

## **F. Trust Primer**

by

**Elise Lin, Ron Shoemaker and Debra Kawecki**

### Introduction

The trust instrument can be a pretty powerful piece of paper. The trust form has always been considered as one of the foremost developments in the common law because of its flexibility. This flexibility allows the trust instrument to serve a number of tax planning purposes. With a little planning, a trust can create a current charitable tax deduction, avoid capital gains tax on the sale of appreciated assets, and significantly lower estate tax. For this reason, trusts are a common estate planning tool.

The Code recognizes this and provides several provisions designed specifically for estate planning. The Code frequently permits trusts with charitable interests to achieve legitimate estate planning goals. However, planners with a variety of tax objectives have used trusts to generate tax-free savings in conjunction with compensation arrangements, pension planning, and education savings. Because uses are not always appropriate, Congress and the Service have occasionally had to step in when tax planning borders on tax evasion. In many of these situations charitable objectives are decidedly subordinate to the desire to avoid capital gains tax or to control an asset into succeeding generations.

Financial advisors function in a highly competitive market. Thus, it is not surprising that some plans may promise more tax savings than they should. To effectively deal with these abusive, often highly-promoted situations, the Service is expanding its abusive trust program so that local units will be in place to coordinate the use of IRC 6700 penalties for abusive trust promotions at the local level. The 1999 CPE, Topic M; discusses using the IRC 6700 tax shelter promotion penalty when promoters market plans that misuse the IRC 170 charitable contribution deduction.

This article describes how IRC 4947 applies the Chapter 42 private foundation excise taxes to trusts that take advantage of charitable deductions. IRC 4947 controls the application of the private foundation excise tax rules contained in Chapter 42 of the Code to both nonexempt charitable trusts and trusts with both charitable and noncharitable interests, entities that can be complex. This article starts with basic trust concepts and then discusses charitable remainder trusts and charitable lead trusts. It also describes emerging IRC 4947 trust issues.

## **Part I - Basic Trust Principles**

### 1. Overview

In the simplest terms, a trust is a three-party arrangement in which the founder of the trust (commonly known as the donor, grantor, or settlor) transfers legal title of the trust property (a res) to a trustee (a fiduciary with respect to the property) to hold and to manage for a third party (the trust's beneficiary) in accord with the grantor's intent. The beneficiary holds beneficial title to the property. A trust can be created either during the grantor's lifetime or at his or her death by an instrument such as a will that takes effect at death.

Some essential trust terms are:

**Grantor** - The grantor is also known as the trustor, settlor, or founder. The grantor is the person who transfers the trust property to the trustee.

**Trust Property** - A trust must have some assets, even if only one dollar. Trust property includes assets like cash, securities, real property, tangible personal property, and life insurance policies. The assets can be either transferred during life of the grantor ("inter vivos") or at his or her death ("testamentary"). The trust property is also referred to as the corpus, principal, estate or trust res.

**Trustee** - The trustee is the individual or entity responsible for holding and managing the trust property for the benefit of the beneficiary. Trustees can be a corporate fiduciary or any competent individual who is not a minor. The trustee holds the legal title to the trust property. As such, the trustee has a fiduciary duty to the beneficiaries with respect to the trust property. In the event of a breach of fiduciary duty, a trustee may be held personally liable. Such breaches include failing to pay out distributions or misappropriation.

**Beneficiary** - The beneficiary is the individual or entity who will receive the benefits of the trust property. The beneficiary holds the beneficial title to the trust property. The trust document must clearly identify the beneficiary or beneficiaries.

### 2. Purpose of the Trust

Every trust must have a legal purpose. The purpose is distinct from the grantor's motives or objectives in establishing a trust. For example, a trust can benefit a specific beneficiary and achieve tax benefits for the grantor. Benefiting the beneficiary is the

trust's purpose. Achieving certain tax objectives might be the primary motive of the donor, but it is not the purpose of the trust.

Trusts can provide advantages for estate, financial, personal or business purposes, including:

1. Giving a beneficiary the benefit of property, such as the income generated by property, with the property going to a successor beneficiary upon a contingency such as the initial beneficiary's death;
2. Enabling the grantor to delay payments of assets to beneficiaries until after they reach the age of majority. A trust can provide partial distributions to a beneficiary and delay the ultimate distribution to the beneficiary to an age well beyond majority;
3. Protecting a beneficiary "from himself." These trusts, commonly called "spendthrift trusts", give the trustee the power to withhold payments to the beneficiary in case the beneficiary has legal judgments or claims against him or her. The beneficiary's creditors generally cannot reach assets in the trust.

### 3. Tax Law Concepts

#### A. Simple Trust

A simple trust must distribute all its income currently. Generally, it cannot accumulate income, distribute out of corpus, or pay money for charitable purposes. If a trust distributes corpus during a year, as in the year it terminates, the trust becomes a complex trust for that year. Whether a trust is simple or complex determines the amount of the personal exemption (\$300 for simple trusts and \$100 for complex trusts), that applies in calculating the tax owed.

#### B. Complex Trust

A complex trust is any trust that does not meet the requirements for a simple trust. Complex trusts may accumulate income, distribute amounts other than current income and, make deductible payments for charitable purposes under section 642(c) of the Code.

#### C. Grantor Trust

A grantor trust is a trust over which the grantor has retained certain interests or control. The grantor trust rules in IRC 671-678 are anti-abuse rules. They prevent the grantor from taking tax advantages from assets that have not left his or her control. The

anti-abuse rules treat the grantor as owner of all or a portion of the trust. The grantor is subject to tax on trust income so treated even if he or she does not actually receive the income.

#### D. Revocable Trust

If the grantor retains the ability to revoke the trust and revest the trust assets in the grantor, the trust is revocable and the income is taxable to the grantor under the grantor trust rules. Assets in a revocable trust are included in the grantor's gross estate for federal estate tax purposes.

Revocable trusts also called living trusts, are one of the more frequently misunderstood trust concepts. They are used primarily as a will substitute. Assets in trust avoid the cost, time, expense, and publicity of probate.

Because a revocable trust may be a will substitute, it may provide for direct gifts to charity as well as establishing a split interest trust, a charitable remainder trust, or a charitable lead trust. For example, a revocable trust may establish a charitable remainder trust upon the grantor's death to benefit a surviving spouse or child. The noncharitable beneficiary can receive an income payment for life, or for a term of years. The remainder will pass to charity at the death of the noncharitable income recipient or the end of the term.

Similarly, a grantor may use a will or a revocable trust to establish a charitable lead trust, with an interest for charity during a term of years or for the life of certain individuals, and the remainder to the grantor's spouse, child or other heir.

