NAMING A CRT AS THE BENEFICIARY OF A RETIREMENT ACCOUNT

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Part V - Choosing the Type of CRT
[this is a portion of a comprehensive work in process on all aspects of naming a CRT as the beneficiary of a retirement account. This portion of the paper is to identify which type of CRT is best depending on the circumstances]

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A. Overview

B. Tax-Exempt Status of CRTs

Like a qualified retirement plan account, a CRT is exempt from the income tax.\(^1\) No matter how much income a CRT may earn in a year, no tax is paid until a distribution is made to a taxpaying beneficiary.

The one exception is if a CRT holds an asset that generates unrelated business taxable income ("UBTI"). The CRT must pay a confiscatory 100% tax on the full amount of the UBTI.\(^2\) The asset that is most likely to generate UBTI is a partnership interest or an LLC interest of a commercial business.\(^3\) Debt-financed investment property can also trigger UBTI,\(^4\) but such property would usually not be received as a distribution from a retirement plan account.

C. How Long? Term of Years or for Life?

A CRT’s term may exist for the lives of one or more individuals or for a fixed term of years (maximum 20). The requirement that there must be a minimum 10% charitable deduction (described at infra below in Part V.F.2) means, as a practical matter, that it is difficult to establish a CRUT that lasts for the life of a beneficiary under age 27 or for the lives of multiple beneficiaries under age 38. For very young beneficiaries, a CRT for a term of years is the only option.

A CRT for a term of years will also provide the greatest assurance to people who are most interested in having distributions last for more than five years. If a beneficiary of such a CRT dies before the term has been completed, then distributions can be made to successor beneficiaries.\(^5\) By comparison, if a CRT is established for the life of a single beneficiary who dies within a year after the CRT was funded, then the assets in the CRT will be immediately transferred to a charity. Family members may feel that they would have been better off with a simple five year liquidation of the inherited retirement account. Mortality risk with a CRT that will last for the life of a beneficiary can be reduced by naming multiple lifetime beneficiaries of the CRT and by using life insurance in conjunction with the funding of the CRT.

D. Choosing the Trustee and the Charity

Whereas many living grantors to CRTs also act as the trustee of the CRT, this is not possible with a testamentary CRT that will receive retirement assets. Consequently, it is important to select a competent trustee who can administer a testamentary CRT that could last for the lives of multiple CRT beneficiaries, or for a term of up to 20 years. An institutional trustee could provide greater competence and longevity compared to an individual named as trustee. At the very least, the trust instrument should name an institution that is willing to administer the
CRT as a successor trustee in the event that an individual trustee resigns. Some commercial trust companies will not administer a CRT that holds less than $200,000, although some charities are willing to administer a CRT with minimum assets of $100,000.

It is also important to identify a charity that is likely to be in existence to receive the CRT’s assets when the trust terminates. Since a CRT might last for as long as 50 years, it would be helpful to list stable, established charities as contingent beneficiaries in the event that the primary charity has gone out of existence.

One charitable strategy that may be appealing to many donors is to have the CRT terminate into donor advised funds that will be advised by the donor’s descendants (e.g., grandchildren). This arrangement may be particularly attractive when a testamentary CRT will only last for a term of years. The CRT could terminate into donor advised funds that will make charitable grants based on the grant recommendations made by the same individuals who had received distributions during the term of the CRT (in most cases, the donor’s children and grandchildren). Such an arrangement will be most effective in a family that has instilled a spirit of philanthropy and has educated descendants on effective grant-making use of donor advised funds.6

The same philanthropic strategy could work if the CRT liquidates into a private foundation. It is possible for a CRT to itself become a private foundation when the distributions to non-charitable beneficiaries terminate.7

E. Choosing the Best Type of CRT - CRATs, CRUTs, FLIPCRUTs, NIMCRUTs

1. Definitions

There are five types of CRTs:

1. **Charitable Remainder Annuity Trust** (“CRAT”)8 - A trust that pays a fixed dollar amount (at least 5% and no more than 50% of the value of the property contributed to the trust) each year to one or more income beneficiaries for life (or for a fixed term of years -- maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations.

2. **Charitable Remainder Unitrust** (“Standard CRUT”)9 - A trust that pays a fixed percentage (at least 5% and no more than 50% ) of the value of the trust’s assets each year (redetermined annually) to one or more income beneficiaries for life (or for a fixed term of years -- maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations.

3. **Charitable Remainder Net-Income Unitrust** (“NICRUT”)10 - A trust that pays the lesser of that year’s net income or a fixed percentage (between 5% and 50%) of the value of the
trust’s assets each year (redetermined annually) to one or more income beneficiaries for life (or for a fixed term of years -- maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations. A trustee may insist on a net-income limitation when a donor contributes a illiquid asset, such as real estate, that doesn’t generate enough cash to make the annual required distributions of 5% or more. NICRUTs are rarely established -- donor’s prefer NIMCRUTs or FLIPCRUTs.

4. Charitable Remainder Net-Income With Make-up Unitrust (“NIMCRUT”)¹¹ - A NIMCRUT is a NICRUT with a “make-up” provision in the trust instrument. The trust can pay in excess of the stated payout percentage to the income beneficiary in order to make up any shortfall from a prior year when the net income limitation caused the beneficiary to receive an amount that was less than the stated payout. For example, if a NIMCRUT with a stated 5% payout only earns 3% of net income in its first year, it would only distribute 3% to the income beneficiary. If in the second year it earned 8%, it could distribute 7% to the income beneficiary: 5% for the stated percentage plus a 2% make-up amount for the reduced distribution in the first year (oversimplified).

5. Flip Unitrust (“FLIPCRUT”)¹² - A FLIPCRUT is a unitrust that begins as a NICRUT or a NIMCRUT but converts into a standard CRUT the year after a specified date or a “triggering event” occurs. This is the most popular type of CRT for receiving illiquid assets that may take a while to sell, such as real estate or closely-held stock. The triggering event is usually defined to be the sale of the illiquid asset. When it converts to a standard CRUT, the trust will usually hold liquid investments that can easily be sold to make the required distributions.

2. Which will work best?

In most cases, the choice will boil down to using a CRAT, a CRUT or a FLIPCRUT (there is no such thing as a “FLIPCRAT”). Neither a NIMCRUT nor a NICRUT have much appeal for donors, especially since a FLIPCRUT is essentially a NIMCRUT or a NICRUT that has the added advantage of a chance to convert to a standard CRUT.

The principal difference between a CRAT and a CRUT is that the former requires a fixed dollar payout and the latter requires a fixed percentage payout. Estate planners usually recommend a lifetime CRUT for a young individual because of the possibility that payments may gradually increase over a long time span if the CRUT’s investments increase in value. If the value of the CRUT’s investments fall in any given year, then the distributions for that year will decline as well.

A CRAT might be perceived as a more desirable option if the CRT will last for a short time period, such as for a term of years or for the remaining life of an elderly beneficiary. The fixed CRAT payments will not fluctuate with the changing value of potentially volatile investments that are held by the CRAT. Such steady payments can give many people a level of
comfort. But they offer no protection against inflation.

