Comments on Notice of Proposed Rulemaking
Prop. Treas. Reg. Section 1.643(a)-8 and Amendments to Treas. Reg. Section 1.664-1

Date: September 29, 2000

The following comments and recommendations express the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments and recommendations were prepared by members of the Committee on Exempt Organizations. Primary responsibility was exercised by Carolyn M. Osteen, Lawrence P. Katzenstein, chair of the subcommittee on Charitable and Split-Interest Trusts, Martin Hall, and Robert H. M. Ferguson, Chair of the Committee on Exempt Organizations. These comments were reviewed by Richard S. Gallagher of the Section’s Committee on Government Submissions and by Douglas M. Mancino, Council Director for the Committee on Exempt Organizations.

Although many of the members of the Section of Taxation who participated in preparing these comments and recommendations have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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I. Executive Summary

As members of the Committee on Exempt Organizations of the American Bar Association, Section of Taxation, we welcome the opportunity to comment on Prop. Treas. Reg. §1.643(a)-8 and amendments of Reg. §1.664-1 (the "proposed regulations"). The proposed regulations modify the application of the rules of section 664(b) of the Internal Revenue Code of 1986 as amended ("the Code") governing the character of certain distributions from a charitable remainder trust ("CRT"), with the aim of preventing taxpayers from using CRTs to achieve inappropriate tax avoidance. More specifically, the proposed regulations are designed to prevent transactions by which taxpayers transfer appreciated assets to a CRT and, in return,
receive distributions of cash while avoiding paying tax on the gain in the assets. The authority of the Treasury to issue regulations is recognized as extremely broad. We believe that the proposed regulations appropriately address the application of the section 664 rules. The proposed regulations also mitigate problems of self-dealing and unrelated business income that arise when CRTs are manipulated for tax avoidance. Moreover, we believe that the 1994 Notice, interpreting section 664 of the Code, and the 1997 legislation amending section 664, followed by the 1998 regulations gave taxpayers sufficient warning of the proposed regulations.

The members of the Committee on Exempt Organizations who are the authors of these comments represent many charitable organizations. The charitable community is united in its opposition to inappropriate use of the section 664 rules because such use could ultimately lead to restriction of the charitable remainder trust provisions in ways detrimental to legitimate charitable interests or even repeal. We believe that for the most part the trust arrangements addressed by the proposed regulations have been created by donors with little or no charitable interest. This was not the intent of Congress when it enacted Section 664.

We understand that this and similar techniques have been marketed with confidentiality or secrecy agreements designed to keep word of these trust arrangements from reaching the Service. Marketers have also charged substantial fees, often based on a percentage of the transaction, to their clients. We believe that such fee arrangements are inappropriate in the charitable context and may reflect the lack of true intention to benefit charity.

II. Specific Comments

A. IRC Section 664(b) Rules May Allow for Inappropriate Tax Avoidance; the Proposed Regulations Correct These Abuses

Charitable remainder trusts, governed by section 664 of the Code, provide for a periodic distribution to a noncharitable beneficiary for life or for a term of years, with an irrevocable remainder interest held for the benefit of a charity. The amount distributed to the noncharitable beneficiary may be either a sum certain (a charitable remainder annuity trust) or a fixed percentage of the net fair market value of the trust’s assets valued annually (a charitable remainder unitrust). An alternative to the standard charitable remainder unitrust is the income only trust paying the lesser of net income or the fixed percentage unitrust amount. The difference or deficit can, if the trust so provides, be made up in later years out of excess income (a net income with make-up unitrust), although the make-up provision is optional.

IRC Section 664(b) provides a tier system for determining the character of amounts distributed by a charitable remainder trust in the hands of the beneficiary to whom the distribution is made. It is important to consider the purpose of this system, which is to ensure that to the extent the trust realizes income or capital gains, the income or gain flows through to the beneficiary and is taxable in the beneficiary’s hands. A trust
distribution is deemed first to carry out ordinary income (including short-term capital gains) to the beneficiary whether earned in the current year or accumulated from a prior year. In successive tiers, long-term capital gain is deemed next distributed, then tax-exempt income and finally non-taxable trust corpus.

Manipulation of the Section 664(b) rules makes it possible in unusual cases for a taxpayer to avoid taxes associated with trust distributions in ways that are inappropriate and were unintended. Some tax advisors have advocated that cash needed for CRT distributions can be generated by borrowing or entering into a forward sales contract instead of selling appreciated assets used to fund the trust. If the cash-generating transaction is not closed out until the year in which the CRT terminates and the assets are paid to charity, these advisors argue that the only gain recognized by and taxable to the taxpayer will be the gain deemed carried out in the final year distribution (which may be very small if the trust terminates early in the calendar year). In addition to avoiding tax, the effect of these techniques is typically to shift the bulk of the investment risk on to the charitable remainder interest.

