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Recommendations for Guidance Addressing Treatment of Early Terminations of Charitable Remainder Trusts ("CRTs")

TRUSTS AND ESTATES LAW SECTION

T&E #1

April 6, 2017

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This memo makes recommendations for guidance addressing the treatment of early terminations of charitable remainder trusts ("CRTs") under section 664(e).[1]

The 2015 PATH Act[2] amended section 664(e) to clarify the proper method of valuing the interests of certain CRTs that terminate before the end of their stated terms. Early terminations of CRTs raise several considerations on which guidance from the Internal Revenue Service (the "Service") would be welcome and appropriate. In addition, in light of the changes made by the 2015 PATH Act, we would recommend that the Service reconsider its "no rule" position regarding certain consequences of the early termination of a CRT, at least insofar as it relates to the early termination of a CRT of which the remainderman is a public charity.[3]

[1] "Section" and "§" references are to the Internal Revenue Code of 1986 (the "Code") or the Treasury regulations promulgated thereunder.

[2] Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113 (12/18/2015) (the "2015 PATH Act").

[3] For these purposes, a public charity is any organization that qualifies under section 170(c) but is not a private foundation as defined in section 509(a).

I. Background on Charitable Remainder Trusts

A. Forming Charitable Remainder Trusts

CRTs are formed pursuant to section 664 and are generally exempt from tax on their income.[4] A CRT typically is required to make distributions to an income beneficiary for the life of an individual or for a period of 20 years or less, after which the assets of the CRT are transferred to a charitable remainderman.[5] The distributions made to the income beneficiary are generally includible in income by the income beneficiary and taxable under the special "tier" system of section 664(b).[6] At the end of the trust term, the remaining assets of the trust are transferred to a charitable remainderman that qualifies under section 170(c).[7]

Section 664 provides for two basic types of CRTs: charitable remainder annuity trusts ("CRATs") and charitable remainder unitrusts ("CRUTs"). A CRAT generally is required to pay, at least annually, a fixed dollar amount (the "annuity amount") of at least five percent, and not more than 50 percent, of the initial value of the trust to an income beneficiary.[8] A CRUT, on the other hand, generally is required to pay, at least annually, a fixed percentage (the "payout rate") of at least five percent, and not more than 50 percent, of the fair market value of the trust's assets (the "unitrust amount"), determined at least annually, to an income beneficiary.[9]

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[4] § 664(c)(1). If a CRT recognizes unrelated business taxable income ("UBTI"), it pays an excise tax equal to the amount of the UBTI recognized. See § 664(c)(2)(A).

[5] The income beneficiary is typically the grantor that established the CRT and transferred assets to it. Sometimes, the grantor and spouse will be the income beneficiaries. The grantor can gratuitously name a third party (e.g., the grantor's child) as the income beneficiary but would be subject to gift tax on the value of the gifted income interest.

[6] Under the tier system, the CRT tracks its income based on character and nature, and distributions to the income beneficiary are generally deemed "sourced" from the highest taxed income first. See § 664(b).

[7] § 664(d)(1)(C) (for CRATs); § 664(d)(2)(C) (for CRUTs).

[8] § 664(d)(1)(A).

[9] § 664(d)(2)(A). Some CRUTs are "income only" and are required to make payments to the income beneficiary only if the CRUT realizes income for trust accounting purposes in that year. § 664(d). If distributions are limited by trust accounting income in some years, trusts vary in how they treat the foregone unitrust amounts. For some CRUTs, known as Net Income CRUTs ("NICRUTs") the foregone amounts are never distributed to the lifetime beneficiaries. In contrast, for other CRUTs, known as Net Income with Makeup CRUTs ("NIMCRUTs"), the foregone amounts are distributable to the extent the CRUT subsequently generates trust accounting income.