#### E. Irrevocable Trust

An irrevocable trust is one that, by its terms, cannot be revoked.

### **Part II - IRC 4947**

The Tax Reform Act of 1969 imposed a new tax plan on charitable organizations and charitable giving. Congress was responding to abuses, particularly from charities controlled by limited (typically family) interests. The most significant changes are the distinction between public charities and private foundations, and the excise taxes in Chapter 42 of the Code that apply to restrict the activities of private foundations. The provisions of Chapter 42 are anti-abuse rules designed to insure private foundations operate to achieve charitable purposes rather than benefit the limited interests that control them.

Private foundations are not the only narrowly controlled entities that enjoy tax advantages available for charitable giving. Trusts with only charitable beneficiaries and trusts with both charitable and noncharitable beneficiaries enjoy the benefit of tax deductible contributions. These trusts are also subject to the same abuses that led to the imposition of Chapter 42 on private foundations. The benefits sought by the private foundation reforms of the Tax Reform Act of 1969 would have been substantially undercut if charitable and split interest trusts were not also subject to the anti-abuse rules.

IRC 4947 subjects trusts with charitable interests to some or all of the Chapter 42 excise taxes. It is a “loophole” closer. Without it, narrowly controlled foundations could achieve most of the benefits of tax exempt status without the safeguards created by the Chapter 42 excise taxes. In calculating the taxable income of a trust, an unlimited charitable deduction is available. Thus a charitable trust not exempt under section 501(c)(3) would not pay tax or pay very little tax after deducting its charitable contribution.

IRC 4947(a)(1) provides that nonexempt charitable trusts will be subject to all Chapter 42 excise taxes. A nonexempt charitable trust has assets held in trust for charitable beneficiaries only. There are no noncharitable interests. A nonexempt charitable trust can be created during the life of the grantor or to take effect at the grantor's death. The trustee may see no benefit in applying for exemption under section 501(c)(3) but because of IRC 4947, the trust is subject to Chapter 42. A split interest trust described in IRC 4947(a)(2) has both charitable and noncharitable interests. In a charitable remainder trust, noncharitable interests terminate when the person or persons holding the life interest dies or when the specified term of years is completed. After a reasonable period of settlement, these trusts if they continue in existence rather than terminate are no longer split-interest trusts. They have metamorphosed into nonexempt charitable trusts now subject to all of Chapter 42.

A charitable lead trust is also subject to IRC 4947. Unlike charitable remainder trusts, the charitable lead trust pays the charity a stream of payments with the remainder going to individual beneficiaries. In certain tax planning situations, the lead trust can provide advantages to the grantor.

#### 1. IRC 4947 (a)(1) Trusts

The nonexempt charitable trust is subject to all Chapter 42 private foundation provisions as well as IRC 507 through IRC 509. The split-interest trust is never subject to IRC 4940 and IRC 4942 and only rarely to IRC 4943 and IRC 4944. The statute reads that a nonexempt charitable trust will be treated as an organization described in IRC 501(c)(3), thus subjecting it to all of Chapter 42. While treated as if it were described in IRC 501(c)(3) for certain purposes, the nonexempt charitable trust is not actually tax exempt by virtue of IRC 501(c)(3).

A nonexempt charitable trust is subject to the rules of IRC 4947(a)(1) if it:

- (1) Is a trust which is not exempt from taxation under section 501(a), and
- (2) All of the unexpired interests are devoted to one or more exempt purposes described in IRC 170(c)(2)(B), and for which a charitable deduction was allowed under an income tax, estate tax, or gift tax provision. Reg. 53.4947-1(b)(1).

This is a complicated way of saying that IRC 4947(a)(1) applies to trusts with only charitable beneficiaries and the grantor or the grantor's estate took a charitable deduction. Often, nonexempt charitable trusts apply to the Service for a ruling on public charity status, usually under IRC 509(a)(3). Care needs to be taken to determine that the trust's assets are devoted solely to purpose described in IRC 170(c)(2)(B). For example, if a trust were paying out part of its income for political purposes it would not meet the definition of IRC 4947(a)(1) and could not receive a favorable ruling under IRC 509(a)(3). Of course, contributions to the trust should not have been deductible under IRC 170 but the public charity ruling may be the first time the Service sees the trust instrument.

## 2. IRC 4947(a)(2)

Split-interest trusts are a common income and estate planning tool to reduce taxes for persons who are also charitably inclined. There are a number of different types of split interest trusts. Charitable remainder trusts, charitable lead trusts and pooled income funds.

Split-interest trusts are often promoted by charities with the charity serving as the trustee. This is not required. For charitable remainder trusts and charitable lead trusts, there is no requirement that the named charity even know of its impending gift. A charity does not have to be specifically named as the remainderman at the time the charitable remainder trust is created. The remainderman can be described by class (such as any organization exempt under section 501(c)(3) of the Code). The specific remainderman may be chosen at a later date by a trustee, with the specific power to choose the remainder beneficiary. A private foundation controlled by the grantor's family can be the remainder beneficiary. This may effect the size or timing of the grantor's charitable deduction.

Charitable remainder trusts have been discussed in a number of recent EO CPE Texts. See FY 2000 CPE Text, Topic P, paragraph 3.B. (page 226); FY 1999 EO CPE Text, Topic P, paragraphs 3.B. (page 319), 6. (page 331), and 7. (page 333).

A charitable remainder trust is generally exempt from tax under IRC 664 of Subchapter J, not under 501(a). Exemption under section 501(c)(3) would not be appropriate because of the private interest present in each split interest trust.

### 3. Charitable Remainder Trusts, IRC 664

#### A. In General

Like Chapter 42, IRC 664 and related provisions (IRC 170(f), 2055(e), and 2522(c)) were enacted as a part of the Tax Reform of 1969. See section 201(a), (d), and (e) of the Act.

#### B. Current Beneficiary and Remainder Beneficiary

A charitable remainder trust consists of two distinct components:

- (1) A private interest in the form of a right to a stream of payments from the trust for life or a term certain (not in excess of 20 years). A charity may be the recipient of part of the annuity or unitrust amount so long as there is at least part of the amount going to a noncharitable beneficiary each year. For simplicity, the recipient of the annuity or unitrust amount is referred to as the noncharitable beneficiary and,
- (2) A charitable interest in the assets remaining in the trust payable to an organization(s) described in IRC 170(c) at the expiration of the preceding non-charitable interest. A charitable remainder trust is irrevocable.