A FLIPCRUT might be the best choice when a retirement account holds an illiquid asset that cannot produce the required annual CRT distributions of 5 percent (or more). The trust instrument can provide that the triggering event will be the sale of that asset, in which case the trust “flips” into a standard CRUT in the following year. A FLIPCRUT can also serve as a retirement income vehicle. For example, the trust instrument can provide that the triggering event will be the beneficiary’s 66th birthday. The FLIPCRUT can invest in low-yield growth assets that produce little distributable income and then convert to higher yield assets after the trust flips.

F. CRT Requirements That Can Pose Challenges to Estate Planners

There are many technical rules that apply to CRTs. For example, the CRT beneficiary can have the power to change which charity will receive the remainder interest, and the CRT trustee should not promise to invest in tax exempt bonds. There are many good treatises and articles that explain the many technical rules. In the author’s experience, the following issues are the ones that most frequently pose challenges to structuring a gift to a CRT:

1. Annual payouts between 5% and 50%

The minimum annual distributions from a CRT to its beneficiaries is 5 percent of the value of the assets. A CRT cannot have a stated percentage of 3 percent or 4 percent, even though several states have adopted a 4 percent default rule under their state statutes for unitrusts and net-income trusts.

The minimum 5 percent distribution requirement has been an administrative challenge in the low interest rate environment of the past dozen years. Trustees often sell some assets in order to make the required distributions, which usually isn’t a tax problem since the trust is tax-exempt. The only way to distribute less than 5 percent is if the trust instrument contains a net-income limitation (that is, the CRT is a NICRUT, a NIMCRUT or a FLIPCRUT).

2. Minimum 10% charitable deduction

a. The requirement

The value of the charity’s remainder interest of a CRT must be at least 10 percent of the initial net fair market value of all property placed in the trust, computed using the Section 7520 discount rates in effect at the time of contribution. Since a CRUT (unlike a CRAT) can receive several contributions over time, the 10 percent requirement must be met every time that a contribution is made to a new or pre-existing CRUT. If a contribution is made to a trust that fails the 10 percent requirement, the trust will not qualify as a tax-exempt CRT.
b. Impact on payout or the projected term of trust

Oversimplified, there are two ways that the present value of a charity’s remainder interest in a CRT can be less than 10 percent of the value of the property that was contributed to the trust. The first is if the stated payout rate is too high (e.g., “for the next 20 years, distribute to my child 30 percent of the trust’s assets each year”). The solution is to lower the CRT’s payout rate, but it cannot be lowered below 5 percent. Many CRT agreements contain clauses that provide that if the rate stated in the trust instrument is too high, then the CRT’s distribution percentage rate will be automatically reduced to whatever rate is necessary to satisfy the 10 percent requirement. Other agreements simply state that the distribution percentage will be whatever the maximum permitted rate is in the month that the trust is funded.\(^\text{20}\)

The second way is if the projected term of the trust is too long. For example, if you invest $5 today and earn 3 percent interest every year for the next 100 years, then the $5 will grow to $100 in 100 years. Thus, the present value today of receiving $100 in 100 years is just 5 percent, which is less than 10 percent. The 10 percent requirement limits the projected term of a CRUT to a maximum of roughly 50 years.

This made it hard (impossible?) in the low interest rate environment of 2014 to establish a CRUT that would last for the life of any individual under age 27. The problem was particularly challenging for a CRAT, where there can be a greater impact caused by the large spread between the fixed distribution amount (that must be at least 5 percent of the value of the contributed property) and the assumed investment return of the assets in the trust (in the year 2014, the Section 7520 rate was never higher than 2.4 percent). For example, in the year 2014, a CRAT could not be established to make distributions for the life of anyone under age 70.\(^\text{21}\)

Things become even more challenging when there are multiple beneficiaries. The projected life expectancy for the last-to-die of a group of individuals increases as more individuals are added to the pool. For example, if in 2014 there was only one beneficiary of a CRUT, then the 10 percent test was met with a beneficiary as young as age 27. If there were two beneficiaries who were the same age (e.g., husband and wife), then they had to be at least age 38. With three beneficiaries who were the same age the minimum age climbed to age cvxkjsd and for four same-age beneficiaries the minimum age was 46. The comparable minimum ages for a CRAT was considerably higher: one beneficiary (age 71); two beneficiaries who were the same age (both must be at least age 73); and three beneficiaries who were the same age (each must be at least age 987q54kjslkjn).

What can an estate planner do if the beneficiaries are so young that a CRT fails the 10 percent test? One strategy is to create multiple CRTs. For example, if a client has three children who are triplets and each is age 27, there could be three CRTs (one for each child) rather than a single CRT. Another option is to have a CRT for a term of years. A term of years CRT would permit distributions to be made over more than the 5 year time limit for liquidating an inherited retirement account, but not longer than the 20 year term limit permitted for such a CRT.
c. Multiple beneficiaries - and what about the grandchildren?

Most CRT governing instruments provide that when there are multiple concurrent lifetime beneficiaries of the CRT and one beneficiary dies, then future distributions will be divided among the surviving beneficiaries. Thus, if a CRT distributes $3,000 monthly to three children ($1,000 per child) and one child dies, most trust instruments will provide that thereafter the $3,000 will be divided among the two surviving children ($1,500 apiece). The last surviving beneficiary would receive monthly distributions of $3,000 until death, at which point the CRT would terminate and the trust’s assets would be distributed to the charitable beneficiaries.

Instead of this arrangement, many people would prefer to have a deceased child’s share of CRT distributions paid to that child’s descendants per stirpes rather than to the surviving siblings. As a practical matter, per stirpes distributions to grandchildren over their lifetimes is usually not possible with a CRT. If there are more than three grandchildren, they would all have to be in their late 40’s at the time of the grandparent’s death in order to meet the minimum 10% charitable remainder threshold necessary for the trust to qualify as a CRT. This is rarely the case.

For those individuals who want their retirement assets to benefit their grandchildren, there are a variety of options. The first is to abandon the CRT idea and leave retirement assets outright to both children and grandchildren, recognizing that the inherited retirement accounts will have to be liquidated in five years.

The second is to establish a CRT that benefits the children for a term of years (maximum 20 years), rather than for the lives of the children. A terms of years CRT can contain per stirpes provisions that would operate in the event of an early death of one of the children. The trust will qualify as either a CRAT or a CRUT, regardless of the identity or age of the beneficiaries, since it will terminate at the end of a fixed term.22

A third option is to establish a single CRT that benefits all grandchildren for a term of 20 years and establish another CRT that lasts for the lives of the children.23 Another option is to establish a single CRT that lasts only for the lives of the children and use life insurance to compensate a surviving spouse and grandchildren in the event of the early death of one of the children. Any combination of these options is possible (e.g., name both descendants and CRTs as beneficiaries of retirement accounts).

