THE REMAINDER INTEREST TO CHARITY?

An estate tax deduction is allowed for the gift of the remainder interest to a charity described in §2055(a), but in the case of a split interest gift, only if the gift is to a qualifying annuity trust, unitrust or pooled income fund. As was the case with the gift tax deduction, but unlike the case with the income tax deduction, there is no percentage limitation.

The charities described in IRC §2055(a) are similar, but not identical, to those described in §170(c) or §2522(a), which keeps life interesting.

210IRC §2055(a).
ARE THERE ANY SPECIAL RULES APPLICABLE TO THE ESTATES OF NONRESIDENT ALIENS?

Rules similar to those of U.S. citizens apply to estates of nonresident aliens.\(^{212}\)

DO THE SPLIT INTEREST TRUST RULES APPLY TO A REMAINDER INTEREST IN A PERSONAL RESIDENCE?

If a remainder interest in a personal residence is left to charity, most of the special rules otherwise applicable to CRTs do not apply. If the interest is not in trust, see IRC §§2055(e)(2) and 170(f)(3)(B)(i) and Treas. Reg. § 20.2055-2(e)(2)(ii). If the interest is in trust, §2055(e)(2)(A) applies, but not the other special rules.

WHAT HAPPENS IF CHARITY TAKES AN IMMEDIATE INTEREST UNDER A NONQUALIFYING TRUST AS A RESULT OF A SETTLEMENT AGREEMENT?

The IRS has ruled that an estate tax charitable deduction is available where the remainder interest in a nonqualified charitable remainder trust was accelerated as the result of a settlement of a bona fide will contest.\(^{213}\)

HOW DO THE EXISTENCE AND PAYMENT OF ADMINISTRATION EXPENSES AFFECT THE CHARITABLE ESTATE TAX DEDUCTION?

If a CRT is entitled to equitable reimbursement because, for example, the executor took an income tax rather than an estate tax deduction for administration expenses, the right to the reimbursement is considered in valuing the gift.\(^{214}\)

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\(^{212}\)IRC §§2106(a)(2), 2106(a)(2)(E), 2056(d), 2523(i). PLR 9244013.


| **How do the tier rules operate when long term capital gain property is contributed to a CRT?** | Whether income that is distributed to the beneficiary of the annuity or unitrust interest is characterized as ordinary, capital gain, exempt, corpus, etc. is determined under the tier rules.215 |
| **Will gain be recognized by the grantor on transfer of property to a CRT?** | Gain realized on the sale of the tax-exempt bonds is not taxed to the trust because it is income tax exempt. (The two-year resale rule of Section 644 does not apply to charitable remainder trusts.216) However, if capital gain is realized by the trust and the proceeds invested in tax-exempt securities, the annual distributions are taxed to the recipient as capital gains until an amount equal to the full capital gain has been distributed. |
| **What happens if the trustee is under an express or implied obligation to dispose of the property contributed?** | Ordinarily, gain on the transfer of appreciated property to a CRT will not be recognized by the grantor, unless other property besides an annuity or unitrust interest is exchanged, or unless the property is subject to a debt that exceeds its basis, in which case the bargain sales rules apply.217 |
| **Is the beneficiary of the unitrust or annuity interest ever entitled to take a depreciation deduction?** | If the trust invests in depreciable property, the depreciation deduction may inure to the noncharitable beneficiaries.219 |

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215IRC §644(e)(3).
216IRC §644(e)(3).
219IRC §167(d); see also PLRs 8610067, 9030042, 9030041, 8931019, 8931020.