#### C. Two Types of Charitable Remainder Trusts

The charitable remainder trust takes two forms; (i) the charitable remainder annuity trust (CRAT) and (ii) the charitable remainder unitrust ("CRUT"). IRC 664(d)(1) and 664(d)(2) and (d)(3), respectively. The primary distinction between the CRUT and the CRAT is the manner used to determine the amount of the payment to the noncharitable beneficiary.

#### D. Charitable Remainder Annuity Trust

A charitable remainder annuity trust pays a specific amount of money to the noncharitable beneficiary every year. The annuity can be either a stated dollar amount or a fixed percentage of the fair market value of the assets on the date contributed to the trusts. The annuity may not be less than 5 percent. For transfers after June 18, 1997, the

annuity may not be greater than 50 percent of the fair market value of trust assets as of the date of the transfer of assets to the trust. See IRC 664(d)(1).

The payout does not vary and it does not matter how much income is earned by the trust during the year. If assets held by the trust are producing substantial gains, the noncharitable beneficiary will not benefit. If income is insufficient to support the payout the difference is made up from the principal of the trust. Because the annuity is fixed, the noncharitable recipient receives no benefit from any appreciation in trust assets from year to year. The amount that will actually pass to the charity cannot be determined until the expiration of the noncharitable interest. However, the present value of the remainder interest is determined at the time of the contribution using actuarial tables. If the assets have been appreciating, the charity will benefit. If the corpus has been invaded to pay the annuity to the noncharitable beneficiary, there may be little left for the charity.

E. Charitable Remainder Unitrust

The charitable remainder unitrust pays a fixed percentage (of not less than 5 percent) of the net fair market value of its assets valued annually and for transfers after June 18, 1997, not more than 50 percent. The unitrust payout will be different each year because the payout is based on an annual valuation. IRC 664(d)(2). If the value of the unitrust assets increases, the payout to the noncharitable beneficiary will increase. The advantage of the unitrust over the annuity trust to the noncharitable beneficiary is that the unitrust serves as a hedge against inflation.

As with the annuity trust, the amount the charity will actually receive can not be determined until the noncharitable interest terminates.

F. NICRUTs and NIMCRUTS

Two varieties of CRUTS are permitted under the Code. They can be used to avoid the invasion of corpus when the trust's income is not sufficient to make the unitrust payment. Both the NICRUT and the NIMCRUT permit the trustee to pay the lesser of the fixed percentage or the trust's actual income. NIMCRUT stands for net income with make-up charitable remainder unitrust. This type of trust pays to the noncharitable beneficiary the lesser of:

- (1) The fixed percentage (not less than 5 percent nor more than 50 percent) of net fair market value of assets of the trust valued annually (the same as the CRUT) or
- (2) The amount of the actual trust accounting income (not tax income) for the year. IRC 664(d)(3).

If the trust income is less than the fixed percentage amount for any given year, a shortfall is created because the beneficiary is getting less than the fixed percentage amount. The amount of shortfall may be "made up" in a later year.

Trust A has a unitrust payout of 5%. In year 1 through 4, the trust has no net income and the unitrust payout is \$0.00. In year 5 the trust earns 8%. The extra 3% can be used to make-up the short fall.

The make-up must come from extra trust accounting income, not from principal. The NICRUT is the same as the NIMCRUT except there is no make-up provision

The NIMCRUT is commonly used when the donor wants to place property that does not produce regular income and is not readily marketable into a charitable remainder unitrust. Grantors often use a NIMCRUT to hold real estate and stock or other interests in a closely held business. If the grantor were to donate only unimproved real estate to a regular unitrust, the trust would earn no income and part or all of the real estate would need to be sold in order to make the fixed payment to the noncharitable recipient. This would probably not achieve the grantor's goal, which most likely was to hold the property in trust while it appreciated. By using a NIMCRUT, the payment to the income beneficiary is \$0.00, the lesser of the unitrust percentage amount or the trust accounting income. An expensive and, perhaps, fruitless effort to sell part of the trust property is avoided. In this scenario, either a NICRUT or a NIMCRUT will do.

The NIMCRUT will be used by grantors who wish to have small current income payments and larger payments in the future.

Grantor is 50 years old and is contemplating retiring in 10 years. He owns a parcel of appreciating real estate. He is in a high tax bracket and does not currently need any income. He places the property in a NIMCRUT. It makes no current payment to him, as it has no income. This continues for 10 years. In year ten he retires and the trustee sells the property. The settlement is used to invest in income producing assets. The trust now pays him the unitrust percentage, which is 7%. The trust is making 11%. The makeup provision of the NIMCRUT can now be used to pay him additional payments to make up the payments that were not received in the earlier years. He now has additional retirement income at a time when he may be in a lower tax bracket.

#### G. Flip Unitrust

An other variety of unitrust is called the "flip" trust. This trust starts out as either a NICRUT or a NIMCRUT. On the occurrence of a specific event set forth in the trust document, it "flips" or converts automatically to a straight fixed percentage unitrust.

A and B, husband and wife, want to be able to help fund the college expenses of their granddaughter, C. C is 10 years old. A and B own property that is currently appreciating without producing income. They are advised to set up a flip unitrust. The unitrust amount is set at 10%. For the first 8 years the trust will be a NIMCRUT. C is the beneficiary but she receives no income during the 8 year NIMCRUT period. The triggering event to flip the trust is C's 18<sup>th</sup> birthday. The property has significantly appreciated in value. It is sold and the proceeds are invested in income producing assets.

Any trust accounting income received during the year of C's 18<sup>th</sup> birthday that exceeds the 10% unitrust amount may be paid to C under the IRC 664(d)(3)(B) make-up provisions upon the flip to a standard fixed percentage unitrust, any unpaid makeup amount is forfeited. The trust assets have greatly appreciated in value so that the 10% received by C should be sufficient to fund her college expenses. Even if the trust income is not sufficient, because the trust is now a regular CRUT, corpus can be invaded to pay the unitrust amount. A and B will get a charitable deduction based on the present value of the remainder interest upon setting up the trust, but, the present value of C's unitrust interest will be subject to gift and generation skipping transfer tax. They will not have to pay capital gains on the sale of the property. Income from the trust will be taxed at C's lower tax rate. The property will be removed from A and B's estate, lowering their estate tax.

Reg. 1.664-3(a)(1)(i)(c) provides the authority for the flip provision. Specifically, that regulation permits the net income method for a unitrust for an initial period and then fixed percentage amount for the remaining period of the trust only if the governing instrument provides for certain conditions. These conditions include the requirement that the change in unitrust payment method is triggered on a specific date or by a single event whose occurrence is not discretionary with, or in the control of, the trustees or any other persons. Reg. 1.664-3(a)(1)(i)(d) provides that the sale of unmarketable assets, or the marriage, divorce, death, or birth of a child are permissible triggering events because they are not considered to be discretionary with any person. This list is not all inclusive.

