Charitable Remainder Trusts
and
Charitable Lead Trusts

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Charitable Alternatives

SECTION I. Charitable Remainder Trusts.

I. Charitable Remainder Trusts.

A. General Rules and Reformation.

Under the Tax Reform Act of 1969, a remainder interest in trust will qualify for an estate tax charitable deduction only if the trust is in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or remainder interest in a pooled income fund. IRC §2055(e)(2)(A); see Private Letter Ruling 7825082. IRC §2055(e) is constitutional. Lynn E. Zabel, Executor of Estate of Beulah G. Palmer v. U.S., ___ USTC ¶___ (D.C. Neb 1998); Estate of Gillespie, 75 T.C. 374 (1980). See Private Letter Rulings 9517020; 8506089 and 8045010 in which the rules of IRC §2055(e) seem to have been circumvented by an outright gift to charity with the requirement that the charity pay an annuity to noncharitable beneficiaries.

1. The Tax Reform Act of 1976 and the Revenue Act of 1978 amended IRC §2055(e)(3) to provide that non-qualifying testamentary trusts created prior to 12/31/78 may be amended prior to 12/31/78 (later extended to 12/31/81) to comply with the provisions of IRC §2055(e)(2)(A). IRC §2055(e)(3). IRC §2055(e)(3) also applies to inter vivos trusts. This legislation is to be liberally construed. See Southeast Banks Trust Co. v. U.S., 79-1 USTC ¶13,297 (D.C. Fla. 1979). But see Strafford Nat'l Bk. v. U.S., 82-2 USTC ¶13,414 (D.C. N. Hamp. 1981). There is no extension for filing a refund claim based upon a reformed trust. Harris Trust and Savings Bank v. U.S., USTC ¶13,399 (Ct. Clms. 1981).

2. Rev. Rul. 74-283, 1974-1 Cum. Bull. 157, provides that Estate of Bosch, 387 U.S. 456 (1967), is inapplicable to certain reformed charitable remainder trusts. See Estate of Ida S. Glick, 142 Misc. 2d 650 (N.Y. Surr. Ct. 1989); Shriner's Hospital for Crippled Children v. Maryland National Bank, 312 A.2d 546 (Md. Ct. of Appeals 1973); In re Will of Stalp, 359 N.Y.S.2d 749 (Surr. Ct. Kings Co. 1974), for judicial decisions amending non-qualifying charitable remainder trusts. See also Rev. Rul. 76-17, 1976-1 Cum. Bull. 279; Rev. Rul. 76-370, 1976-2 Cum. Bull. 286; Rev. Rul. 77-491, 1977-2 Cum. Bull. 332. Non-judicial reformation may or may not be effective. See Craft v. Comm'r, 74 T.C. 1439 (1980); Private Letter Rulings 9517020; 8950001, 7726060. See also Edmisten v. Sands, 300 S.E.2d 387 (N.C. Sup. Ct. 1983), in which the local

court "construed" the faulty trust to avoid the prohibition against "reformation"; Estate of Burdon-Miller, 456 A.2d 1266 (Maine 1983). See also Private Letter Rulings 200218008; 200002029; 9743004 for rulings dealing with reformation to correct "scrivener's errors."

3. The Tax Reform Act of 1984 amended IRC §§2055(e)(3), 170(f), 2522(c) and added IRC §664(f). The purpose of these amendments was to enact permanent reformation rules which will allow the reformation of most defective split-interest trusts. Private Letter Ruling 8647036. The last statute permitting reformation only applied to trusts executed before December 1, 1978, and required the commencement of a proceeding for reformation prior to December 31, 1981. See I.A.1. above. A trust created before 1982 can be reformed under the new law even though it could have been reformed under the old law, but was not. See Private Letter Ruling 8529004. According to the IRS, IRC §2055(e)(3) is the exclusive remedy for a defective split-interest trust. Private Letter Ruling 9326003. But see I.B.6 below.

4. New IRC §2055(e)(3)(J) allows reformation of the payout rate or the duration (or both) for trusts that do not meet the new 10% minimum charitable contribution rules of IRC §664(d).

5. The remainder interest must be a "reformable interest" under two tests:

   a. One test appears in IRC §2055(e)(3)(C)(ii) and may be called the "fixed interest" rule. It requires that all non-charitable payments (before the remainder vests in possession) must be expressed either in specified dollar amounts or as a fixed percentage (with a minimum of 5%) of the fair market value of the property. See Private Letter Rulings 9535025; 9526031; 9515029; 9326003; 9326056; 9312020; 9243039; 9109054; 9101027.

      (1) An exception to the fixed interest rule provides that it will not apply if a judicial proceeding is commenced to change the interest into a qualified interest not later than the 90th day after the due date (including extensions) for the federal estate tax return, or if no such return is required to be filed, not later than the 90th day after the due date (including extensions) for the charitable remainder trust's first income tax

return. See IRC §2055(e)(3)(C) (iii); Estate of Edith L. Bevan, T.C. Memo, 1989-256; Hall Estate v. Comm'r, 93 T.C. 745 (1989), aff'd in unpublished opinion 8/19/91 (6th Cir. 1991); Private Letter Rulings 201115003; 9716019; 9728007; 9422044; 9020020; 8950001. Although the statutory language is not entirely clear, presumably the action required by this exception need only be commenced, not completed, at the stipulated time. See Private Letter Ruling 9422044. However, the deadline for reforming cannot be extended under Reg. § 301.9100-3 because the deadline is statutory and not regulatory. Private Letter Ruling 200548019.

(2) A second exception provides that the rule will not apply in the case of any interest passing under a will executed before January 1, 1979, or under a trust created before that date. IRC §2055(e)(3)(C)(iv); Wells Fargo Bk. v. U.S. (Wand Estate), ____ F.Supp. ____ (C.D. Calif. 1990), aff'd, 1 F.3d 830 (9th Cir. 1993); Reddert Estate v. U.S., ____ F.Supp. ____ (D.C.N.J. 1996); Private Letter Ruling 8749027.

(3) Even when the exceptions to the "fixed interest" rule do not apply, an opportunity may exist to come within the requirements of that rule. If the non-charitable taker is willing, he can disclaim the offensive aspects of his interest to cut back to an acceptable specified dollar amount or fixed percentage. See Private Letter Rulings 9633004; 9341003; 9349010; 9004011 (disclaimers of right to principal invasions); 9549016 (no reformation because life beneficiary did not disclaim right to receive principal). For a "bootstrap" reformation/disclaimer, see Private Letter Ruling 9050005. It may not matter that the disclaimer could not be a "qualified disclaimer" under IRC §2518 for federal gift tax purposes if the resulting assignment could be characterized as "an undivided portion of the taxpayer's entire interest in property" under IRC §170(f)(3)(B)(ii). A disclaimer might have saved the day in Estate of Bevan, T.C. Memo 1989-256. See also Rev. Proc. 74-6, 1974-

1 Cum. Bull. 417, as a potential means to qualify.

b. The other test that must be met in order for an interest to qualify as a "reformable interest" may be called the "deductibility" rule. This rule requires that the subject charitable remainder be deductible under IRC §2055(a) at the decedent's death but for IRC §2055(e)(2). See IRC §2055(e)(3)(C)(i). This rule requires an analysis of pre-Tax Reform Act of 1969 law. It must be demonstrable by reference to pre-1970 case authority that a power of invasion is limited by an "ascertainable standard." It must also be proven that the possibility of invasion pursuant to this standard is so remote as to be negligible. See Rev. Rul. 70-450, 1970-2 Cum. Bull. 195, and Private Letter Ruling 9221014, in which the satisfaction of this test was questionable. See also Private Letter Rulings 9740008; 9648042; 9642010; 9635018; 9623019; 9549016; 9531003; 9523030; 9507018; 9327006.

6. When the reformation is over, there must be a "qualified interest."

a. The reformed trust must comply with the so-called "mandatory" governing instrument requirements, many of which are regulatory, not statutory, creations. See Rev. Rul. 72-395, 1972-2 Cum. Bull. 340; Rev. Rul. 80-123, 1980-1 Cum. Bull. 205, dealing with the description of alternate remaindermen, and Rev. Rul. 82-165, 1982-2 Cum. Bull. 117, dealing with funding period requirements. See Private Letter Ruling 200305023.

b. A key question is always which kind of charitable remainder trust vehicle best suits the situation.

c. How to compensate the non-charitable taker for the loss of the principal invasion provision (if such a provision is present) is a matter for negotiation. Such compensation may be reflected in either or both of (1) the unitrust percentage that is specified or (2) the provisions governing trust investments. In connection with the structuring of trust investment policy, always be mindful of the requirements of Reg. §1.664-1(a)(3).

7. The process that transforms the "reformable interest" into a "qualified interest" must be a "qualified reformation" under three tests:

   a. First, there is an actuarial test. See IRC §2055(e)(3)(B)(i). This test requires that the difference in actuarial value (determined as of the date of the decedent's death) between the reformable interest and the qualified interest must not exceed five percent of the actuarial value (so determined) of the reformable interest. See Private Letter Rulings 9339006; 9221014; 8828083; 8828054. It appears that new IRC §2055(e)(3)(J) is not subject to this limitation.

   b. Second, there is an equal duration test. See IRC §2055(e)(3)(B)(ii). In the context of charitable remainders, this test requires that the non-charitable interest terminate at the same time both before and after reformation. There is a single exception to the equal duration test, but it appears not in IRC §2055(e)(3)(B)(ii), where the equal duration test appears, but can be found at the very end of IRC §2055(e)(3)(B). The exception allows a term to be reduced to 20 years. A reduction to a term of years less than 20 would seem not to qualify. But see, Private Letter Ruling 9422044. It is important to note that this exception applies only with respect to term-of-years interests. If the non-charitable interest runs for 21 years or until the beneficiary's prior marriage, the exception may not be available. But see IRC §664(f). It appears that new IRC §2055(e)(3)(J) is not subject to this limitation.

   c. Third, there is an effective date test. See IRC §2055(e)(3)(B)(iii). This test requires that all changes made by the reformation must be effective as of the decedent's date of death, see Estate of Thomas, T.C. Memo 1988-295, or retroactive to the date of creation. Technical Advice Memorandum 9845001.

8. Reformation can be accomplished without going to court. Private Letter Rulings 9845001; 8737088; 8730034; 8720019. Many jurisdictions by statute permit reformation without court involvement. See Ill. Rev. Stat., ch. 148, §51. Timing may be important if you do not want to pay the tax and sue

for a refund. However, there may be compelling reasons to go to court.

a. A court "construction" proceeding may be necessary to comply with the fixed interest test.

b. Another reason may be the right to continuing court jurisdiction. If the IRS determines that the instrument still is defective, resort to the continuing jurisdiction of the court should permit any such "defect" to be cured. See Private Letter Ruling 8817004 in which the IRS allowed a second reformation to cure defects in the first reformation as long as the first reformation was timely.

c. If one or more of the non-charitable beneficiaries is a minor, such minor may not be able to consent to reformation.

d. A court order should bind the state attorney general if he receives notice.

9. Deduction or refund.

a. In order to claim a deduction, must the reformation be completed before the return is due? The deduction is limited, when allowable, to the amount that would have been deductible with respect to the reformable interest but for IRC §2055(e)(2). See IRC §2055(e)(3)(E).

b. Prior law denied interest on an allowed claim for refund for the period prior to the expiration of the 180th day after the date on which the claim was filed. That rule carries into current law in modified form, although it is hard to find. See P.L. 98-369, §1022(e)(3), under the amendment notes for IRC §664(f). Interest on deficiency is not payable if trust is reformed. See Oxford Orphanage, Inc. v. U.S., 85-2 USTC ¶13,643 (4th Cir. 1985), reversing 84-1 USTC ¶13,575 (D.C.N.C. 1984). In Oxford, a deduction was claimed although the reformation had not been completed before the return was filed. The IRS sought interest under the 180-day rule of pre-1984 IRC §2055(e)(3) and lost. Accord, Shriners Hospitals for Crippled Children v. U.S., 88-1 USTC ¶13,744 (1987), rev'd 88-2 USTC ¶13,789 (1988); See Rev. Rul. 80-281,

1980-2 Cum. Bull. 282; Private Letter Ruling 7906015 to the contrary.

10. Suppose IRC §2055(c)(3) is not available.

a. Will a disclaimer work? Unfortunately, normally what is needed is missing from the governing instrument as originally drafted, and, while disclaimers can serve to eliminate an offensive provision (in some cases), it cannot serve to add a needed provision. See Private Letter Rulings 200541038; 9823037; 9341003; 9349010; 9004011. If the beneficiary whose rights prevent the trust from qualifying dies prior to the due date of the estate tax return, the death will be treated as a "disclaimer." Private Letter Ruling 9728026.

b. Consider the approach in Edmisten v. Sands, 300 S.E. 2d 387 (N.C. Sup. Ct. 1983). There, the Supreme Court of North Carolina was faced with a defective charitable remainder trust. There was no IRC §2055(e)(3) equivalent in effect at the time. The court simply held that it was construing the governing instrument to read as required by federal tax law. In other words, the offending provisions were deemed never to have existed. The needed provisions were deemed always to have been part of the governing instrument. In short, the document always was good and never was bad, in spite of what it might actually have said prior to the court's "construction." In view of the new IRC §2055(e)(3), it seems certain that the taxpayer's resort to this technique will be greeted with hostility by the government. IRC §2055(e)(3)(B) defines a "qualified reformation" broadly to include a "construction." It is likely, therefore, that the government will reject any "construction" obtained in an environment in which the requirements of IRC §2055(e)(3) cannot be satisfied.

c. Consider a post-mortem settlement that forsakes the defective split-interest trust for wholly charitable and wholly non-charitable interests. See The Northern Trust Co. v. United States, 78-1 USTC ¶13,229 (N.D. Ill. 1977); Oetting v. United States, 544 F. Supp. 20 (E.D. Mo. 1982), where the government prevailed at the trial court level against a post-mortem settlement designed to circumvent IRC §2055(e). The case was reversed on

appeal for interesting reasons, 712 F.2d 358 (8th Cir. 1983). See Technical Advice Memorandum 200306002.

After Northern Trust, the IRS issued Rev. Rul. 77-491, 1977-2 Cum. Bull. 332, reiterating its longstanding position that such arrangements should not result in deduction. However, taxpayers continued to win in this area. See also Rev. Rul. 78-152, 1978-2 Cum. Bull. 296; Hubert Estate v. Comm'r, 101 T.C. 314 (1993); National Bk. of Fayetteville v. United States, 727 F.2d 741 (8th Cir. 1984); Strock Estate v. United States, 655 F.Supp. 1334 (W.D. Pa. 1987); Parkes Estate v. United States, 655 F.2d ____ (10th Cir. 1987); Estate of Thomas, T.C. Memo 1988-295; Rev. Rul. 78-152, 1978-9 Cum. Bull. 296.

The IRS finally has given up and reversed its position. Rev. Rul. 89-31, 1989-1 Cum. Bull. 277 revokes Rev. Rul. 77-491 and modifies Rev. Rul. 78-152. However, application of the rules still is uncertain. See Estate of Simpson, T.C. Memo 1994-259; La Meres Estate, 98 T.C. 294 (1992); Terre Haute First Nat'l. Bk. v. U.S., 91-1 USTC ¶60,070 (S.D. Ind. 1991); Estate of Burdick v. Comm'r, 96 T.C. 168, aff'd, 979 F.2d 1369 (9th Cir. 1992); Estate of Johnson v. U.S., 90-2 USTC ¶60,032 (S.D. Miss. 1990), rev'd, 941 F.2d 1318 (5th Cir. 1991); Private Letter Rulings 200127038; 200032010; 9845016; 9845015; 9812014; 9211013; 9038033; 8949004; 8945004; 8948004; 8927057. See also Warren Estate, 93-1 USTC ¶60,127 (5th Cir. 1993).

d. The life beneficiary's death before the due date of Form 706 results in an automatic reformation under IRC §2055(e)(3)(F). C. Harbison, 2000-2 USTC ¶60,389 (2000).

11. The rescission of a charitable remainder trust in a litigated rescission action that the donors won was not self-dealing under IRC §4941 or a taxable expenditure under IRC §4945. See Private Letter Rulings 200601003; 200219012.

12. A bequest to a charitable remainder trust created before October , 1972, is not deductible for estate tax purposes even though the spouse who died prior to October , 1972, received a deduction for the remainder interest at the time of her death. Rev. Rul. 76-198, 1976-1 Cum. Bull. 280. Property passing after 1969 to an old style charitable remainder trust

as a result of the nonexercise of a general power of appointment created in the will of a decedent who died before 1970 is not deductible for estate tax purposes. Rev. Rul. 76-504, 1976-2 Cum. Bull. 286. See Sorenson v. Comm'r, 72 T.C. 1180 (1979); Ellis First National Bank of Bradenton v. U.S., 77-1 USTC ¶13,178 (1977). See also Wells Fargo Bank v. U.S., 79-1 USTC ¶13,275 (1979), aff'd, Case No. 79-4287 (unpublished opinion).

13. Reformation was allowed in Private Letter Ruling 200218008 for a scrivener's mistake. See also, Private Letter Rulings 201048031; 200831002; 200338006.

B. Drafting Sources.

The area of charitable remainder trusts is very technical, and careful adherence to the Code, the Regulations, and other interpretive material is essential. But see Estate of Minnie L. Boeshore, 78 T.C. 523 (1982), acq. in result, 1987-2 Cum. Bull., in which a technical and restrictive regulation (Reg. §20.2055-2(e)(2)(vi)(e)) was held invalid; General Counsel's Memorandum 39163 (11/2/83) for the IRS analysis of Boeshore; and the IRS's acquiescence in IRB 1987-24,4. Based on Boeshore, the IRS has amended the regulations, and revoked Rev. Rul. 76-225, 1976-1 Cum. Bull. 281. See also Private Letter Ruling 7803029, in which the IRS does not disqualify a unitrust for an obviously inadvertent omission. But see Private Letter Ruling 7835037, in which the IRS rejects an argument that the mandatory provisions are administrative and the decedent's intent is controlling.

1. The statutory and regulatory framework for charitable remainder trusts are in IRC §664, and in Reg. §§1.664-1-1.664-3. The IRS no longer will rule on the qualification of standard unitrusts and annuity trusts. Rev. Proc. 89-19, 1989-1 Cum. Bull. 161, amplifying Rev. Proc. 89-3, and Rev. Proc. 90-33, 1990-1 Cum. Bull. 551, amplifying Rev. Proc. 90-3.

2. New annuity trust forms are contained in Rev. Proc. 2003-53-56 (all intervivos), 2003-57-60 (all testamentary). New unitrust forms are contained in Rev. Proc. 2005-52 through Rev. Proc. 2005-59. A provision of a trust voiding the trust if the IRS disallows a charitable deduction for the remainder prevents the trust from qualifying as a valid charitable remainder trust. Rev. Rul. 76-309, 1976-2 Cum. Bull. 196; Private Letter Ruling 7802037. However, a provision which makes a creation of the trust contingent upon a favorable IRS

ruling will not disqualify the trust. Rev. Rul. 76-309, supra. The rules for "flip" unitrusts are in Reg. §1.664-3(1)(c).

3. "Savings clause" which requires the trustee to return the contributed property to the donor if the trust does not qualify is void if the trust does qualify. The clause does not affect the qualification. Private Letter Ruling 7924027. See also General Counsel's Memo 39676; Private Letter Rulings 8732026; 8406007; 7945001. Such a clause may be helpful in giving a court the reasons it needs to reform a trust under IRC §2055(e)(3). See Estate of Kathryn M. Smart, ____ N.Y.S.2d ____ (Surr. Ct. N.Y. Co. 1985).

4. It is not sufficient to incorporate by reference the requirements of IRC §664. Private Letter Ruling 8421007. However, it may be sufficient to incorporate the trusts in Rev. Procs. 89-20, 89-21, 90-30, 90-31, and 90-32 although the Rev. Procs. appear to require a written document which is "substantially similar."

5. Power in trustee to amend trust to qualify it under IRC §664 is ineffective by itself to cure defects in trust for estate tax purposes, but the power itself does not disqualify the trust. Private Letter Ruling 7828006 (pre-IRC §2055(e)(3)). See Teitell, Faulty Charitable Remainder Trusts Saving the Estate Tax Deduction, 118 Trusts & Estates 54 (1979).

6. Judicial reformation to correct "mistakes" was allowed in Private Letter Rulings 200251010; 200218008; 200002029; 9743004.

7. As a result of the Economic Recovery Tax Act of 1981, if a spouse is the only non-charitable beneficiary of a qualified (under IRC §664) charitable remainder trust, the trust will qualify for the unlimited marital deduction added by IRC §§2056(b) and 2523(a). A charitable deduction also is allowed on the death of the spouse so no transfer tax will be payable on the entire transfer.

   a. The statute is not clear whether a spouse's life interest in a pooled income fund or in a personal residence or farm will qualify for the unlimited marital deduction. However, the Committee Reports are clear that such interests qualify. See H.R. Rep. No. 201, 97th Cong. 1st Sess. 162 (1981) and Senator S. Symms Comments in Cong. Rec. S8346 (7/24/81 ed.).

b. Even if the trust is not a qualified IRC §664 trust, an unlimited marital deduction will be allowed for the life interest if the trust is a "qualified terminable interest property" trust [IRC §2056(b)(7)(B)] having charity as a remainderman. IRC §2055(b).