On the contribution of assets to a CRT, the grantor is entitled to a charitable deduction for income, estate, and gift tax purposes equal to the present value of the charitable remainder interest created.[10] In the case of a CRUT, the value of the remainder interest is determined under section 1.664-4 by multiplying the net fair market value of the trust by certain factors, periodically published in IRS tables, chosen based on the payout rate and remaining term of the CRUT.[11] This method reflects the assumption that an amount based on the payout rate is distributed annually during the expected term of the income interest and disregarding any restrictions on distributions based on the net income of the trust.[12] For a CRUT, the value of the income interest for gift or estate tax purposes is determined by subtracting the value of the remainder interest, as calculated under section 1.664-4, from the value of the assets transferred to the trust.[13]

In the case of a CRAT, the value of the income interest for purposes of calculating any gift or estate tax payable on the gratuitous transfer of the income interest is determined using factors based on the annuity amount and the expected term of the income interest.[14] The value of the remainder interest for purposes of income, gift, and estate tax deductions is determined by subtracting the present value of the income interest from the net fair market value of the CRAT.[15] Although this valuation method is

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[10] See § 170(f)(2)(A) (income tax deduction for lifetime transfers); § 2522(a), (c)(2)(A) (gift tax deduction for lifetime transfers); § 2055(a), (e)(2)(A) (estate tax deduction for testamentary trusts). The amount of the deduction is determined in accordance with section 170. See Treas. Reg. § 1.664-2(c)-(d) (for CRATs). See Treas. Reg. § 1.664-4(a), (d)-(e) (for CRUTs). See also discussion *infra* notes 10 through 15.

[11] See § 664(e); Treas. Reg. § 1.664-4. See also Treas. Reg. §§ 1.7520-1(a)(3), 20.7520-1(a), and 25.7520-1(a); Rev. Rul. 72-395, 1972-2 C.B. 340. Thus, for a NIMCRUT and a NICRUT, the net income limitation is disregarded in valuing the income interest. See *supra* note 9.

[12] See Treas. Reg. § 1.664-4(a)(3).

[13] See Treas. Reg. § 25.2512-5(d)(2)(i) (for gift tax purposes: "[t]he fair market value of a life interest or term for years in a charitable remainder unitrust is the fair market value of the property as of the date of transfer less the fair market value of the remainder interest, determined under §1.664-4(e)(4) and (e)(5)"), and 20.2031-7(d)(2) (i) (for estate tax purposes: "[t]he fair market value of a life interest or term of years in a charitable remainder unitrust is the fair market value of the property as of the date of valuation less the fair market value of the remainder interest on that date determined under § 1.664-4(e)(4) and (5)").

[14] See Treas. Reg. § 1.664-2(c) ("The present value of an annuity is computed under § 20.2031-7(d) of this chapter for transfers for which the valuation date is on or after May 1, 2009 . . . ").
Section 20.2031-7(d) provides tables from which the taxpayer can calculate factors that are used to determine the present value of the annuity interest.

[15] See Treas. Reg. § 1.664-2(c) ("For purposes of sections 170, 2055, 2106, and 2522, the fair market value of the remainder interest of a charitable remainder annuity trust (as described in this section) is the net fair market value (as of the appropriate valuation date) of the property placed in trust

technically the reverse of the method used for CRUTs (i.e., the remainder interest is valued based on the difference between the current net fair market value and the present value of the income interest, rather than vice versa), the two methods are effectively the same.[16]

For any CRT created after July 28, 1997, the value of the remainder interest must be at least 10% of the fair market value of the assets transferred to the trust at creation.[17]

B. Termination of Charitable Remainder Trusts

Typically, a CRT terminates on the death of the measuring life or the expiration of a term of years, as provided in the trust instrument. On termination, the assets in the CRT pass to the charitable remainderman. A CRT may, however, terminate prior to its stated term in several instances. For example, the income beneficiary may gratuitously assign its income interest to the charitable remainderman.[18] On a gratuitous transfer, no gain or loss is recognized by the income beneficiary and the income beneficiary is considered to have made a charitable contribution of its interest to the charitable remainderman and, accordingly, is entitled to income and gift tax charitable deductions.

A CRT may also terminate prior to its stated term in a non-gratuitous transfer. The charitable remainderman, the income beneficiary, and the trustee can agree to terminate the trust (or an undivided portion thereof) in a transaction in which the income beneficiary and the remainderman each receives the value of its respective interest.[19] An early termination may occur, for example, because a charitable remainderman has a

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less the present value of the annuity"). See also § 20.2031-7(d)(1) ("The fair market value of a remainder interest in a charitable remainder annuity trust, as defined in §1.664-2(a), is the present value determined under §1.664-2(c)").

[16] The annuity interest is calculated using tables provided under § 20.2031-7(d)(6). See *supra* note 14. These tables provide factors to determine the remainder interest, not the annuity interest, so the taxpayer must subtract the remainder factor provided from the number 1 and divide by the § 7520 rate to determine the annuity factor. These tables are based on the assumption that the annuity amount is paid at the end of each year. If annuity payments are not actually paid at year end, the taxpayer must adjust accordingly. See Treas. Reg. §§ 20.2031-7A(d)(2), 25.2512-5A(d)(2).