There are provisions in the regulations for the effective date of the "flip" provision that are complex and beyond the scope of the article. But, the reformation of a trust to add a flip provision could result in a self-dealing transaction under IRC 4941 in the absence of authority to the contrary. The issue of self-dealing under IRC 4941 was discussed in the FY 1999 EO CPE Text, Topic P, pages 333-335. It is clear that a "flip" qualifying under the requirements of the IRC 664 regulations will not constitute an act of self-dealing, including trust document reformations occurring under the effective date provisions of Reg. 1.664-3(a)(1)(i)(f).

For example, under Reg. 1.664-3(a)(1)(i)(f)(3), if a unitrust without a flip provision in its governing instrument begins legal proceedings to reform the governing instrument to add a flip provision by a certain date, it will not commit an act of self-dealing under IRC 4941 or fail to qualify as a valid IRC 664 trust. The deadline for starting the reformation proceeding, or for amending the trust if permitted, is June 30, 2000. Of course, if the governing instrument is not reformed according to the regulations, an act of self-dealing may have occurred. For additional information on the issue of the flip provision and self-dealing in the context of governing instrument reformations, see the FY 2000 CPE Text, Topic P, pages 226-229.

#### H. CRUT and CRAT Creativity

Not all CRUTS and CRATS look alike. The Grantor has a number of options in drafting the trust agreement to meet special needs.

- (1) Upon the creation of a charitable remainder trust the trust instrument can reserve a power for the noncharitable beneficiary to appoint by will the charitable remaindermen. Rev. Rul. 76-7, 1976-1 C.B. 179.
- (2) Upon the creation of an inter-vivos charitable remainder trust, the grantor may reserve a power to substitute another charity as the remainderman in place of the charity named in the trust document. Rev. Rul. 76-8, 1976-1 C.B. 179.
- (3) The charitable remainder interest need not be named in the trust document and the trustee may be vested with the power to name the charitable recipient of the remainder interest. However, all charitable remainder trusts must provide that the trustee will transfer the remainder to a qualified charitable organization if the named organization is not qualified at the time payments are to be made to it. Regs. 1.644-2(a)(6)(iv) and 1.644-3(a)(6)(iv)

**NOTE:** Contrast these rules with the more restrictive rules applied to IRC 501(c)(3) exempt organizations for designating charitable recipients subsequent to the date of the gift. Consider; (a) the material restriction or condition requirement of the community trust regulations and Regs. 1.507-2(a)(8); (b) the limited rights under IRC 170(b)(1)(E)(iii) for pooled common funds; and (c) the limits for naming charitable recipients under the organizational test for supporting organizations. See Rev. Rul. 79-197, 1979-1 C.B. 204.

- (4) The donor may be named as trustee or retain the power to substitute himself as trustee. Rev. Rul. 77-285, 1977-2 C.B. 213. However,

only an independent trustee may have the power to allocate the annuity or unitrust amount among the various named recipients. Rev. Rul. 77-73, 1977-1 C.B. 175. The donor may not retain the power to name himself as trustee when the trustee has the power to allocate the annuity or unitrust amount among the various named recipients. Rev. Rul. 77-285.

- (5) The noncharitable interest is payable to "persons". The term "persons" is defined to include a trust, estate, partnership, association, company, or corporation (See IRC 7701(a)). If the income recipient is not an individual (or combination of individual and charity) the term of the trust must be a term of years, not more than 20 years.
- (6) Payment of the annuity or unitrust amount may be made to the guardian of a minor. The payment of a portion of the annuity or unitrust amount may be made to an IRC 170(c) charitable recipient. Regs. 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i). The trust document may also provide the trustee with the discretion to distribute a portion of the annuity or unitrust amount to a charitable recipient. In all cases there must be at least one noncharitable recipient of the annuity or unitrust amount. IRC 664(d)(1) and (2).
- (7) It is not uncommon that the annuity or unitrust payment is payable, in succession, to the grantor and the grantor's spouse for life. The grantor may reserve the right to revoke, by a direction in the last will and testament, his or her spouse's income right in the trust. Rev. Rul. 74-149, 1974-1 C.B. 157. The reservation of a power of revocation by the grantor-spouse is also not uncommon.
- (8) Charitable remainder trusts are funded with many different types of assets. It is a common practice to fund the trusts with appreciated assets. As discussed above, the sale of appreciated assets by the trust is not taxable with respect to the trust.
- (9) An inter vivos charitable remainder unitrust, created during the life of the grantor, may receive additions to the trust assets by transfers of property made during the grantor's life or at his death by a provision in his will. Rev. Rul. 74-149. Additional property contributions may not be made to a charitable remainder annuity trust. Regs. 1.664-2(b).

- (10) Charitable remainder trusts are commonly established during the grantor's lifetime under a trust document. More infrequently, charitable remainder trusts are established at death under a provision of the decedent's last will and testament. A revocable trust can also be used, which creates a charitable remainder trust at death. The Service has published, in several revenue procedures, sample documents of provisions that meet the requirements of IRC 664 and the regulations.
- (11) The trust may satisfy the annuity or unitrust amount by making a distribution of property rather than cash. A property distribution to satisfy the annual payout requirement is treated as a sale or exchange by the trust. Regs. 1.664-1(d)(5).

#### 4. Tax Benefits of Charitable Remainder Trusts

A number of tax benefits are associated with charitable remainder trusts:

- (1) The donor of a lifetime gift generally receives a current income tax deduction under IRC 170 even though the trust principal may not be distributed to charity for many years.
- (2) The trust is generally exempt from tax on the income earned by the trust.
- (3) The grantor has a choice.
  - a. Sell the property first, pay the tax and put cash in trust.
  - b. Place the asset in trust and have the trust sell it without paying tax.

If the grantor transfers appreciated property to a CRUT (CRATS don't work as well), a subsequent sale of the property by the trust will usually not be taxable to the trust. Thus, a tax-free sale by the trust increases corpus, which increases the income available to the recipient of the unitrust amount.