8. A merger of two charitable remainder trusts was approved in Private Letter Ruling 8942014.

9. The doctrine of "substantial compliance" does not apply to reform a charitable remainder trust when reformation could have been accomplished through traditional means. Estate of Tamulis v. Comm's, 509 F.3d 373 (7th Cir. 2007).

C. Amount of Charitable Deduction.

1. Deduction for a unitrust determined under Reg. §1.664-4. Factor computed taking into account frequency of payment to non-charitable beneficiaries, valuation date, and percentage of fair market value of trust assets payable to non-charitable beneficiary. Generally, charitable deduction is maximized by providing for annual rather than more frequent payments to non-charitable beneficiary; valuation of trust assets on first day of taxable year and payment of unitrust amount on last day of taxable year; using unitrust paying more than the assumed rate of return under the tables and annuity trust for payments of the assumed rate of return under the tables or less. Departure from the IRS tables will be permitted only in rare circumstances. Private Letter Ruling 8104042, citing Rev. Rul. 77-195, 1977-1 Cum. Bull. 295. For the new rules relating to terminally ill beneficiaries, see Reg. §§1.7520-3(b); 20.7520-3(b); 25.7520-3(b); and Rev. Rul. 96-3, IRB 1996-3, 1. Contingency that makes remainder less than 10% disqualifies the trust. Private Letter Ruling 200414011.

2. Deduction for annuity trust determined under Reg. §20.2031-10 (one life or term of years) (see Notice 89-60 I.R.B. 1989-22), or from IRS Publication 1458 (Actuarial Values-Beta) (revised in light of the new variable interest rates). Beginning December 1, 1983, the tables assumed a 10% discount rate. Under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), the tables will be revised monthly, beginning in June, 1989. The new rate will be 120% of the federal mid-term rate. IRC §7520. Deduction may be maximized by providing for one payment per year rather than payment at more frequent intervals; payment on last day of taxable year;

and use of annuity trust paying less than the required rate of interest and unitrust for trust paying more than the required rate of interest. Contingency that makes remainder less than 10% disqualifies the trust. Private Letter Ruling 200414011.

3. If grantor of inter vivos charitable remainder unitrust retains a unitrust interest having an adjusted payout rate of less than 5.660, only a portion of trust assets are includable in the grantor's estate under IRC §2036. Rev. Rul. 76-273, 1976-2 Cum. Bull. 268 (6% tables). The same rule applies for an annuity trust. See Rev. Rul. 82-105, 1982-1 Cum. Bull. 133. Under the 10% tables, the unitrust adjusted payout rate which will result in less than all the trust being included in the grantor's estate is 9.091.

4. For an example of the computation of the estate tax credit allowed for gift taxes paid on the creation of a charitable remainder trust during lifetime, see Rev. Rul. 74-491, 1974-2 Cum. Bull. 290.

5. According to the IRS, the possibility that an annuity trust's principal and income will be exhausted before charity receives the remainder must be so remote (less than 5%) as to be negligible. Rev. Rul. 77-374, 1977-2 Cum. Bull. 329, approved in George H. Moor, T.C. Memo 1982-299 (5/27,/82). See Teitell, Unfavorable Charitable Remainder Annuity Trust Ruling, N.Y.L.J. 12/14/77, p. 1; Private Letter Rulings 8125123; 7850068. See also Rev. Rul. 78-255, 1978-1 Cum. Bull. 294, wherein the IRS allowed a deduction for the charitable remainder even though the bequest was contingent on death of beneficiary within 30 days of testator's death. The possibility of the beneficiary's death was so remote as to be negligible. IRS has ruled that Rev. Rul. 77-374 does not apply to a regular unitrust or to an income-only unitrust. Private Letter Rulings 8419005, 7915038. But see Gen. C. Mem. 37770 which casts doubt on the safety of the unitrust from the reach of Rev. Rul. 77-374 under certain circumstances. The 10% tables reduced the difficulties with Rev. Rul. 77-374, but the new floating interest rates may make predictions difficult. See also Private Letter Ruling 9019072 (IRS gave factor of .00018 for unitrust). The IRS ruling that even if the trust is not qualified for the estate or gift tax deduction, it qualifies for the generation skipping transfer tax (so that the transfer is not a direct skip because of the charitable interest), Private Letter Ruling 9440010, was

revoked in Private Letter Ruling 9532006, so that the transfer was a direct skip.

6. Equitable adjustment which increases principal of a charitable remainder trust is included in principal for determining the amount of the deduction. Rev. Rul. 78-445, 1978-2 Cum. Bull. 242; Private Letter Ruling 8016002.

7. Deduction is determined at time trust is created and subsequent events generally do not change the deduction. See Simmons v. U.S., 80-1 USTC ¶9,287 (D.C. Ariz. 1980), aff'd, ____ F.2d ____ (9th Cir. 1982).

8. Until the final Regulations for the new 10% tables were published, a donor had the option to elect to use the 6% tables or the 10% tables. IR 83-158 (12/22/83).

9. An appraisal is required for lifetime gifts. See revised Form 8283 (Rev. October, 1986). An appraisal is critical. See Todd v. Comm'r, 118 T.C. ____ (2002); Bond v. Comm'r, 100 T.C. 32 (1993); Fair v. Comm'r; T.C. Memo 1993-377; D'Arcangelo v. Comm'r, T.C. Memo 1994-572; Hewitt, 109 T.C. 258 (1997), aff'd, 98-2 USTC ¶50,880 (4th Cir. 1998). But see, Herman v. U.S., 99-2 USTC ¶50,899 (U.S. Dist. Ct.). The trustee of a split-interest trust signs Form 8283. Reg. §1.170A-13(c)(7)(v).

10. Deduction available only for assets actually passing to the trust. See Estate of Warren v. Comm'r, 93 T.C. No. 57 (1989); Private Letter Ruling 9419006.

11. The trust must qualify when created, not at a later date. See Private Letter Rulings 9016068; 9017004.

12. Under the new substantiation rules (IRC §170(f)(8)), charitable remainder and lead trusts are exempt from giving the donor the quid pro quo acknowledgement. IRC §170(f)(8)(C); Prop. Reg. §1.170A-13(f)(13).

13. Under amended IRC §664(d), the minimum charitable deduction must be 10%, effective for transfers after 7/28/97, including new transfers to existing trusts. Nonqualifying transfers may be declared void or reformed. IRC §2055(e)(3)(J). See Private Letter Ruling 200022014 for an approach to reformation. See also, Taxable Giving, July, 2000 for a complete analysis of the 10% rule and the reformation revocation rules.

14. In Estate of Burchell v. U.S., 2001-1 USTC ¶60,410, taxpayer attempted to use actual life expectancy rather than the tables to value the life estate.

15. Rev. Proc. 2005-24, 2005-16 I.R.B. 909, providing for retroactive disallowance of the income tax deduction unless spousal right of election is waived, is ill-conceived and unnecessary. See, Private Letter Ruling 200541038. Rev. Proc. 2005-24 has been postponed "until further guidance." Notice 2006-15.

D. Charitable Remainder Unitrust.

A charitable remainder unitrust pays the non-charitable beneficiary an annual unitrust amount equal to a specified percentage (not less than five percent) of the net fair market value of the trust assets, valued annually. Upon the death of the non-charitable beneficiary, the trust terminates, and the assets are paid to or held for the benefit of the charitable remainderman. Every charitable remainder unitrust must contain certain mandatory provisions, and may contain other optional provisions.

1. The trust instrument must provide for payment to the non-charitable beneficiary of a specific percentage of the trust assets (unitrust amount) which cannot be less than five percent nor more than 50% of the net fair market value of all property in the trust, valued annually. IRC §664(d)(2)(A); Rev. Rul. 74-19, 1974-1 Cum. Bull. 155 (in response to Rev. Rul. 74-19, N.Y. SCPA §2309(3) was amended to provide that trustee's commissions are chargeable entirely to principal); Rev. Rul. 74-39, 1974-1 Cum. Bull. 156; Rev. Rul. 76-280, 1976-2 Cum. Bull. 195. See Private Letter Rulings 8211015, 7816077, 7948088 and 8146002, which approve unusual payout provisions. If the percentage payable to the non-charitable beneficiary increases during the trust term, the trust does not qualify. Rev. Rul. 80-104, 1980-1 Cum. Bull. 135 (7% to X during grantor's lifetime, 9% after grantor's death). Under the Proposed Regulations, for a standard unitrust only, the payments to the beneficiaries had to have been made by the end of the taxable year. Prop. Reg. §1.664-3(a)(1)(e). Notice 97-48, IRB 1997-48 (12/1/97) gave some relief for 1997 if the payout rate was 15% or less or if the payments were taxable to the beneficiaries. Final Reg. §1.664-2(a)(1)(i) expands the "safe harbors" for payment after the end of the year, but the substance of the new rule is that the beneficiary must be taxed on the distribution.

a. The valuation date may be any day of the taxable year, or a combination of dates. Reg. §1.664(a)(1)(iv).

b. If the valuation date is other than the first day of the taxable year, the instrument must provide for valuation on the last day of a short taxable year or on the day the non-charitable beneficiary's interest terminates. Reg. §§1.664-3 (a)(1)(v)(a), and (a)(1)(v)(b). See Rev. Rul. 76-467, 1976-2 Cum. Bull. 198; Private Letter Ruling 7819042. The instrument must be specific about what the date is in the year the unitrust period ends. Private Letter Ruling 8138086.

c. For an IRS approved form for a situation where no valuation date occurs in a short taxable year, see Rev. Rul. 82-165, 1982-2 Cum. Bull. 117.

d. The percentage is to be applied to the trust "assets", not just to the trust "principal." See Private Letter Ruling 7734073.

e. The trustee may be given the power to select the valuation date. Private Letter Ruling 7818028.

f. If the income of the trust is insufficient to make the payments, principal must be used, unless the trust is an income-only trust. Private Letter Ruling 8044020.

g. Change in valuation date as a result of IRC §645(a) does not disqualify trust if the valuation date is not after the date of the first payment. Private Letter Ruling 8916008.

2. No payments other than the unitrust amount may be paid to any non charitable beneficiary. Reg. §1.664-3(a)(4). See Rev. Rul. 77-58, 1977-1 Cum. Bull. 175. The grantor may not reside in a house transferred to the unitrust because rent-free use of property is payment other than a unitrust amount. See Private Letter Rulings 7802016 and 7724055. Fees may not be charged against the unitrust amount even if the amount is never less than 5%. Rev. Rul. 74-19, 1974-1 Cum. Bull. 155; Private Letter Rulings 8805023; 7807096. A trust may be amended (if permitted by state law) to allow payment of excess income to charity during the beneficiary's lifetime because such a provision could have been included at the time the trust was created. Private Letter Ruling 8034056, reversing Private Letter Rulings 8015122; 200010035;

200052035. The trustee (other than a grantor) should be able to "sprinkle" the unitrust amount between the charitable and non-charitable beneficiaries. See Private Letter Rulings 201117005; 9052038; 9801013. The trust may require the donor's consent before distributions are made during the donor's lifetime to charity. Private Letter Ruling 9442017. The charitable remainderman may not guarantee the payments to the non-charitable beneficiaries. Private Letter Ruling 9034010. Return of erroneous contribution is not self-dealing and will not disqualify the trust. Private Letter Ruling 200601003

3. The non-charitable beneficiary must be a person which is not a charitable organization described in IRC §170(c). The non-charitable beneficiary need not be an individual. A corporation may be the grantor and the beneficiary for a term not to exceed 20 years. Private Letter Rulings 9205031; 9253055; 9512002. A trust may be the non-charitable beneficiary. Rev. Rul. 76-270, 1976-2 Cum. Bull. 194; Private Letter Rulings 9821029; 96190042-44; 9422044; 9328041; 9101010; 9253055. But compare Private Letter Ruling 7953029 with Private Letter Ruling 8105097. However, the current position of the IRS is that if an individual is the non-charitable beneficiary, a trust for the individual may be the non-charitable beneficiary only if the actual beneficiary is incompetent. Rev. Rul. 2002-20, 2002-1 Cum. Bull. 794. See also Private Letter Rulings 199903001; 9839024; 9710008-10 revoking Private Letter Rulings 96190042-44; Technical Advice Memo 9831004. If the non-charitable beneficiary is an individual, the individual must be alive and ascertainable at the time the trust is created. IRC §§664(d)(1)(A) and (2)(A). Gifts to certain classes of beneficiaries are permissible. Reg. §1.664-3(a)(3)(iii). The beneficiary may not be a pet, Rev. Rul. 78-105, 1978-1 Cum. Bull. 295, but a deduction may be allowed if the provisions for the pet are void under state law. Reference to "spouse" as recipient will not disqualify trust if identity is ascertainable. Private Letter Ruling 7918002. The income interest is subject to claims of beneficiary's creditors. In re Jeffrey Charles Mark, 2001-2 USTC ¶50,754 (D.Minn.).

4. The non-charitable beneficiary may receive payments for either a term not to exceed 20 years, or for his life or the lives of other non charitable beneficiaries. See Private Letter Rulings 9322031; 8749052; 8108085; 7913133. The period of payment must commence with the creation of the trust, which is the date of death in a testamentary remainder trust.

Rev. Rul. 82-165, 1982-2 Cum. Bull. 117. See Private Letter Ruling 8033091. A modification to a charitable remainder trust which modifies the order in which non-charitable beneficiaries receive the unitrust amount disqualifies the trust. Private Letter Ruling 9143030 (the consent of all parties is treated like a power to amend).

However, in the case of a testamentary trust, Reg. §1.664-1(a)(5)(i) permits deferral of the payment of the unitrust amount until the end of administration. Rev. Rul. 80-123, 1980-1 Cum. Bull. 205, modified Rev. Rul. 72-395 and requires that testamentary charitable remainder trusts provide that the obligation to pay the annuity trust amount or the unitrust amount begins on the date of death and also for corrective payments. IR 83-158 (12/22/83) provides that the "corrective payment" provisions of existing trusts will not have to be changed. For trusts created between 10/24/83 and 30 days after the final Regulations are published, either the 6% or the 10% rate can be used. See Rev. Rul. 82-165, 1982-2 Cum. Bull. 117. See also Teitell, Testamentary Charitable Remainder Trusts - New Requirements, N.Y.L.J. 7/7/80, p.1. See Private Letter Rulings 9617036; 9617037; 9039020; 7825012, which explain the computation of amounts due beneficiaries for the period prior to funding. Rev. Rul. 88-81, 1988-2 Cum. Bull. 127, provides new sample forms for the interest rate to be charged on corrective payments. The new Rev. Procs. do not have the "corrective payment" language of Rev. Rul. 88-81, because interest on deferred payments is not required. Rev. Rul. 92-57, 1992-1 Cum. Bull. 123 (1992-29 IRB 4), modifies Rev. Rul. 88-81 and Rev. Rul. 82-165. The latest "clarification" of this issue is in Private Letter Rulings 9617036; 9617037. See Warren, Gorham & Lamont, "Charitable Giving and Solicitation," Vol. 7, No. 24 (9/19/95), for an excellent discussion of the various "methods" of computing the deferred payments.

a. The grantor of an inter vivos trust may retain the testamentary power to revoke the interest of the non-charitable beneficiary. Reg. §1.664-3(a) (4). The power to revoke will avoid gift tax on the non-charitable beneficiary's interest, but the income tax deduction will be currently available. Rev. Rul. 79-243, 1972-2 Cum. Bull. 343; Private Letter Rulings 8949061; 8204176; 8204214; 7828051; 7921081. See Reg. §25-2511-2(c). An inter vivos power to revoke will disqualify the trust. Private Letter Ruling 8430006.

(i) The power should not be retained unless the grantor is a beneficiary because the trust will be included in the grantor's gross estate under IRC §2038. See Private Letter Ruling 8949061.

(ii) Also, it is possible that the value of the remainder may be measured by the grantor's life expectancy and not the beneficiary's life expectancy. Such an interpretation would violate Reg. §1.664-3(a)(5) and Reg. §1.664-2(a)(5). See Private Letter Ruling 8949061.

(iii) For the tax consequences of the release of the power to revoke, see Private Letter Ruling 8949061.

(iv) The new Rev. Procs. do not contain powers to revoke, but they are still necessary to avoid a current gift unless the other beneficiary is a U.S. citizen spouse. See Private Rulings 9511029; 9511007.

b. Upon revocation, a distribution to charity may be required. See Reg. §1.664-3 (a)(4).

c. Until the enactment of IRC §664(f), remarriage was not a proper terminating event, but a reduction in payments upon remarriage did not disqualify the trust. Rev. Rul. 76-291, 1976-2 Cum. Bull. 284. The addition of IRC §664(f) should change this result. See Private Letter Rulings 201117005; 9821009; 9511029; 9322031.

d. If an individual's interest is to terminate at the expiration of a life, it must be his life and not the life of another beneficiary. Private Letter Ruling 7913133. See Private Letter Ruling 9322031.

e. See Rev. Rul. 77-471, 1977-2 Cum. Bull. 322, for the method of computing the amount includable in the non-charitable beneficiary's estate when the beneficiary of a unitrust dies during the deferral period.

f. According to the IRS, an in terrorem provision will disqualify the trust because the interest of the non-charitable beneficiary may terminate by an event other than his death or the expiration of a fixed number of

years. Private Letter Rulings 7732011; 7942073; 8321028. This position seems clearly to be incorrect, but the issue should be moot after the addition of IRC §664(f).

g. See Private Letter Ruling 8647007, in which the IRS allowed a unitrust to terminate early by division according to actuarial interests. See also, Private Letter Rulings 200846037; 200548023; 200127023; 8805024. If the remainder beneficiary is a private foundation of which the donors are disqualified persons, the termination is an act of self-dealing. See Private Letter Ruling 200525014, revoked by 200614032.

h. See Private Letter Ruling 8805024 in which the IRS reviews the income and gift tax consequences of a partial early termination by a transfer of the life interest by the grantor to the remainderman. See also Rev. Rul. 86-60, 1986-1 Cum. Bull. 302; GCM 39404; GCM 38380; Private Letter Rulings 200552015; 200310024; 200140027; 200205008; 9817010; 9721014; 9511041; 9529039; 9409017. If the life interest is transferred by a non-grantor or by a grantor/beneficiary, the transfer is a transfer of a capital asset. Rev. Rul. 72-243, 1972-1 Cum. Bull. 233; Private Letter Rulings 200310024; 200140027; 20010035; 8948023; 8613046; 8311063; 8052092. The gift of the life interest does not result in a termination of private foundation status under IRC §507. Private Letter Ruling 9408012. A gift of a partial interest in the life beneficiary's interest is deductible. Private Letter Ruling 9550026 (approving a gift of a 20% interest in the life beneficiary's interest). Private Letter Ruling 200524014 approves a division of unitrust and then a gift of the unitrust interest in one trust without jeopardizing the status of the remaining trust.

i. The swap of the life beneficiary's interest for a gift annuity was approved in Private Letter Ruling 200152018. See also Private Letter Ruling 200152018 in which the consequences of the use of an IRA to purchase a gift annuity were discussed.

j. The IRS has allowed the division of one unitrust into two identical trusts when the grantors dissolved their

marriage. Private Letter Rulings 200524013; 200502037; 200340022; 200221042; 200109006; 9403030; 9851006; 9851007; 9409017. Likewise where the division was part of a will contest settlement. Private Letter Ruling 200229046.

k. Retention of power to revoke rendered the gift to the life beneficiary's incomplete, thus allowing a disclaimer following the grantor's death. Private Letter Ruling 200204022.

5. On termination of the non-charitable beneficiary's interest, the trust assets must be paid to or retained for the use of a charitable organization described in IRC §170(c). Reg. §1.664-3(a) (6)(i). A trust which required that $10,000 of the remainder be distributed to an individual and the balance to charity did not qualify. Private Letter Rulings 8338109; 7821064; 7933054; 7951049. IRC §170(c) is an income tax provision, and if a deduction is desired for estate tax purposes, the organization must also be qualified under IRC §2055(a). See Rev. Rul. 76-307, 1976-2 Cum. Bull. 56; Rev. Rul. 77-385, 1977-2 Cum. Bull. 331; Private Letter Rulings 7925089; 7929052; 7803050. (Savings clause prohibiting trustees who could choose charities from exercising powers in a manner that would disqualify the trust was valid to save trust that only referred to IRC §170(c)). The donor may impose restrictions on the remainderman's use of the property. See Private Letter Ruling 7912042. Trust qualified when upon the grantor's death, the annuity amount was paid to another trust wholly for charitable purposes. Private Letter Ruling 8749052.