[17] See § 664(d)(1)(D) (for CRATs); § 664(d)(2)(D) (for CRUTs).

[18] For a partially gratuitous transfer of an income interest in a CRT, see I.R.S. Priv. Ltr. Rul. ("PLR") 200631006 (April 14, 2006).

[19] The parties to an early termination may seek, or may be required to obtain, the consent or approval of the state attorney general or other official charged with oversight of charitable entities in the jurisdiction of organization of the remainderman. This would provide an additional layer of independent review of the termination process.

current need or desire for funds for its operations.[20] Typically, in a nongratuitous early termination, the charitable remainderman would receive the present value of its remainder interest in the trust and the income beneficiary would receive the present value of its income interest in the trust. The termination of a CRT (in full or in part) prior to the expiration of its stated term may be effected in several ways (or a combination thereof):

(1) The CRT could distribute assets to the income beneficiary and charitable remainderman in a commutation in proportion to the relative present values of their future interests in the trust; such distribution could be *pro rata* or non *pro rata* with respect to the assets in the trust;

(2) The CRT or the charitable remainderman could transfer to the income beneficiary payment equal to the value of the income beneficiary's interest in the CRT after which the interests in the CRT would merge in the charitable remainderman, which would then receive any assets remaining in the trust;

(3) The CRT or the income beneficiary could transfer payment equal to the value of the charitable remainderman's interest in the CRT in exchange for its interest in the CRT, and the income beneficiary would then receive any assets remaining in the trust; or

(4) Both the income beneficiary and the remainderman could sell their interests in the CRT to a third party buyer, receiving consideration in the exchange.

C. Tax Consequences of Early Terminations

For many years, the federal tax consequences of the early termination of a CRT were considered to be generally fairly clear and had been the subject of various letter rulings.[21] On an early termination, the income beneficiary and the charitable remainderman apportioned the value of the trust based on the relative present values of their respective interests determined in accordance with section 664(e) (i.e., using the same methodology that was used to determine the value of the remainder interest on the formation of the trust). Specifically, the values of the remainder and income interests were determined by assuming that the CRT would earn and pay to its income beneficiary an amount equal to the annuity payment (for CRATs) or unitrust payout rate (for CRUTs) as determined under the trust instrument until the end of the trust term. This method is

[20] See, e.g., PLR 200152018 (Sept. 26, 2001) (where the charitable remainderman requesting the early termination needed funds for the construction of an academic building).

[21] See, e.g., PLR 200304025 (Oct. 23, 2002); PLR 200252092 (Oct. 3, 2002); PLR 200208039 (Nov. 29, 2001).

consistent with the methodology described in Treas. Reg. § 1.664-4(b)(3), which requires that the present value of a remainder interest in a CRT be determined based on the assumption that the trust will distribute yearly the amount described in the governing instrument.[22]

Although many rulings clearly provide that the methodology used to value the income interest on an early termination of a NICRUT or NIMCRUT is the same as that provided for by 664(e) as amended by the 2015 PATH Act (discussed below),[23] some of the letter rulings were arguably less clear and could have been read to have applied a different valuation methodology.[24]

The other tax consequences of an early termination were fairly straightforward. Consistent with case law,[25] the income beneficiary recognized capital gain.[26] Any basis

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[22] Treas. Reg. § 1.664-4(b)(3) ("The assumption that the amount described in § 1.664-3(a)(1)(i)(a) is distributed in accordance with the payout sequence described in the governing instrument"). Note that Treas. Reg. § 1.664-3(a)(1)(i) is titled "[p]ayment of fixed percentage at least annually," and clause (a) reads: "General rule. The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market value of the trust assets determined annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section. This paragraph (a)(1)(i)(a) is applicable for taxable years ending after April 18, 1997." Treas. Reg. § 1.664-3(a)(1)(i)(a).