Although the trust is generally exempt on the income it earns under IRC 664(c), the annuity or unitrust payments distributed to the noncharitable recipient may be taxable to the recipient. The distributions are characterized as ordinary income, capital gain income, other income, or as a distribution of trust principal under ordering rules for establishing priorities under IRC 664(b). Thus, the noncharitable recipient is taxed on

amounts received from the trust to the extent that the trust has current or previously undistributed ordinary or capital gain income

## 5. Charitable Lead Trust

A charitable lead trust (CLT) pays the charity first. It is defined in IRC 170(f)(2)(B). IRC 4947(a)(2) applies to a charitable lead trust. There is an annuity version and a unitrust version. The charitable lead trust is a split-interest trust that is the reverse of the charitable remainder trust. In the charitable lead trust, the charitable payment is a guaranteed annuity or fixed percentage of fair market value of trust property, valued annually, payable to charity for a term of years or for the life or lives of specified individuals. Charity comes first. The remainder interest in the trust is paid to private interests, often the grantor or the grantor's heirs.

A CLT can be either a grantor trust or a complex trust.

- (1) Non-grantor CLT. The income from this trust is taxed to the trust not the grantor. The grantor does not get an income tax charitable deduction for the transfer to the trust. The trust is entitled to a charitable deduction for any amount of gross income paid to a charity during the year. This trust is mostly used to avoid transfer taxes.
- (2) Grantor CLT. The income from the trust is taxed to the grantor but the grantor gets an income tax charitable deduction for the present value of the annuity or unitrust interest at the time the assets are transferred. This must be an inter vivos trust because the income has to be taxed to the grantor.

The reason CRATS are not preferred over CRUTS is that an annuity, being fixed, benefits the charitable remainderman because the income beneficiary does not share in the appreciation of the trusts assets. In lead trusts, charitable lead annuity trusts are usually preferred rather than charitable lead unitrusts. The grantor wants to benefit the remainderman because the remainderman is the grantor or the grantor's designee. A charitable lead annuity trust pays out a uniform payment to the charity. Any appreciation remains in the trust to benefit the remainderman.

## 6. Pooled Income Fund

A pooled income fund is established and maintained by a public charity, that

- (1) Pays income to the grantor or an individual beneficiary named by the grantor; and

- (2) Passes the remainder interest to charity.

The grantor contributes property to a commingled fund established and maintained by a charitable organization. Income earned by the fund is paid out yearly to each donor or other named beneficiary in proportion to the assets contributed. On the death of the donor or other named income beneficiary, a portion of the assets attributable to the income interest is severed from the fund and transferred to the charity.

There are a number of important differences between a charitable remainder trust and a pooled income fund.

- (1) For the pooled income fund, the income beneficiary receives his full proportionate share of all trust accounting income earned by the pooled fund
- (2) There is no predetermined annuity or fixed percentage payment amount.
- (3) Because the payment is based on income, there is never any invasion of corpus. If the fund earns no income, it makes no payment for the year.
- (4) The pooled income fund is managed by the exempt organization (usually with the assistance of a professional investment company). A CRT can be trustee or managed by virtually anyone, including the grantor.
- (5) From the grantor's perspective, a CRT is much more flexible but a PIF has the advantage of simplicity.

#### 7. 4947(a)(1) and (a)(2) the Private Foundation Issues

All the split-interest trusts identified above are subject to IRC 4947(a)(2). Under IRC 4947(a)(2), a split interest trust is subject to IRC 507, IRC 508(e), IRC 4941, IRC 4945, and, in some cases, IRC 4943 and IRC 4944.

IRC 4947(b)(3) provides rules for excluding a split-interest trust from IRC 4943 and IRC 4944. IRC 4943 and 4944 do not apply to most split-interest trusts because of this exclusion. The calculations called for in IRC 4947(b)(3) must be made to determine if IRC 4943 and 4944 will or will not apply.

### **Part III - UBI**

A charitable remainder trust that realizes any amount of unrelated business income, as defined in IRC 512, is taxed as a complex trust for that year. Regs. 1.664-1(c). Typically, IRC 514 creates the problem, as a trust has debt financed income if it takes property subject to a mortgage. There are two exceptions.

- (1) A trust will not have UBI for a period of ten years following a gift as long as it does not assume the debt.
- (2) An inter vivos trust will not have UBI for a period of 10 years following a gift as long as the debt was placed on the property for more than 5 years from the making of the gift and the debt is not assumed.

Many situations, such as borrowing on an insurance policy, or receiving income from a working gas and oil interest, create UBI. Because unrelated debt financed income can arise after the creation of the trust, a trustee without a tax background may not be aware of these complex rules.

The treatment of unrelated business taxable income to a charitable remainder trust was the subject of recent Court of Appeals opinion. The trust received unrelated taxable income through no action of its own. Leila G. Newhall Unitrust v. Commissioner, 105 F.3d 482 (9<sup>th</sup> Cir. 1997) concerns the treatment of a charitable remainder unitrust trust which received unrelated business taxable income. The trust was a shareholder in a publicly traded company. In 1983 the company underwent a partial liquidation and transferred certain of its assets to two newly formed publicly traded limited partnerships. The trust received interests in the two limited partnerships. There was an additional transfer of publicly traded partnership interest when the company completely liquidated. IRC 512(c) requires that partnership income be included in unrelated business taxable income (“UBTI”) if the conduct of the partnership’s business directly by the organization would have resulted in UBTI. IRC 664(c) provides that a charitable remainder antitrust shall be exempt from tax unless that trust has UBTI. Sec. 1.664-1(c), Income Tax Regs., states that a charitable remainder unitrust that receives UBTI is taxable on all of its income. The Court concluded that the trust had partnership income that was subject to unrelated business income tax and thus it was taxable as a complex trust on all of its income and not merely to the extent of UBTI.

## **Part IV - Estate Administration**

### **1. An Exception to Self-dealing**

IRC 4941, which provides that any sale, exchange or leasing of property between a private foundation and a disqualified person is an act of self-dealing, could make it vary difficult to administer an estate.

For example, an individual's will or trust may establish several trusts to be administered after the grantor's death. The testator may have specified the assets to be used to fund each bequest but the choices may not be appropriate to achieve the testator's intent. Or the testator may not make any specific bequest, giving the residue of his or her estate to charity after the specific bequests.

Testator A bequeathed \$100,000 to his wife and a piece of unimproved real estate of equivalent value to private foundation Z, of which A was the creator and manager. In keeping with state law and to meet the needs of the private foundation and the spouse, the executor exercises his power and distributes the \$100,000 cash to the foundation and the real estate to A's wife.

The spouse and the private foundation are both pleased with the outcome, but has an indirect act of self-dealing occurred? The regulations under IRC 4941 specifically provide an exception to the general rules on self-dealing to ease estate administration.