6. If the named charitable remainderman is not qualified at the time when the trust assets are distributable to it, the trust instrument must provide for an alternative charitable remainderman. See Private Letter Ruling 7908058. The selection of the alternate charitable remainderman may be left to the trustee, to the non-charitable beneficiary or to the grantor by will or deed. Rev. Rul. 76-8, 1976-1 Cum. Bull. 179; Private Letter Rulings 9504012; 9331044; 9326049; 9014033; 9022014; 8919016; 8407035; 8312060; 8002044; 7928014; 7923037. See also, Rev. Rul. 69-285, 1969-1 Cum. Bull. 222; Private Letter Ruling 9634025. If the grantor retains the right to designate the remaindermen, the gift is incomplete, Private Letter Rulings 9106008; 8407035, but the trust will qualify. See also Rev. Rul. 76-8, 1976-1 Cum. Bull.

179; Rev. Rul. 76-371, 1976-2 Cum. Bull. 305. If the grantor or beneficiaries have the power to designate charities other than 50% charities, the income tax deduction is limited to the lower limitations of IRC §170; Rev. Rul. 80-38, 1980-1 Cum. Bull. 56; Rev. Rul. 79-368, 1979-2 Cum. Bull. 109. See also Rev. Rul. 68-417, 1968-2 Cum. Bull. 103. Private Letter Rulings 9818027; 9826021-022; (reformation permitted to allow designation of private foundations, but deduction reduced).

7. The trust instrument must provide for proration of the unitrust amount in the case of a short taxable year. Reg. §1.664-3(a)(1)(v); Rev. Rul. 79-428, 1979-2 Cum. Bull. 253; Private Letter Rulings 7734073; 7933020; 8211112. The 1989 New Rev. Procs. are incorrect on this issue, but the 1990 New Rev. Procs. are correct. See Private Letter Ruling 7842021. Alternatively, the payments to the non-charitable beneficiary may terminate with the last regular payment preceding the non-charitable beneficiary's death. Reg. §1.664-3(a)(5)(i); Rev. Rul. 74-386, 1974-2 Cum. Bull. 189. If the trust is for a term of years only, the provision may not be necessary. Private Letter Ruling 8111077. In joint life trusts, it is advisable to provide for proration of the unitrust amount between the non-charitable beneficiaries or that the first to die does not receive any additional payments.

8. The trust instrument must either prohibit additional contributions, or must contain a formula setting forth a procedure for valuing any additional contributions. Reg. §1.664-3(b). See Rev. Rul. 74-149, 1974-1 Cum. Bull. 157; Rev. Rul. 74-481, 1974-2 Cum. Bull. 190; Private Letter Rulings 8211112; 8120083; 8116062; 7908058; 7807080 and 7842021.

   a. If future contributions are prohibited, instrument should prohibit any donor, not just the grantor, from making such additional contributions. See Private Letter Ruling 7727017. See Private Letter Ruling 200052026 in which the IRS allowed the return to the grantors of a gift that was prohibited under the trust.

   b. Omission of the "additional contributions" provision disqualifies the entire trust, not just additional contributions. Private Letter Ruling 7828006.

   c. If payments to the non-charitable beneficiary terminate with the payment next preceding the date of

the beneficiary's death, the "additional contribution" formula of Rev. Rul. 72-395 must be modified.

d. Funding a trust from a probate estate and a revocable trust does not violate the prohibition against additional contributions because all property passing as a result of death of the donor is considered one contribution. Private Letter Ruling 8121108.

9. The trust instrument must contain some, but not all, of the prohibitions imposed on private foundations. IRC §4947(a)(2); IRC §508(e); Rev. Rul. 74-368, 1974-2 Cum. Bull. 390. State law imposes these restrictions automatically. See Cal. Prob. Code §16,100 et seq.; N.Y. EPTL 8-1.8; Rev. Rul. 75-38, 1975-1 Cum. Bull. 161.

10. The trust instrument must provide that if the amount paid to the non-charitable beneficiary is incorrect because of an incorrect valuation, an adjustment in future payments will be made. Reg. §1.664-3(a)(1)(iii); Private Letter Ruling 7913092; Rev. Rul. 82-165, 1982-2 Cum. Bull. 117, provides a new sample form for this provision in testamentary trusts. See Rev. Rul. 74-403, 1974-2 Cum. Bull. 381, for a suggestion that federal estate and gift tax concepts be used to value assets. See also Private Letter Ruling 7825066.

11. If distributions in kind to charity are permitted prior to the termination of the non-charitable beneficiary's interest, the basis of the assets distributed must be representative of the basis of all assets available for distribution. Reg. §1.664-3(a)(4); Private Letter Ruling 7933002. See Private Letter Ruling 7726031 for a seemingly erroneous application of the "fairly representative" rule to distributions of the unitrust amount.

12. A variation of the unitrust is the "income-only" unitrust. The income-only unitrust provides that the non-charitable beneficiary receives the lesser of the trust's income (as defined in IRC §643(b)) for each taxable year, and the unitrust amount. See Rev. Rul. 76-310, 1976-2 Cum. Bull. 197. The instrument may, but need not, provide that if trust income for a given year is less than the unitrust amount, the deficiencies may be paid to the non-charitable beneficiary in subsequent years from excess income. Reg. §1.664-3 (a)(1)(i)(b). According to several Private Letter Rulings, if the "liability" to pay the deficiency in future years is taken into account in determining the value of the trust assets each

year, the trust may allocate post-contribution capital gain to "income." Private Letter Rulings 9442017; 9511029; 9511007. However, Prop. Reg. §1.664-3(b)(3) does not require the reduction of the value by the liability; it is silent on the issue.

a. The income-only unitrust is useful when the trust assets consist of low income producing assets which cannot be readily converted into higher income producing assets.

b. An income-only unitrust may be used to retain a controlling interest in a closely held corporation because a charitable remainder trust is not subject to the excess business holdings rule of IRC §4943.

c. The income-only unitrust may be used if the non-charitable beneficiary is initially in high income tax brackets, but will soon be in low brackets.

d. For purposes of computing the charitable remainder, the income-only feature is disregarded.

e. A "flip" unitrust (an income-only unitrust that becomes a standard unitrust upon the occurrence of a condition) was approved in Private Letter Ruling 8732026. However, a reformation from an income-only unitrust to a fixed-percentage unitrust was not permitted in Private Letter Ruling 9506015, in which the IRS stated that the technique was not available even if the reformation was appropriate. Private Letter Rulings 200031034; 200002029 and 9822041, in which reformation was permitted due to a "scrivener's error." Cafferata, "Putting More Flexibility in the Net Income Limitation on Charitable Remainder Trusts," 7 J. Tax. of Exempt Organizations 18 (July/August, 1995). See also, Private Letter Rulings 9516040; 9522021. Reg. §1.664-3(c)(1) permits "flip" unitrusts. See, Paragraph L.20, infra.

13. The trust instrument must not restrict the trustee from investing trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Reg. §1.664-1(a)(3); Rev. Rul. 73-610, 1973-2 Cum. Bull. 213; Rev. Rul. 73-571, 1973-2 Cum. Bull. 213; Private Letter Rulings 7749034 and 7803029.

a. A requirement that the trustee invest in tax exempt securities violates Reg. § 1.664-1(a)(3). Private Letter Ruling 7802037.

b. Requiring the approval of the life beneficiary before changing investments violates Reg. §1.664-1(a)(3); Private Letter Rulings 8041100; 7928014; 7928076; 7948108.

c. A charitable remainder trust may invest in life insurance. Private Letter Rulings 199915045; 8745013; 7928014.

d. Funding a unitrust with closely held stock subject to a buy-sell agreement does not restrict the trustee. Private Letter Ruling 8015036.

e. A trustee may commingle trust assets with other trusts as long as adequate records are kept. Private Letter Rulings 9231008; 8212067.

f. Tangible personal property may be used to fund a charitable remainder trust but no income tax deduction will be allowed until the property is sold if the grantor or family member is the beneficiary. IRC §170(a)(3); Private Letter Ruling 9413020.

g. Holding a partnership interest will not violate Reg. §1.664-1(a)(3). Private Letter Ruling 9533014.

14. Debts, taxes, and administration expenses must be paid before funding the trust. See Private Letter Rulings 8003153, 7724055, and 7842021. But see Private Letter Ruling 200305023.

15. No death taxes may be paid from an inter vivos remainder trust. See Rev. Rul. 82-128, 1982-2 Cum. Bull. 71, effective for trusts created after 10/3/82; Private Letter Rulings 9512016; 9512017; 9225026; 9107010. See Teitell, Charitable Remainders - Drastic Ruling, N.Y.L.J. 8/2/82, p.1, for an excellent discussion of the ruling. See also Private Letter Ruling 8313052 which did not require an amendment of a pre-10/4/82 trust to take into account Rev. Rul. 82-128 with respect to additional contributions. See also, Technical Advice Memorandum 9419006 for a discussion of how death taxes are computed in a charitable remainder trust following a QTIP trust. It appears to be permissible to obligate the

grantor's estate to pay death taxes, at least in the first instance, instead of putting the burden on the life beneficiary whose interest covers the taxes. See Atkinson Est. v. Comm'r., 115 T.C. 26 (2000) aff'd, 309 F.3d 1290 (11th Cir. 2002); Private Letter Rulings 200305023, 9512016; 9512017.

16. A trust may be a donor to a charitable remainder trust for a term of years. Private Letter Ruling 9821029.

17. A limited liability company may be the grantor and beneficiary of a charitable remainder trust for a term of years. Private Letter Ruling 199952071. Likewise for an S corporation, Private Letter Rulings 9512002; 9253055; 9205031, but individuals cannot be beneficiaries after the term of years. Private Letter Ruling 200203034.

18. The payments must be made to the non-charitable beneficiary or the trust will be disqualified. Atkinson Est. v. Comm'r, 115 T.C. 26 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002).

E. Charitable Remainder Annuity Trust.

A charitable remainder annuity trust pays the non-charitable beneficiary a sum certain which is not less than five percent of the initial net fair market value of the trust assets. Upon the death of the non-charitable beneficiary, the trust terminates, and the assets are paid to or held for the benefit of the charitable remainderman. For values of remainder interests in annuity trusts, see IRS Publication 1457 (Actuarial Values-Alpha). See Notice 89-60, I.R.B. 1989-22. Every charitable remainder annuity trust must contain certain mandatory provisions, and may contain other optional provisions.

1. The trust instrument must provide for payment to the non-charitable beneficiary of a sum certain (annuity amount) which cannot be less than five percent not more than 50% of the initial net fair market value of all property in the trust. IRC §664(d)(1)(A); Rev. Rul. 74-19, 1974-1 Cum. Bull. 155; Rev. Rul. 76-280, 1976-2 Cum. Bull. 195. See Private Letter Rulings 8211015, 7816077, 7948088 and 8146002, which approve unusual payout provisions. See also N.Y. SCPA 2309(3). If the percentage payable to the non-charitable beneficiary increases during the trust term, the trust does not qualify. Rev. Rul. 80-104, 1980-1 Cum. Bull. 135. If the income of the trust is insufficient to make the payments, principal must be used. Private Letter Ruling 8044020. Under Prop. Reg. §1.664-2(a)(1)(i), the payment must have been

made by the end of the taxable year. Notice 97-68, IRB 1997-48 (12/1/97) gave some relief for the 1997 tax year if the payout rate was 15% or less, or if the distributions to the beneficiary for 1997 were taxable. Final Reg. §1.664-2(a)(1)(i) expands the "safe harbors" for payment after the end of the year, but the substance of the new rule is that the beneficiary must be taxed on the distribution.

2. The initial fair market value of the trust is determined when the trust is funded, not on the date of death. Private Letter Ruling 8020130. But see Matter of Dee, 103 Misc. 2d 199, (N.Y. Surr. Ct. 1980).

3. No payments other than the annuity trust amount may be paid to any non-charitable beneficiary. Reg. §1.664-2(a)(4). See Rev. Rul. 77-58, 1977-1 Cum. Bull. 175. Rent-free use of property is not permissible. Private Letter Rulings 7802016 and 7724055. No fees may be charged against the annuity trust amount. See Rev. Rul. 74-19, 1974-1 Cum. Bull. 155; Private Letter Rulings 8805023; 7807096. A trust may be amended (if permitted by state law) to allow payment of excess income to charity during the non-charitable beneficiary's lifetime because such a provision could have been inserted in the instrument at the time of creation. Private Letter Ruling 8034056, reversing Private Letter Rulings 8015122; 200010035; 200052035. The trustee (other than a grantor) may "sprinkle" the annuity amount between charity and the non-charitable beneficiary. Private Letter Rulings 201117005; 9052038; 9801013. The charitable remainderman may not guarantee the payments to the non-charitable beneficiary. See Private Letter Ruling 9034010. Return of erroneous contribution is not self-dealing and will not disqualify the trust. Private Letter Ruling 200601003.

4. The non-charitable beneficiary must be a person which is not a charitable organization described in IRC §170(c). The non-charitable beneficiary need not be an individual. A corporation may be the grantor and the beneficiary of a trust for a term not to exceed 20 years. Private Letter Rulings 9205031; 9253055; 9512002. A trust may be the non-charitable beneficiary. Rev. Rul. 76-270, 1976-2 Cum. Bull. 194; Private Letter Rulings 9821029; 96190042-44; 9422044; 9328041; 9253055; 9101010. Compare Private Letter Ruling 7953029, with Private Letter Ruling 8105097. However, the current position of the IRS is that if an individual is the non-charitable beneficiary, a trust for the individual may be the

non-charitable beneficiary only if the actual beneficiary is incompetent. Rev. Rul. 2002-20, 2002-1 Cum. Bull. 794. See also Private Letter Rulings 199903001; 9839024; 9710008-10 revoking Private Letter Rulings 96190042-44; Technical Advice Memo 9831004. If the non-charitable beneficiary is an individual, the individual must be alive and ascertainable at the time the trust is created. IRC §664(d)(1)(A), (2)(A). Gifts to certain classes of beneficiaries are permissible. Reg. §1.664-2(a)(3)(i). The beneficiary may not be a pet, Rev. Rul. 78-105, 1978-1 Cum. Bull. 205. but a deduction may be allowed if the provisions for the pet are void under state law. Reference to "spouse" as recipient will not disqualify trust if identity is ascertainable. Private Letter Ruling 7918002. The income interest is subject to claims of beneficiary's creditors. In re Jeffrey Charles Mark, 2001-2 USTC ¶50,754 (D.Minn.).

5. The non-charitable beneficiary may receive payments for either a term not to exceed 20 years, or for his life or the lives of other non charitable beneficiaries. See Private Letter Rulings 9322031; 8749052; 8108085; 7913133. The period of payment must commence with the creation of the trust, which is the date of death in a testamentary remainder trust. Rev. Rul. 82-165, 1982-2 Cum. Bull. 117. See Private Letter Ruling 8033091. A modification to a charitable remainder trust which modifies the order in which non-charitable beneficiaries receive the unitrust amount disqualifies the trust. Private Letter Ruling 9143030 (the consent of all parties is treated like a power to amend).

However, in the case of a testamentary trust, Reg. §1.664-1(a)(5)(i) permits deferral of the payment of the unitrust amount until the end of administration. Rev. Rul. 80-123, 1980-1 Cum. Bull. 205, modified Rev. Rul. 72-395 and requires that testamentary charitable remainder trusts provide that the obligation to pay the annuity trust amount or the unitrust amount begins on the date of death and also for corrective payments. IR 83-158 (12/22/83) provides that the "corrective payment" provisions of existing trusts will not have to be changed. For trusts created between 10/24/83 and 30 days after the final Regulations are published, either the 6% or the 10% rate can be used. See Rev. Rul. 82-165, 1982-2 Cum. Bull. 117. See also Teitell, Testamentary Charitable Remainder Trusts - New Requirements, N.Y.L.J. 7/7/80, p.1. See Private Letter Rulings 9617036; 9617037; 9039020; 7825012, which explain the computation of amounts due beneficiaries for the period prior to funding. Rev. Rul. 88-81,

1988-2 Cum. Bull. 127, provides new sample forms for the interest rate to be charged on corrective payments. The new Rev. Procs. do not have the "corrective payment" language of Rev. Rul. 88-81, because interest on deferred payments is not required. Rev. Rul. 92-57, 1992-1 Cum. Bull. 123 (1992-29 IRB 4), modifies Rev. Rul. 88-81 and Rev. Rul. 82-165. The latest "clarification" of this issue is in Private Letter Rulings 9617036; 9617037. See Warren, Gorham & Lamont, "Charitable Giving and Solicitation," Vol. 7, No. 24 (9/19/95), for an excellent discussion of the various "methods" of computing the deferred payments.

a. The grantor of an inter vivos trust may retain the testamentary power to revoke the interest of the non-charitable beneficiary. Reg. §1.664-3(a) (4). The power to revoke will avoid gift tax on the non-charitable beneficiary's interest, but the income tax deduction will be currently available. Rev. Rul. 79-243, 1972-2 Cum. Bull. 343; Private Letter Rulings 8949061; 8204176; 8204214; 7828051; 7921081. See Reg. §25-2511-2(c). An inter vivos power to revoke will disqualify the trust. Private Letter Ruling 8430006.

   (i) The power should not be retained unless the grantor is a beneficiary because the trust will be included in the grantor's gross estate under IRC §2038. See Private Letter Ruling 8949061.

   (ii) Also, it is possible that the value of the remainder may be measured by the grantor's life expectancy and not the beneficiary's life expectancy. Such an interpretation would violate Reg. §1.664-3(a)(5) and Reg. §1.664-2(a)(5). See Private Letter Ruling 8949061.

   (iii) For the tax consequences of the release of the power to revoke, see Private Letter Ruling 8949061.

   (iv) The new Rev. Procs. do not contain powers to revoke, but they are still necessary to avoid a current gift unless the other beneficiary is a U.S. citizen spouse. See Private Letter Rulings 9511029; 9511007.

b. Upon revocation, a distribution to charity may be required. See Reg. §1.664-2(a)(4).

c. Remarriage is not a proper terminating event, but a reduction in payments upon remarriage will not disqualify the trust. Rev. Rul. 76-291, 1976-2 Cum. Bull. 284. The addition of IRC §664(f) should change this result. See Private Letter Rulings 9821009; 9511029; 9322031.

d. If an individual's interest is to terminate at the expiration of a life, it must be his life and not the life of another beneficiary. Private Letter Ruling 7913133. See Private Letter Ruling 9322031.

e. According to the IRS, an in terrorem provision will disqualify the trust because the interest of the non-charitable beneficiary may terminate by an event other than his death or the expiration of a fixed number of years. Private Letter Rulings 7732011; 7942073; 8321028. This position seems clearly to be incorrect, but the issue should be moot after the addition of IRC §664(f).

f. See Private Letter Ruling 8647007, in which the IRS allowed a unitrust to terminate early by division according to actuarial interests. See also Private Letter Rulings 200127023; 8805024. If the remainder beneficiary is a private foundation of which the donors are disqualified persons, the termination is an act of self-dealing. See Private Letter Ruling 200525014, revoked by 200614032.

g. See Private Letter Ruling 8805024 in which the IRS reviews the income and gift tax consequences of a partial early termination by a transfer of the life interest by the grantor to the remainderman. See also Rev. Rul. 86-60, 1986-1 Cum. Bull. 302; GCM 39404; Private Letter Rulings 200140027; 200304025; 200304024; 9817010; 9721014; 9511041; 9529039; 9409017. If the life interest is transferred by a non-grantor or by a grantor/beneficiary, the transfer is a transfer of a capital asset. Rev. Rul. 72-243, 1972-1 Cum. Bull. 233; Private Letter Rulings 200525014; 200140027; 200010035; 8948023; 8613046; 8311063; 8052092. The gift of the life interest does not result in a termination of private foundation status under IRC §507. However, an actuarial split of the trust is a termination under IRC §507. Private Letter Ruling

200304025. Private Letter Ruling 9408012. A gift of a partial interest in the life beneficiary's interest is deductible. Private Letter Ruling 9550026 (approving a gift of a 20% interest in the life beneficiary's interest). Private Letter Ruling 200524014 approves a division of unitrust and then a gift of the unitrust interest in one trust without jeopardizing the status of the remaining trust.

h. The swap of the life beneficiary's interest for a gift annuity was approved in Private Letter Ruling 200152018. See also Private Letter Ruling 200230018 in which the consequences of the use of an IRA to purchase a gift annuity were discussed.

i. The IRS has allowed the division of one unitrust into two trusts when the grantors dissolved their marriage. Rev. Rul. 2008-41, 2008-30 IRB 170. Private Letter Rulings 200832021; 200524013; 200221042; 200109006; 9403030; 9851006; 9851007; 9409016. See also, Private Letter Ruling 200304025. Likewise where the division was part of a will contest settlement. Private Letter Ruling 200229046. See also, Private Letter Ruling 200204022.

j. Retention of power to revoke rendered the gift to the life beneficiary's incomplete, thus allowing a disclaimer following the grantor's death. Private Letter Ruling 200204022.