Anytime there is a possible payment to a grandchild, an estate planner should consider the possible impact of the generation skipping tax24 if the estate will be large enough to trigger a federal estate tax liability. A CRT cannot be the source of payment of estate tax liabilities25 and proper GST allocations or alterative tax payment arrangements should be implemented. As will be illustrated later, there can also be income tax problems when retirement assets in a taxable estate are used to fund a CRT.26

d. Term of years CRT
By naming a term of years CRT as the beneficiary of a retirement account, distributions of retirement assets (and the income that they generate) could be made to the decedent’s beneficiaries for a term longer than the 5 year period that generally applies to an inherited retirement account, but not longer than the 20 year limit permitted for a term of years CRT. Upon the CRT’s termination, the trust’s remaining assets would be distributed to the charitable remainderman. As mentioned above, an attractive beneficiary might be donor advised funds that will be advised by the same individuals who had benefitted from the assets in the CRT over the CRT’s term.27

The maximum permitted payout percentage that will allow a term of years CRT to satisfy the minimum10 percent charitable remainder requirement can vary every month, depending on the Section 7520 rate that is in effect for that month. For most of 2014 the applicable rate was 2.2% and the highest permitted payout for a term-of-years CRUT (including a FLIPCRUT, NICRUT or NIMCRUT) that would exist for a term of between six and twenty years was:

<table>
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<th>Years</th>
<th>Payout</th>
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<tbody>
<tr>
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<td>32.5%</td>
<td>11</td>
<td>19.3%</td>
<td>16</td>
<td>13.7%</td>
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<tr>
<td>7</td>
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<td>17.8%</td>
<td>17</td>
<td>12.9%</td>
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<tr>
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<td>25.5%</td>
<td>13</td>
<td>16.5%</td>
<td>18</td>
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<tr>
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<td>23.0%</td>
<td>14</td>
<td>15.5%</td>
<td>19</td>
<td>11.6%</td>
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<tr>
<td>10</td>
<td>21.0%</td>
<td>15</td>
<td>14.5%</td>
<td>20</td>
<td>11.1%</td>
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</table>

The comparable maximum payouts for a term-of-years CRAT to meet the 10 percent requirement were:

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<tbody>
<tr>
<td>6</td>
<td>16.1%</td>
<td>11</td>
<td>9.3%</td>
<td>16</td>
<td>6.7%</td>
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<tr>
<td>7</td>
<td>14.0%</td>
<td>12</td>
<td>8.6%</td>
<td>17</td>
<td>6.4%</td>
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<tr>
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<td>12.4%</td>
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<td>11.1%</td>
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<tr>
<td>10</td>
<td>10.1%</td>
<td>15</td>
<td>7.1%</td>
<td>20</td>
<td>5.6%</td>
</tr>
</tbody>
</table>

The beneficiary of a high-payout CRUT will likely receive deceasing amounts every year. The CRUT’s assets will usually decline every year since the investment return will probably be less than the high distribution rate. Although the amount of each year’s CRAT distribution would remain the same throughout the term of the CRAT, the problem for the beneficiary of a 20 year CRAT is the effect of inflation. For example, if inflation is 3% per year, then the last fixed payment at the end of a 20 year term would have the purchasing power of just 55% of the first year’s payment.28

A maximum-payout term of years CRUT will usually make a final distribution to the
charitable remainderman that is much less than the original contribution to the CRUT. The only way that the trust’s assets could increase is if the CRUT could consistently earn more than the high stated payout percentage. For example, if the trustee can only earn the Section 7520 rate, the assets in a maximum-payout term of years CRUT that begins with $100,000 should fall to between just $12,000 and $16,000 by the time the trust terminates.

This can impact a trustee’s decision to agree to serve as the trustee of such a CRUT. To make the administration of a high-payout CRUT economically viable, the trust would have to begin with considerably more assets than just the $100,000 or $200,000 minimum amount often cited by commercial trustees. The other option is to reduce the stated payout percentage to a rate closer to what the trustee projects could be earned on the trust’s assets (but not lower than the minimum 5 percent required for a trust to qualify as a CRT). Using a 5 percent distribution rate when the CRUT can steadily earn 7 or 8 percent would permit growing payments to the beneficiary and a large distribution to the charity when the term ended.

A high-payout CRUT’s assets will usually decrease, even when it can annually earn 3 or 5 percent more than the Section 7520 rate. By comparison, a CRAT that earns such higher yields will usually have more assets than a comparable CRUT to distribute to the charity upon the trust’s termination. For a term of years maximum-payout CRT established in 2014, the charitable remainderman would receive the following amounts upon the trust’s termination, depending on the actual yield earned by the trustee over the term of the trust:

| DOLLARS DISTRIBUTED TO A CHARITY AT END OF CRT's TERM OF YEARS FOR A CRT DISTRIBUTING THE HIGHEST PERMITTED PAYOUT PERCENTAGE |
| (Rounded to nearest hundred dollars - Original contribution $100,000 in month when Sec 7520 rate = 2.2%) |
| Annual yield actually earned by CRT: | CRUT | CRAT |
| 2.2% | 5.0% | 7.0% | 2.2% | 5.0% | 7.0% |
| TERM | | | | |
| 10 years | $12,500 | $17,500 | $22,100 | $12,700 | $35,900 | $57,200 |
| 15 years | $14,000 | $22,400 | $31,000 | $14,000 | $54,700 | $97,000 |
| 20 years | $15,500 | $28,400 | $43,300 | $15,700 | $80,200 | $157,400 |

3. Avoid multiple donors to a single CRT

The Service concluded in a 1995 private letter ruling that a CRUT that would be funded by multiple contributors (two grandparents and six grandchildren) would fail to qualify as a valid CRT. The Service’s logic was that the joint transfers had the effect of the donors acting as associates in an association (taxable as a corporation rather than a trust) that “pooled their assets with an object to carry on business and divide the gains therefrom.” The safe-harbor CRT documents released in 2005 seem to reiterate the Service’s policy against multi-donor CRTs, but
allowed an exception for a multi-donor CRT that was established with contributions from both a husband and a wife.\textsuperscript{30}

The question may arise: can a surviving spouse designate as the beneficiary of her or his retirement assets, a testamentary CRUT that the first-spouse-to-die established for the benefit of the children of their marriage? Perhaps the surviving spouse is already a beneficiary of that testamentary CRUT. It seems that such an arrangement could qualify under the husband and wife exemption contained in the 2005 safe-harbor CRT documents. A single CRT would also reduce the administrative costs that would exist with multiple CRTs.

4. Private foundation self-dealing rules apply to CRTs

A CRT is subject to some of the private foundation excise taxes.\textsuperscript{31} The CRT’s trust instrument should specifically state that it will not engage in transactions that violate these excise taxes.\textsuperscript{32} The provision that comes up most often is the prohibition on self-dealing. Beneficiaries should not borrow or buy from, or lend or sell to, the CRT since that would be a violation of the self-dealing rules of Section 4941.