[23] See, e.g., PLR 200304025 (Oct. 23, 2002) ("H and W will receive a lump sum distribution from Trust 3 equal to the present value of their unitrust interests effective on the date of termination determined by using the discount rate in effect under § 7520 on the date of termination, and by using the methodology under § 1.664-4 of the regulations for valuing interests in charitable remainder trusts"); PLR 200252092 (Oct. 3, 2002) ("U represents that the actuarial values of the shares will be determined using the discount rate in effect under section 7520 of the Code on the date of termination, and using the methodology under section 1.664-4 of the regulations for valuing interests in charitable remainder trusts"); PLR 200208039 (Nov. 29, 2001) ("X represents that the values will be determined using the discount rate in effect under section 7520 of the Code on the date of termination, and using the methodology under section 1.664-4 of the regulations for valuing interests in charitable remainder trusts").

[24] See, e.g., PLR 200152018 (Sept. 26, 2001) ("Under § 25.2522(c)-3(d)(2)(ii), the present value of a remainder interest in a charitable remainder unitrust is to be determined under § 1.664-4 . . . . The present value of the unitrust interest and annuity are determined in accordance with § 7520 and § 25.2512-5(d)").

[25] See McAllister v. Comm'r, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947), acq., Rev. Rul. 72-243, 1972-1 C.B. 233.

[26] See, e.g., PLR 200739004 (June 21, 2007); PLR 200314021 (Dec. 24, 2002); PLR 200127023 (Apr. 4, 2001).

in the property or trust interest was disregarded in determining the amount of the income beneficiary's capital gain.[27]

Further, the termination payment to the income beneficiary pursuant to the early termination did not constitute self-dealing for purposes of section 4941.[28] The income beneficiary of a CRT will often be the grantor of the CRT (or related to the grantor of the CRT) and, thus, will be classified as a disqualified person (or "DQP") with respect to the CRT.[29] Accordingly, most transactions between the income beneficiary and the CRT would constitute self-dealing. Indeed, the payment of the annuity or unitrust amounts by the CRT to the income beneficiary would constitute self-dealing if not for the exception provided by section 4947(a)(2)(A), which expressly excludes payments of annuity and unitrust amounts from the section 4941 self-dealing rules.[30] In its earlier rulings, the Service extended this exception to early terminations, reasoning that, if the receipt of the annuity or unitrust payments by the income beneficiary during the remaining term of the CRT did not constitute self-dealing, the "anticipatory" payment of these same amounts on

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[27] Previously, there was some debate as to whether the income beneficiary was entitled to offset the amount realized by its basis in the income interest. Section 1001(e) denies a basis offset upon transfer of a term interest unless the transfer is "part of a transaction in which the entire interest in property is transferred." § 1001(e)(3). Arguably, an early termination could be a transaction described in section 1001(e)(3). Notwithstanding, the legislative history of section 664(e) makes clear that this is not the appropriate result. When section 1001(e)(3) does apply to a CRT – as, for example, when all of the interests in the CRT are sold to a third party – the income beneficiary's share of the trust's uniform basis otherwise applicable must be reduced by the trust's untaxed income. Treas. Reg. §§ 1.1014-1(c), (d), Ex. 7 and 8. See also Notice 2008-99, 2008-2 C.B. 1194.

[28] CRTs are subject to the self-dealing rules of section 4941. See § 4947(a)(2). See also Treas. Reg. § 53.4947-1(c)(2)(i).

[29] Section 4946(a)(1)(A) provides that "substantial contributors" are DQPs, and section 507(d)(2) provides that creators of trusts are substantial contributors with respect to the trusts. Thus, if the grantor is the income beneficiary, the grantor will be a DQP. Members of the grantor's immediate family will also be DQPs. § 4946(a)(1)(D). A CRT is a "split-interest trust" within the meaning of section 4947(a)(2). Many (though not all) of the rules applicable to private foundations apply to a split-interest trust "as if such trust were a private foundation." § 4947(a)(2). Among the private foundation rules that apply to CRTs is the excise tax, effectively a prohibition, on "self-dealing" imposed by section 4941. The grantor of the CRT will be treated as a substantial contributor and therefore a DQP with respect to the CRT because section 4946(a)(1)(A) provides that "substantial contributors" are DQPs and section 507(d)(2) provides that creators of trusts are substantial contributors with respect to the trusts. Therefore, acts of self-dealing between the CRT and an income beneficiary who formed the trust would be prohibited under section 4941.