6. On termination of the non-charitable beneficiary's interest, the trust assets must be paid to or retained for the use of a charitable organization described in IRC §170(c). Reg. §1.664-2(a)(6)(i). A trust which required that $10,000 of the remainder be distributed to an individual and the balance to charity did not qualify. Private Letter Rulings 8338109; 7821064; 7933054; 7951049. See Rev. Rul. 76-270, 1976-2 Cum. Bull. 194. IRC §170(c) is an income tax provision, and if a deduction is desired for estate tax purposes, the organization must also be qualified under IRC §2055(a). See Rev. Rul. 76-307, 1976-2 Cum. Bull. 56; Rev. Rul. 77-385, 1977-2 Cum. Bull. 331; Private Letter Rulings 7925089; 7929052; 7803050. (Savings clause prohibiting trustees who could choose charities from exercising powers in a manner that would disqualify the trust was valid to save trust that only referred to IRC §170(c).) The donor may impose

restrictions on the remainderman's use of the property. See Private Letter Ruling 7912042. Trust qualified when upon the grantor's death, the annuity amount was paid to another trust wholly for charitable purposes. Private Letter Ruling 8749052.

7. If the named charitable remainderman is not qualified at the time when the trust assets are distributable to it, the trust instrument must provide for an alternative charitable remainderman. The selection of the alternate charity may be left to the trustee, to the non-charitable beneficiary, or to the grantor (by will or deed). Rev. Rul. 76-8, 1976-1 Cum. Bull. 179; Private Letter Rulings 9504012; 9331044; 9326049; 8919016; 8407035; 8312060; 8002044; 7922014; 7923037. See also, Rev. Rul. 69-285, 1969-1 Cum. Bull. 222; Private Letter Ruling 9634025. If the grantor retains the right to designate the remaindermen, the gift is incomplete, Private Letter Rulings 9106008; 8407035, but the trust will qualify. See also Rev. Rul. 76-8, 1976-1 Cum. Bull. 179; Rev. Rul. 76-371, 1976-2 Cum. Bull. 305. If the grantor or beneficiaries have the power to designate 20% charities instead of 50% charities, the income tax deduction is limited to the 20% limitation; Rev. Rul. 80-38, 1980-1 Cum. Bull. 56. Rev. Rul. 79-368, 1979-2 Cum. Bull. 109. See also Rev. Rul. 68-417, 1968-2 Cum. Bull. 103. Private Letter Rulings 9818027; 9826021-022; (reformation permitted to allow designation of private foundations, but deduction reduced).

8. The trust instrument must provide for proration of the annuity trust amount in the case of a short taxable year and in the year of the non-charitable beneficiary's death. Reg. §1.664-2(a)(1)(iv); Rev. Rul. 79-428, 1979-2 Cum. Bull. 253; Private Letter Rulings 7734073; 7933020; 8211112. The 1989 New Rev. Procs. are incorrect on this issue, but the 1990 New Rev. Procs. are correct. See Private Letter Ruling 7842021. Alternatively, the payments to the non-charitable beneficiary may terminate with the last regular payment preceding the non-charitable beneficiary's death. Reg. §1.664-2(a)(5)(i); Rev. Rul. 74-386, 1974-2 Cum. Bull. 189; Private Letter Ruling 7734073. If the trust is for a term of years only, the provision may not be necessary. Private Letter Ruling 8111077. In joint life trusts, it is advisable to provide for proration of the unitrust amount between the non-charitable beneficiaries or that the first to die does not receive any additional payments.

9. The trust instrument must prohibit additional contributions. Reg. §1.664-2(b). If future contributions are prohibited, instrument should prohibit any donor, not just the grantor, from making such additional contributions. See Private Letter Ruling 7727017. Funding a trust from a probate estate and a revocable trust does not violate the prohibition against additional contributions because all property passing as a result of death of the donor is considered one contribution. Private Letter Ruling 8121108.

10. The trust instrument must contain some but not all, of the prohibitions imposed on private foundations. IRC §508(e); Rev. Rul. 74-368, 1974-2 Cum. Bull. 390. State law imposes these restrictions automatically. See Cal. Civ. Code §2271.1; N.Y. EPTL 8-1.8; Rev. Rul. 75-38, 1975-1 Cum. Bull. 161.

11. The trust instrument must provide that if the amount paid to the non-charitable beneficiary is incorrect because of an incorrect valuation, an adjustment in future payments will be made. Reg. §1.664-2(a)(1)(iii); Rev. Rul. 82-165, 1982-2 Cum. Bull. 117, provides a new sample provision; Private Letter Ruling 7913092. See Rev. Rul. 74-403, 1974-2 Cum. Bull. 381, for a suggestion that federal estate and gift tax concepts be used to value assets; Private Letter Ruling 7825066. But see Private Letter Ruling 7848046 which disapproves of the valuation of assets for "estate tax purposes" instead of for "tax purposes."

12. If distributions in kind to charity are permitted prior to the termination of the non-charitable beneficiary's interest, the basis of the assets distributed must be representative of the basis of all assets available for distribution. Reg. §1.664-2(a)(4); Private Letter Ruling 7933002. See Private Letter Ruling 7726031 for a seemingly erroneous application of the "fairly representative" rule to distributions of the unitrust amount.

13. The trust instrument must not restrict the trustee from investing trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Reg. § 1.664-1(a)(3); Rev. Rul. 73-610, 1973-2 Cum. Bull. 213; Rev. Rul. 73-571, 1973-2 Cum. Bull. 213.

a. A requirement that the trustee invest in tax-exempt securities violates Reg. §1.664-1(a)(3). Private Letter Rulings 7802037 and 7803029.

b. Requiring the approval of someone other than a trustee before changing investments violates Reg. §1.664-1(a)(3). Private Letter Rulings 8041100; 7928014; 7928076; 7948108.

c. A charitable remainder trust may invest in life insurance. Private Letter Rulings 8745013; 7928014.

d. Funding a unitrust with closely held stock subject to a buy-sell agreement does not restrict the trustee. Private Letter Ruling 8015036.

e. A trustee may commingle trust assets with other trusts as long as adequate records are kept. Private Letter Ruling 8212067.

f. Tangible personal property may be used to fund a charitable remainder trust but no income tax deduction will be allowed until the property is sold if the grantor or family member is the beneficiary. IRC §170(a)(3); Private Letter Ruling 9413020.

g. Holding a partnership interest will not violate Reg. §1.664-1(a)(3). Private Letter Ruling 9533014.

h. The power, but not the obligation, to purchase a commercial annuity to satisfy the annuity payments will not disqualify the trust. The trust provided mandatory criteria for the rating of the company if the annuity was purchased. Private Letter Ruling 201126007.

14. Debts, taxes, and administration expenses must be paid before funding the trust. See Private Letter Rulings 8003153, 7724055, and 7842021. But see, Private Letter Ruling 200305023.

15. Stating annuity amount in dollar terms rather than percentage terms may lead to no estate tax deduction. See Rev. Rul. 78-283, 1978-2 Cum. Bull. 243.

16. No death taxes may be paid from an inter vivos remainder trust. See Rev. Rul. 82-128, 1982-2 Cum. Bull. 71, effective

for trusts created after 10/3/82; Private Letter Rulings 9512016; 9512017; 9225026; 9107010. See Teitell, Charitable Remainders - Drastic Ruling, N.Y.L.J. 8/2/82, p.1, for an excellent discussion of the ruling. See also Private Letter Ruling 8313052 which did not require an amendment of a pre-10/4/82 trust to take into account Rev. Rul. 82-128 with respect to additional contributions. See also, Technical Advice Memorandum 9419006 for a discussion of how death taxes are computed in a charitable remainder trust following a QTIP trust. It appears to be permissible to obligate the grantor's estate to pay death taxes, at least in the first instance, instead of putting the burden on the life beneficiary whose interest covers the taxes. See Atkinson Est. v. Comm'r., 115 T.C. 26 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002); Private Letter Rulings 200305023; 9512016; 9512017.

17. A trust may be a donor to a charitable remainder trust for a term of years. Private Letter Ruling 9821029.

18. A limited liability company may be the grantor and beneficiary of a charitable remainder trust for a term of years. Private Letter Ruling 199952071. Likewise for an S corporation, Private Letter Rulings 9512002; 9253055; 9205031, but individuals cannot be beneficiaries after the term of years. Private Letter Ruling 200203034.

19. The payments must be made to the non-charitable beneficiary or the trust will be disqualified. Atkinson Est. v. Comm'r, 115 T.C. 26 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002).

F. Income Taxation of Charitable Remainder Trusts.

See L. Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates; Sixty-Six Years of Astigmatism," 40 Tax. L. Rev. 5 (Fall, 1984).

1. Trust required to file Form 5227, as revised, for 1981 and thereafter.

2. Trust exempt from income tax on all ordinary income and capital gains, except in year in which trust has unrelated business income. IRC §664(c); IRC §512; Private Letter Ruling 8834039. All income of the trust is subject to tax, not just the unrelated business income. Leila G. Newhall Unitrust v. Comm'r., 104 T.C. 236 (1995), aff'd, 105 F.3d 482 (9th Cir. 1997). See paragraph K below for some difficulties created if the trust has unrelated business income.

a. Encumbered assets may produce debt-financed income which is unrelated business income. IRC §514(b). See Private Letter Rulings 8104098; 8110096; 7911067; 7906038 and 7943062 for some guidance in dealing with encumbered property after contribution or distribution. Gift of interest in joint venture to remainder trust did not cause the trust to have debt-financed income because the venture's liabilities were non-recourse and were within the exceptions in IRC §514. Private Letter Ruling 8530031. See also, Private Letter Ruling 199952086 (corporation owned by charitable remainder trust received debt financed income; not attributable to the trust); Private Letter Ruling 199952071 ("dividends" from an UPREIT are not unrelated business income even though the UPREIT's property was mortgaged); Rev. Rul. 66-106, 1966-1 Cum. Bull. 151; Private Letter Rulings 200251016-18 (borrowing does not create unrelated business taxable income when borrowing is in a foreign corporation).

b. Sale by trust of donated subdivided lots does not produce unrelated business income because trust is not in the real estate business. Private Letter Ruling 8003051.

c. Borrowing from an insurance policy will produce acquisition indebtedness. Siskin Memorial Fdn. v. U.S., 790 F.2d 480 (6th Cir. 1986); Private Letter Ruling 8745013.

d. Use of trust assets as collateral for loans made by third parties to the charitable remaindermen does not cause the trust income to be unrelated. Private Letter Ruling 8807082.

e. Trust not subject to minimum tax on tax preferences. Rev. Rul. 74-317, 1974-2 Cum. Bull. 13; see also Rev. Rul. 73-43, 1973-1 Cum. Bull. 37.

f. Trust funded with income in respect of a decedent (IRA account) qualifies; the character of the income (ordinary) remains in the trust for purposes of IRC §664(b). Private Letter Ruling 9237020. If IRC §691 income is paid to a charitable remainder trust, who is entitled to the IRC §691(c) deduction? One interpretation is that no one is entitled to the

deduction; another interpretation is that the trust is entitled to the deduction, and the deduction reduces the income in the various tiers (how and in what order?); a third interpretation is that the non-charitable beneficiary is entitled to the deduction as distributions are made. See Private Letter Ruling 200230018 for the tax consequences of transferring an IRA at death in exchange for a charitable gift annuity.

g. Trust sales of raffle tickets for chance to win trust asset is not unrelated income because the work is performed by volunteers. Private Letter Ruling 9517037.

h. In an unusually funded unitrust, the IRS ruled that the trust was an "association" taxable as a corporation, and therefore, not a qualified charitable remainder trust. Private Letter Ruling 9547004. See also Private Letter Ruling 200203034, in which the IRS ruled that because the beneficiaries of a charitable remainder trust created by an S corporation were the S corporation and the shareholders, the trust was an association and therefore not qualified.

i. The income of a corporation is not unrelated business taxable income. Private Letter Ruling 200230004. See, IRC §512(b)13). Likewise as to distributions from a foreign corporation. Private Letter Ruling 201043041.

3. Non-charitable beneficiaries are taxed on distributions under special rules of IRC §664(b) rather than under IRC §661; 662. There has been some uncertainty as to the distribution rules applicable to "income-only" unitrusts. Reg. §1.664-1(d)(1)(i) is inconsistent with IRC §664(b). However, the position of the IRS is that Reg. §1.664-1(d)(1)(i) applies to all types of remainder trusts. Private Letter Rulings 7905034; 7904028. Reg. §1.664-3(b)(3) makes it more clear that IRC §664(b) applies to all charitable remainder trusts.

4. Year of inclusion of distributions is year when amounts payable, not necessarily in the year received. Reg. §1.664-1(d)(4); Private Letter Ruling 8341001; Advance Notice 94-78, IRB 1994-32 (8/18/94). To cure the perceived abuse outlined in the Notice, Reg. § 1.664-2(a)(1)(i); 1.664-3(a)(1)(i) mandate payment to the non-charitable beneficiaries before the end of the year (except for income-only trusts), unless the beneficiary is taxable on the distribution. See Reg. §§1.664-

2(a)(1)(i); 1.664-3(a)(1)(i). Also IRC §§664(d)(1)(A) and (2)(A) have been amended to provide for a maximum payout rate of 50%, effective for transfers after 6/18/97. To stop the "new" accelerated charitable remainder trust, Prop. Reg. §§1.643(a)-8 and 1.664-1(d)(1)(iii) treat distributions that are not taxable, are not a return of basis and are not from cash contributed to the trust as a sale of a prorata portion of the trust's assets.

5. Distributions to beneficiaries are taxed in the following manner under IRC §664(b):

   a. As ordinary income to the extent of the trust's ordinary income for the current year and its undistributed ordinary income for prior years.

   b. As capital gains to the extent of the trust's undistributed capital gains for the current year and its undistributed capital gains for prior years. Highest tax rate gains will be deemed distributed first. Notice 98-20, 1998-13 IRB 1; Notice 99-17, 1999-14 IRB __ (4/5/99).

   c. As other income (e.g., tax exempt interest) to the extent of the trust's other income for the current year and such undistributed other income for prior years.

   d. As a tax-free distribution of trust principal.

   e. Prop. Reg. §§1.664-1(d)((1), (2) and (e)(1) set forth ordering rules within the tiers to take into account rate differences for similar types of income (e.g. dividends vs. interest).

   f. The rules of IRC §664(b) do not apply to distributions in satisfaction of the non-charitable beneficiary's entire interest in an early termination of the trust. Private Letter Ruling 8948023.

   g. According to the IRS, the IRC §691(c) deduction is not passed out to the non-charitable beneficiary; it is trapped in the trust. Private Letter Ruling 199901023.

   h. New Reg. §1.643(a)-8(d) and IRC §643(a)(7) create the "deemed sale" rule to prevent the use of charitable remainder trusts to avoid or reduce capital gain.

6. A non-resident alien individual beneficiary of a charitable remainder trust will be taxed under the terms of any treaty with his country, and not necessarily under IRC §664(b). Private Letter Ruling 8023050.

7. Depreciation may be allocated to the non-charitable beneficiary under certain circumstances, thus sheltering the income from the trust. Private Letter Ruling 8610067. See also, Private Letter Rulings 8931019; 8931020; 8931021; 8931022; 8931023.

   a. A "regular" charitable remainder trust need not require a reserve. As to "regular" charitable remainder trusts, the reserve will offset some of the income taxable to the beneficiary even if the trustee establishes a reserve in his discretion. Private Letter Rulings 8922019; 8922020; 8922021; 8922022; 8922023.

   b. In an "income-only" trust, a reserve is required. Private Letter Rulings 8931019; 8931020. See also, Rev. Rul. 90-103, 1990-2 Cum. Bull. 159, relating to a pooled income fund.

8. It is permissible to allocate bond discount to income in the year of redemption if such allocation is permitted by local law and the instrument. Private Letter Rulings 9018015; 8604027.

9. All payments from a deferred annuity are "income" in the hands of a non-natural person such as a trust. Thus, a deferred annuity may be a good investment for an income-only unitrust that is intended to provide future income to the donor. Private Letter Ruling 9009047.

10. A consent dividend is "ordinary" income under IRC §664(b)(1), but cannot be used to pay the makeup of IRC §664(d)(3)(A) because there is no receipt of money. Private Letter Ruling 199952035.

11. The Tax Reform Act of 1986 initially caused some uncertainties in the administration of charitable remainder trusts:

   a. If the trust's valuation date is the first day of its taxable year (stated as a specific date, i.e. April 1), what happens to the date as a result of the required change to a calendar year? See Reg. §1.664-3(a)(i)(iv). Changing terms of trust to value assets on the first

business day to accommodate the new rules is permissible. Private Letter Rulings 8828041; 8825095; 8822035. The ruling applies where the "valuation date is prior to the date of the first quarterly payment." See also Technical Corrections Act of 1988, §114(c)(4).

b. The year ending 12/31/87 will be a short taxable year for all fiscal year trusts. Presumably, the various rules for computation of the unitrust or annuity trust payments will apply, Reg. §§1.664-3(a)(1)(v); 1.664-2(a)(1)(iv); Rev. Rul. 76-467, 1976-2 Cum. Bull. 198, but the actual payment dates may not be clear (i.e. a 10/31 fiscal year trust may provide for payments in quarterly installments on the last day of January, April, June and October). The year 11/1/87-12/31/87 does not have any payment date in it. What happens if the trust terminates payments to the recipient with the payment prior to death? (i.e. the recipient of a 10/31 trust dies on 1/1/88) Without the change in the law, the recipient would not be entitled to the 1/31/88 payment. However, he was alive on 12/31/87, and under state law or the IRS interpretation of the new taxable year rules, he may be entitled to a prorated amount through 12/31/87.

c. Can the recipient average over 4 years the 1987 short year income? See Technical Corrections Act of 1988 §114(c), which makes §1403 of the Tax Reform Act of 1986 applicable on an optional basis. See IRS Notice 88-45, which provides that if a beneficiary dies within the four-year period, the remaining income is included in his gross income for the taxable year of death. See Private Letter Ruling 9050054.

G. Tax Treatment of Accumulated Income During Administration.

1. When an estate's or revocable trust's tax income is allocable to a charitable remainder trust described in IRC §664 or to a pooled income fund or to a QTIP trust with charitable remainder, is that income currently taxed to that estate or trust?

2. If current taxation is to be avoided by the distributor-entity, only the IRC §642(c)(2) set-aside deduction can provide the tax shelter. When the distributor-entity is a trust, the set-aside deduction generally is not available. Certain "old" trusts may claim set-aside deductions under proper circumstances,

but generally resort to IRC §642(c)(2) has been restricted to estates since the enactment of the Tax Reform Act of 1969. There is disagreement over the rectitude of this dichotomy. For background, see L. Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax. L. Rev. 1, 204-207 (Fall, 1984).

3. If the distributor-entity is a probate estate, to what extent can the IRC §642(c)(2) set-aside deduction be claimed? The answer may depend both on the accounting character of the tax income in question and on the nature of the distributee-charitable remainder entity.

   a. In the case of charitable remainder trusts described in IRC §664, there is a threshold problem created by some peculiar regulatory language. Reg. §1.642(c)-2(d) provides in its first sentence that a set-aside deduction is allowable if "under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside . . . will not be devoted to [a charitable] purpose . . . is so remote as to be negligible." This, in effect, restates the pre-Tax Reform Act of 1969 rule first forged in the Hartford-Connecticut Trust Co. line of cases. See, for example, Hartford-Connecticut Trust Co. v. Eaton, 36 F.2d 710 (2d Cir. 1929); Bonfils v. Comm., 40 B.T.A. 1079 (1939); Holcombe v. U.S., 41 F. Supp. 471 (D. Mass. 1941). Unfortunately, in its next sentence, Reg. §1.642(c)-2(d) provides that "where there is possibility of invasion of corpus of a charitable remainder trust . . . in order to make [a noncharitable] payment . . . no deduction will be allowed . . . in respect of any amount set aside by an estate for distribution to such . . . trust." This language may be read as in direct conflict with that quoted above. Here, any possibility is fatal. Above, a possibility is fatal only if it is not "so remote as to be negligible." A strict reader of regulations may, therefore, conclude that under no circumstances may a set-aside deduction be claimed with respect to either ordinary income or capital gain income bound for either a charitable remainder annuity trust or a charitable remainder unitrust. See Private Letter Ruling 8341001; GCM 39249 (6/27/84).

b. As to a charitable remainder annuity trust, if the set-aside deduction is allowable at all, it is allowable probably only as to capital gain income that is accounting principal. Sheltering of some part of ordinary income would be defensible only in the rarest of cases, although, as a matter of law, such defense may not be precluded. The IRS has ruled that the IRC §642(c)(2) deduction is not available. Private Letter Rulings 8341001; 8810006; GCM 39249 (6/27/84).

c. As to a standard charitable remainder unitrust, if the set-aside deduction is allowable at all, its allowance, even in the context of capital gain income allocable to principal, is more difficult to substantiate than would be the case with a charitable remainder annuity trust. At least the annuity is fixed. The unitrust payment is variable. Does the short-cut funding period payment of Reg. §1.664-1(a)(5) help?

d. As to an income-only unitrust, the result, at least as to capital gain income, may be better, particularly if the "no-make-up" option is adopted.

e. As to a QTIP with charitable remainder, the capital gain income, if allocable to corpus, is eligible for set-aside deduction under pre-Tax Reform Act of 1969 rules.

f. As to a pooled income fund, the result with respect to capital gain income allocable to corpus normally should be the same as for the QTIP with charitable remainder. Logic may suggest that undistributed ordinary income realized by the estate cannot be sheltered by an IRC §642(c)(2) deduction inasmuch as such income may be paid, either by the estate or by the pooled income fund, to the one or more non-charitable beneficiaries specified in the governing will document. However, Rev. Rul. 76-445, 1976-2 Cum. Bull. 193 ruling deals with a pooled income fund the governing instrument of which provides, in part,

> "that in the case where a transfer to the fund is directed by will or other instrument to be effective upon the death of the donor, and such transfer includes income accumulated during the period of administration of the estate of the donor and payable to the fund under governing state law, such income shall be income payable

by the fund to the beneficiary of the life income interest created by the donor."