5. Problematic assets
   a. Partnership interests

When a CRT owns a partnership or an LLC interest, it is deemed to be engaged in the underlying activities of that partnership or LLC.\textsuperscript{33} Thus, if a partnership or an LLC is engaged in a commercial business activity, then a tax exempt organization that owns an interest in that partnership or LLC must report its share of those profits as UBTI.\textsuperscript{34}

Only the portion of the income that is attributable to a partnership’s or LLC’s unrelated commercial activities is subject to UBTI. A tax-exempt organization usually will not pay any tax on its share of partnership income from passive investments, such as interest, dividends and capital gains.\textsuperscript{35} Thus, holding a partnership interest or an LLC interest of an investment club, whose income consists entirely of interest, dividends and capital gains, should not trigger UBTI to a CRT, unless the investments were financed with debt.\textsuperscript{36}

b. S corporation stock

A Section 401(a) retirement plan, such as an ESOP, is eligible to own S corporation stock.\textsuperscript{37} A charity is also eligible to own S corporation stock.\textsuperscript{38} But neither an IRA\textsuperscript{39} nor a CRT is eligible to be a shareholder of an S Corporation. A transfer of S corporation stock to a CRT will terminate the corporation’s Subchapter S tax status.\textsuperscript{40} If a qualified plan holds S corporation stock and if that plan’s assets will be transferred at death to a CRT, then the stock should be sold inside the qualified plan account and only the proceeds, rather than the S corporation stock, should be transferred to the CRT.
c. Debt-encumbered property

There are serious complications that discourage individuals from donating mortgaged property to a CRT. The donor has been relieved of a liability, perhaps triggering the private foundation self-dealing tax and perhaps causing the CRT to be reclassified as a grantor trust.41

It is rare (but not impossible) for a retirement account to hold mortgaged property. There is no legal authority that explains the outcome when a retirement plan transfers mortgaged property to a CRT. Caution dictates that the retirement plan should sell such mortgaged property rather than transfer it to a CRT.

What happens if a CRT or a retirement plan borrows money to make an investment? Even when there are no commercial activities, there can be UBTI from "debt-financed" income.42 Usually passive investment income, such as interest, dividends and capital gains, is excluded from UBTI.43 However, such income may be taxable if it was obtained with debt financing.44 Thus a retirement plan's purchase of stocks or securities on a margin account can produce taxable debt-financed UBTI45 as can the purchase of rental property that was financed with debt.46 If a CRT borrows money to make an investment, then the debt-financed UBTI will be taxed at the CRT’s confiscatory 100% rate.

G. Added Requirements for CRATs That Pose Challenges

1. Only one contribution possible

A trust fails to qualify as a CRAT unless its governing instrument states that no additional contributions may be made to the CRAT after the initial contribution.47 This prohibition does not apply to a CRUT. Despite the prohibition, the tax regulations provide that “all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution.”48 Thus, a testamentary CRAT could probably be funded with contributions from multiple retirement accounts as well as a bequest from an estate or from a grantor trust after the death of the settlor.49 As is explained below in Part V.I.1, there can be income tax advantages if a separate CRT will receive retirement plan assets rather than commingling retirement assets with other assets in a CRT.

2. Five percent probability that CRAT’s assets will not be exhausted

The IRS takes the position that no estate tax charitable deduction is allowed for a contribution to a CRAT that will make payments over someone’s lifetime unless there is less than a 5 percent chance that the corpus will be exhausted.50 The IRS did not want to allow a charitable deduction when it was possible that the annuity payments would consume all of the assets and nothing would be paid to a charity. It is mathematically possible for a contribution to a CRAT to qualify for the 10 percent minimum charitable deduction yet fail the 5 percent probability test. This 5 percent probability test does not apply to a CRUT, nor does it apply to a CRAT that is payable over a fixed term of years.

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Whereas the 10 percent charitable remainder interest is a statutory requirement for a trust to be a CRAT, the IRS’ 5 percent probability requirement only goes to whether an estate can claim an estate tax charitable deduction for a contribution to a CRAT. For estates that are well below $5 million, there is no need for a charitable estate tax deduction and this requirement can be ignored when planning a bequest of retirement assets to a CRAT (after making full disclosure to the client). Cautious estate planners might opt to bypass the 5 percent probability issue by using a CRAT for a term of years or a CRUT. For taxable estates of over $5 million, the entire notion of a bequest of retirement assets to a CRT should be reexamined because of a potential income tax problem for the beneficiaries of the CRT, explained at infra Part V.I.4.

H. Asset protection issues

In 2014, the Supreme Court concluded in a unanimous decision that an inherited IRA was not afforded the protection extended to “retirement funds” under bankruptcy law.\textsuperscript{51} This development caused many estate planners to recommend that clients name as their IRA beneficiary a trust that contained spendthrift clauses.

A typical spendthrift clause prohibits a creditor from seizing a beneficiary’s interest in a trust and prohibits the beneficiary from voluntarily or involuntarily assigning his or her interest in the trust to anybody else. Often the trustee has the discretion to avoid making distributions from the trust to a beneficiary. This power might be exercised when there is a creditor who is ready to seize each and every distribution that leaves the trust payable to the beneficiary.

With the requirement that inherited IRAs must be liquidated in just five years, naming a tax-exempt CRT as the IRA’s beneficiary is becoming an attractive option compared to naming a conventional taxable trust. If a CRT has no spendthrift clause, the interest of a beneficiary can be seized by creditors. But a CRT can contain spendthrift clauses. To the extent that these clauses are effective, they could prevent a creditor from seizing the CRT beneficiary’s interest and prevent the CRT beneficiary from assigning his or her interest in the CRT to somebody else.

On the other hand, a CRT trustee is subject to very rigid requirements that distributions must be made each year pursuant to the instructions in the trust instrument. Once a distribution leaves a trust, it can be seized by a creditor. When there is just one beneficiary of a CRT, there is not the flexibility that a trustee could have with a conventional trust to withhold distributions to the beneficiary. Failure to make the required distributions can disqualify the CRT.\textsuperscript{52} When there are multiple beneficiaries of a CRT, a trustee can be given the power to allocate different amounts to different beneficiaries.

Finally, there is concern that the spendthrift clauses might not be effective. In 2014, a bankruptcy court held that the broad spendthrift clause contained in a mother’s trust did not prevent creditors from seizing a share of the trust’s assets when one of the mother’s four children filed a petition in bankruptcy.\textsuperscript{53}
I. Four-tier system for income distributions to beneficiaries

1. Overview

Instead of the usual pass-through rules that apply to distributions from conventional trusts, distributions from charitable remainder trusts are subject to a “four-tier” system. The distribution regime is commonly referred to as WIFO (“worst-in, first-out”). The income that is subject to the highest tax rates will be distributed from the trust before income that qualifies for lower tax rates can be distributed. Thus, all of the ordinary income from both the current year and from all prior years must be fully distributed from the first tier before a single dollar of capital gain income is distributed from the second tier, and so on.

The four-tier system provides that distributions from a charitable remainder trust shall have the following characteristics to the income beneficiary:

(1) First, as amounts of income (other than capital gains) to the extent of such income for that year and undistributed income of the trust for all prior years;

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

(3) Third, as other income (such as tax-exempt municipal bond interest) to the extent of such income for the year and such undistributed income of the trust for all prior years; and

(4) Fourth, as a distribution of trust corpus.