Facilitating this type of tax avoidance was not the intent of section 664. Rather, in enacting section 664, Congress desired to encourage deferred gifts to charity and, more specifically, to enhance the value of CRT contributions accruing to charities. Congress hoped that the section 664 rules would give CRT donors "greater flexibility in the making of charitable gifts in the form of remainder interests." Staff of the Joint Comm. on Internal Revenue Taxation, 1st Cong., The General Explanation of the Tax Reform Act of 1969 83 (1969). At the same time, Congress hoped the new section 664 rules would reduce the flexibility of trustees to enhance a donor/beneficiary’s interests at the expense of the charitable remainder interest. Congress intended to "remove the flexibility of the prior provisions whereby it was possible to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust’s investments." Id. at 84. The General Explanation of the Tax Reform Act thus reflects a clear Congressional intent to avoid precisely the types of CRT transactions that have emerged — avoidance of tax for the donor coupled with increased investment risk for the charitable beneficiary.

The proposed regulations would counter this unintended and inappropriate tax avoidance. Specifically, the regulations would impose a deemed sale rule, applicable whenever a distribution is made from a CRT that is not characterized in the hands of the recipient as income and is neither a return of basis nor attributable to a deductible contribution of cash to the trust. Under these circumstances, the CRT would be treated as having sold a pro rata portion of its assets, consequently recognizing a pro rata portion of the built-in gain. The regulations themselves are brief, but with examples making their purport clear. The background commentary contains considerable helpful information and analysis regarding the nature of the inappropriate tax avoidance techniques.
B. The Proposed Regulations Mitigate Problems of Self-Dealing

The proposed regulations also address problems of self-dealing likely to arise when CRTs are used for tax avoidance purposes. Self-dealing, prohibited under IRC section 4941, will occur in the CRT context when trust assets or income are transferred to, or used by or for the benefit of the non-charitable donor beneficiary, and the transaction jeopardizes the remainder interest of the charitable beneficiary. Self-dealing does not include payments for the mandated trust distributions to the beneficiary/ies but rather use of the trust to achieve tax-free or deferred treatment of trust distributions which are in fact distributions of income. In the typical tax-avoidance CRT addressed by the proposed regulations — where, as previously described, a donor contributes highly appreciated assets to a trust, and the trustee borrows money or enters into a forward sale contract to pay the required distribution to the donor beneficiary — the sale of trust assets is clearly being manipulated for the tax benefit of the donor and prohibited self-dealing may have in fact occurred. ¹

The approach set forth in the proposed regulations – forcing taxpayers to treat this type of transaction as a deemed sale – will likely eliminate the use of these transactions as devices for tax avoidance. Thus, the self-dealing that occurs concomitant with these transactions will be eliminated as well. However, should prohibited self-dealing continue to occur, the proposed regulations reiterate IRS's authority to, "in appropriate circumstances...impose the tax on self-dealing transactions under section 4941." ² Prop. Treas. Reg . § 1.643(a)-8, 64 Fed. Reg. 56718-5672 (1999).

C. The Proposed Regulations Also Eliminate UBIT Problems

The proposed regulations treat the cash-generating event as a deemed sale but attempt to address the alternative possibility that unrelated business income may arise when CRTs are used for tax avoidance purposes. Under IRC section 664(c), CRTs are exempt from Subtitle A taxes, including the federal income tax, except when the trust has unrelated business taxable income ("UBTI") as defined by IRC section 512. Section 514 causes any exempt organization which realizes debt-financed income to have UBTI for purposes of Section 512 when indebtedness is incurred to acquire or improve income-producing property or when the indebtedness is "reasonably foreseeable at the time of such acquisition or improvement...." ³ Since a CRUT must make distributions of the prescribed percentage amount at least annually, it must have cash or liquid assets and if it does not have cash or liquid assets, it must finance the distribution or make distribution in kind. If cash is received by the trustee in anticipation of sale of trust assets, the cash receipt of necessity involves an extension of credit from some third party who is looking exclusively to the securities or assets held by the trust to repay the cash.

As previously described, in the paradigmatic tax avoidance CRT addressed by the proposed regulations, a trustee either borrows money or enters into a forward sale of
trust assets, receiving an advance on account. This financing transaction, no matter which form it takes, is in substance a foreseeable borrowing, generating debt-financed unrelated business income described by Section 512 that will cause the CRT to be taxable. Thus, in trying to achieve tax avoidance, the trustee will have created a situation where the trust loses its tax exemption for both the year of the distribution and the subsequent year of the sale.