This provision embodies the proper logic, but, surprisingly, the ruling holds that as a consequence of the provision the fund does not qualify as a pooled income fund under IRC §642(c)(5). Contributions to a nonqualified pooled income fund are, of course, not deductible for any federal tax purpose.

(i) If one assumes a qualified pooled income fund, the foregoing may mean either of two things. First, if the will and pooled income fund say nothing on this subject, the meaning of the ruling has to be that, sooner or later, the estate must distribute income allocable to the pooled income fund to the fund, and the fund must use the income so distributed to it to buy units of participation in the fund as a whole. The income beneficiary specified in the will ends up getting only income on period of administration income, rather than the period of administration income itself. The tax effect is that ordinary income, in the year earned by the estate, is eligible for a set-aside deduction.

(ii) The other possible result is better economically. According to Rev. Rul. 76-445, if the pooled income fund's governing instrument "provides that the estate may retain the income from the transferred property that has accumulated during a reasonable period of estate administration, and pay such income to the life income beneficiary, whenever permitted by state law and the donor's will (or other governing instrument)," the fund will be considered a qualified pooled income fund. But how often will a pooled income fund's governing instrument contain such a provision? Furthermore, how often will the donor's will expressly provide for distribution of period of administration income directly to the income beneficiary? One must look at both the disposing will (or other instrument) and the governing instrument of the fund to determine whether the magical provisions exist. Both the will and the fund

stipulations must be there; either without the other apparently will not do. When both are present, the estate may distribute period of administration income directly to the named income taker (or takers), bypassing the pooled income fund altogether. The estate's distribution and each income taker's receipt will be governed by normal subchapter J rules.

H. Tax Treatment of Income Distributed During Administration.

1. To the extent that ordinary income and capital gain income accumulated during administration cannot be sheltered by an IRC §642(c)(2) set-aside deduction, Private Letter Ruling 8341001, neither is an estate entitled to an IRC §642(c)(1) "paid" deduction with respect to distributions of amounts of gross income in partial or complete funding of an IRC §664 charitable remainder trust. See Private Letter Rulings 8603002; 8604005.

2. If an IRC §642(c)(1) deduction is not allowable, one might assume that, to the extent of the estate's DNI, an IRC §661 deduction should be available with respect to such funding distributions. Some commentators disagree, however, and conclude that no IRC §661 deduction may be claimed in such circumstances. See, for example, J. L. Peshel and E. D. Spurgeon, Federal Taxation of Trusts, Grantors and Beneficiaries, ¶11.02 [E], p. 11-14 (1978), citing as substantiation for this concern Rev. Rul. 68-667, 1968-2 Cum. Bull. 289, and, more importantly, Mott v. U.S., 462 F.2d 512 (Ct. Cls. 1972), cert. denied, 409 U.S. 1108 (1973).

a. The Mott case and its progeny are troublesome. See, Estate of O'Connor v. Comm., 69 T.C. 165 (1977), and Pullen v. U.S., 80-1 USTC ¶9105 (D. Nebr. 1979), aff'd (w/o opinion) (8th Cir. 1980). These cases stand for the proposition that no IRC §661 deduction is permissible as to a distribution to a non-taxable beneficiary, whether or not an IRC §642(c) deduction is allowable.

b. Several commentators, concerned by the Mott interpretation of the interaction of IRC §§661 and 663(a)(2), have opined that the IRC §661 deduction is, and should be, available in this situation. See, Ferguson, Freeland & Stephens, Federal Income Taxation of Estates and Beneficiaries, note 17, at 131

(1984 Supp.), and Baetz, "Tax Planning for Sophisticated Charitable Transfers: The Divide Between Downright Doable and Dangerous," 62 TAXES 996, 999 (1984). The leading commentator concurs, expressing, however, some disagreement with the Ferguson et al logic and embracing, among other reasons, the Baetz view that "if the Section 661 deduction were not allowable, Reg. §1.664-1(a)(5)(iii) would be rendered meaningless in stating that the 'treatment of a distribution to a charitable remainder trust . . . shall be governed by the rules of subchapter J . . . .'" Baetz, supra, ftn. 14, at 999. See Schmolka, supra, at 288-295.

c. A district court took exception to the Mott-O'Connor-Pullen line of cases and held that a deduction under IRC §661(a)(2) is allowable with respect to a distribution to a charitable beneficiary in cases where no IRC §642(c) deduction can be claimed, but the decision has been reversed. See United States Trust Co. v. U.S., 85-2 USTC §13,642 (S.D. Miss. 1985), rev'd., 86-2 USTC ¶9777 (5th Cir. 1986). See Private Letter Ruling 8341001; GCM 39249 (6/27/84; Love Charitable Foundation v. U.S., 83-2 USTC ¶9441 (8th Cir. 983).

d. The IRS has ruled that a IRC §661(a) deduction is available for distributions to fund a split-interest trust, distinguishing, Mott, Pullin, etc. Technical Advice Memorandum 8603002 (lead trust); Private Letter Ruling 8810006; GCM 39707. See Reg. §1.664-1(a)(6), Example (5).

I. "Bypass" Funding During Administration.

1. If permitted by local law or the terms of the governing instrument, the executor may distribute some part or all of the estate's taxable income directly to the non-charitable "income" beneficiaries of unitrusts and annuity trusts. Regs. §1.664-1(a)(5)(iii) allows this mode of funding and indicates that the "treatment of a distribution . . . to a recipient in respect of an annuity or unitrust amount, paid . . . by an estate, or by a trust which is not a charitable remainder trust, shall be governed by the rules of subchapter J." See Private Letter Ruling 9647023.

2. Suppose the estate realizes $20,000 of accounting income of which $15,000 is taxable dividends and $5,000 is tax-exempt

interest. The executor distributes $40,000 in cash to the charitable remainder trust, charging the distribution to accounting principal, and distributes $10,000 directly to the non-charitable beneficiary, A. The trust and A are both second-tier beneficiaries and thus ratably share the estate's $20,000 of DNI. More importantly, they also ratably share each class of income deemed distributed. This leaves A with 1/5 of both the taxable and tax-exempt income to be recognized under IRC §662.

a. This technique tends to thwart the IRC §664(b) tax character rules.

b. Moreover, the technique may prompt prolonged estate administration and very delayed charitable remainder trust funding.

3. Since an estate is not obligated to fund a charitable remainder trust, the Regulations set forth an elaborate network of "funding period rules" to make it easier to determine how much the non-charitable takers must be paid with respect to the period during which funding, and, therefore, payment have been deferred. See Reg. §1.664-1(a)(5)(i) and (ii).

J. IRC §664(b) Tax Character Crisis.

1. The tax character of amounts received by non-charitable beneficiaries from tax-exempt charitable remainder trusts described in IRC §664 is determined by the application of a unique set of rules. See IRC §664(b) and Reg. §1.664-1(d). These rules require that each charitable remainder trust maintain a record of trust life-to-date pools of various kinds of income. The pools are arranged in descending priority as follows: ordinary income, short-term capital gain, long-term capital gain, other income and corpus. Each payment to a non-charitable beneficiary is ascribed the tax character in that beneficiary's hands of the highest priority pool in which value exists. Each such payment depletes to the extent of the payment's value that pool from which it derives its tax character. A lower priority pool can be drawn against only if all higher priority pools are exhausted.

2. To which pool is "period of administration" taxable income received by a charitable remainder trust assigned? If that income was not taxed in the estate, it should be assigned to the ordinary income or short-term or long-term capital gain

pool, as the case may be, just as would result from the normal application of the subchapter J tax character rules. See IRC §662(b). If that income was previously taxed in the estate, it is still ordinary income or capital gain, but it seems unfair to characterize it as such when the effect is that it will or may be taxed again in a non-charitable beneficiary's hands.

3. Such prior-taxed income should be allocated to the so-called "other income" pool and, moreover, deserves to be classified as nontaxable in the non-charitable beneficiary's hands. Regulations indicate that the throwback rules do not apply to charitable remainder trusts (whether exempt or non-exempt). See Reg. §1.664-1(d)(1)(ii).

   a. Unfortunately, Reg. §1.664-1(d)(1)(i)(c) indicates only that "other income" includes tax-exempt interest. There is nothing in the regulations about prior-taxed income.

   b. Nevertheless, there can be no justification for the possibility of double taxation in this circumstance. However, it is important, if the non-taxable income characterization is utilized, clearly to indicate the source and description of this form of "other income," both on the trust's tax report and on the tax advice form delivered to each non-charitable beneficiary.

K. IRC §664 Tax Exemption and Unrelated Business Income.

1. IRC §664(c) exempts charitable remainder unitrusts and charitable remainder annuity trusts from all taxes imposed by Subtitle A of the Code. This exemption applies to any taxable year unless the trust, for such year, has unrelated business income (within the meaning of IRC §512). See Private Letter Ruling 8834039. Historically, any unrelated business income forfeited the exemption as to all trust income. Leila G. Newhall Unitrust v. Comm'r, 104 T.C. 236 (1995), aff'd, 105 F.3d 482 (9th Cir.1997) (income from limited partnership engaged in a trade or business).

2. Most passive investments do not yield such income. See IRC §512(b). However, the receipt of income from "debt-financed property" is considered unrelated business income. See IRC §§512(b)(4) and 514. Also, borrowing against a life insurance policy and investing borrowings will generate unrelated business income. Siskin Memorial Fdn. v. U.S., 790 F.2d 480 (6th Cir. 1986).

3. If loans are made to the trust to enable the trust to make the required payout or to pay expenses (such as property taxes), do the loans create acquisition indebtedness under IRC §514?

4. Beginning with taxable years beginning after December 31, 2006, unrelated business taxable income in a charitable remainder trust does not result in the loss of the trust's tax exempt status on income that is not unrelated business taxable income. However, a new excise tax is imposed by IRC § 664(c)(2)(A). The excise tax is 100% of the unrelated business taxable income. For purposes of this rule, unrelated business taxable income is determined under the rules of IRC § 512. The excise tax under IRC § 664 is subject to the same rules as other excise taxes under the private foundation excise tax provisions (IRC Chapter 42). The excise tax is reported on Form 4720.

5. Final regulations, Reg. § 1.664-1(c), have been issued. The excise tax is payable from trust principal, but the unrelated business taxable income becomes part of the tier system that governs distributions to beneficiaries. For example, if the unrelated business taxable income is an item of ordinary income, the tax is payable from the principal of the charitable remainder trust, but the distribution to the non-charitable beneficiary will include the item of income in the first tier. Thus, there is double taxation of unrelated business taxable income: one tax is imposed at the trust level and the other tax is imposed at the beneficiary level.

6. Whether a charitable remainder trust should invest in assets that generate unrelated business taxable income is a question of economic return versus tax burden and fiduciary obligations and liabilities. For example, if an investment in a hedge fund generates substantial returns, but a relatively small portion of the return is unrelated taxable income, paying the excise tax may be an appropriate trade off for the substantial return that could not be obtained elsewhere. On the other hand, if the return is mostly unrelated business taxable income, absent some other reason for the investment, there may be fiduciary liability for incurring the tax.

L. Planning Techniques.

1. No invasions are permitted for the benefit of non-charitable beneficiary, making the charitable remainder trust inflexible for meeting emergency needs. See Rev. Rul. 77-58, 1977-1

Cum. Bull. 175, and Private Letter Ruling 7812065 (Texas law) for the effect of a state law provision which gives the trustee the power to invade principal. The solution is to create two trusts, one non-qualifying and one qualifying, with provision in the qualifying trust prohibiting such invasion. See Fowler, Charitable Remainder Trusts and Pooled Income Funds - Using Computer Simulation to Rank the Benefits, 11 Tax Advisor 68 (February, 1980). If a spouse is the intended life beneficiary, consider using a QTIP charitable remainder trust. See II. below.

2. Annuity trust provides no hedge against inflation; unitrust has downside risk if assets depreciate in value.

3. Annuity trust may be easier to administer because valuation of assets is made once; unitrust requires annual valuation.

4. Private foundation prohibitions may prove troublesome.

   a. Self-dealing rules of IRC §4941 apply.

      (i) Investment of trust funds in corporate trustee's common trust funds is not self-dealing. Rev. Rul. 73-571, 1973-2 Cum. Bull. 213. See also Private Letter Rulings 9533041; 8230133. Purchase of assets by a disqualified person from a revocable trust which became several irrevocable charitable remainder trusts upon the grantor's death was permitted during administration pursuant to Reg. §53.4941(d)-1(b)(3).

      (ii) Contribution of encumbered assets may be an act of self-dealing. Reg. §53-4941(d)2(a)(2). See Private Letter Ruling 7943062. But see Private Letter Rulings 8315022, 8114025 and 7807041, in which the IRS ruled that an initial transfer of encumbered property is not self-dealing. Reg. §53.4941(d)-1(a). Subsequent transfers of encumbered property will be self-dealing. Encumbered assets may produce debt-financed income. IRC §514. See Private Letter Ruling 9241064, in which the exception in IRC §514(c)(2)(B) prevented adverse tax consequences. If the trust continues to pay the mortgage on which the grantor is liable, the trust will be a grantor trust under IRC §677, and

the trust will not qualify. Private Letter Ruling 9015049 (grantor remained personally liable on the mortgage). But see, Private Letter Rulings 9241064; 8931023; 7808067. See also Adams v. Comm's, 70 T.C. 373 (1978). It appears that many problems associated with funding remainder trusts with encumbered property can be avoided by incorporating the property. Private Letter Ruling 8139045. See Woodburn, Handling Gifts of Debt-Encumbered Property, 21 Est. Plng. 287 (Sept./Oct. 1994).

(iii) Grantor may receive reasonable compensation for services rendered to the trust. Information Letter, 6/14/77. If the grantor is the trustee, payment of trustee's fees may convert 70% income to 50% income (prior to 1982). See Private Letter Rulings 8033026 and 8035078.

(iv) Redemption of closely held stock of donor's corporation from trust is not self-dealing if offer to redeem is at fair market value and is made to all shareholders. Private Letter Rulings 200230004; 8309063; 9347035, revoked without comment (but probably because the redemption was for a note, which would violate the "no extension of credit" rule of IRC §4941) by Private Letter Ruling 9731034. See also Private Letter Ruling 8320036; Rockefeller v. U.S., 83-2 USTC ¶9724 (1983). A one shareholder redemption is not self-dealing if the shareholder owns all of the class of stock being redeemed. Private Letter Ruling 9015055. See also Private Letter Ruling 9501038.

(v) The trustee's act of funding a charitable remainder trust with encumbered property will not be an act of self-dealing. Private Letter Ruling 8404118.

(vi) Securing remainderman's loan with trust assets is not self-dealing because the remainderman is not a "disqualified person." Private Letter Rulings 8823057; 8807082, citing Reg. §53.4946-1(a)(7).

(vii) Is a "sale" of the income beneficiary's interest to the remainderman self-dealing? See Private Letter Ruling 8948023 (no ruling on this issue, but ruling that the beneficiary has a zero basis under IRC §1001).

(viii) The IRS's position on whether a gift of an undivided interest in investment property to a charitable remainder trust is self-dealing is unclear, although the IRS' position seems to be softening. See GCM 39770 and Private Letter Rulings 9726006; 9705013; 9651037; 9632637; 9533041; 9533014; 9535015; 9540063; 9448047. In Private Letter Ruling 9114025, the IRS ruled favorably on a gift of limited partnership interests to various charitable remainder trusts. The donors retained some of the partnership interests outside of the trusts. What is missing from the ruling is the background of the transaction. The donors first attempted to give undivided interests in the property (a shopping center) to the charitable remainder trusts, but the IRS took the position that such gifts were acts of self-dealing based on §101(1)(2)(E) of the Tax Reform Act of 1969, which provides that the use of jointly owned property by a private foundation and a disqualified person will not be self-dealing if both interests were acquired prior to October 9, 1969. See Reg. §53.4941(d)-4(e)(1), which contains the same exception. In the Private Letter Ruling, the IRS ruled that gifts of partnership interests were not gifts of undivided interests, and therefore, there was no self-dealing. See also Private Letter Rulings 200548026 (which contains a comprehensive analysis of many issues relating to the ownership of a partnership interest in a partnership comprised of disqualified persons and the trust); 9726006; 9716023; 9651037; 9632637; 9633007-013; 9533014; 9533041.

(ix) Creation and funding of a charitable remainder trust to satisfy the donor's prior enforceable pledge to charity is not self-dealing even though the charity agreed to name the charity after the donor. The benefit to the donor was deemed

incidental. Private Letter Ruling 9233053 was revoked in Private Letter Ruling 9714010, citing Rev. Rul. 73-407, 1973-2 Cum. Bull. 383. However, the law in this area is changing. See Private Letter Rulings 8128072; 9610032 and 9703020, revoking 9540042; Reg. §53.4941(d)-2(f)(1). See also, G.C.M. 38103 and 39644; Shoemaker and Jones, "Income Deferral Abuse and Other Issues," Continuing Professional Education, Exempt Organizations - Technical Instruction Program for FY 1997 (1996), p. 139.

(x) Sale by charitable remainder trust to ESOP in which disqualified persons have an interest is not self-dealing. Private Letter Ruling 9542040. See, Rev. Rul. 81-76, 1981-1 Cum. Bull. 516.

(xi) The fact that a charitable remainder trust's trustee could vote a small block of stock to retain the donor as an officer and employee of the corporation whose stock the trust owned was considered an incidental benefit and not self-dealing. Private Letter Ruling 9623018.

(xii) Distribution to pay taxes in bankruptcy proceeding is self-dealing. Private Letter Ruling 200022005.

b. Excess business holdings prohibitions of IRC §4943 do not apply during split-interest period. See Rev. Rul. 74-368, 1974-2 Cum. Bull. 390. It is possible to use a trust to retain control of closely held business. See Sugarman and Tomasulo, Solving Excess Business Holdings Problems, Parts I and II, 118 Trusts & Estates 34 (May, 1979), 118 Trusts & Estates 30 (June, 1979).

(i) If retention of stock required and if no dividends paid, trust may violate rules re investment restrictions.

(ii) If no dividends are paid, use "income-only" unitrust to avoid periodic liquidation or distribution of assets.

(iii) If family are fiduciaries, provide for special trustee to value stock each year. But see Rev. Rul. 80-83, 1980-1 Cum. Bull. 210, in which the

grantor's fiduciary obligations saved the gift tax deduction. See Report of Committee on Ways and Means, H. Rep. No. 91-413 (Part I), 91st Cong., 1st Sess. 50 (1969), 1969-3 Cum. Bull. 239. See Private Letter Ruling 8648048.

c. Contribution of encumbered property to inter vivos charitable remainder trust is a bargain sale. Reg. §1.101-2(a)(3). See Private Letter Rulings 7808016; 7903075. See Private Letter Ruling 7943062 for a discussion of the consequences of contributing a limited partnership interest and Private Letter Ruling 8530031 for the consequences of contributing an interest in a joint venture. Borrowing from an insurance policy owned by the trust will produce acquisition indebtedness. Private Letter Ruling 8745013.

d. IRC §4947(a) will not apply to a split-interest trust if the charitable deduction is not taken, even if the deduction would be allowed. See Private Letter Ruling 8032056.

e. Estate distribution of encumbered real property to trust is not self-dealing. Private Letter Rulings 7807041; 7906038. Post-death "exchange" of community property interests coupled with refinancing was approved in Private Letter Ruling 7906038.

f. IRC §4944 does not apply. Private Letter Ruling 9407006.

5. If an income-only unitrust is used, how much is the non-charitable beneficiary entitled to receive prior to the funding of the trust from the probate estate? The answer should be nothing because the trust has earned no income, unless income or interest is allocated to the trust during administration under state law or the governing instrument. See Private Letter Ruling 7825012 and Petkun, Hamlin and Downing, 435 T.M., Charitable Remainder Trusts and Pooled Income Funds, A-17-A-18.

