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**3:45 – 5:15 p.m.**

**New Developments: Charitable Remainder Trusts in the New  
Economic Environment**

**Presented By:**

**Ramsay H. Slugg, J.D.  
Senior Vice President  
National Wealth Strategies Group  
U.S. Trust, Bank of America Private Wealth Management**

# **New Developments: Charitable Remainder Trusts in the New Economic Environment**

## **I. Primer – Charitable Remainder Trusts**

### **A. Structure**

1. Irrevocable Trust (although designation of charitable beneficiary(ies) may be changed after creation)
2. Inter vivos or testamentary
3. “Income” interest
  - a. Annuity or unitrust
  - b. 5% minimum – 50% maximum
  - c. For life, lives, or term of years not to exceed 20
  - d. Present value of the remainder must be at least 10% of the principal at time of funding
  - e. 5% probability of exhaustion test
4. Many different types of CRTs
  - a. Charitable Remainder Annuity Trust (CRAT)
  - b. “Standard” Charitable Remainder Unitrust (STANCRUT)
  - c. Net Income Charitable Remainder Unitrust (NICRUT)
  - d. Net Income with Make-up Charitable Remainder Unitrust (NIMCRUT)
  - e. FLIP Charitable Remainder Unitrust (FLIPCRUT)
  - f. Inter vivos or testamentary
  - g. Add “bells & whistles”

- h. Important to follow the formalities
  - i) Sections 170(f)(2)(A), 2055(e), and 2522(c)(2)(A) require that qualifying split-interest trusts for income, estate and gift tax charitable deduction purposes must be a charitable remainder trust, charitable lead trust or pooled income fund
    - a) These rules have been in effect for 40 years, but new cases arise every year where the rules have been violated
  - ii) Galloway v United States of America, 492 F.3d 219 (3<sup>rd</sup> Cir., 2007), where an estate tax charitable deduction was denied for transfer to split interest trust with 2 individuals and 2 charities as beneficiaries
  - iii) But see PLR 200832003 (August 8, 2008) where Service permitted a testamentary trust to be reformed into a valid CRUT
  - iv) But see, ESB Financial v. United States, 2008-2 U.S.T.C. 60,567 (D.Kan. 2008), where reformation proceeding was not commenced within required 90 days after due date for the estate tax return.
  - v) See also, TAM 200840008, disallowing charitable deduction for non-qualifying split-interest trust, even though trust was timely reformed under state (Texas) law but not timely under 2055(e)(3)
  - vi) Follow the rules!

B. Common Reasons to Use

- 1. Five benefits of CRTs
  - a. Deduction - Income tax charitable deduction for the present value of the remainder going to charity, subject to limitations applicable to all charitable gifts
    - i) Public/private charity
    - ii) Type of property contributed
    - iii) Itemized deduction phase-outs

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- b. Diversify and Defer - Ability to sell an appreciated asset/diversify a portfolio without incurring current capital gains taxation
  - c. Enhanced Return – Almost without exception, donor will receive a higher current after tax return from a CRT than the donor received from the contributed asset (although donor loses access to principal)
  - d. Estate Tax Savings – Whatever remains in the CRT at donor's death is, practically speaking, not subject to estate tax
  - e. Benefit Charity – Benefit charity or charities of donor's choice
- C. CRTs work better in certain tax/economic environments
- 1. High capital gains rates
    - a. Higher rates provide more incentive to defer
    - b. Prospect of changing rates
  - 2. Applicable Federal Rate
    - a. The higher the AFR, the lower the value of the annuity of a CRAT, the higher the present value of the remainder
    - b. Should not affect unitrust planning
  - 3. Transaction volume
- II. Breaking Up Is Hard To Do...But Not For CRTs (Terminations of Existing CRTs)
- A. Reasons to Form Inter vivos CRATs are All Upside Down
- 1. Low capital gains tax rates (and expected to be higher in the future)

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2. Low AFRs (and expected to be higher in the future)
  - a. The lower the AFR, the higher the value placed on the annuity interest
  - b. This reduces the value of the income tax charitable deduction for annuity trusts
3. Low volume of transactions (and we hope it will be higher in the future!)

