

the Service ruled it would disregard the right of election, even without a waiver, but only if the spouse did not exercise the right of election. Rev. Proc. 2005-24, 2005-16 IRB 909. However, Rev. Proc. 2005-24 created many practical problems for donors, trustees, advisors and charities. In IRS Notice 2006-15, 2006-8 IRB 501, the Service stated that, until further notice, a spousal waiver of a right of election is no longer needed for CRUT and CRAT qualification. The Service extended the June 28, 2005 grandfather date indefinitely. Therefore, a spouse's right of election, even without a waiver, will be disregarded, but only if the surviving spouse doesn't exercise that right.

CRUTs—Specifies that the income beneficiary will receive annual payments determined by multiplying a fixed percentage (at least 5 percent but not more than 50 percent) by the net FMV of the trust assets determined each year. For each contribution to the trust, the value (determined under IRC Section 7520) of the remainder interest must be at least 10 percent of the net FMV of the property as of the date the property is contributed. IRC Section 664(d)(2)(D). On the death of the beneficiary (or survivor beneficiary, if there is more than one), the charity gets the remainder. IRC Section 664(d)(2).

A variation, net income with makeup charitable remainder unitrust (NIMCRUT), calls for the trustee to pay only trust income if actual income is less than the stated percentage. Deficiencies in distributions (when trust income is less than the stated percentage) are made up in later years if trust income exceeds the stated percentage. Under another variation, net income charitable remainder unitrust (NICRUT), deficiencies are not made up. IRC Section 664(d)(3) and Treas. Regs. Section 1.664-3(a)(1)(i)(b). The regulations prohibit pre-contribution capital gain as NIMCRUT and NICRUT income. TD 8791.

Regulations authorize "flip" unitrusts (FLIPCRUT), a NIMCRUT or NICRUT that switches to a standard (fixed percentage) CRUT on an allowable triggering event (for example, sale of closely held stock) specified in the trust agreement.

Appraisal requirements on CRUTs funded with "unmarketable assets" are imposed for determining the trust's annual payment when the donor, the donor's spouse, a beneficiary or a related or subordinate party is the trustee.

CRAT—Specifies a fixed dollar amount (at least 5 percent but not more than 50 percent of the initial net FMV of transferred property) paid annually to the

income beneficiary for life. The value of the charitable remainder interest, determined under IRC Section 7520, must be at least 10 percent of the initial net FMV of all property placed in the trust. IRC Section 664(d)(1)(D). On the death of the beneficiary (or survivor beneficiary, if there is more than one), the charity gets the remainder. IRC Section 664(d)(1).

For charitable remainder trusts (CRTs), the 50 percent maximum annual payout requirement applies to transfers to trusts after June 18, 1997. The 10 percent minimum remainder interest requirement is effective for transfers to trusts after July 28, 1997. The 10 percent requirement doesn't apply to transfers in trust under a will executed before July 29, 1997 if the decedent died before 1999 without having republished the will or, on July 28, 1997, was under a mental disability preventing him from changing the disposition of his property and didn't regain competence to dispose of the property before he died.

Regulations give a host of rules for CRUT and CRAT payments after year-end (by April 15) to satisfy the prior year's required payout. See TD 8791 and TD 8926.

Caveat: CRUTs and CRATs must be operated according to their explicit terms. In *Atkinson v. Comm'r*, 309 F.3d 1290 (11th Cir. 2002), cert. denied, 540 U.S. 946 (2003), a CRAT's failure to comply with the required annual payment regulations resulted in complete loss of the estate tax charitable deduction where seven quarterly payments weren't made. An additional estate tax of \$2,654,976 was incurred. That certainly got everyone's attention. And in Technical Advice Memorandum 2006280268 a CRUT that wasn't operated according to its terms was not qualified and was disregarded, even though the trust document met all the requirements of a CRUT. The trust should also meet state law investment requirements, such as prudent investor rules. See *Estate of Rowe*, 274 A.D.2d 87, 712 N.Y.S.2d 662 (N.Y. App. Div., 3d Dept. 2000), motion for leave to appeal denied, 96 N.Y.2d 707, 725 N.Y.S.2d 637 (2001).