6. Diversification.

a. Because a charitable remainder trust pays no income taxes, it can sell appreciated assets without payment of capital gains tax. This results in a higher asset base

upon which the percentage is applied. For an excellent article on the economics of a charitable remainder trust, see Hoisington, The Truth About Charitable Remainder Trusts (How To Separate the Help from the Hype), 45 Tax Law. 293 (1992). See also, Ashby, Charitable Remainder Unitrust as a Refuge for Low Basis Property, 117 Trusts & Estates 312 (1978); Tidd, Charitable Remainder Trusts: Funding and Investment Considerations, 57 Taxes 577 (1979).

b. No gain is recognized upon transfer of appreciated securities to a charitable remainder trust. Private Letter Ruling 7809093. See Moerschbaecher, Avoiding Prearranged Sales in Planned Giving Through Charitable Remainder Trusts, 8 J. Tax Exempt. Org. 107 (Nov./Dec. 1994); Tidd, Anticipated Sale of Donated Assets May Cause Gain to Charitable Donor, 25 Est. Plng. 67 (1998); Walker, Gifts of Appreciated Property and the Assignment of Income Doctrine, 11 J. Tax. Exempt. Org. 195 (March/April 2000). For example, if a donor of an inter vivos remainder trust has highly appreciated securities which yield 2-1/2% on fair market value, and these securities are placed in a standard trust, a capital gains tax will be imposed on the trust when the trust sells the securities in order to increase the yield. If the securities are given to a charitable remainder trust, the trust can sell and diversify without payment of capital gains tax, and the beneficiary will receive increased annual payments. See Ferguson, 108 T.C. 244 (1997), aff'd, 174 F.3d 997 (9th Cir. 1999), and Rauenhorst v. Comm'r, 119 T.C. No. 9 (2002), for an excellent discussion of the assignment of income doctrine in the context of a gift to a charity. See also Rev. Rul. 60-370, 1960-2 C.B. 203; Private Letter Rulings 200321010; 9814032; Palmer, 62 T.C. 684 (1974); Blake, 697 F.2d 473 (2d Cir. 1982); Rev. Rul. 78-197, 1978-1 C.B. 83; Private Letter Ruling (FSA) 200149007.

c. Whether or not a charitable remainder trust funded with appreciated securities can be used to give the non-charitable beneficiary tax-exempt income is not clear. See Rev. Rul. 60-370, 1960-2 Cum. Bull. 203; Private Letter Rulings 7726031 and 7815017. Private Letter Ruling 7803041 indicates that trust initially funded with tax-exempt bonds is qualified. If trust

requires investment in tax-exempt securities, it will not qualify because such a provision restricts the trustee's investments contrary to Reg. §1.664-1(a)(3). Private Letter Ruling 7802037. See Teitell, Tax-Exempt Charitable Remainder Trusts - Mission Untaxable, N.Y.L.J. 4/3/78, p.1.

d. A charitable remainder trust is a private foundation for purposes of IRC §170(e)(5) if a private foundation is or may be the remainder beneficiary. See Private Letter Rulings 9320016; 9247018; 9441032; 9734034; for the IRS' view on how restricted stock can qualify for the deduction allowed by IRC §170(e)(5).

7. The trustee may be given the power to "sprinkle" among various beneficiaries. Reg. § 1.664-2(a)(3)(ii); 1.664-3(a)(3)(ii). Private Letter Rulings 8010127; 8049072. Charity may be one of two potential distributees as long as there is at least one non-charitable beneficiary. Private Letter Ruling 9052038. Trustee should not be one who would cause trust to be subject to IRC §674(a). Rev. Rul. 77-285, 1977-2 Cum. Bull. 213, clarified by Announcement 77-157, IRB 1977-47, 21.

8. Revocable trust that becomes charitable remainder trust on death must provide for payment of taxes, expenses, etc. from trust before distribution to remainder trust. See Rev. Rul. 72-395, 1972-2 Cum. Bull. 340, § 7.09.

9. Use disclaimers to avoid inappropriate powers. See Estate of Jaecker, 58 T.C. 166 (1972). See also Rev. Rul. 76-546, 1976-2 Cum. Bull. 290; Rev. Rul. 76-545, 1976-2 Cum. Bull. 289.

10. The grantor of an inter vivos trust may be the trustee under certain circumstances, despite an early private ruling to the contrary. See Rev. Rul. 77-285, 1977-2 Cum. Bull. 213, clarified by Announcement 77-157, IRB 1977-47, 21; Private Letter Rulings 9120016; 9048049; 8648048; 7730015. See also, Teitell, Charitable Remainder Trusts - Who Can (And Should) Be The Trustee?, 117 Trusts & Estates 320 (1978). A beneficiary may be a trustee. Private Letter Ruling 8032074. Hard to value assets ("unmarketable assets" as defined in IRC §731) must be valued by an independent trustee or by a "qualified appraisal" if the trustee is the beneficiary or a related or subordinate party. Reg. §1.664-1(a)(7). See H. Rep. No. 413, (Part I), 91st. Cong., 1st. Sess. 50 (1969), 3 Cum. Bull. 239; Private Letter Rulings 200029031; 200034019; 9442017; 9623018.

a. It is no longer necessary for tax purposes for a joint and survivor trust created with community property to provide that each donor has the right to revoke the other donor's interest to avoid a taxable gift. See Reg. §25.2511-2(c); Private Letter Rulings 7921081; 7905024; Rev. Rul. 79-243, 1979-2 Cum. Bull. 343. However, retention of the power may be appropriate in case of divorce.

b. If right of revocation exercised, the payments can be made to the estate of the revoking spouse (and thus to his heirs). Private Letter Ruling 8028018.

c. The grantor may reserve the right to change charities by Will or deed. Private Letter Rulings 9712031; 9120016.

d. In Private Letter Ruling 9712031, the IRS approved a trust in which the grantor reserved the right to direct the trustee to distribute assets to charity during the non-charitable beneficiaries' lifetime, to negotiate the corporate trustee's compensation and the power to designate investment managers. See also, Private Letter Ruling 200034019. See Private Letter Ruling 9442017, in which the IRS refused to rule on the last power. It is possible for this latter power to make the trust a grantor trust, which would disqualify it as a charitable remainder trust. See IRC §675.

11. Purchase of life insurance will not automatically violate IRC §4944. Private Letter Ruling 8745013. See also Rev. Rul. 80-133, 1980-1 Cum. Bull. 258; Private Letter Ruling 7928014. In Private Letter Ruling 9227017 the payment of insurance premiums on trust policy on grantor's life did not cause the trust to be a grantor trust under IRC §677(a)(3) because the premiums were paid from principal and the proceeds were allocated to principal, therefore coming within the exception under IRC §677 for policies payable for a charitable purpose. The trust was an income only trust; the result would have been different if the trust was a standard trust. Also, if the state's underproductive property statute is applicable, the IRC §677 exception might not apply; therefore, the trust should waive the application of such statutes. Borrowing against the policy to make trust investments will generate unrelated business taxable income, thus disqualifying the trust as a tax exempt entity. Private Letter Ruling 8745013.

12. Use of a zero coupon bond funded income only unitrust will avoid current income tax and payout requirements if the bond appreciation is allocated to principal. See Private Letter Ruling 860427 (Cal. law allocated the discount to principal).

13. A net income trust that purchased a commercial deferred annuity (for retirement purposes) was qualified. Private Letter Ruling 9009047. See also, Private Letter Ruling 9752035 and Technical Advice Memorandum 9825001 that approved the purchase of deferred annuities based on "the particular facts of this case." Normally, a deferred annuity held by a trust is not "deferred" for income tax purposes. IRC §72(u)(1), but in Private Letter Ruling 199933033, there was a contrary result.

14. A charitable remainder trust may be the beneficiary of qualified plan proceeds, and the trust will pay no income tax on receipt. Private Letter Rulings 200336020; 9818009; 9634019; 9253038; 9341008. See, Hoyt, Transfers From Retirement Plans to Charities and Charitable Remainder Trusts; Laws, Issues and Opportunities, 13 Va. Tax Rev. 641 (Spring, 1994). The plan distributions to the trust will be considered first-tier income (ordinary income) for purposes of IRC §664(b). Private Letter Ruling 9634019. See Perrin, The IRA-To-Charity Technique: Should Charity Begin At Home, 135 Trusts and Estates, No. 10, 18 (September 1996) for an analysis of the economics.

15. Gold Krugerrand coins are a permissible investment, and are not tangible personal property. Private Letter Ruling 9225036.

16. An S corporation may be the grantor of a charitable remainder trust for a term of years with the corporation as the non-charitable recipient. Private Letter Rulings 9512002; 9340043.

17. In Private Letter Ruling 9501004 the IRS ruled that the well publicized "option" technique would not be respected because a transfer of an option to a charitable remainder trust is not a transfer of an interest in property that would qualify for an income tax deduction under IRC §170(f)(3), and would not be a completed gift because the option is not binding when granted. See Rev. Rul. 81-282, 1981-2 Cum. Bull. 78 and Rev. Rul. 80-186, 1980-2 Cum. Bull. 280. The IRS's view of applicable local law (Ca.) re the binding nature of the option

is questionable. Prior Private Letter Ruling 9240017 (approving the option transfer) was withdrawn by Private Letter Ruling 9417005 prior to the issuance of Private Letter Ruling 9501004. For a pre-Ruling discussion, see Wakeman and Schultz, "Charitable Options: The Use of an Option Agreement to Facilitate Gifts of Real Estate to Charitable Remainder Trusts," Tax Management - Estate, Gifts and Trust Journal 207 (1991).

18. In Advance Notice 94-78, IRB 1994-32 (8/8/94), the IRS provided an "in terrorem" announcement for the "high payout/short-term" charitable remainder trust. Despite the Notice, the technique seems to work technically. Amended IRC §664(d)(1)(A) and (2)(A) were enacted to end the "abuse."

19. Tangible personal property may be contributed to a charitable remainder trust, but no deduction is allowed until the property is sold because IRC §170(a)(3) disallows a charitable deduction for an interest in tangible personal property until the non-charitable interest terminates. When allowed, the deduction is limited to the remainder interest in the basis because the use of the property is unrelated to the charity's purposes. Private Letter Ruling 9452026. This ruling can be distinguished from Private Letter Ruling 9501004 (the "option" ruling) because although no income tax deduction was allowed, a gift tax deduction was allowed. Neither deduction was allowed at the creation of the trust in Private Letter Ruling 9501004. Is it possible that the gift could be related use property? For example, suppose the gift is a painting and the remainderman is a museum. Also, does the beneficiary have an interest if he cannot use the property without destroying the nature of the trust? See Private Letter Rulings 7802016; 7724050. See Private Letter Ruling 9828001, in which the fair market value of property subject to an option was determined when the option lapsed.

20. In Private Letter Rulings 9506015, 9516040 and 9522021 the IRS ruled that an income-only unitrust cannot convert to a normal unitrust upon the occurrence of an event. Reg. §1.664-3(c)(1) permits "flip" trusts if unmarketable assets (defined in IRC §731(c)) are transferred, and certain criteria are satisfied:

    a. The trust must provide that the trust is an income-only trust until a specific date or a specific event which is not discretionary with, or is beyond the control of the

trustees or any other person. Examples of events that are permissible "triggers" are the sale of assets, death, divorce, birth of a child. Reg. §1.664-3(a)(1)(d).

b. The trust must switch to a normal unitrust in the first year following the event described in a.

c. Any make-up amount must be forfeited.

d. The effective date for the "final" rules on flip trusts is December 10, 1998, but there are other effective date rules for certain trusts created before December 10, 1998. See, Reg. §1.664-3(a)(1)(f).

e. Trusts without flip provisions could have been reformed by June 30, 2000 by judicial or non-judicial means to add a flip feature.

21. Private Letter Rulings 9711013; 9442017; 9511007; 9511029 allow capital gain to be allocated to income. See, Sen. Fin. Comm. Rept. 91-552, pg. 89., for a contrary view. The rulings permitted pre-contribution appreciation to be treated as income, but some practitioners believed that it is more appropriate to permit only post-contribution appreciation to be treated as income. Several states have passed statutes authorizing the trust to permit the trustee to allocate post-contribution appreciation to income so that such a provision will not "depart fundamentally from state law" within the meaning of IRC §643. The theory behind only permitting post-contribution appreciation to be allocated to income is that to allocate pre-contribution appreciation to income would depart fundamentally from state law, notwithstanding the contrary private letter rulings. See Private Letter Rulings 9711013; 9643014; 9609009. IRS 1996 Training Manual, Section K, page 139, contains an article on the perceived abuse of the use of a charitable remainder trust as an income deferral technique. Reg. §1.664-3(b)(3) permits only post-contribution gain to be allocated to income, if the trust so provides. Private Letter Rulings 199907013; 9833008. In a net income with make-up trust, the contingent "make-up" liability does not have to be taken into account in valuing the trust assets. TD8791 (12/10/98), Section V.

22. IRC §2702 does not apply to charitable remainder trusts, Reg. §25.2702-1(c)(3), but Reg. §25.2702-1(c)(3) changes the existing Regulation <u>for all income-only trusts (including flip trusts)</u> if a family member has an interest in the trust as well

as the donor or the donor's spouse. If so, the value of the donor's interest is disregarded unless the donor's interest follows the other interest. Some commentators argued that a net-income without makeup is not abusive and should not be covered by the new rules because the secondary beneficiary can never get more than the current income, but the final Regulations do not make an exception for "without make-up" trusts.

23. The circumstances surrounding the creation of a charitable remainder trust with a "wealth replacement" insurance policy are under examination in Ohio when the "numbers" did not work as expected (or promised?). Martin v. The Ohio State Univ. Fdn., 2000 Ohio App. _____ (2000), an appeal to the appeals court remanded the case for a new trial.

II. Comparison Between the IRC §2056(b)(7) Qualified Terminable Interest Charitable Remainder Trust and the IRC §664 Charitable Remainder Trust.

A. Availability.

1. The non-charitable beneficiary of an IRC §664 charitable remainder trust can be any person or persons. IRC §664(d); Rev. Rul. 76-270, 1976-2 Cum. Bull. 194. It is permissible to permit the trustee to sprinkle the unitrust amount or the annuity trust amount among many beneficiaries. Reg. § 1.664-2(a)(3)(ii); 1.664-3(a)(3)(ii). However, for the IRC §664 trust to qualify for the marital deduction, no one other than the spouse (and the grantor) may have an interest preceding the charitable interest. IRC §2522(g); 2056(b)(8). Arguably, this restriction makes no sense as long as the spouse is the only "current" beneficiary.

2. The QTIP trust must have a spouse as the beneficiary, and no one other than the spouse can have a current interest in income or principal. IRC §2056(b)(7)(B)(ii).

B. Transfer Tax Impact.

1. The creation of an IRC §664 trust usually results in a gift tax or estate tax being imposed upon the non-charitable transfer. However, if the non-charitable beneficiary is a spouse, the spouse's interest in the trust qualifies for the unlimited marital deduction. IRC §2056(b)(8). Therefore, if the spouse is the only non-charitable beneficiary, the entire trust is not subject to gift tax or estate tax, except if there is a contingency. See IRC §664(f).

2. Since the QTIP trust was designed to qualify for the unlimited marital deduction, no gift or estate tax is payable upon its creation, and if the trust passes to charity upon the termination of the spouse's interest, no gift or estate tax is payable at that time. IRC §2044; 2055(b); Prop. Reg. § 20.2056(b)(8); 20.2044-1(b); Private Letter Ruling 9122029. A defective "QTIP" trust with a charitable remainder is not eligible for the charitable deduction at the first death. Private Letter Ruling 8742001. See also Private Letter Ruling 8730004.

C. Payments to Beneficiary.

1. An IRC §664 charitable remainder unitrust must pay to the beneficiaries only a fixed percentage (not less than 5%) of the annual fair market value of the trust assets. IRC §664(d)(2)(A). An IRC §664 charitable remainder annuity trust must pay an annuity of not less than 5% of the initial fair market value of the trust assets. IRC §664(d)(1)(A). An alternative to the charitable remainder unitrust is the income-only unitrust, which pays the lesser of the unitrust amount and the trust's actual income each year. IRC §664(d); Reg. §1.664-3(a)-(1)(i)(b); Rev. Rul. 76-310, 1976-2 Cum. Bull. 197. No other payments are permitted to be made to the non-charitable beneficiaries during the term of the trust. Reg. § 1.664-3(a)(4); 1.664-2(a)(4); Rev. Rul. 77-58, 1977-1 Cum. Bull. 175. In testamentary trusts, the non-charitable beneficiaries must have a right to payments beginning with the date of death, although actual payments may be postponed until the trust is funded. See Rev. Rul. 80-123, 1980-1 Cum. Bull. 205. In an income-only trust, it is not clear whether the non-charitable beneficiaries are entitled to income during administration.

2. The spouse must receive all of the income from a QTIP trust, at least annually. IRC §2056(b)(7)(B)(ii). Under state law, the life beneficiary of a trust is entitled to income from the date of death. See, e.g., Cal. Prob. C. 663(c). It is possible to pay the spouse an annuity, as long as the annuity always is equal to or exceeds the income of the trust. Invasions of principal are permitted for the spouse's benefit, but no invasions of principal are permitted for anyone else's benefit during the spouse's lifetime. IRC §2056(b)(7)-(B)(ii). Because the QTIP trust will be included in the spouse's estate for estate tax purposes in any event, IRC §2044, no adverse estate tax consequences result from the availability of the

power of invasion, and it is not necessary for there to be any standard whatsoever from an estate tax point of view. See paragraph H.2, below, for a potential adverse income tax consequence during administration of a power of invasion not limited by an ascertainable standard. The standards for invasions of principal for the spouse and the existence of a power to invade for the spouse are dependent upon the grantor's or testator's intentions.

D. Powers of Appointment.

1. The life beneficiary or beneficiaries of an IRC §664 trust may be given the power to alter the ultimate charitable recipients, but only qualified charitable organizations may be the remainder beneficiaries. Rev. Rul. 76-8, 1976-1 Cum. Bull. 179. Rev. Rul. 76-7, 1976-1 Cum. Bull. 179; Rev. Rul. 76-371, 1976-2 Cum. Bull. 305.

2. A spouse may be given a testamentary power of appointment over a QTIP charitable remainder trust, IRC §2056(2)(7)(B)(ii), but the ability to appoint to non-charitable beneficiaries may result in an estate tax at the spouse's death and also in the frustration of the grantor's or testator's intention to benefit charity. If the spouse does not have sufficient property to use up his or her exemption equivalent, the existence of the power of appointment gives the spouse the ability to give property equal to the value of the exemption equivalent to individuals without imposition of tax. The balance of the trust will pass to charity selected by the grantor or testator in the original instrument, or by the spouse pursuant to the power.

E. Election.

1. To obtain the unlimited marital deduction for a transfer to an IRC §664 trust with the spouse as the sole non-charitable beneficiary requires no special election because the spouse's interest in the trust automatically qualifies for the deduction. IRC §2056(b)(8).

2. An election is required on a gift tax return or estate tax return in order to have a QTIP trust qualify for the unlimited marital deduction. IRC §2056(b)(7)(B)(v).

F. Income Taxation.

1. An IRC §664 trust is exempt from income tax unless the trust has unrelated business income within the meaning of IRC §512. IRC §664(c). In any year in which the trust has unrelated business income, the trust becomes subject to tax under the normal rules of Subchapter J. IRC §664(c).

   a. Distributions to the beneficiaries are taxed in accordance with the provisions of IRC §664(b) rather than in accordance with the principles of Subchapter J whether or not the trust is exempt.

   b. Under IRC §664(b), distributions to the non-charitable beneficiaries are taxed as follows:

      i. as ordinary income to the extent of the trust's ordinary income for the current year, and to the extent of the accumulated ordinary income from prior years;

      ii. as capital gain to the extent of the trust's current capital gain, and to the extent of the trust's accumulated capital gain from prior years;

      iii. as other income (i.e. tax exempt income) to the extent of the trust's other income for the current year, and to the extent of the trust's accumulated other income from prior years; and

      iv. as distributions of principal.

2. Distributions to the spouse from a QTIP charitable remainder trust are taxed in accordance with the provisions of Subchapter J, and generally, the spouse will receive taxable income to the extent of the trust's distributable net income. Distributable net income will be made up of a proportionate amount of the different kinds of income which enter into the distributable net income computation. Since capital gains usually are not part of distributable net income, capital gains will be taxed to the trust. Even if the spouse does not have the power to appoint the property away from charity, a capital gain tax will be payable by the trust on capital gain because the set-aside deduction of IRC §642(c) is not available to trusts. Only if the capital gain is distributed to the charitable remaindermen will tax on capital gain be avoided

during the administration of the trust. With respect to the rules during the administration of the estate, see Section I.G.-K. above.

G. Transactions With Life Beneficiaries.

1. IRC §4941 applies to IRC §664 trusts. Therefore, transactions between the trust and the surviving spouse (such as private annuities, sales, use of property, etc.) are prohibited. But see Private Letter Rulings 8948023; 8647007.