The "forced sale" treatment required of these transactions by the proposed regulations will likely reduce the number of such transactions and thus concomitantly reduce the associated UBIT problems. However, should inappropriate transactions nevertheless continue, the proposed regulations indicate they will be challenged by the IRS. "To the extent that a charitable remainder trust financed a distribution by borrowing funds or entering into a forward sale or other similar transaction... the trust may be treated as having unrelated business taxable income under section 512 from the transaction." Prop. Treas. Reg. § 1.643(a)-8, 64 Fed. Reg. 56718-5672 (1999).

D. The 1994 IRS Notice and 1997 Congressional Legislation Gave Taxpayers Notice of Proposed Regulations

1994 IRS Notice: In 1994, the IRS said that it would challenge attempts to use short term CRTs to convert appreciated assets into cash to avoid a substantial portion of the tax on the gain. I.R.S. Notice 94-78, 1994-2 C.B. 555. The IRS described the paradigm "abusive" short-term trust likely to be challenged: one with a payout rate of 80 percent, a term of two years, funded with non-income-producing assets. The CRT would make no actual distributions in the first year; rather, all assets would be sold at the beginning of the second year, with the donor/beneficiary then receiving a distribution with respect to the first year treated as a trust corpus. Furthermore, the IRS made it clear that, beyond the improper CRT described, no CRT at odds with the intent of section 664 would be free from scrutiny. In language clearly sufficient to put taxpayers on notice of the consequences should they try to use CRTs for tax avoidance, the IRS wrote: "A mechanical and literal application of regulations that would yield a result inconsistent with the purposes of the CRT provisions may not be respected." Id.

1996 and 1997 CPE Texts: The Service further addressed improper CRT schemes in a series of CPE articles. In a 1996 article entitled "Self-Dealing and Other Issues Involving Charitable Remainder Trusts," the Service sought to "educate exempt organization examiners about this scheme, aid them in identifying and examining unitrusts that are used in this scheme, and inform them of the remedies that are available to annul the outcome of this scheme." Michael Seto and David Jones, Self-Dealing and Other Tax Issues Involving Charitable Remainder Unitrusts, CPE Exempt Organizations Technical Instruction Program for FY 1996 159 (1996). To achieve this end, the CPE text provided detail on the characteristics of improper CRTs, explained how IRC section 4941 could be used to rectify these problems, and highlighted further legal attacks that it would potentially invoke to tax the gain on the appreciated trust assets. 4
In 1997, the Service published a further CPE article related to the CRT abuses identified its 1994 Notice. The article, entitled "Charitable Remainder Trusts: The Income Deferral Abuse and Other Issues," described abuses specific to net income with makeup unitrusts ("NIMCRUTs"). According to the IRS, a NIMCRUT with both a net income limitation (a provision allowing a trustee to pay the non-charitable beneficiary the lesser of net income or the fixed payment due) and a makeup provision (allowing the difference or deficit to be made up in a later year out of excess income) could be manipulated to achieve inappropriate and unintended tax deferral. Specifically, a non-charitable beneficiary could avoid distributions in the trust’s early years, instead realizing all trust income -- including the makeup amount -- in the trust’s later years. Such a scheme would be of particular benefit to taxpayers in lower tax brackets during the later years of the trust. The Service also reiterated its broader purpose in the 1997 CPE article – to crack down on section 664 rule manipulations not originally contemplated by Congress. Ron Shoemaker and David Jones, Charitable Remainder Trusts: The Income Deferral Abuse and Other Issues, CPE Exempt Organizations Technical Instruction Program for FY 1997 139 (1997).

The Taxpayer Relief Act of 1997: The 1994 IRS Notice received Congressional reinforcement with the Taxpayer Relief Act of 1997. The Act imposed two requirements on charitable remainder trusts: First, the Act stated that a CRT must require an annual payout not exceeding 50% of the fair market value of the trust assets. Second, the Act held that the present value of the charitable remainder unitrust must be at least 10% of the fair market value of the property transferred to the trust on the date of the contribution. A trust failing to meet these requirements would not qualify under Section 664 as a CRT and would be taxed as a complex trust.

As in the IRS Notice of 1994, the portion of the 1997 Act dealing with charitable remainder trusts was explicitly intended to counter "opportunities for abuse...inconsistent with the purpose of the charitable remainder trust rules." S. Rep. No. 105-33, at 201 (1997). Moreover, beyond merely reinforcing the government’s intent to crack down on tax avoidance through CRTs, the Act notified taxpayers that additional, similarly-spirited Treasury Department Regulations would likely be forthcoming. In its Conference Report, Congress stated, "The Conferees intend that this provision of the conference agreement not limit or alter . . . the Treasury Department’s authority to address abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries." H.R. Conf. Rep. No. 105-220, at 608 (1997).