The term "indirect self-dealing" shall not include a transaction with respect to a private foundation's interest or expectancy in property . . . held by an estate (or revocable trust, including a trust which has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if-

This exception applies if certain specific conditions are met. The purpose of the exception is to allow flexibility to shift assets during administration of the estate to facilitate the carrying out of the decedent's intent provided in the will or revocable trust instrument. One important condition for the application of this exception is that exchanges of assets must be at equal fair market values. Reg. 53.4941(d)-1(b)(3)(iv). The other requirements for qualifying for the estate administration, found generally in Reg. 53.4949-1(b)(3)(i) through (v), are as follows:

- (i) The administrator or executor of an estate or trustee of a revocable trust either, possesses a power of sale with respect to the property, has the power to reallocate the property to another beneficiary, or is required to sell the property under the terms of any option subject to which the property was acquired;

- (ii) Such transaction is approved by the probate court having jurisdiction over the estate (or trust);
- (iii) Such transaction occurs before the estate is considered terminated for federal income tax purposes;
- (iv) The estate (or trust) receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate or trust.
- (v) With respect to transactions occurring after April 16, 1973, the transaction either:
  - (a) Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up,
  - (b) Results in the foundation receiving an assets related to the active a carrying out of its exempt purposes, or
  - (c) Is required under the terms of any option, which is binding on the estate (or trust).

## 2. A Clarifying Point

Reg. 53.4941(d)-1(b)(3) can be confusing because it refers to a "revocable trust". In reading this paragraph, treat the term "revocable trust" as a trust that has become irrevocable upon the testator's death. Because trusts and estates have a period of existence during which the testator's affairs are wrapped up, the subject of the termination of revocable trusts as well as split-interest trusts under IRC 4947 is discussed in detail in the following section.

## 3. An Act of Self-dealing

The following situation constitutes an act of self-dealing, because the estate administration exception does not apply.

- (1) A revocable trust is winding up its affairs during a reasonable period of settlement.
- (2) It purchases property for less than fair market value from a private foundation.

(3) The trust is a disqualified person to the foundation under IRC 4946.

The exception is not available because of the below market rate sale.

4. Rockefeller v. U.S., constitutionality confirmed

The possibility of self-dealing and the estate administration exception was pivotal in Rockefeller v. United States, 718 F.2d 290 (8<sup>th</sup> Cir. 1983), cert. den. 466 U.S. 962 (1984), in which the court considered a case where the Service imposed a self-dealing penalty on an executor. On February 22, 1973, Winthrop Rockefeller died. Pursuant to the terms of his Last Will and Testament, dated November 14, 1972, he left the residue of his estate to a charitable trust created under his Will. The Will contemplated that property known as Winrock Farms would constitute a substantial part of the residue and would compose a substantial part of the trust.

On September 30, 1975, plaintiff, the son of Winthrop Rockefeller, and the executor of the estate of Winthrop Rockefeller, executed an agreement with the executor of Winthrop Rockefeller's estate to purchase all the stock of Winrock Farms. The plaintiff and the estate obtained an independent appraisal of the fair market value of the Winrock Farms' stock, and petitioned the Probate Court of Conway County, Arkansas, the probate court with jurisdiction over the estate for approval of the sale. The Probate Court entered an order approving the sale at the appraised fair market value, and plaintiff purchased the stock at that value on December 19, 1975.

After auditing the estate's 1975 tax return, the Internal Revenue Service issued a report proposing certain adjustments in the estate's tax return. The proposed adjustments were based on certain findings of fact, one of which was that the sale of the stock to the plaintiff was not at fair market value. The Commissioner relied on the definition of self dealing in § 4941(d)(1), which includes indirect sales between a disqualified person and a private foundation, and failure to meet the requirements of Reg. § 53.4941(d)-1(b)(3). The plaintiff argued that IRC 4941 was unconstitutional and that even if the statute was constitutional, the regulation is unconstitutional. The Court upheld the Service, holding both the Code section and the estate administration regulation constitutional.

5. Estate of Reis, gives a broad reading to 4941

Estate of Bernard J. Reis v. Commissioner, 87 T.C. 1016 (1986) was an important win for the Service. Mark Rothko was a well-known American abstract expressionist painter who died in 1970. Bernard J. Reis, was one of the executors of his estate. Reis also was one of the directors of the Mark Rothko Foundation. In his will, after making certain specific bequests to family members, Mark Rothko bequeathed all his remaining property to the foundation.

Reis also was an officer and employee of the Marlborough Gallery, Inc. In May of 1970, shortly after Rothko's death, the executors of the estate, including Reis, entered into contracts on behalf of the estate with the gallery. The agreement provided that Rothko's paintings, which comprised the bulk of the estate's assets could be sold only by the gallery or its affiliated corporations throughout the world. The contracts were to last 12 years, and the gallery was to receive a commission of 50 percent of the proceeds from the sale of each painting.

The Service argued that because the foundation was a beneficiary under Mark Rothko's will, it had a vested beneficial interest in the property of the estate. The Service maintained that Reis' acts with respect to the property of the estate simultaneously and adversely affected the foundation's beneficial interest and constituted an indirect use of foundation assets by or for the benefit of Reis. The Service cited section 53.4941(d)-1(b)(3) of the regulations, as authority for the general proposition that acts of self-dealing with respect to property of an estate also will be regarded as acts of self-dealing with respect to assets of a private foundation that has a beneficial interest in the property of the estate.

The court agreed, explaining:

In summary, regardless of whether the foundation is considered to have had a vested or merely an expectancy interest under New York law in the property of the Mark Rothko Estate, under section 4941 and the relevant Treasury regulations, the expectancy interest the foundation had in the estate is treated as an asset of the foundation, and transactions affecting property of the estate are treated as affecting assets of the foundation. Such transactions are excepted from the definition of acts of self-dealing under section 4941 only if they qualify for the exception described in section 53.4941(d)-1(b)(3), Excise Tax Regs., or under one of the other available exceptions (e.g., the exception for transactions which provide only incidental benefits to disqualified persons).

## **Part V - Termination of an Estate Issues for Trusts and Estates**

The termination issue is important. The date of termination controls when the provisions of IRC 4947 apply. The nature of the beneficiaries determines whether IRC 4947(a)(1) or IRC 4947(a)(2) applies.

### **1. 4947(a)(1)**

Reg. 53.4947-1(b)(2)(ii) concerns the application of IRC 4947(a)(1). IRC 4947(a)(1) will apply when:

- (1) An estate distributes all its net assets to charitable beneficiaries, and
- (2) Is considered terminated for federal income tax purposes under Reg. 1.641(b)-3(a). The purpose of Reg. 1.641(b)-3(a) is to prevent an estate from continuing in existence for federal income tax purposes after it has completed all of its duties and avoiding the private foundation rules.