2. IRC §4941 does not apply to QTIP charitable remainder trusts. The trustees and the surviving spouse may enter into transactions with each other. Also, the surviving spouse may be permitted to use property held in the QTIP charitable remainder trust on a rent-free basis (i.e., the family residence and tangible personal property).

H. Income Taxation During Administration.

1. An estate which is distributable to an IRC §664 trust is subject to the normal rules of Subchapter J during administration. The Service's position is that no set-aside deduction is available pursuant to IRC §642 for capital gain since there is a possibility that the capital gain will be utilized to pay the annuity trust amount or unitrust amount to the non-charitable beneficiary. The set-aside deduction should be available if the charitable remainder trust is an income-only unitrust without a make-up provision because the non-charitable beneficiary never can receive more than the ordinary income of the estate or the trust. In addition, it should be available for an annuity trust under certain circumstances. See Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax. L. Rev. 1, 271 (Fall, 1984). If the estate plan is implemented through a funded revocable trust, even the set-aside deduction for an income-only unitrust will not be available unless the capital gain actually is distributed to the charitable remainder trust during administration. See Section I.G.-K. above.

2. An estate which is distributable to a QTIP charitable remainder trust also is subject to the normal rules of Subchapter J during administration. However, there is some authority for the proposition that the estate may be entitled to a set-aside deduction for capital gain during administration if the possibility of invasions of principal for the surviving

spouse's benefit is so remote as to be negligible. See Schmolka, supra.

l. Investments.

1. Certain investment limitations exist in an IRC §664 trust:

a. The self-dealing rules of IRC §4941 apply.

i. Contributions of encumbered assets may be an act of self-dealing. Reg. §53.4941(d)-2(a)(2); Private Letter Ruling 7943062. But see Private Letter Rulings 8315022, 8114025, and 7807041, in which the Service ruled that an initial transfer of encumbered property is not self-dealing. In addition, encumbered assets may produce debt financed income, IRC §514, and the existence of debt financed income will destroy the income tax exempt status of the IRC §664 trust. Distributions of encumbered real property from an estate to a testamentary IRC §664 trust is not self-dealing. Private Letter Rulings 7807041; 7906038. A post-death "exchange" of community property interests coupled with a refinancing was approved in Private Letter Ruling 7906038.

ii. Redemptions of closely-held stock of donor's corporation may be self-dealing, unless the offer to redeem is at fair market value and is made to all shareholders. See Private Letter Rulings 8309063; 832006; Rockefeller v. U.S., 83-2 USTC 9724 (1983).

iii. The excess business holdings prohibition of IRC §4943 does not apply during the time that the trust is a split-interest trust. See Rev. Rul. 74-368, 1974-2 Cum. Bull. 390. However, if disqualified persons are the fiduciaries, it appears to be necessary to provide for someone other than the disqualified persons to value the stock each year. See Report of Committee on Ways and Means, No. 91-413, 60; Rev. Rul. 80-83, 1980-1 Cum. Bull. 210. Although IRC §4943 does not apply during the split-interest period, any business income generated by a partnership or other unincorporated business will result in

unrelated business income and the loss of the trust's income tax exempt status.

b. IRC §4944 (jeopardy investments) applies to an IRC §664 trust. Although what constitutes a jeopardy investment is not clear, many high yield investments (i.e., third mortgages) may not be appropriate. Reg. §53.4944-1(a)(2).

c. Certain assets are inappropriate for funding an IRC §664 trust, although such assets may be held by a QTIP charitable remainder trust. For example, a QTIP charitable remainder trust is a qualified Subchapter S trust under IRC §1361(d), but an IRC §664 trust is not. Rev. Rul. 92-48, 1992-1 Cum. Bull. 301; Private Letter Ruling 8922014.

d. No provision of the trust may prevent the trustees from investing the assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Reg. §1.664-1(a)(3); Rev. Rul. 73-610, 1973-2 Cum. Bull. 213; Rev. Rul. 73-571, 1973-2 Cum. Bull. 213. Requiring the approval of someone other than a trustee for changing investments violates Reg. §1.664-1(a)(3). See Private Letter Rulings 8041100; 7928014; 7928076; 7948108. See Tidd, Charitable Remainder Trusts: Funding and Investment Considerations, 57 Taxes 577 (1979).

2. A QTIP charitable remainder trust has no limitations on the nature of its investments, except such limitations as may be imposed by state law or by the terms of the governing instrument.

a. To qualify for QTIP treatment, the surviving spouse must be entitled to all of the income from the trust, and the trustees must not be prohibited from investing the trust assets in a manner which would not yield a reasonable amount of income. However, the power to retain or invest in underproductive or unproductive property will not be fatal if the spouse has the right to require that the property be made productive within a reasonable time. See Reg. §20.2056(b)-5(f)(4); Private Letter Ruling 7916006; Rev. Rul. 75-440, 1975-2 Cum. Bull. 372.

b. Greater investment flexibility in the QTIP charitable remainder trust may make overall estate planning for the family easier. For example, since the QTIP charitable remainder trust is subject to capital gains tax, investments in that trust may be directed toward high income, low appreciation investments, thus giving the surviving spouse a higher than normal yield. Concurrently, the trustees of a credit shelter trust created at the death of the testator may focus their investment strategy on capital appreciation (with or without current capital gains tax) to maximize the property passing to children free of tax on the surviving spouse's death.

J. Term of Trust.

1. Generally, an IRC §664 trust must terminate either upon the expiration of a term of years (not more than 20), or upon the spouse's death. As a result of the enactment of IRC §664(f) in the Tax Reform Act of 1984, the spouse's or any non-charitable beneficiary's interest may terminate upon the occurrence of any other contingency, but the charitable deduction is computed without regard to the contingency. See Rev. Rul. 76-291, 1976-2 Cum. Bull. 284. However, to be entitled to the marital deduction for an IRC §664 trust for the spouse's benefit, his or her interest must be for life. IRC §2056(b)(8).

2. The spouse's interest in a QTIP charitable remainder trust may be for a term of years or for the spouse's life. IRC §2056(b)(7)(B)(ii); Reg. §20.2056(b)-8(a)(2). Other contingencies will disqualify the trust.

3. If the spouse gives up the Income Interest, a gift and income charitable deduction is available. See IRC §2519 and Private Letter Ruling 200013015.

K. Qualified Domestic Trust - IRC §2056A.

1. Revenue Reconciliation Act of 1989 (H.R. 3299) provides for a charitable deduction at the death of a spouse beneficiary of a qualified domestic trust (QDOT). IRC §2056A(b), "overruling" prior law. See Private Letter Ruling 8942056.

2. For gift tax purposes, the $100,000 exemption is available for present interests that meet the usual gift tax marital

deduction requirements of IRC §2523. IRC §2523(i)(2); 2523(g).

a. The present value of the non-citizen spouse's interest in the IRC §664 trust must be less than $100,000.

b. Is the interest a present interest? See Estate of Kolker, 80 T.C. 1082 (1983) (no); Private Letter Rulings 8637084; 8932018 (yes).

3. A non-citizen spouse's interest in a charitable remainder trust will qualify for the marital deduction if the trust otherwise qualifies under IRC §2056(b)(8). IRC §2056A(e). Private Letter Ruling 9244013 allows the marital deduction for a non-citizen spouse's interest in an IRC §664 trust if the requirement of IRC §2056A is met. See Pusey, "Qualified Domestic Trust Provisions: Problem Areas Affecting Charitable Remainder Trust," 18 Tax Mgmt Est. Gifts and Trusts J. 139 (Sept/Oct 1993).

SECTION II. Alternatives to Charitable Remainder Trusts.

I. Split Gift.

For the client who desires to leave a small annuity to a relative or other beneficiary, the client may be well advised to take the portion of the total gift that represents the life beneficiary's interest and purchase a commercial annuity, leaving the balance of the total gift outright to charity. For example, assume that the client wishes to leave his aunt an annuity of $6,000 per year for her life. Assuming an 8% return, one alternative is to create a $75,000 charitable remainder annuity trust paying $6,000 per year. If the aunt is age 70, the value of her interest is $36,313 and the value of the charitable interest is $38,687. Rather than creating the trust, the client might direct his executors to purchase a commercial annuity for the aunt for $36,313, and leave $38,687 to charity. Even if the commercial annuity costs more than $36,313, the administration expenses of maintaining the trust probably will dilute the charitable remainder in any event, and the charity will not have the use of the funds until the aunt dies. By splitting the gift into two parts, the aunt receives her current income, and the charity receives current use of its funds.

II. Pooled Income Fund.

A pooled income fund has been referred to as a "poor man's" charitable remainder trust. A pooled income fund is a fund maintained by a public charity, contributions to which are pooled in a single fund. Each donor is entitled to receive his or her proportionate share of the income from the

fund each year. Reg. §1.642(c)-5(b)(2). Upon the donor's death, the remainder interest in the donor's contribution passes to the "host" public charity. Although the pooled income fund's concept is similar to a charitable remainder trust, there are some differences which may be important in a particular situation:

A. The beneficiary receives a proportionate part of the income from the fund each year rather than fixed annuity or a unitrust amount. IRC §662. In inflationary times, it is likely that the income will be increasing just as it does in a charitable remainder unitrust, but there is no way to prevent a decrease such as there is with a charitable remainder annuity trust.

B. The character of the income received by the non-charitable beneficiary is determined under Subchapter J rather than by IRC §664(b). Thus, the non-charitable beneficiary receives a proportionate part of each type of income earned by the fund, with the characterization of the income passing through to the beneficiary.

C. Only the "host" public charity may be the trustee of a pooled income fund, and therefore, the client loses the opportunity to have the fund managed by one or more specified individuals. Rev. Rul 75-116, 1975-1 Cum. Bull. 182. However, in most cases, the amount of principal is too small for an individually managed fund, and if a corporate trustee is the trustee for the charitable remainder trust, the principal may be managed in the common trust fund anyway.

D. Upon termination of the life beneficiary's interest, the principal passes to the host charity which must be a public charity described in IRC §170(b)(1)(A) [except subsections (vii) and (viii)]. There is no opportunity to choose multiple charities (except by making gifts to multiple pooled income funds), to change charitable beneficiaries at a later date, or to name private foundations.

E. The fund may not invest in tax exempt securities. IRC §642(c)(5)(C).

F. The income may not be sprinkled. Reg. §1.642(c)-5(b)(2).

G. It is not clear when the interests of the non-charitable beneficiaries begin in a testamentary transfer. See Rev. Rul. 76-445, 1976-2 Cum. Bull. 193; Private Letter Ruling 8810006. See Section I. above. The interests of the non-charitable beneficiaries in charitable remainder trusts must begin as of the date of death, Rev. Rul. 82-165, 1982-2 Cum. Bull. 117, but payment may be deferred. Reg. §1.664-1(a)(5)(i).

H. Creation of an interest in a pooled income fund is easy; the fund documents have been approved by the Service and usually all that is required is to sign a few prepared documents and make the contribution. No separate trust instrument is required, there is no requirement to file separate income tax returns each year, and all record keeping is handled by the fund itself. IRS approved forms are now contained in Rev. Proc. 88-53, 1988-2 Cum. Bull. 712, which supersedes Rev. Rul. 82-38, IRB 1982-11, 6, and Rev. Rul. 72-196, 1972-1 Cum. Bull. 194. See also Rev. Proc. 88-54, 1988-2 Cum. Bull. 715.

I. Life interest in pooled income fund will qualify as qualified terminable interest property. See H.R. Rep. 794, 97th Cong., 2d Sess. 17 (1982) for the Committee Report view that the interest qualifies even if payments to the spouse terminate with the last payment preceding death.

III. Charitable Gift Annuity.

A. The charitable gift annuity involves the donor's transfer of money or property to charity in exchange for charity's promise to pay the donor or another an annuity. The charitable gift annuity gives charity immediate use of the transferred property as opposed to the deferred use available under unitrusts, annuity trusts or pooled income funds (except in those states where insurance laws require that reserves be maintained with respect to such annuities). The price paid by charity for such immediate use is simply that the annuity obligation represents a general obligation against the assets of the charity.

B. A charity is free to negotiate any annuity rate it deems appropriate. Most charities, however, issue such annuities on the basis of tables published by the Committee on Gift Annuities, the theory behind such uniform rates being that charities should compete on their merits, not on the basis of the annuity rates they offer.

C. Charitable gift annuities are not intended to be competitive with annuities offered by commercial insurers. The rates published by the Committee on Gift Annuities are uniform for males and females in contrast to commercial annuities that pay higher rates to males because of their shorter life expectancy.

D. The gift annuity transaction is a "part sale-part gift" transaction. This means that when appreciated property is transferred in exchange for an annuity, gain will be realized. It also means that the transaction will result in a charitable income tax deduction as to the gift component.

E. The value of the donor's charitable deduction is the difference between the fair market value of the property transferred to charity and the value of the annuity contract received in exchange. The value of the annuity is to be determined in accordance with Reg. §1.170A-1(d). The Service provides tables to govern the determination. For annuities entered into after November 24, 1984, the tables in Reg. § 25.2512-5 and 20.2031-7 are to be used instead of the tables in Rev. Rul. 72-438, 1972-2 Cum. Bull. 38. Rev. Rul. 84-162, 1984-2 Cum. Bull. 200.

F. The gain, if any, realized upon the exchange may be eligible for installment treatment if the annuity is non-assignable and the donor is the annuitant (or one of two annuitants if there is more than one).

1. The bargain sale rules of IRC §1011 require that the donor's basis in the transferred property be allocated between the gift component and the sale component of the transaction. See Reg. § 1.1011-2(a)(4); 1.1011-2(b). This allocation increases the gain recognized.

2. When gain is eligible for installment reporting, recognition occurs ratably over the life expectancy of the annuitant. Once all gain has been reported, such reporting stops even though the annuitant is alive. If the annuitant dies before all gain has been recognized (and there is no survivor annuitant), the unrecognized gain dies too and escapes tax altogether. See Reg. §1.1011-2(a)(4)(ii).

3. See Estate of Bullard, 87 T.C. 261 (1986), and the newly modified bargain sale rules in Reg. §1.170A-4 and Reg. §1.1011-2.

G. The annuity payments are taxed in the hands of the annuitant under the normal IRC §72 rules. An exclusion ratio must be determined in order to permit calculation of that portion of each annuity payment that is excluded from ordinary income. This excluded element is considered tax free return of capital except to the extent of that part of it, if any, that is recognizable capital gain. New tables have been issued to compute the exclusion ratio for annuities issued after 6/30/86. The excludable portion of each payment ceases to be excludable if the donor lives beyond his life expectancy, but any "unused" investment in the contract is deductible on the donor's final income tax return. IRC §72(b)(2) and (3). See Private Letter Ruling 200230018 in which the IRS discussed the consequences of using an IRA at death to purchase a gift annuity:

1. The entire amount of the IRA is includable in the gross estate.

2. The estate is entitled to a charitable deduction for the charitable interest.

3. The estate will not recognize income when the IRA is distributed to charity.

4. Not discussed in the ruling is how much is taxable to the annuitant each time a payment is made. Presumably, everything should be taxable because the IRA had no basis. There also was no discussion of how the IRC § 691(c) deduction would work (or would not work) if the estate is subject to estate tax. See Private Letter Ruling 199901023 in which the IRS ruled that the IRC § 691(c) deduction is not passed out to the non-charitable beneficiary in a charitable remainder trust; it is trapped in the trust.

5. Deferred annuities are permitted. Private Letter Ruling 200449033. See also Private Letter Rulings 200449033; 9743054; 9017071; Rev. Rul. 72-438 Cum. Bull. 438.

IV. Annuity Carve Out Gift.

Although the Tax Reform Act of 1969 purportedly limited the methods by which a donor could give a split-interest gift and receive a charitable income, estate, and gift tax deduction, at least one private ruling has approved a split-interest gift which did not fall within the statutory requirements. In Private Letter Ruling 8045010 an individual left a bequest outright to charity on the condition that the charity pay an annuity to named individuals for the individuals' lives. The charitable deduction was allowed for the difference between the amount of the gift and the present value of the annuity. Accord, Private Letter Ruling 8540037. This arrangement sounds like a charitable remainder annuity trust in disguise, and in fact, it accomplishes the same result. However, there are some differences which may or may not be important to a particular client:

A. All of the payments to the annuitant are ordinary income as contrasted with the tier system of income taxation in IRC §664(b).

B. The annuitant is relying on the charity's solvency for the duration of the annuity. If the charitable organization ceases to pay the annuity, the annuitant is relegated to a lawsuit, and in the event of the charity's bankruptcy, the annuitant is a general creditor.

C. This technique has been approved in the private letter rulings. Therefore, there is no assurance that courts will approve it, or that the IRS will not take an adverse position on audit. See also Rev. Rul. 83-20, 1983-1 Cum. Bull. 231.

D. If the transaction is between a disqualified person and a private foundation, the transaction is an act of self-dealing. Private Letter Ruling 8819007.

V. Remainder Interest in Personal Residence or Farm.

A. An estate tax charitable deduction is only available for a remainder interest not in trust in a personal residence or farm. IRC §2055(e)(2); Reg. §20.2055-2(e); Ellis First National Bank of Bradenton v. U.S., 77-1 USTC 13,178 (1977); Private Letter Ruling 8110016. See Teitell, Gift of Residence or Farm with Retained Life Estate, 115 Trusts & Estates 360 (1976). The remainder interest need not be in the entire residence or farm. Rev. Rul. 87-37, 1987-1 Cum. Bull. 5. Private Letter Ruling 8341009 (interest in 90% not qualified). Reformation not available to cure a defective gift. Private Letter Ruling 8341009. The IRS ruled in Rev. Rul. 85-23, 1985-1 Cum. Bull. 327, that the "so remote as to be negligible" test of Rev. Rul. 77-374 is applicable to remainder interests in residences and farms.

B. In Rev. Rul. 76-357, 1976-2 Cum. Bull. 285, the IRS ruled that no estate tax deduction is available for a trust remainder interest in a personal residence unless the trust is a qualified charitable remainder trust or pooled income fund. See Rev. Rul. 76-543, 1976-2 Cum. Bull. 287; Rev. Rul. 76-544, 1976-2 Cum. Bull. 288, distinguished in Private Letter Ruling 8241099, and revoked in Rev. Rul. 87-37, 1987-1 Cum. Bull. 5. See also Estate of Cassidy, 49 T.C.M. 580 (1985).

C. The rules relating to the sale of the residence by the life tenants and the charity are unclear. Rev. Rul. 77-169, 1977-1 Cum. Bull. 286, held invalid in Estate of Blackford, 77 T.C. 1246 (1981); See Rev. Rul. 83-158. 1983-2 Cum. Bull. 159, which distinguishes Rev. Rul. 76-543 and Rev. Rul. 77-169; and Rev. Rul. 77-305, 1977-2 Cum. Bull. 72, for other restrictions on gifts of residences. In General Counsel's Memorandum 39243 (4/4/84) and in Rev. Rul. 84-97, 1984-2 Cum. Bull. 196, the IRS allowed a deduction for the remainder interest even though state law required the sale of the farm by the charity 10 years after acquisition. See also Private Letter Rulings 7835010, 8309007; 8112056; 7812005; 8002021; 8020106. But see Private Letter Ruling 8141037, which distinguishes Rev. Rul. 77-169 on the same facts. Private Letter Rulings 8810004 and 8812003 did not allow the deduction because the charity had no choice between taking an interest in the property and taking the proceeds of sale. It distinguished Rev. Rul. 83-158; Private Letter Ruling 9151022 (reformation available to cure defects).

D. "Personal residence" means any residence, not only a principal residence.

1. Includes stock in co-op apartment. Private Letter Ruling 8431007.

2. Vacation home qualifies.

3. Furniture and furnishings that are not "fixtures" under state law are not part of "residence." Rev. Rul. 76-165, 1976-1 Cum. Bull. 279. Heating and air conditioning are fixtures and are eligible for deduction. Private Letter Rulings 9329017; 8529014.

4. Salt royalty is not a residence or farm even though it is located beneath a residence and beneficiary continues to reside in the residence after decedent's death. Estate of Brock v. Comm'r., 71 T.C. 901 (1979), aff'd, 80-2 USTC 13,379 (9th Cir. 1980).

5. Gifts of partial remainder interests qualify. Rev. Rul. 87-37, 1987-1 Cum. Bull. 5, revoking Rev. Rul. 76-544, 1976-2 Cum. Bull. 288. A discount for the co-tenancy is appropriate and reduces the charitable deduction. See Estate of Youle, 56 T.C.M. 1594 (1989); Estate of Fawcett, 64 T.C. 889 (1975), acq. 1978-2 Cum. Bull. 2.

6. Deduction allowable even if part of residence is rented to a third party. Rev. Rul. 78-303, 1978-2 Cum. Bull. p. 122; Private Letter Ruling 8711038.