1998 Regulations: Following the passage of the 1997 Act, the Treasury Department adopted amendments to certain section 664 regulations, again underscoring an intent to crack down on "abuses associated with the use of accelerated CRTs." Guidance Regarding Charitable Remainder Trusts and Special Valuation Rules for Transfers of Interests in Trusts, 63 Fed. Reg. 68188-01 (Explanation of Provisions of 1998 Treas. Reg.). The 1998 amendments to Regulations 1.664-3 allowed individuals to establish a net income charitable remainder unitrust that changes or "flips" to a standard unitrust
during the term of the trust if certain requirements are satisfied. The amendments also allowed a trustee of a charitable remainder annuity trust or standard charitable remainder unitrust to pay the annuity or unitrust amount within a reasonable time after the close of the tax year for which it is due only if 1) the payment is income in the recipient’s hands under Section 664(b)(1)-(3) or 2) the trustee distributes non-cash property that it owned at the close of the tax year to satisfy the payment and the trustee elects to treat income generated by the distribution as occurring on the last day of the tax year to which the payment relates.

The 1998 amendments to Regulation section 25.2702-1(c)(3) adopted simultaneously with the amendments to the section 664 regulations eliminated the so-called "near-zero" charitable remainder unitrust. This technique involved the creation of a charitable remainder unitrust paying the lesser of net income or the fixed percentage amount with a makeup account under which the donor was the first income beneficiary for a term of years, and the donor’s child (or other individual beneficiary was the second income beneficiary following the donor’s retained term interest. A completed gift was made at the time the trust was established consisting of the present value of the child’s future income interest determined by deducting from the market value of the assets transferred the present value of both the donor’s retained interest and the charitable remainder. Assuming that the donor survived until the end of the term, there would be no further transfer tax issues. The trust property would not be included in the donor’s estate when she died, and no estate taxes would be attributable to the child’s interest, because the trust assets would not be included in the donor’s estate. The near-zero CRUT would be administered so that, during the period of the donor’s term interest, the trustee invested for capital appreciation as opposed to current yield or invested in deferred-income vehicles. The donor received minimal actual distributions (and not the distributions it was assumed the donor would receive in calculating the gift tax consequences at inception). A substantial make-up account was thereby accumulated. When the child’s interest begins, the trustee would switch investment philosophy to current yield or sell the deferred investment. The child would benefit from the make-up account without gift tax cost to the donor. In addition, the donor’s estate was not augmented by the assumed trust payments.

Treasury Regulations finalized in December 1998 undo the effectiveness of such planning. They provide that, when the CRT has an income beneficiary other than the donor, the donor’s U.S. citizen spouse, or both, the income interest of the donor is valued at zero under the special valuation rules contained in Code Section 2702 unless the donor holds the second of two consecutive non-charitable interests. The result is that the entire non-charitable interest is a taxable gift by the donor when the trust is first established. The leverage is lost.

III. Conclusion
The charitable remainder trust structure, now including Sections 664, 643, 2702 among others, is a complex one. The Treasury regulations promulgated to date have been designed to elucidate and confirm the original intention of the drafters of that structure to allow a donor a deduction for a gift only when the charitable remainder is protected from invasion and to cause the income beneficiary to be taxed on income as actually distributed. Schemes manipulating the CRT rules to the disadvantage of the remainderman for the purpose of avoiding tax must be measured against the statutory and regulatory structure and the statute and regulations construed in accordance with the clear intent of Congress to prevent such results.

Footnotes

1 According to the General Explanation of the Tax Reform Act of 1969, a self-dealing transaction does not require a direct transfer of money or property. General Explanation of the Tax Reform Act of 1969, at 31. Using a CRT to achieve tax avoidance can thus qualify as self-dealing. Furthermore, while certain benefits have been exempted from the self-dealing rules under Treas. Reg. § 53.4947-1(c)(2)(1), minimization of the non-charitable beneficiary’s tax payment is not one of these excepted.

2 Note that almost identical language was used by the IRS in its IRS Notice. “In appropriate circumstances, the Service may impose the tax on self-dealing transactions under section 4941 because the trustee’s postponement of the sale of trust assets beyond the first year may constitute a use of trust assets for the benefit of the donor, who is a disqualified person under § 4941(d)(1)(E).” I.R.S. Notice 94-78, 1994-2 C.B. 555.

3 Section 514(c)(1)

4 The further avenues of legal attack described include: the form v. substance doctrine (a transaction is examined to determine whether there is economic substance as opposed to mere tax avoidance), a challenge based on an inability to assign one’s income to another, and a challenge as to the trust’s qualification as a charitable remainder unitrust. Seto and Jones, supra, at 172.