The estate will be treated as a charitable trust between the date the estate is considered terminated and the date of final distribution of all of the net assets to charity. It will be subject to 4947(a)(1) and all of the excise taxes under Chapter 42 of the Code.

## 2. 4947(a)(2)

Termination is also a significant issue for split-interest trusts. Regs. 53.4947-1(b)(2)(iii) permits a split-interest trust to remain subject to IRC 4947(a)(2) rather than IRC 4947(a)(1) in the following situation.

- (1) A split-interest trust where the noncharitable interests have terminated, and,
- (2) The charitable remainder beneficiaries are entitled to distributions of trust property.

The trust is still treated as a split-interest under IRC 4947(a)(2) until the date of final distribution of all of its net assets. If the trust is considered terminated for federal income tax purposes under Regs. 1.641(b)-3(b), then IRC 4947(a)(1) rather than IRC 4947(a)(2) shall apply. The difference between the two sections is significant. For example, IRC 4942 is applied to a charitable trust under IRC 4947(a)(1) but not to a split interest trust under IRC 4947(a)(2).

Grace periods for termination of other types of IRC 4947 trusts are also described in the regulations.

## **Part VI - Trusts and IRC 509(a)(3)**

The only way a nonexempt charitable trust can avoid Chapter 42 is to become a public charity. The supporting organization rules of IRC 509(a)(3) offer the most likely possibility for public charity status. Split interests trust can not qualify for exemption or public charity status until all life interests terminate because they serve private interests.

Trusts applying for 509(a)(3) status usually request classification under the “operated in connection with” relationship. Applicants will be trusts created with

exclusively charitable beneficiaries or split interests trusts where the payments to private parties have terminated.

Frequently, during bank mergers the surviving bank will discover that the trust department it acquired did not file for exempt status for hundreds of small trusts. It is questionable whether these bank trustee nonexempt charitable trusts will qualify under the "operated in connection with" test. For an in depth discussion of this issue see the 1997 EO CPE Text, Topic I.

## **Part VII - Filing Requirements**

### **1. Filing Requirements**

The returns, forms and schedules that this section refers to are the following:

Form 990, Return of Organization Exempt from Income Tax;  
Schedule A (Form 990), Organization Exempt Under 501(c)(3);  
Form 990-PF, Return of Private Foundation;  
Form 990-T, Exempt Organization Business Income Tax Return;  
Form 1041, U.S. Fiduciary Income Tax Return;  
Form 1041-A, Trust Accumulation of Charitable Amounts; and  
Form 5227, Split-interest Trust Information Return

### **2. Exempt Charitable Trusts**

Generally, exempt charitable trusts treated as public charities are required to file Form 990, Schedule A, and Form 990-T, if applicable. However, trusts whose annual gross receipts are not normally more than \$25,000 do not have to file Form 990 and Schedule A. Exempt charitable trusts treated as private foundations are required to file Form 990-PF and 990-T, if applicable.

### **3. Pooled Income Funds under 642(c)(5)**

Pooled Income Funds ("PIF") are required to file Form 5227. However, a PIF created before May 27, 1969, is not required to file Form 5227 provided no amounts were transferred to the PIF after that date. If the PIF has any taxable income, gross income of \$600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien, the PIF must file Form 1041. In addition, if the PIF is not required to distribute currently all the income to beneficiaries, then Form 1041-A must also be filed.

4. Charitable Trusts under 642(c)(6)

This type of charitable trust is treated as a taxable private foundation that must file Form 990-PF. Form 1041 must be filed if the trust has any taxable income for the tax year, gross income of \$600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien.

5. Charitable Remainder Trusts under 664

Charitable remainder trusts (“CRT”) must file Form 5227. However, a CRT created before May 27, 1969, is not required to file 5227 provided that no amount was transferred to the trust after such date. Generally, the CRT is not subject to tax and as such, is not required to file Form 1041. However, if the CRT receives unrelated business taxable income within the meaning of section 512, the CRT is subject to tax as if it were a complex trust for such taxable year and must file Form 1041. See section 1.664-(1)(c) of the Income Tax Regulations and Leila G. Newhall Unitrust v. Commissioner, 105 F.3d 482 (9<sup>th</sup> Cir. 1997), aff’g. 104 TC 236 (1995). Furthermore, if the trust is not required to distribute all the income currently to the beneficiaries, Form 1041-A must also be filed.

6. Nonexempt Charitable Trusts under 4947(a)(1)

A nonexempt charitable trust must file Form 990 and Schedule A or Form 990-PF. Form 990 and Schedule A does not have to be filed if the trust does not have annual gross receipts that are normally more than \$25,000. In addition, Form 1041 must also be filed if the trust has any taxable income, gross income of \$600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien. However, if the trust has no taxable income, Form 990 or Form 990-PF may be used to satisfy the requirements of filing Form 1041.

7. All other section 4947(a)(2) trusts treated as private foundations

These trusts must file Form 5227. However, trusts created before May 27, 1969, is not required to file Form 5227 provided no amounts were transferred to the trust after that date. Form 1041 must also be filed if the trust has any taxable income for the tax year, gross income of \$600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien. In the event that the trust is not required to distribute currently all the income to the beneficiaries, then Form 1041-A must also be filed.

## **Part VIII - Current Trust Issues**

### **1. Accelerated Trusts**

The FY 1996 EO CPE Text, Topic G discussed the accelerated unitrust issue described in Notice 94-78, 1994-2 C.B. 555. Notice 94-78 describes the scheme, as asserted by certain taxpayers as follows:

In these transactions, appreciated assets are transferred to a short-term charitable remainder unitrust that has a high percentage unitrust amount. For example, assume that capital assets with a value of \$1 million and a zero basis are contributed to the trust on January 1. Assume further that the assets pay no income and that the term of the trust is two years, the unitrust amount is set at 80 percent of the fair market value of the trust assets valued annually.

The unitrust amount required to be paid for the first year is \$800,000, but during the first year no actual distributions are made from the trust to the donor as the recipient of the unitrust amount. At the beginning of the second year, all the assets are sold for \$1 million, and the \$800,000 unitrust amount for the first year is distributed to the donor between January 1 and April 15 of the second year. The unitrust amount for the second year is \$160,000 (80 percent times the \$200,000 net fair market value of trust assets). At the end of the second year, the trust terminates, and \$40,000 is paid to the charitable organization.

Proponents of this transaction contend that the tax treatment of this example would be as follows. Because the trust had no income during the first year, the entire \$800,000 unitrust amount is characterized as a distribution of corpus under section 664(b)(4).

