WALK THE TALK

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Estate of Melvine B. Atkinson v. Commissioner, 115 TC No. 3 (July 26, 2000) serves as a strong reminder that careful administration of a charitable remainder trust is every bit as important as careful drafting.

In August, 1991, the decedent created the Melvine Atkinson Charitable Remainder Annuity Trust and funded it with almost $4 million. The trust document contained all the right terms. It provided the settlor an annuity of 5% of the fair market value of the trust assets as of the date of creation. Following the settlor's death (which occurred in June, 1993) the trust instrument provided for the continuation of the 5% annuity for the benefit of secondary individual beneficiaries. The trust instrument contained a condition that the individual beneficiaries provide funds to pay their share of any state or federal death taxes for which the trust would be liable upon the settlor's death.

The trust instrument clearly met the requirements for creating a valid charitable remainder annuity trust (CRAT) under section 664(d)(1):

- The annuity was at least 5% but no more than 50% of the initial fair market value of the trust, and the payments were for the lives of individuals living at the time of creation of the trust;
- No payments (including taxes) other than the annuities were payable to any person other than a section 170(c) charity;
- Following the termination of the annuities the remainder interest passed to a section 170(c) charity;
- The value of the charitable remainder was at least 10% of the initial value of the trust.

But, two fatal flaws were made during the administration of the trust. First, the settlor never took her 5% annuity payments.[1] Second, the settlor gave one of the secondary individual beneficiaries a signed a notarized document stating that she would not be liable for her share of estate taxes. The decedent's separate estate was not large enough to cover all of the administration expenses and death taxes, and it was necessary to invade the CRAT to make up the shortfall.[2]

The settlor's failure to take her annuity payments certainly did not reduce the amount ultimately passing to charity. However, one of the goals of the legislators in drafting section 664(d)(1)(A) was to limit the amount that could be accumulated tax free and, in parity with the treatment of private foundations, to insure that each year a minimum amount would be returned to the economy and subjected to tax.[3] The failure to take the annuity payments was held, by the Tax Court, to be a fatal omission, and disqualified the trust from a charitable deduction in the settlor's estate.

The disqualification of the trust because of the tax payments on behalf of the secondary beneficiary was even clearer. Regulation section 1.664-1(6), Example (3) and Revenue Ruling 82-128[4], clearly state that a trust will not qualify as a CRAT if the grantor's taxes or debts can be paid from the trust. The result was that no charitable deduction was allowed for federal estate tax purposes.

The authors recognize that the invasion of trust assets to pay the taxes of the secondary beneficiary is a clear violation of the regulations and, standing alone, would defeat the charitable deduction in the estate. The other reason for the disallowance of the deduction, namely the failure to pay the 5% annuity amount gives us more concern.

The sample form for charitable remainder annuity trusts described in Revenue Procedure 89-21[5] tacitly acknowledges delays in paying the annuity. Even though Section 5 of the revenue procedure requires that a trust operate in a manner consistent with the terms of the agreement, Section 4, Paragraph 2 provides for a recalculation of the annuity payments in case of an incorrect determination of fair market value, and Section 4, Paragraph 3 requires a proration for a short year or for the year of death. And, example (6) of regulation section 1.664-1(a)(6) explains how to handle payments made 9 months after funding when the funding, itself, is delayed by 2 and 3/4 years. Furthermore, regulation section 1.664-3(a)(1)(b) and Revenue Procedure 90-31[6] approve income exception trusts, which grant charitable deductions for charitable remainder unitrusts (CRUTs), but not for CRATs, that pay out the lesser of 5% of net asset value or net income. Regulation section 1.664-3(a)(1)(c) goes even one step further and permits an income exception trust to convert, at a later date, to a straight income trust. These regulations show that there are instances in which charitable trusts, containing appropriate language, may refrain from paying a 5% unitrust amount in some years.

Furthermore, recognizing that calculation of the payout amount may, as a practical matter, not always be completed by December 31 of each year, the IRS does permit some unitrusts and annuity trusts to delay payment until the due date of Form 5227 (April 15 of the following year).[7] The IRS had originally taken a much more rigid stance, fearing that by delaying payment the taxpayer could, under the tier rules, turn a payment

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1 There was unsupported testimony that checks were issued but were uncashed.

2 The Trustee initially resisted the beneficiary's claim but the parties eventually reached a settlement.

3 S. Rept. 91-552 (1969), 1969-3 C.B. 423, 481.

4 1982-2 C.B. 71.

5 1989-1 C.B. 842.

6 1990-1 C.B. 539.