[30] See also Treas. Reg. § 53.4947-1(c)(2).

an early termination of a CRT should similarly not be treated as self-dealing.[31] In so ruling, the Service appeared to treat, for the purposes of the self-dealing rules, every early termination of a CRT as if it involved a transaction between the CRT and the income beneficiary, regardless of the actual form of the early termination. Thus, the Service analyzed an early termination where the income beneficiary sold its interest in the CRT to the non-DQP remainderman in the same manner as if the income beneficiary had engaged in a commutation directly with the CRT.[32] In the former case, absent a recharacterization of the transaction, there is no self-dealing because there is no transaction between the DQP and the CRT.[33]

In addition, under the Service's prior rulings, the termination was not subject to tax under section 507, which imposes a tax on a private foundation upon the termination of its private foundation status under certain specified circumstances.[34] Lastly, the prior qualification of the CRT under section 664 was not affected by the early termination.

In 2007, the Service, in view of the absence of any clear statutory or other authority regarding early terminations of CRTs, became concerned that it may not be appropriate for it to issue rulings on early terminations of CRTs. In particular, the Service was concerned that an early termination of a NICRUT or a NIMCRUT using the subtraction method to value the income and remainderman interest could inappropriately divert value from the charitable remainderman to the income beneficiary.[35] Over time, the Service articulated additional concerns regarding the other tax consequences of an

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[31] See, e.g., PLR 200152018 (Sept. 26, 2001) (termination of charitable remainder unitrust where donor retained a portion of value of his interest); PLR 200127023 (April 4, 2001) (termination of charitable remainder unitrust by sale of interest to charity).

[32] The Service's approach would likely not distinguish between a *pro rata* and a non *pro rata* commutation, at least with respect to whether there was a transaction between the DQP and the CRT. The Service has characterized similar transactions between a beneficiary and a trust as a sale or exchange, which would implicate section 4941(d)(1)(A). See Rev. Rul. 83-75, 1983-1 C.B. 114 (transfer of appreciated property in satisfaction of an annuity treated as a sale under section 1001).

[33] Of course, if the remainderman could not fund the purchase of the income interest other than with the assets that it would receive from the CRT, the income beneficiary could likely be treated as receiving the payment from the CRT. See e.g., Rev. Rul. 75-360, 1975-2 C.B. 110 (finding that an acquisition did not satisfy the "solely for voting stock" requirement of section 368(a)(1)(B) because the cash transferred by target to target's shareholders was funded by a short-term bank loan, which purchaser effectively paid by transferring money to target one week later).

[34] For this purpose, charitable remainder annuity trusts and charitable remainder unitrusts are treated as private foundations. § 4947(a)(2).

[35] See, e.g., PLR 200725044 (Mar. 27. 2007); PLR 200733014 (Apr. 26, 2007); PLR 200809044 (Dec. 6, 2007); PLR 200817039 (Jan. 31, 2008); PLR 200827009 (Apr. 3, 2008).

early termination of any CRT given the lack of any statutory authority. Thus, in 2008, it determined that it would not ordinarily rule on whether the early termination of a CRT should be treated as a sale or exchange of a capital asset.[36] Further, in 2010, the Service announced that it would not ordinarily rule on "[w]hether the termination of a charitable remainder trust before the end of the trust term . . . causes the trust to have ceased to qualify as a charitable remainder trust with the meaning of § 664."[37] These three issues – whether early termination should be treated as a sale or exchange, the character of any gain, and qualification under section 664 – remained on the no rule list until 2014.[38] Finally, in 2015, the Service stated that it would not rule at all on the issue of CRT early terminations; specifically it would not rule on:

> Issues pertaining to the tax consequences of the termination of a charitable remainder trust (as defined in § 664) before the end of the trust term as defined in the trust's governing instrument in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets.[39]

The continued presence of early termination on the "no rule" list increased uncertainty regarding the tax treatment of early terminations[40] and greatly reduced their frequency, thereby deferring the transfer of substantial assets to charity. Indeed, charitable remaindermen and income beneficiaries wishing to access the value of their CRTs have taken to selling their interests to third parties, often at a substantial discount.

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[36] Rev. Proc. 2008-3, 2008-1 C.B. 110, Sec. 4.01(40)-(41). See also Rev. Proc. 2008-3, 2008-1 C.B. 110, Sec. 5.10 (adding to the list of areas under study issues regarding "[w]hether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of § 664").

[37] Rev. Proc. 2010-3, 2010-1 I.R.B. 110 (Dec. 31, 2009), Sec. 4.01(39).