Within each tier, there are layers of income. For example, the tax rate on the long-term capital gain from selling a collectible asset (e.g., a painting) can be as high as 28% but the long-term capital gain tax rate on the gain from selling a share of corporate stock is no more than 20%. Hence, following the WIFO principle, all current and prior-year collectible gains must be distributed in full from a CRT before a single dollar of 15%/20% long-term capital gain can be distributed. Most investment income in the first and second tiers can be potentially subject to the 3.8% surtax on net investment income, but distributions from qualified retirement plans and IRAs are not subject to the 3.8% surtax.
A CRT that was established after 2012 and that holds inherited retirement assets will report distributions to the beneficiary as coming from income from the following sources in the following sequence (income marked with an asterisk ("**") is exempt from the 3.8% surtax):

<table>
<thead>
<tr>
<th>Tier 1 - Ordinary income</th>
<th>Tier 2 - Capital Gains</th>
<th>Tier 3 - Tax-exempt income</th>
<th>Tier 4 - Corpus</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Taxable interest</td>
<td>1. Short-term capital gain (Ordinary income tax rate)</td>
<td>1. Current year’s tax-exempt interest and other tax-exempt income***</td>
<td>1. Section 691(c) income tax deduction for IRD deposited into a CRT (per PLR 199901023 - see infra Part V.I.4)*</td>
</tr>
<tr>
<td>2. Net rents</td>
<td>2. Collectible gain (max 28% rate)</td>
<td>2. Accumulated tax-exempt interest and other tax-exempt income from prior years*</td>
<td>2. Capital contributions to the trust*</td>
</tr>
<tr>
<td>3. Annuity and royalty income</td>
<td>3. Building 1250 recapture gain (max 25% rate)</td>
<td>**</td>
<td>(** no 3.8% surtax on distributions of tax-exempt corpus)</td>
</tr>
<tr>
<td>4. Dividends (non-qualified)</td>
<td>4. Other long-term capital gain (15% or 20% rate)</td>
<td>**</td>
<td>**</td>
</tr>
<tr>
<td>5. Retirement income*** (** no 3.8% surtax on IRA/QRP distribution)</td>
<td>5. NUA capital gain* (15%/20% tax, and also exempt from 3.8% surtax)</td>
<td>(** no 3.8% surtax on tax-exempt income)</td>
<td>(** no 3.8% surtax on distributions of tax-exempt corpus)</td>
</tr>
<tr>
<td>6. Dividends (qualified-15%/20% tax rate)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Implications for IRD

If a CRT is funded with several hundred thousand dollars of IRA or QRP assets, it is very unlikely that the CRT beneficiary will ever receive from that CRT any dividends or long-term capital gains that would be taxed at the advantageously lower rates of 15% or 20%. The entire amount of taxable IRD from the retirement account will be classified as first-tier income rather than fourth-tier corpus. Even if all of the CRT’s assets were invested in stocks and municipal bonds, it could take 15 or 20 years for a CRT with a 5 percent payout (5% times 20 = 100%) to completely distribute the IRD that was deposited into the CRT and thereby permit some lower-taxed qualified dividend income or long-term capital gain income to be distributed. Consequently, investing in lower-yielding tax-exempt bonds makes little sense for a CRT that was funded with retirement assets.

The four tier system also affects the decision of whether to add non-retirement assets to such a CRT. Such a contribution is legally permissible, as explained above in Part V.G.1. Rather than commingle IRD with a deposit of non-IRD assets (stocks, bonds, mutual funds, etc.)
in a single CRT, it may be advisable to have a separate CRT for the IRD assets, particularly when there is a very large retirement accumulation of several hundred thousand dollars. The large amount of first-tier IRD will prevent the distribution of dividend or capital gain income generated from the investment of the non-IRD assets that were deposited in the trust. If, instead, there are two CRTs, a person can receive from one CRT the retirement income IRD (taxed as ordinary income but exempt from the 3.8% health care surtax) and have the chance of receiving dividends and long-term capital gains, taxed at rates as low as 15%, from the other CRT. The threshold issue is whether the potential income tax savings to the beneficiary will outweigh the cost of administering two CRTs.

As a service to upper-income beneficiaries who could be subject to the 3.8% surtax, the trustees of both CRTs and conventional trusts should point out in very strong terms that the IRD from retirement distributions is exempt from the surtax. Unless that is done, many upper-income beneficiaries will likely mistakenly pay the 3.8% surtax on retirement income that is actually exempt from the surtax. The Schedule K-1 that beneficiaries receive from trusts does not illustrate the exemption from the surtax very well.59

3. Long-term capital gain treatment for NUA

When employer stock is received as a lump sum distribution from a Section 401 qualified retirement plan, the net-unrealized appreciation (“NUA”) can qualify for long-term capital gain treatment when the stock is sold.60 Unlike other capital gains, the NUA gain is exempt from the 3.8% surtax.61

4. Controversy if estate tax was paid

a. Overview

blah blah blah ...

Thus, for example if the sole contribution to a testamentary CRT was $100,000 from an IRA that was subject to the 40% federal estate tax, the PLR would have $60,000 classified as first tier ordinary income and the $40,000 (which would normally qualify for the Section 691( c) income tax deduction for the federal estate tax that was paid) would be classified as fourth tier corpus. The only way that any of the $40,000 could be distributed to a beneficiary of the CRT would be if the CRT shrank to less than $40,000 of assets.

b. Tax planning implications

If the Service sticks to this approach, then in most cases it is better to abandon the IRA-to-CRT strategy for wealthy individuals whose estates will be subject to the federal estate tax.

Instead, a wealthy individual would be better advised to leave some or all of the pre-tax
retirement assets outright to charities at death. The combination of federal estate and income taxes (plus in some states the estate and income taxes of the state) can consume as much as 80% of the IRD. Many people will prefer to leave 100% of the assets to a charitable purpose that they have selected rather than leave 80% to the governments in taxes. If there is a large amount of IRD, there may be sufficient assets to justify the cost of establishing a private foundation. By comparison, donor advised funds can provide philanthropic involvement by descendants at a much lower cost, while still avoiding both estate and income taxes.

For those with no charitable intent, it may be better to leave the retirement assets outright to beneficiaries rather than have the assets transferred to a CRT. An outright bequest to beneficiaries will permit them to claim the Section 691(c) income tax deduction to offset the taxable income from the IRD. Thus, a $100 distribution received from an inherited retirement account will only produce $60 of taxable income (oversimplified). By comparison, leaving the retirement assets to a CRT effectively strips away that income tax deduction by placing the deduction in the fourth tier. The $100 distribution received from the CRT will produce $100 of taxable income.

c. The case for different tax treatment

In the humble opinion of this author, the correct tax treatment is to follow the basic rules for the Section 691(c) deduction. They provide that the tax-paying recipient of IRD is entitled to deduct the federal estate tax attributable to IRD in the same taxable year that the IRD is included in the recipient’s income.\(^{62}\)

Until a tax-exempt CRT distributes income to a beneficiary, the CRT’s accumulated undistributed income retains its original character inside the CRT under the four-tier system. When accumulated income is finally distributed, the beneficiary reports the character of the income based on the original character that the income had when the CRT received it.