7 *See* Reg. § 1.664-2(a)(1)(i) and Reg. § 1.664-3(a)(1)(i).

of taxable ordinary income into a non-taxable payment from corpus. The regulations therefore provide that the delay cannot be used to shift the recognition of income past the year when it was due.

The IRS has also provided for annual taxation of the required unitrust distributions even when they are not made within the trust's taxable year. Regulation section 1.664-1(d)(4)(i) provides for the inclusion in income for the year in which the distribution is required to be made, even if actually distributed at a later date.

One would have hoped, then, that the Service would look favorably on the Atkinson trust if the trustee had carried an account payable on the trust books and paid the accrued annuity amounts to the grantor's estate upon her death.[8] But, alas, such hope was in vain. The Service followed the pronouncement in regulation section 1.664-1(a)(4), which requires that a CRAT function exclusively as a charitable remainder trust from its creation. This position, on first blush, seems not only harsh, but even draconian.

The Tax Court also appeared concerned that the secondary beneficiaries could have succeeded to the forgone payments. Aggressive tax planning and administration did, at one time, use net income unitrusts with a make-up provision as a means of passing tax-free gifts to secondary beneficiaries. Donor would create a CRUT requiring a unitrust payout of, say, the lesser of 7% of the annual net asset value of the trust or net income, for donor's life followed by the same unitrust payout for the life of donor's child. The instrument would also provide that in any year in which net income exceeded 7% any shortfalls for years in which net income was less than 7% would be made up to the extent of net income for that year. The gift to the child would be reported as the value of the trust less the value of the remainder to charity and less the value of the 7% unitrust amount retained by the donor. In fact, however, the trust would be invested strictly in growth assets during the donor's life and strictly for income after the donor's death and during the life of the child. The annual payment that the donor should have received would actually end up in the hands of the child. This scheme has been shut down by regulation section 25.2702-1(c)(3), which values the donor's retained interest in a net income make-up trust at zero unless either the donor's interest is the secondary interest, or the only income beneficiaries are the donor and/or the donor's spouse (who is a U.S. citizen.) But, that regulation is effective on May 19, 1997 and did not apply to the Atkinson trust.

There may be different results depending upon whether the trust is an annuity trust or a unitrust. Annuity trusts (the Atkinson trust is an annuity trust) may not accept additional contributions. Additional contributions to an annuity trust would result in lowering the payout amount as a percentage of total contributions. Also, since the annuity is fixed when the trust is created, the annual payout on the additional contribution, itself, would be zero, and flunk the 5% test. Unless the forgone payments are not treated as additional contributions and are returned to the initial annuitant with interest, this logic would apply to disqualify the annuity trust. This is not the case with unitrusts. Forgoing the unitrust payment also serves to increase the net asset value of the trust and thus future unitrust payouts. But unitrusts may accept additional contributions provided the instrument not only permits them, but also provides for a proration of the unitrust amount to account for the additional contributions.[9] Most unitrust documents are drafted with such language. Had the Atkinson trust been a unitrust, the proper solution to the problem, then, might have been to tax the donor on the constructive receipt of the unitrust amounts in the year when they were due, and to treat the failure to take such payments as additional gifts to the trust, subject to the gift tax and qualifying for charitable deductions for both income tax and gift tax purposes. But it is not absolutely clear that the Tax Court would have taken that approach with regard to unitrusts. Furthermore, the IRS would most probably insist on contemporaneous documentation of the decision to make the additional gift. The prudent practitioner, with respect to both annuity trusts and unitrusts, will, then, follow the exact terms of the regulations and the documents, and insure that all unitrust or annuity payments that are required to be made are actually paid, and paid in a timely manner.[10]

Atkinson is a clear warning to practitioners and trustees that it is not sufficient just to recite qualifying language. One must also administer charitable trusts in conformance with their governing instruments. ■

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8 The accrued income due was, in fact, included as an asset of the decedent's estate.

9 Reg. § 1.664-3(b).

10 What if the overly cautious trustee pays the unitrust amount or annuity early? Conrad Teitell raises two additional problems. First, since early payment actually increases the actuarial value of the income interest, should this cause the trust to fail to qualify for the charitable deduction? Second, the increase in the actuarial value of the income interest may even cause the trust to fail the 10% minimum remainder test or the 5% probability test of Revenue Ruling 77-374. We would hope that the IRS and the courts would apply a facts and circumstances test. Conrad Teitell, “Imperfectly Operated Charitable Remainder Annuity Trust Disqualified”, Charitable Giving Newsletter, August 24, 2000.