**B. Motivations to Terminate**

1. Donor/Income Beneficiary
  - a. Don't need the money
    - i) make an additional gift to the charity at a time when the value of the annuity interest is high, increasing the additional income tax charitable deduction
    - ii) this was the primary reason to terminate in the past, the donor giving more money to charity by giving the life estate/income interest to the remainder charity
    - iii) Issues
      - a) CRT is a private foundation, so donor is disqualified person with respect to CRT, and self-dealing issues have to be addressed
      - b) Gift is the income interest/life estate, not the underlying assets, so the gift is a capital asset
        - i. If short-term, 50/30% AGI limit, but the deduction is lower of cost or FMV
        - ii. If long-term, then 30/20% AGI limit, and deduction is limited to cost basis if the remainder beneficiary is a private foundation, or if the donor has the ability to change the remainder beneficiary to a private foundation

- iii. the only meaningful income tax charitable deduction occurs when the income stream is long term and the donee is a public charity
    - iv) Example: PLR 200802024 (May, 2008) where holder of a unitrust interest contributed the unitrust interest to the remainder charity
  - b. Do need (or at least want) the money
    - i) cash out when the value of the annuity interest is high
    - ii) More recent trend, that donor will be receiving the present value of the annuity interest, dividing assets between life and remainder beneficiaries
    - iii) Issues
      - a) State law must allow
      - b) Be aware of self-dealing, which can happen when you have a private foundation as the remainder beneficiary (or power in the donor to change the remainder to a private foundation)
        - i. PLR200833012 is one in a line of PLRs that solidifies the Service's position that early termination will not result in a self-dealing violation under Section 4946(a)(1)(A)
        - ii. Should be permissible so long as the income beneficiary(ies) does not receive any more than the present value of the income stream

- iii. In fact, Service announced in Rev.Proc.2008-3, 2008-1 I.R.B. 110, that it will no longer issue advance rulings on whether the early termination of a CRT, when the beneficiaries will receive their actuarial share of the CRT, will cause the CRT to cease to qualify as a CRT. Rev.Proc. 2008-4, 2008-1 I.R.B. 121 addresses related issues of termination or private foundation status, taxes on self-dealing and taxes on taxable expenditures
  - c) Treated as a sale for income tax purposes
    - i. Basis is zero
    - ii. The interest being sold is capital
    - iii. So, you want it to be long-term, otherwise the whole amount is subject to ordinary income tax rates rather than capital gains tax rates
  - d) Donor (or life estate holder) cannot be terminally ill
  - e) Use the lowest AFR that you can, to give the highest value to the annuity interest
- c. Breaking up is hard to do – but the donors don't want to be married anymore, nor do they want to have anything to do with each other any more, including share a CRT
- i) Rev.Rul. 2008-41, 2008-30 I.R.B. 170 (July, 2008) where Service found that the division of the original CRT into new separate trusts did not cause the original CRT to fail to qualify as a CRT. The division was structured so that each private recipient and the remainder beneficiary had the same beneficial interests before and after the division

- ii) Done correctly, the pro rata division will not be considered a sale, exchange or other disposition, the basis of each separate trust's share of each asset will not change, and the trusts' status as CRTs will not be affected
- iii) In addition to divorce scenario where effectively splitting the CRT into 2 equal parts, another scenario is addressed, that where the original CRT had a joint life, is split into 2 CRTs, with each income beneficiary becoming the survivor beneficiary of the other's CRT

2. Charitable Remainderman

- a. Generous donor, ala II.B.1.a., above
- b. CRT is "underperforming" and the charity would rather cash out now than wait on a future bull market ("sick" CRT)
- c. Charity just has some other reason – capital campaign or needs – and would like to get their money now, not in the future

III. Planning Today

A. Unitrusts

- 1. Are AFR neutral
  - a. high rates, low rates, so what
- 2. But, would seem to work better in inflationary, not deflationary, times
- 3. Low capital gains tax rates and low transaction volume

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- B. Testamentary
  - 1. Effective to “zero-out” the estate by using a CRT with the then present value of the annuity or unitrust interest equal to the applicable exemption amount
  - 2. Effective planning technique for unmarried couples, regardless of whether same or opposite sex
  - 3. Sometimes, it just the “right” fact pattern
    - a. Example of wealthy entrepreneurs, no children, ultimate beneficiary will be family foundation, but in meantime, extended family (parents, siblings, nieces and nephews) to provide for, and CRTs may allow tax efficient manner in which to accomplish multiple goals
    - b. Wealthy child providing for parents in case child predeceases