In oversimplified terms, the correct treatment when a CRT receives $100,000 from a retirement plan where $40,000 of federal estate tax was paid is this: the entire $100,000 should be included in first tier income. But stapled (figuratively) to each dollar of IRD is a 40 cent income tax deduction under Section 691(c). Whenever dollars of IRD are distributed from the CRT to a CRT beneficiary as “first tier” income, the trustee should inform the recipient of the IRD that she or he is entitled to an itemized deduction\(^{63}\) of 40 percent of the IRD. The trustee should report the deduction on line 10 of Schedule K-1 of Form 1041. In addition, the beneficiary should be informed that the distribution will not be subject to the 3.8% surtax since the source of the income was a distribution from a qualified retirement plan.

The same “stapled” income tax deduction should apply if the distribution that the CRT received from a qualified retirement plan was appreciated employer stock. The sale of that stock can generate “second tier” long-term capital gain income from the stock’s NUA.\(^{64}\) In that case, as the CRT beneficiary receives a dollar of NUA second-tier income, the CRT beneficiary should
be informed that there is an offsetting income tax deduction against the long-term capital gain income\textsuperscript{65} and that the net NUA gain is also exempt from the 3.8% surtax.\textsuperscript{66}

J. A charitable gift annuity instead of a CRT?

A charitable gift annuity ("CGA") is an annuity contract whereby a charity agrees to pay a fixed dollar amount over the life of one or (maximum) two individuals.\textsuperscript{67} The value of the annuity must be less than 90 percent of the value of the contributed property, which is why the acquisition of a CGA generates a charitable income or estate tax deduction.\textsuperscript{68} Most charities that offer CGAs use the rates that are recommended by the American Council on Gift Annuities, which tend to generate a larger charitable deduction than just 10 percent.

With much lower administrative costs than a CGA (there is no separate trustee or separate tax return), a CGA is economically feasible with a much smaller dollar investment than a CRT. Many charities will pay annuities for a minimum contribution of between $10,000 and $25,000. By comparison, some charities are willing to administer a CRT for a contribution of no less than $100,000, and most commercial trust companies have a higher minimum for a CRT, such as $200,000 or $500,000.

Only a small percentage of charities offer a CGA or a deferred CGA.\textsuperscript{69} The typical issuer is a university, or hospital foundation, or one of several national charities, with the American Red Cross and the Salvation Army probably issuing the largest number. Many issuers have policies and procedures that might make it difficult for a CGA to be issued for the child of an IRA owner. For example, many universities will not issue CGAs for individuals under age 65, or deferred CGAs for individuals under age 60. It is therefore essential that the charity be contacted to confirm that it will in fact execute the CGA arrangement when the time comes. As is the case with acquiring any annuity, the donor should be cautious and should investigate the financial ability of the organization to honor its financial commitments.\textsuperscript{70}

The annual distributions received under a CGA are taxed under the same rules that apply to the taxation of annuities.\textsuperscript{71} When a person makes a lifetime contribution to acquire a CGA, a portion of each distribution is taxed as annuity income and another portion is a tax-free return of capital.\textsuperscript{72} If the property contributed to the charity included appreciated stock, then a portion of each distribution will also include capital gain income.\textsuperscript{73}

If a CGA is funded at death with the untaxed IRD in a retirement plan account, then the total amount of each annuity distribution from the CGA should be taxed as annuity income since there is usually no tax-free return of capital inside a retirement plan account. It may be helpful for the charity to identify the portion of the annuity income attributable to the IRD since that amount might be exempt from the 3.8% surtax that generally applies to annuity income received by upper-income taxpayers.\textsuperscript{74}

There is currently only one IRS private letter ruling that addresses the consequences of
funding a CGA with a testamentary transfer from an IRA. With the new five year rule to liquidate inherited IRAs and QRP accounts, there will probably be greater interest in using a CGA as a low-cost alternative to a CRT, and the legal outcomes should become clearer.

K. Charitable lead trusts are not tax-exempt

Another type of split-interest charitable trust is a charitable lead trust ("CLT"). Donors are usually attracted to such trusts because, in addition to charitable grants, they can provide estate and gift tax benefits. Unlike a CRT, a CLT is not exempt from the income tax. Either the trust (for a “non-grantor CLT”) or the donor (for a “grantor CLT”) will be subject to income tax on the trust’s income. Hence, a CLT is a lousy beneficiary of IRD. The income tax burden will significantly shrink the CLT’s assets and will reduce whatever other benefits that a CLT could provide.
1. A CRT is tax-exempt under Section 664(c)(1), whereas charities and qualified plans are tax-exempt under Section 501(a).

2. Section 664(c)(2); Reg. Sec. 1.664-1(c).

3. Section 512(c); Reg. Sec. 1.512(c)-1. See also Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner, 724 F.2d 519 (6th Cir. 1983) (retirement plan’s 90% ownership interest in limited partnership that distributed fasteners was taxable, even though the plan physically did no work).

4. Sections 512(b)(4) and 514; Treas. Reg. § 1.514(b)-1(a). The tax problems associated with debt-encumbered investment property are described further at infra Part V.F.5.


6. The education process can begin during the donor’s lifetime. The donor can establish donor advised funds for the children and grandchildren and educate them on philanthropy. Many organizations require a minimum of only $10,000 to establish a donor advised fund. The parent/grandparent can lead by example and identify the charitable interests that were most important to him or to her. The children and grandchildren in such a situation will likely do a better job with the resources in the donor advised fund than others who learn about donor advised funds for the very first time upon the termination of a CRT.

7. Treas. Reg. § 1.664-2(c)(6)(ii). As a practical matter, the CRT would need to have considerable assets to justify the costs of administering a private foundation.


12. Treas. Reg. § 1.664-3(c).

13. See, for example, Michael Jones and Michelle Ward, “Alternative Investments in IRAs”, Trusts and Estates Magazine (June, 2013).

14. Treas. Reg. § 1.664-3(c). The legal standard for the conversion is that it must be “triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons.” Treas. Reg. § 1.664-3(a)(1)(i)(c)(1). The
sale of an illiquid asset, such as real estate, might be considered to be within the discretionary control of the trustee. However, the regulations provide a safe harbor that “a triggering event based on the sale of unmarketable assets ... or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons.” Treas. Reg. § 1.664-3(a)(1)(i)(d).

15. *Id.* (“a specific date”).

16. I.R.C. §§ 664(d)(1)(A) (CRAT) and 664(d)(2)(A) (CRUT)

17. I.R.C. §§ 664(d)(1)(D) (CRAT) and 664(d)(2)(D) (CRUT). The test is applied on the date that the property is placed into the trust rather than on the date that the trust was created. Reg. Sec. 1.664-2(c).

18. Sec. 664(d)(2)(D). If an existing CRUT receives a new contribution that fails the 10% test, there is no affect on the existing assets of the trust but for federal tax purposes the new contribution will be treated as a transfer to a separate trust that is not a CRT. Sec. 664(d)(4).