How payments are taxed to recipient—For CRUTs and CRATs, amounts paid to the recipient retain the character they had in trust. Each payment is treated as:

- first, ordinary income to the extent of the trust's ordinary income for the year and undistributed ordinary income for prior years;
- second, capital gain to the extent of the trust's capital gain for the year and undistributed capital gain for prior years (which can be offset by any capital losses the ben-

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- beneficiary may have from other investments);
- third, tax-exempt income to the extent of the trust's exempt income for the year and undistributed exempt income for prior years; and
- fourth, a tax-free distribution of principal.

Ordering rules also apply for classes of income within first and second categories. IRC Section 664(b) and Regs. Treas. Section 1.664-1(d).

Regulations, which apply retroactively, revise IRC Section 643(b)'s definition of income for NIMCRUTs, NICRUTs and FLIPCRUTs (before they flip) to take into account changes in how a state's laws define trust accounting income. Treas. Regs. Section 1.643(b)-1.

Tax exemption—CRUTs and CRATs were exempt from income tax for a tax year unless the trust had any unrelated business taxable income (UBTI) for the year. UBTI includes certain debt-financed income. Before 2007, a CRT that lost its income tax exemption for a tax year was taxed as a regular complex trust. As such, the trust was allowed a deduction in computing taxable income for amounts required to be distributed in that year (not to exceed the trust's distributable net income for the year.) IRC Sections 6654(i) and 6655. A provision in the Tax Relief and Health Care Act of 2006 provides that starting with the 2007 tax year, a 100 percent excise tax is imposed on the UBTI of a charitable remainder trust. This replaces the rule that took away the CRT's income tax exemption for any year in which it had any unrelated business taxable income. UBTI is considered income of the trust for purposes of determining the character of the distribution made to the beneficiary under the four tiers. And, consistent with earlier law, the tax is treated as paid from corpus. IRC Section 664(c).

Early termination of CRT—The IRS approved the early termination of a CRT and division of the assets between the life tenant and the charitable remainder organizations (based on the value of their respective interests) where all the remainder organizations were public charities. Such termination would not be self-dealing by the donor or trustee under IRC Section 4941(a)(1). See PLR 200616035.

Governing instrument requirements—To assure charitable deductions and avoid adverse tax consequences, a governing instrument must contain specific provisions. Treas. Regs. Sections 1.664-1 through 1.664-3; IRC Sections 508(e) and 4947(a)(2); Rev. Rul. 72-395, 1972-2 CB 340; Rev. Rul. 82-128, 1982-2 CB 71; Rev.

Rul. 82-165, 1982-2 CB 117; Rev. Rul. 88-81, 1988-2 CB 127; Rev. Rul. 92-57, 1992-2 CB 123; Rev. Proc. 89-20, 1989-1 CB 841; Rev. Proc. 89-21, 1989-1 CB 842; Rev. Proc. 90-30, 1990-1 CB 534; Rev. Proc. 90-31, 1990-1 CB 539; Rev. Proc. 90-32, 1990-1 CB 546; and Rev. Proc. 98-56, 1998-2 CB 667.

The IRS has issued specimen annuity trust agreements, Rev. Proc. 2003-53 through Rev. Proc. 2003-60, and specimen unitrust agreements, Rev. Proc. 2005-52 through Rev. Proc. 2005-59. The Service is still in the process of updating its specimen lead trust agreements.

Income tax charitable deduction—Allowed for value of remainder interest; computed using Treasury tables. IRC Section 170(f)(2)(A).

Unitrusts—Treas. Regs. Sections 1.664-3(d) and -4; IRS Pub. 1458.

Annuity trusts—Treas. Regs. Sections 1.664-2(c) and 20.2031-7; IRS Pub. 1457.