(Because the distribution is made before April 15, the distribution is treated as a payment of the unitrust amount for the trust's first year.)

The \$160,000 unitrust amount for the second year is characterized as capital gain, on which the donor pays tax of \$44,800 (\$160,000 times the 28 percent tax rate for capital gains). The donor is left with net cash of \$915,200 (\$800,000 from the first year and \$115,200 net from the second year). If the donor had sold the assets directly, the donor would have paid tax of \$280,000 on the \$1 million capital gain, leaving net cash of only \$720,000.

The Notice asserts that the Service will challenge transactions of this type based on a laundry list of legal theories. Congress amended IRC 664(d)(2)(A) [and 664(d)(1)(A)] to address the problem of the accelerated trust by limiting the maximum amount of the

unitrust payment amount to no more than 50 percent of the fair market value of trust assets.

Notwithstanding the new legislation or Notice 94-78, the real authority that led to the end of this type of accelerated trust abuse was new Reg. 1.664-3(a)(1)(g), which requires that payment generally be made by the end of the year.

Nothing is ever really put to rest. It comes back with a twist. Some tax professionals are advocating or promoting the revival of the accelerated charitable remainder trust in different form.

The new technique relies on the use of standard fixed payment unitrust. It is designed to meet the new 10 percent requirement of IRC 664(b)(2)(D).

- (1) The trustee will borrow a large sum against the trust assets. Assume a unitrust with assets (real estate) of \$1,000,000, a term of 4 years and a fixed unitrust amount of 48 percent .
- (2) The real estate produces no net income but is appreciating at the rate of 10 percent per year. Assume the trustee borrows in the first year the sum of \$480,000 pledged by the real estate, and the interest rate is 10 percent, payable with principal at the end of four years.
- (3) In year one, the trustee distributes \$480,000 of borrowed funds to the donor/income beneficiary as payment of his unitrust amount. The unitrust has earned no income in the first year. This is crucial to the technique because the distribution of \$480,000 is treated, by the proponent of this scheme, as a distribution from trust principal.
- (4) The unitrust payment is nontaxable to the recipient, it is asserted, because it is not a distribution of income under trust accounting principles but is a distribution of principal.
- (5) At the beginning of year 2, the net asset value of the unitrust is \$620,000 (\$1,000,000 asset plus appreciation of 10 percent or \$100,000 less the first year loan obligation distribution of \$480,000 equals \$620,000).
- (6) In year 2, the trustee borrows \$297,600 to pay the unitrust amount ( $\$620,000 \times 48\% = \$297,600$ ). According to the promoters the 2nd unitrust payment is a return of principal.

- (7) The unitrust payments will decline in future years and in some year there may be a sale so that the noncharitable beneficiary will realize some income. However, overall he has realized a substantial reduction in tax liability compared to a sale of the real estate for \$1,000,000.

Another variation of this technique is where the trustee obtains cash for payment of the unitrust amount by entering into a forward sale contract. A forward sale contract is much like a loan against the trust property. Once the property is sold, the seller is obligated to transfer property to the person who advanced the cash under the forward sale contract.

The forward sale contract is not considered as a sale at the time the cash is advanced to the property holder because the property holder has retained the benefits and burdens of ownership. Again, in this variation, the proponent of this scheme may argue that the distribution of cash by the trustee to the noncharitable beneficiary is treated as a tax free distribution of principal rather than the distribution of any income generated by the unitrust.

The Service issued proposed regulations on October 21, 1999, to address the problems caused by loans or forward sale contracts. The explanation of the proposed regulation states:

The IRS and Treasury Department are aware of certain abusive transactions that attempt to use a section 664 charitable remainder trust to convert appreciated assets into cash while avoiding tax on the gain from the disposition of the assets. In these transactions, a taxpayer typically contributes highly appreciated assets to a charitable remainder trust having a relatively short term and relatively high payout rate. Rather than sell the assets to obtain cash to pay the annuity or unitrust amount to the beneficiary, the trustee borrows money, enters into a forward sale, or other similar transaction. Because the borrowing, forward sale or other similar transaction does not result in current income to the trust, the parties attempt to characterize the distribution of cash to the beneficiary as a tax-free return of corpus under section 664(b)(4).

The explanation also discussed legislative intent:

When section 664 was amended by the Revenue Reconciliation Act of 1997, Congress indicated that a scheme that, in effect, attempts to convert appreciated assets to a tax-free cash distribution to the non-charitable beneficiary is “abusive and is inconsistent with the purpose of the

charitable remainder trust rules.” Rep. No. 33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 201 (1997).

The explanation goes on to state that under the authority provided by IRC 643(a)(7), the proposed regulations modify the treatment of certain distributions by charitable remainder trusts for purposes of section 664(b) to prevent a result inconsistent with the purposes of the charitable remainder trust rules.

The language of Proposed Reg. 1.643(a)-8(b) includes the following provisions to address the problem:

- (b) Deemed sale by trust. (1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year for which a distribution of an annuity or unitrust amount from the trust is due, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount-
  - (i) Is not characterized in the hands of the recipient as income from categories described in section 664(b)(1), (2), or (3), determined without regard to this paragraph (b); and
  - (ii) Was made from an amount received by the trust that was not-
    - (A) a return of basis in any asset sold in the trust
    - (B) Attributable to cash contributed to the trust with respect to which a deduction was allowable.

In effect, the proposed regulation will treat the proceeds from the loan proceeds or proceeds from a forward sale contract as if such proceeds resulted from a deemed sale of the appreciated asset by the trust, thus, requiring the recipient to recognize the inherent gain in the year of distribution of proceeds notwithstanding that a sale under the local law provisions may not occur until some future date. The language of the proposed Regulations also set forth certain exceptions to the rule.

## 2. Vulture Trusts

Similar to the vulture, the promoters of this form of charitable lead trust circle in on mortally ill young people. The promoter, prepared with the names and medical records of ailing young people, offers to set up a charitable lead trust using these unrelated individuals as the measuring lives for their wealthy, healthy donors. Described by critics as "the grotesque and the ghoulish", this trust takes advantage of the actuarial tables used by the Service to calculate life expectancy for gift-tax purposes. This structure yields big benefits for the donor and the donor's beneficiaries. In effect, the donor pays minimal

gift taxes, provides insignificant amounts in total payments to the named charity and transfers the remaining but significantly valuable trust assets to the donor's beneficiaries. In response to this practice, Treasury published proposed regulations this past April barring this abusive tax scheme. The new regulations limit the measuring life to the life of the grantor, the grantor's spouse, or a lineal ancestor of the remainder beneficiaries.