19. *Id.*

20. Rather than state the specific payout percentage in the trust instrument, it is possible to draft a formula clause in the trust instrument so that the exact payout rate will be determined at the time that the trust is funded. This is especially helpful for a testamentary CRT. The Section 7520 rates could change so much between the time that a trust instrument is drafted and the time that a CRT is actually funded after the settlor’s death that the fixed percentage that was stated in the trust agreement could be too high for the trust to pass the 10 percent charitable value test. Something akin to: The Trustee shall pay, in each taxable year of the unitrust, a unitrust amount equal to the “payout percentage” multiplied by the net fair market value of the trust assets, as finally determined for federal tax purposes, valued as of the first day of each taxable year of the unitrust. The “payout percentage” shall be the highest rate allowable for this trust to qualify as a charitable remainder trust under Section 664 of the Internal Revenue Code of 1986, as amended. Thus, for example, if a 65 year old used this language in a testamentary CRUT for the benefit of a 33 year old child, the payout percentage would be 5.78% if the 65 year old died immediately but would be 7.66% if he or she died 10 years later and the child was then 43 years old. This computation was made assuming that the 2.2% Section 7520 rate that was in effect for most of 2014 would also be in effect 10 years later, which is not likely. Indeed, the payout rate for a 43 year old will likely be different than 7.66% ten years from now.

21. By comparison, the CRUT computations assume the payout computation will be based on a gradually shrinking pool of assets in the CRUT each year, so a higher stated payout is permitted.

22. See *supra* Part V.E.2.b for a range of possible distribution percentages that vary with the term of a CRAT or a CRUT.
23. A term-of-years CRT may be the only CRT solution for a grandchild under age 27, since such a beneficiary is too young to allow a lifetime CRUT to meet the 10% charitable remainder requirement described in supra Part V.E.2.


27. See supra Part V.D.

28. Computed as: \( \frac{1}{(1.03^{20})} = 55.37\% \).

29. PLR 9547004 (Aug. 9, 1995).

30. “Identity of donor. For purposes of qualification under this revenue procedure, the donor may be an individual or a husband and wife. Appropriate adjustments should be made to the introductory paragraph if a husband and wife are the donors.” (emphasis added by author). Rev. Proc. 2005-54, 2005-2 C.B. 353, Section 5.01(5) (annotations).

31. A CRT is subject to the excise taxes on "self-dealing" and "taxable expenditures," but is usually exempt from the excise taxes on excess business holdings and jeopardy investments. I.R.C. §§ 4947(a)(2) and (b)(3).


33. “The activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of I.R.C. § 501(c)(3).” Rev. Rul 98-15, 1998-1 C.B. 718. This would not be the case, however, if the LLC elected to be treated as a corporation taxed under Subchapter C.

34. Section 512(c); Reg. Sec. 1.512(c)-1. See also Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner, 724 F.2d 519 (6th Cir. 1983) (retirement plan's 90% ownership interest in limited partnership that distributed fasteners was taxable, even though the plan physically did no work).

35. Reg. Sec. 1.512(c)-1; See also S. Rep. No. 1402, 85th CONG., 2d SESS. 2 (1958), reprinted at 1958-1 C.B. 656, 657. Interest, dividends, and capital gains are generally excluded from UBTI. Sections 512(b)(1), (3) and (5) and Reg. Sec. 1.512 The exception would be if the investment income was generated by debt-financed property, described infra, at Part V.F.5.c.

36. Debt-financed income of a partnership passes through to a tax-exempt partner. Section 514(c)(9)(B)(vi). See infra Part V.F.5.c for debt-financed UBTI.
37. Section 1361(c)(6).

38. Id.

39. An IRA is generally not eligible to be a shareholder of an S corporation. See the last sentence of Treas. Reg. § 1.1361-1(h)(1)(vii) and Taproot Administrative Services v. Commissioner, 133 T.C. 202 (2009).

40. The IRS rejected creative arguments that a CRT could perhaps qualify as an S corporation shareholder. Rev. Rul. 92-48, 1992-1 C.B. 301; Private Letter Ruling 8922014 (June 2, 1989) (a CRT cannot be a QSST); Section 1361(e)(1)(B)(iii) (a CRT cannot be an ESBT). There have been several mistaken transfers of S corporation stock to CRTs and the Service has forgiven the transgressions as "inadvertent terminations" provided that the transactions were undone. Private Letter Rulings 200819009 through 200818013 (Jan. 11, 2008); 200704026 and 200703023 (Oct. 16, 2006) and PLR 199908046 (Nov. 19, 1998). Even if a CRT could be a shareholder, any S corporation income that was classified as UBTI would cause the CRT to incur a 100% tax liability because a CRT is subject to a 100% tax rate on UBTI. Section 664(c)(2).

41. Reg. Sec. 1.664-1(a)(6); Private Letter Rulings 9533014 (May 15, 1995) and 9015049 (Jan. 16, 1990) (when a CRT makes payments on a mortgage for which the donor remains liable, the CRT could be a "grantor trust" and thereby fail to qualify as a CRT - see Reg. Sec. 1.677(a)-1(d)).

42. Congress concluded in 1969 that tax-exempt organizations were able to use borrowed funds to acquire rental and other investment property at a competitive advantage over taxable organizations. S. Rep. 91-552, reprinted in 1969-3 CB 423, 464.

43. Interest, dividends, rents and the gain from the sale of non-S corporation stock are exempt from UBIT. I.R.C. §§ 512(b)(1), (3) and (5) and Treas. Reg. § 1.512(b)-1.

44. I.R.C. §§ 512(b)(4) and 514; Treas. Reg. § 1.514(b)-1(a).

45. Southwest Texas Electrical Cooperative, Inc. v. Commissioner, 67 F. 3d 87 (5th Cir. 1995) (treasury notes were debt-financed); Kern County Electrical Pension Fund v. Commissioner, 96 T.C. 845 (1991); Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347 (3rd Cir. 1980).

46. Treas. Reg. § 1.514(b)-1(b)(1)(iii), Example. (2). Compare, though, the exemption for certain real property acquisitions in I.R.C. § 514(c)(9), particularly the special allocation rules contained in I.R.C. § 514(c)(9)(E).

47. Treas. Reg. § 1.664-2(b).

48. Id.
49. In a private letter ruling the IRS concluded that a testamentary CRAT could receive contributions from both the settlor’s estate and the settlor’s inter vivos trust without violating the “additional contributions rule “because all properties passing to the charitable remainder annuity trust by reason of the death of the settlor are considered one contribution.” Private Letter Ruling 8121108 (Feb. 27, 1981).


52. When a trustee failed to make any required distributions to the life beneficiary, the Tax Court and the 11th Circuit Court of Appeals held that the trust failed from its inception to qualify as a CRT. Estate of Atkinson, 309 F.3d 1290 (11th Cir. 2002). See infra Part VII.B.1.


54. Section 664(b); Treas. Reg. §§ Reg. Sec. 1.664-1(d)(1)(I) (general rules) and 1.1411-3(d) (the 3.8% net investment income tax – rules for CRT distributions).

55. Section 1411(a)(1) imposes a surtax of 3.8 percent on the lesser of (A) an individual’s net investment income or (B) the amount by which the individual’s modified adjusted gross income exceeds the threshold amount of $250,000 (married joint returns; $125,000 if file separately) or $200,000 for all other returns (single or head of household).