E. "Farm" means actual working farm, including improvements such as residences, barn, etc. Reg. §20.2055-2(e)(2)(iii); Rev. Rul. 78-303, 1978-2 Cum. Bull. 122; Private Letter Rulings 8241099; 7826106.

F. Valuation of Remainder Interest.

1. Depreciation is not taken into account for valuing the remainder interest for estate and gift tax purposes. Rev. Rul. 76-473, 1976-2 Cum. Bull. 306. Depreciation is taken into account for income tax purposes. IRC §170(f) (4); Reg. § 1.170A-12(b); § 25.2512-9. See Private Letter Rulings 9329017; 8125017, 8125198, 8110163.

2. Value determined under Reg. §20.2031-10 and IRS Publication 1459 (Actuarial Values-Gamma).

G. Special valuation under IRC §2032A is not available for the life interest. Rev. Rul. 81-220, 1981-2 Cum. Bull. 175.

H. Some restrictions on charity's use of the property are permitted. Private Letter Ruling 7807101. For the effect of restrictions on value, see Rev. Rul. 85-99, IRB 1985-29, 7; General Counsel's Memorandum 39380.

I. Gift of mortgaged farm will qualify, but will be a bargain sale. Private Letter Ruling 9329017.

J. Transfer of interest in farm to donor's foundation allowed, but donor was not involved in the farming operations (farm leased to third parties) nor in the foundation's affair. The deduction is limited to basis and 20% of adjusted gross income. Private Letter Ruling 9714017.

SECTION III. Charitable Lead Trusts.

I. General Rules.

A. A "lead" trust is a split-interest trust in which the charitable interest precedes the non-charitable remainder. After the Tax Reform Act of 1969, the benefits of lifetime lead trusts have been reduced materially, and have not received the attention focused on charitable remainder trusts. The unification of the estate and gift tax in the Tax Reform Act of 1976 revitalized the lead trust as a means of avoiding transfer tax, but fluctuating interest rates make the use of lead trusts interest sensitive. See Callahan, Charitable Lead Trusts - The Forgotten Member of the Trilogy, 11 Univ. Miami Inst. on Est. Plng. 500 (1977); Muchin, Lubelchek, and Grass, Charitable Lead Trusts Can Provide Substantial Estate Planning Benefits, 48 J. Tax 2 (1978); Burgren, The Charitable Lead Trust, 13 Tax Advisor 586 (Oct. 1982).

B. To be deductible for estate tax purposes, the trust must meet restrictive requirements: The charitable interest must be in the form of a guaranteed annuity trust interest or a unitrust interest. IRC §2055(e) (2)(B). Annuity interests for a term of years or for a term of years plus lives-in-being is qualified. Rev. Rul. 85-49, 1985-1 Cum. Bull. 330. Interest must be in trust unless paid insurance company or similar by organization. Reg. § 20.2055-2(e) (2)(v)(c); 20.2055-2(e)(2)(vi)(c).

1. A trust which provides for payment of the lesser of a fixed percentage and the actual trust income does not qualify (i.e.

no "income-only" lead trust). Rev. Rul. 77-300, 1977-2 Cum. Bull. 352.

2. If interest of charity is specified percentage of guaranteed annuity or unitrust interest, the trust qualifies. Rev. Rul. 77-327, 1977-2 Cum. Bull. 353.

3. Reformation may save the charitable deduction. Private Letter Ruling 7951052. See I.A.3.-10, above.

C. The amount of the estate tax deduction is equal to the actuarially computed present value of the annuity interest or of the unitrust interest. Private Letter Ruling 8004054. Until the final Regulations for the new 10% tables were published, donors could elect to use the 6% tables or the 10% tables. IR 83-158 (12/22/83).

1. To value the annuity trust interest, see Reg. §20.2031-10; Reg. §20.2055-2(f)(2)(iv); Reg. §1.7520-3(b)(2)(i); Reg. §20.7520-3(b)(2)(i); Reg. §25.7520-3(b)(2)(i).

2. To value the unitrust interest, subtract the value of the remainder interest from the fair market value of the property passing into trust. Reg. §20.2055-2(f)(2)(v); Reg. §1.7520-3(b)(2)(i); Reg. §20.7520-3(b)(2)(i); Reg. §25.7520-3(b)(2)(i). See also Rev. Rul. 77-223, 1977-1 Cum. Bull. 298, restated in Rev. Rul. 78-183, 1978-1 Cum. Bull. 302, for computation of annual deduction for unitrust interest passing to charity for 10 years, 1 mo.

3. Deduction only allowable for the minimum amount it is evident that the charity will receive. Reg. §20.2055-2(f)(2)(iv); Reg. §20.2055-2(f)(2), example (2); Reg. §25.7520-3(b)(2)(v), example 5.

4. A lifetime gift to a lead trust is a gift "for the use of" charity, and any excess deduction cannot be carried forward. Private Letter Ruling 8824039.

II. Taxation of Lead Trusts.

A. Unless the trust is a grantor trust, the trust taxed as a normal trust under Subchapter J. See Private Letter Ruling 7808067. The power in a nongrantor to "acquire" trust assets by substituting assets of equal value made the trust a grantor trust, notwithstanding the use of the term "reacquire" in IRC §675(4). Private Letter Ruling 9642039; 9224029.

B. IRC §642(c) deduction available for all amounts paid to charity.

1. Proposed Regulation §1.642(c)(3) provides for normal Subchapter J rules to apply to a lead trust. Historically, the lead trust provided for payment of the annuity or unitrust amount first from ordinary income, then from capital gain, and finally from principal. See Rev. Rul. 71-285, 1971-2 Cum. Bull. 248. Private Letter Rulings 8728034; 8021095; 8021143. However, the payment sequence can be pushed too far. See General Counsel Memorandum 39161; Private Letter Ruling 8727072. Prior to the Proposed Regulation, the IRS had been ruling that the ordering of the income distributions as set forth in this section will not be given effect. Private Letter Rulings 9821030; 9348012; 9233038; 9052013; 9048044; 8828047; 8823022. According to the IRS, the normal rules of IRC §642 will apply. See Private Letter Rulings 9821030; 9348012; 9233038; 8931029.

2. Any income (ordinary or capital gain) not distributed to charity will be taxed to the trust because it may pass to non-charitable beneficiaries. Reg. § 20.2055-2(e)(2)(vi)(f); 20.2055-2(e)(2)(vii)(e).

3. Lead trusts were subject to throwback rules, but accumulated income used to satisfy deficiencies in payment of annuity or unitrust amount were not accumulation distributions. Reg. §1.665(b)-1A(c)(2).

4. IRC §644 applied to inter vivos lead trusts. Private Letter Ruling 8032089. IRC §663(b) also applies. See Private Letter Ruling 8922053 outlining the requirements for getting an extension of the 65-day rule under Reg. §1.9100-1(a).

5. No deduction will be allowed under IRC §642 for unrelated business income. IRC §681; see Private Letter Rulings 8728034; 8026032.

6. Straight line depreciation may be taken on depreciable property. Private Letter Ruling 7808067. See Private Letter Ruling 8330107 for the treatment of the depletion allowance in a lead trust.

7. For tax years beginning on or after 1/1/83, neither inter vivos nor testamentary lead trusts are subject to AMT.

8. No IRC §642(c) deduction will be allowed for payments made under a commutation provision under a trust which did not

allow such payments if they caused the trust not to qualify as a lead trust. Technical Advice Memo 8745002.

9. No deduction under IRC §642 for in kind distributions; the distributions must be of the "gross income" itself. Private Letter Ruling 8931029. However, if the trust realizes capital gain on the distribution (because the in kind assets are appreciated), a deduction will be allowed. Rev. Rul. 83-75, 1983-1 Cum. Bull. 114; Private Letter Ruling 9201029.

10. A transfer of appreciated property to charity did not cause there to be a tax preference for AMT purposes. See Rev. Rul. 83-75, 1983-1 Cum. Bull. 114; Private Letter Ruling 9044047.

11. The retention of the right to change the charitable beneficiaries of a lead trust will cause the trust to be included in the grantor's estate. Private Letter Rulings 200328030; 9629009; 9642039. See, Rev. Rul. 77-275, 1977-2 Cum. Bull. 346.

III. Drafting Testamentary Lead Trusts.

A. Rev. Proc. 2007-45, Rev. Proc. 2007-46, Rev. Proc. 2008-45 and Rev. Proc. 2008-46 contain approved forms for *inter vivos* and testamentary charitable lead trusts. Historically, private letter rulings have suggested that many of the charitable remainder trust provisions should be included in charitable lead trusts (Private Letter Rulings 8052068 and 7938099), and the new forms contain many of the remainder trust provisions. The Revenue Procedures continue the IRS policy of permitting amendments to qualify the trusts. See, Private Letter Ruling 8121066.

B. "Annuity amount" must be a fixed amount payable annually. Generally, it is expressed as a percentage of the initial fair market value of the trust assets. There is no minimum payout as there is in a remainder trust.

C. "Unitrust interest" must be a fixed percentage of the annual fair market value of the trust assets. There is no minimum percentage as there is in a remainder trust. See Private Letter Ruling 9415009, in which the IRS conditioned a ruling on a 5% minimum. The ruling is clearly wrong and was "clarified" in Private Letter Ruling 9431051 to correct the IRS error. See Rev. Rul. 78-101, 1971-1 Cum. Bull. 301, in which a 4% lead trust was approved. However, a unitrust amount of the lesser of the trust's annual income and 6% of the annual fair market value does not qualify. See Rev. Rul. 77-300, 1977-2 Cum. Bull. 352.

D. There is no limitation on the term of a lead trust, although it is generally limited to a term of years.

1. The term may be for a specified, but unlimited, period of years. Reg. §20.2055-2(e)(2)(vi)(a). See Rev. Rul. 85-49, 1985-1 Cum. Bull. 330. Contrast the remainder trust which is limited to 20 years. IRC §664(d)(1)(A) and 664(d)(2)(A).

2. The term may be for the life or lives of ascertainable living persons. Reg. § 20.2055-2(e)(2)(vi)(a) and 20.2055-2(e)(2)(vii)(a). See Rev. Rul. 85-49, 1985-1 Cum. Bull. 330. Only the lives of the donor, the donor's spouse or lineal ancestor's of the remaindermen may be the measuring lives.

3. There can be no non-charitable beneficiaries during the term of the charity's interest. Reg. § 20.2055-2(e)(2)(vi)(f); 20.2055-2(e)(vii)(e). However, "tandem" payments to a non-charitable beneficiary are permitted and similar payments may be made from a separate share within the trust. Private Letter Rulings 8222064; 8225094; 8226127; 8226134; 8226136.

4. Excess income may be paid to charity during the term, but no payments may be made to non-charitable beneficiaries. Reg. § 20.2055-2(e)(2)(vi)(d); 20.2055-2(e)(2)(vii)(d); Rev. Rul. 88-82, 1988-2 Cum. Bull. 336; Private Letter Ruling 8651030.

5. No additions may be made to an annuity lead trust. See Private Letter Rulings 8034093; 8021095. Additions may be made to a lead unitrust. Private Letter Rulings 8052068; 8043077.

E. Generally, IRC §4947(a)(2) applies to the lead trust. See Reg. §53.4947-1(c)(2) for some exceptions.

1. If the charitable income interests exceed 60% of the value of the trust, the trust instrument must expressly prohibit both the acquisition or retention of assets which would subject the trust to tax under IRC §4944 (jeopardy investments) and IRC §4943 (excess business holdings). Reg. § 20.2055-2(e)(vi)(e). Rev. Proc. 2007-45 and 46 are incorrect in that they do not prohibit both the acquisition and retention. In the case of a testamentary lead trust, the values used for the 60% test are the values used for federal estate tax purposes. Private Letter Ruling 8025199. Real estate, even mortgaged real estate, does not violate IRC §4944. See Private Letter Ruling 7808067.

2. Generally, the "no-no" provisions of IRC §508(e) apply, and either must be in the instrument, or state law must make provisions applicable. See Cal. Civil Code §2271.1; N.Y. EPTL 8-1.8. See Private Letter Rulings 8241098; 8006029; 7946100; 7946057.

   a. IRC §4943 and 4944 will not apply if the charitable lead interest does not exceed 60% of the value of the trust. Stating the payout as a formula that is ascertainable on the date of death is acceptable. Private Letter Ruling 9128051.

   b. According to the IRS, all of the income must be paid to charity to take advantage of the 60% rule. Private Letter Ruling 8241098. See Private Letter Rulings 8110159 and 8110160 to the contrary. The IRS's latest position is questionable in light of Reg. §53.4947-2(a)(2). See Rev. Rul. 88-82, 1988-2 Cum. Bull. 336.

3. If the lead trust makes distributions to a private foundation, must the trust exercise expenditure responsibility? See IRC §§4942, 4945. The issue could have been addressed in Private Letter Ruling 9207024, but was not. See also Private Letter Ruling 9138069.

4. It appears that if the provisions of Reg. §53.4941(d) – 2 are followed, it is possible to transfer a related party's promissory notes to a charitable lead trust or to a private foundation without the imposition of the self-dealing tax under IRC §4941. See, Private Letter Rulings 200729043; 200232033. However, any modification of the notes most likely will result in self-dealing. A common technique to permit family members to purchase interests in businesses is to have the purchase occur during the administration of the estate or revocable trust, and comply with the provisions of the regulation. The notes resulting from the sale and purchase can be distributed to the foundation or lead trust, with the interest and principal payments funding the required distributions.

F. Instrument should provide for alternate charitable beneficiaries in the event the initial beneficiaries lose exemption before termination of trust. However, it is not necessary to do so; as long as the charity qualifies at the time the trust is created, the deduction will be allowed. See Private Letter Ruling 8824052.

1. See Rev. Rul. 77-275, 1977-2 Cum. Bull. 346 and Private Letter Ruling 8051170 (for gift tax purposes, the retention by the grantor of the right to change charitable beneficiaries results in an incomplete gift). The position in Private Letter Ruling 8051170 has been changed in Private Letter Ruling 8130033. See also Private Letter Rulings 8204097; 8204153; 8206107; 8051170, supplementing Private Letter Ruling 8021143.

2. It is not necessary to name the charitable beneficiaries; the trustee or someone else may be given the power to designate qualified charitable beneficiaries. Rev. Rul. 78-101, 1978-1 Cum. Bull. 301; Private Letter Rulings 9331015; 8116043; 8043077; 7930079. See Private Letter Rulings 8152079 and 8051170 for the IRS position on the gift tax effects of the donor's relationship with the charitable beneficiary.

G. The "net income" of the trust should include capital gains so that IRC §642(c) deduction will be available for amounts paid to charity. The statutory "tier system" of IRC §664 does not apply to lead trusts, but the instrument should create a tier system to take advantage of the IRC §642(c) deduction for capital gains. But see Private Letter Rulings 2000240027; 199947022; 199903045; 9750020; 8823022, in which the IRS ruled that such provisions will not be given effect. See, Reg. §1.642(c)-3(b)(2). In an inter vivos lead trust, consideration should be given to allocating depreciation, depletion, and amortization to principal to reduce the accumulated income over the amount required to be paid to charity. The Rev. Procs. do not address this issue. See III.B.2., supra.

H. Provide for termination on expiration of term or on date of satisfaction of charitable obligation.

1. It should be possible to use net income in excess of annual distributions to prepay future installments. Private Letter Rulings 199952071 and 8110159 approve such payments, but seem to be aberrations because the IRS takes the position that such provisions will disqualify the trust. Rev. Rul. 88-27, 1988-1 Cum. Bull. 331; Private Letter Rulings 8050078; 8043129, supplementing 8028087 and 8004054. Rev. Rul. 88-27 and Technical Advice Memo 8745002 contain detailed analyses of the rationale for disallowing the deduction. Since 1982, IRS has not ruled on trusts with commutation provisions. Rev. Rul. 82-22, IRB 1982-13, 16, Section 3.01, 8 and 36. The issue of prepayment was discussed when the Regulations were adopted, but a decision was made not to include anything

about prepayment in the Regulations. Technical Memorandum T.D. 8318, 7/11/74, 39 F.R. 25452. See Private Letter Ruling 8647007, which allows an early termination of a remainder trust, and Private Letter Ruling 8808031, which allows the early termination of a lead trust by court order. See Rebecca K. Crown Income Charitable Fund v. Comm'r, 98 T.C. 327 (1992), aff'd, 93-2 USTC 50,645 (7th Cir. 1993), in which the Court discusses commutation at length, but decides the issue in the case as a technical (and apparently correct) reading of the specific trust. In Private Letter Ruling 9734057, the IRS ruled that if a trust is commuted, no estate tax deduction will be allowed for the lead interest because the interest is not a guaranteed annuity, citing Rev. Rul. 88-27, supra. See also, Private Letter Ruling 200225045. The forms in the Rev. Procs. do not address prepayment, but the annotations do, and prohibit it.

2. Satisfaction in kind permitted at fair market value on date of distribution. Reg. §1.664-1(d)(5). If there is appreciation in the assets distributed, the trust will have gain and will be entitled to an IRC §642 deduction. Rev. Rul. 83-75, 1983-1 Cum. Bull. 114. See also IRC §1011(b). However, no IRC §642(c) deduction allowed unless the distributions are items of gross income. Private Letter Ruling 8931029 (in kind stock distributions do not qualify), amended in Private Letter Ruling 9201029. Query whether the trust can characterize capital gain as income to avoid the problem?

3. If prepayment is permitted, valuation of prepayment determined under Reg. § 20.2031-10(f).

I. Pay death taxes, administration expenses etc. before funding testamentary lead trust. See Private Letter Ruling 7914008.

J. A provision permitting interest free loans to a lead trust may disqualify it. See Private Letter Ruling 8213127, referring to Private Letter Ruling 8125019. Query whether the practice of making such loans will have the same result. IRC §7872 may make the issue academic.

K. Although not required in the case of a lead trust, interest on deferred payments of the charitable payments should be required in the instrument. See Reg. §1.664-1(as)(5), which applies only to remainder trusts. The Rev. Procs. do not address this issue.

L. "In terrorem" clauses should be avoided, although the IRS's reasoning in two letter rulings in the remainder trust area is questionable. Rulings 7942073; 7732011, both involving remainder trusts.

M. A "perpetuities savings clause" will not disqualify the trust even if it could result in the trust terminating before its normal term. Private Letter Ruling 8104213.

N. If lead trust is included in revocable trust, provide for current payments of the annual amount to take advantage of the IRC §642(c) deduction. A set aside under IRC §642(c) only is available to estates.

O. Under new regulations, any certain family members may be measuring lives. Reg. §§1.170A-6(c)(2); 1.170A-6(e); 20.2055-2(e); 25.2522(c)-3(c); 25.2522(c)-3(e).

IV. Planning for Lead Trusts.

A. Testamentary lead trust only useful for very wealthy because family members must wait to receive benefits. Funding pursuant to a formula at time of death was approved in Private Letter Rulings 9128051 and 9118040.

B. Objective usually is to count on inflation and appreciation to permit early prepayment of charitable obligation. The IRS has stopped ruling on whether commutation provisions will disqualify the trust. Rev. Rul. 82-22, IRB 1982-13, 16. See Technical Advice Memo 8745002; General Counsel Memorandum 39676; Private Letter Rulings 9138069; 8110159; 8043129; 8004054 and 7747005.

C. Prevents large amounts from passing to charity and possibly being dissipated.

D. IRS §644 applied to inter vivos lead trusts. See Private Letter Ruling 8032089.

E. Reg. §53.4942(a)-2(b)(2) (requiring lead payments to be included in private foundation's distributable amount) held invalid in Ann Jackson Family Foundation v. Comm'r, 97 T.C. 534 (1991), aff'd, 15 F.3d 917 (9th Cir. 1994).

F. Giving a non-adverse person the power to substitute assets in a non-fiduciary capacity (IRC §675) will cause the lead trust to be a grantor trust (thus allowing an income tax deduction in the year of creation) without adverse estate tax consequences. Private Letter Rulings 9642039; 9407014; 9247024; 9224029. The Rev. Procs. sanction this

method for creating grantor trust status, but permit other alternatives.

G. Effect of Tax Reform Acts of 1982 and 1986 on lead trusts.

1. Use of unitrust lead trust will leverage the $1,000,000 exclusion from generation skipping transfer tax. An annuity lead trust is subject to IRC §2642(e). See Teitell, "Diminished Benefits of Lead Trusts," N.Y.L.J. 7/10/87, pg. 1; Technical Corrections Act of 1988, § 114(g)(4).

2. Unlimited marital deduction should postpone the creation of most lead trusts until the surviving spouse's death.

H. Be careful to exclude the donor of an inter vivos lead trust from the family foundation's board of trustees if the foundation is a recipient of the lead trust's payments. Private Letter Ruling 9725012; See also Private Letter Ruling 199947022. The donor's spouse may act for the foundation unless he or she also is a grantor (e.g. community property). Private Letter Ruling 200043039.

I. Tiered annuity payments appear to be possible as long as they are ascertainable at the time of creation. Rev. Proc. 2007-45 and 46; Private Letter Ruling 9112009.