Caveat: Annuity trusts must meet "5 percent probability test" of Rev. Rul. 77-374, 1977-2 CB 329. But see *Moor*, 43 TCM 1530 (1982). A 1978 General Counsel's Memorandum (GCM 37770) proposed a ruling to the IRS (but was not issued by IRS) that would in limited circumstances, depending on the facts of each case, apply Rev. Rul. 77-374 to CRUTs.

Capital gain—No capital gain incurred on transfer of unmortgaged appreciated assets to trust. Rev. Rul. 55-275, 1955-1 CB 295 and Rev. Rul. 60-370, 1960-2 CB 203. Similarly, there's no capital gain to donor on a sale by trust, except as taxable under four-tier system.

Exception: Gain taxable to donor if trust assets sold and invested in tax-exempt securities pursuant to agreement between donor and trustee. See Rev. Rul. 60-370, 1960-2 CB 203.

Caution: Don't fund unitrusts or annuity trusts with mortgaged property or donor-created undivided interests. PLRs 9015049 and 9114025.

Estate tax—IRC Section 2055(e)(2)(A).

One-life—When the donor is beneficiary, FMV of trust principal at death included in gross estate and then deductible as charitable contribution, resulting in a wash.

Two-life—When funded with donor's separate property, with donor as first beneficiary and another as survivor beneficiary, the FMV of trust principal at donor's death is included in his gross estate, but is then fully deductible as charitable contribution if second beneficiary does not survive. If second beneficiary survives, the charitable remainder (based on the survivor's age at the donor's

death) is a deductible charitable contribution.

Gift tax—IRC Section 2522(c)(2)(A). Value of the charitable remainder is fully deductible, so charitable gift is immune from gift tax. When there is a life interest other than donor's, there is a gift by donor to non-charity beneficiary of value of beneficiary's life interest. Value of that gift depends on type of property ownership and when other beneficiary's payments are to begin. It's often possible for donor to avoid gift tax (when donor is one of the beneficiaries) by reserving right to revoke life beneficiary's interest by will only. Treas. Regs. Section 1.664-3(a)(4) and Rev. Rul. 74-149, 1974-1 CB 157.

Gift and estate tax marital deductions—When donor's U.S. citizen spouse is the only other beneficiary, a marital deduction is allowed for the spouse's life interest. IRC Sections 2056(b)(8) and 2523(g). And a charitable deduction is allowed for the remainder interest. IRC Sections 2055(e)(2) and 2522(c)(2). Thus, there is no transfer tax. For 2007 gifts to alien spouses, an annual exclusion of \$125,000 in gift tax (adjusted annually for inflation) may be available and estate tax marital deduction may be available if qualified domestic trust (QDOT) rules are met. Treas. Regs. Section 20.2056A-2(b).

Specialized small business investment company—A small business investment company (SSBIC) is one way to

avoid capital gain on an earlier sale. An SSBIC is a corporation or partnership licensed by the Small Business Administration, which finances small businesses owned by the disadvantaged. You can rollover tax-free up to \$50,000 of gain on publicly traded securities in any year (with a \$500,000 lifetime cap.) IRC Section 1044 and Small Business Investment Act of 1958 as amended, P.L. 85-699, 15 U.S.C. 681 et seq. The basis in the SSBIC is reduced by the amount of any gain not recognized on the sale of the publicly traded securities. Thus, any gain protected from tax on the rollover will be taxed on a later sale of the SSBIC stock. The SSBIC rollover can serve as a capital gains escape hatch for an individual who sold long-term appreciated publicly traded securities and then learns that he could have made an outright charitable gift of the securities—or transferred them to a charitable remainder trust for sale and reinvestment—without having to pay capital gains tax. The donor within 60 days of the sale of his publicly traded stock can use the sales proceeds (within the \$50,000 annual limit on gain) to buy stock in an SSBIC. Then, the donor either makes an outright gift of the SSBIC stock to charity or contributes the SSBIC stock to a charitable remainder trust. The charity can keep the SSBIC stock or sell it—without capital gains to the charity or the donor. And a charitable remainder trust can keep the SSBIC stock as an investment or can sell the SSBIC stock and reinvest the sales proceeds without capital gains to the donor or the trust.