56. Section 1411(c)(5), Treas. Reg. § 1.1411-8.

57. Modified from example contained in Treas. Reg. § 1.1411-3(d)(2)(ii), Example 1. A CRT’s accumulated income from before the year 2013 is exempt from the 3.8% surtax on net investment income, but most investment income after 2012 is subject to the surtax. Treas. Reg. § 1.1411-3(d). To simplify things, this table ignores pre-2013 income.


59. By way of example, if someone is named as the beneficiary of a retirement plan account, he or she will receive a Form 1099-R from the retirement plan administrator that reports retirement plan distributions. The IRS computer is programmed to ignore such distributions from inclusion as “net investment income.” If, however, the retirement plan beneficiary is a trust, then the trustee reports income and deductions to the trust beneficiary on Schedule K-1.

The 2013 Schedule K-1 (to Form 1041) tax form does not contain clear information on how the exemption from the 3.8% surtax for retirement plan income should be reported to the trust beneficiaries. IRD income is reported on line 5 (Other Portfolio and Nonbusiness Income - royalties, annuities, and IRD) of Schedule K-1. That amount is then reported on Schedule E and then carried over in full to Form 8960, which includes the full amount as investment income that could be subject to the 3.8% surtax. There is no distinction on Line 5 between income from
royalties and conventional annuities (which are subject to the 3.8% surtax) and IRD from retirement distributions (which are not). Until matters are clarified, the full amount of retirement income should probably be reported on Schedule K-1 as a negative adjustment with Code “H.” This is the clumsy approach whenever a retirement account makes a distribution to a trust that redistributes the amount to a beneficiary. The system works much better when the individual is named as a beneficiary of a retirement account and receives the Form 1099-R.

60. See *supra* Part II.C for the rules governing eligibility for NUA treatment.


62. Section 691(c)(1)(A); Reg. Sec. 1.691(c)-1(a); Rev. Rul. 92-47, 1992-1 C.B. 198 (Holding 2). When all IRD is received in a single year, then the entire 40% Section 691(c) deduction is claimed in that year. Reg. Sec. 1.691(c)-1. Rev. Rul. 92-47, 1992-1 C.B. 198 (lump sum distribution from an IRA). If there are systematic installments, such as an annuity, then the Section 691(c) income tax deduction is claimed ratably over the projected term. Sec. 691(d); Reg. Sec. 1.691(c)-1(c)(2) and 1.691(d)-1.

There is no clear formula for calculating the amount of the deduction when IRD is recognized with unequal distributions over multiple years from an inherited IRA. The problem is that each distribution from an inherited IRA or QRP account could consist of two types of income: (1) IRD and (2) investment income earned after the decedent's death. The portion of each distribution that represents IRD generates an offsetting income tax deduction whereas the portion that is attributable to investment income earned after the decedent's death does not. Rev. Rul. 92-47, 1992-1 C.B. 198 (Holding 3). The accepted practice in the field seems to be FIFO (“first-in, first-out”). The Section 691(c) deduction is applied to all distributions up to the amount of IRD included on the estate tax return, and thereafter all further distributions are taxed as ordinary income with no offsetting deduction. The FIFO method is the simplest and the easiest to verify.

63. Rev. Rul. 78-203, 1978-1 C.B. 199. Someone who claims the standard deduction, rather than itemizing deductions, gets no tax benefit from the Section 691(c) deduction. The deduction is claimed near the bottom of Schedule A (“other miscellaneous deductions”). It is not subject to the 2%-of-adjusted-gross-income ("AGI") limitation that most miscellaneous deductions are subject to. Sec. 67(b)(7).

64. See the rules for NUA described in *supra* Parts II.C and V.I.3.

65. When IRD consists of a long-term capital gain, then the IRD deduction is applied to reduce the long-term capital gain, which might be taxed at a rate of only 15% or 20%, rather than a deduction against ordinary income where the taxpayer might obtain a benefit at a higher marginal tax rate. I.R.C. § Sec. 691(c)(4). This is further evidence that the Section 691(c) deduction is “stapled” to the type of income that the IRD generated.

67. Section 514(c)(5).

68. Sections 501(m)(3)(E), 501(m)(5) and 514(c)(5); Reg. Sec. 1.170A-1(d).

69. A deferred CGA is an arrangement whereby the annuity payments begin in a year after the charity receives the contribution, such as the year that the donor attains age 66 and is expected to begin retirement.


71. Reg. Sec. 1.1011-2(c)(8).

72. Section 72(b). The exclusion ration is computed over the expected term of the annuity, which is usually the individual’s remaining life expectancy. If an individual lives longer than the projected life expectancy and recovers the full amount of the investment in the contract, then all future payments are fully taxable as annuity income. If the individual dies before the full amount has been recovered, an income tax deduction can be claimed on the individual’s final income tax return. Section 72(b)(3).

73. Reg. Sec. 1.1011-2(a)(4). The capital gain income would also be reported ratably over the term of the projected payments, described in the preceding footnote.

74. Whereas the annuity income of upper-income annuitants (individuals with income over $200,000, or $250,000 on a married joint return) is generally subject to the 3.8% surtax, distributions from QRPs and IRAs are not. Compare the rule for conventional annuities (Section 1411(c)(1)(A)(i), Reg. Sec. 1.1411-1(d)(1)) with the exemption for QRP and IRA distributions (Section 1411(c)(5), Reg. Sec. 1.1411-8). If an IRA is used to acquire a testamentary CGA for an upper-income beneficiary, will the entire CGA payment be subject to the surtax? Or will each payment consist of a combination of annuity income (that is subject to the surtax) and IRD (that is not), computed in a manner analogous to how capital gain is reported by living donors who contribute stock? Nobody knows. By comparison, if IRD from a QRP or an IRA is contributed to a CRT, the IRD’s exemption from the 3.8% surtax should maintain its character when it is distributed from the CRT. See supra Parts V.I.1 and 2.

75. Private Letter Ruling 200230018 (Apr. 22, 2002). An individual named a charity as the beneficiary of an IRA and left instructions with the charity that it should use the IRA proceeds to issue a CGA. The IRS concluded that if an estate tax return will be filed, the full value of the IRA should be reported but there would be a partially offsetting charitable estate tax deduction for the CGA. The IRS concluded that the estate would not recognize taxable income on the transfer from the IRA to the charity, but no explanation was given concerning the income tax consequences of the annuity payments to the annuitant.
A charitable lead trust is the inverse of a CRT: the trust pays amounts to a charity for a period of years and then the remainder interest is distributed to non-charitable beneficiaries, typically family members related to the original donor. The charity’s income interest must be either a guaranteed annuity of fixed payments (a charitable lead annuity trust, or “CLAT”) or annual distributions of a percentage of the fair market value of the trust’s property, revalued annually (a charitable lead unitrust, or “CLUT”). I.R.C. § 170(f)(2)(B)(income tax); I.R.C. § 2055(e)(2)(estate tax); I.R.C. § 2522(c)(2)(B)(gift tax).

Such a trust may be able to claim offsetting charitable deductions for distributions that are required to be made to charities.

I.R.C. § 671.