[38] Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (Dec. 31, 2010), Sec. 4.01(39), (42)-(43); Rev. Proc. 2012-3, 2012-1 I.R.B. 113 (Jan. 2, 2012), Sec. 4.01(39), (42)-(43); Rev. Proc. 2013-3, 2013-1 I.R.B. 113 (Dec. 31, 2012), Sec. 4.01(40), (44)-(45); Rev. Proc. 2014-3, 2014-1 I.R.B. 111 (Dec. 30, 2013), Sec. 4.01(37), (42),(44).

[39] Rev. Proc. 2015-3, 2015-1 I.R.B. 129, (Dec. 31, 2014), Sec. 3.01 (68). See also Rev. Proc. 2016-3, 2016-1 I.R.B. 126 (Dec. 31, 2015), Sec. 3.01 (71).

[40] See, e.g., MICHAEL I. FRANKEL AND KAREN T. SCHIELE, N.Y. CITY BAR ASS'N: TRUST AND ESTATES SECTION, EARLY TERMINATION OF CHARITABLE REMINDER TRUSTS (Apr. 4, 2008) (requesting clarity on the proper valuation of CRT interests after the Service issued the no rule position).

D. The 2015 PATH Act Amendments to Section 664

On December 8, 2015, H. R. 4192 (the "Bill") was introduced in the House of Representatives by a group of members of the House of Representatives Committee on Ways and Means (Representatives Pat Tiberi, Charles Rangel, John Larson, Richard Neal, Erik Paulsen, and Todd Young). The Bill proposed to amend section 664(e) to provide that, on the early termination of certain CRTs, the values of interests in such CRTs are determined using the same valuation method as used for valuing the remainder on formation of the trust. Congress, wanting to encourage early terminations of CRTs in order to allow charities to receive assets earlier than they otherwise would receive them, adopted the proposed amendment to section 664 as part of the 2015 PATH Act. Section 664(e) as amended provides that:

> For purposes of determining the amount of any charitable contribution, the remainder interest of a charitable remainder annuity trust or charitable remainder unitrust shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year. *In the case of the early termination of a trust which is a charitable remainder unitrust by reason of subsection (d)(3), the valuation of interests in such trust for purposes of this section shall be made under rules similar to the rules of the preceding sentence.*

(Emphasis added.) The Introductory Statement to the Bill (the "Introductory Statement") provided:

> …charitable remainder trusts present an opportunity for donors to transfer assets for the benefit of charity. Lack of certainty regarding the tax consequences of early terminations of these trusts has deterred early terminations, which has deferred the transfer of substantial assets to charity. Early terminations of charitable remainder trusts should be encouraged because they permit charities to access their share of the trust's assets earlier (and, in some instances, decades earlier) than otherwise would be the case. This is particularly compelling given that, under current economic conditions, many charities have been forced to cut back on many deserving programs. My bill provides that, on an early termination of a charitable remainder trust, the donor and the charity will apportion the value of the trust using the same methodology that was used to determine the value of the remainder interest on formation. The donor will recognize capital gain on the total value received, the charity will receive its share of the trust's assets, and the early termination will not constitute self-dealing or otherwise disqualify the charitable remainder trust.[41]

[41] 161 CONG. REC. 177, E1726 (daily ed. Dec. 8, 2015) (statement of Rep. Tiberi).

Thus, the sponsors of the Bill evidenced their intent that, on the early termination of a CRT: (1) the value of the assets of the CRT be apportioned between the charitable remainderman and the income beneficiary on the basis of the value of the assets of the CRT on termination, the annuity amount or payout rate, and the anticipated remaining term of the income interest, (2) the receipt by the income beneficiary of a distribution or other payment representing its share of the value of the CRT not constitute self-dealing, (3) the trust not be disqualified as a CRT under section 664, (4) the income beneficiary recognize capital gain equal to the amount received by it and not be entitled to offset the amount realized by any basis in its interest in the CRT or the assets of the CRT, and (5) the CRT not be subject to the tax under section 507.[42]

II. Recommendations

Given the foregoing, we believe that it is appropriate for the Service to issue guidance that clarifies the tax consequences of early terminations of CRTs and addresses certain potential abuses.

The amendment to section 664(e), along with the Introductory Statement, makes clear that early terminations of CRTs should be permitted and certain ancillary consequences should follow. Specifically, the statutory language provides that, on the early termination of a NICRUT or NIMCRUT, the value of the assets of the CRT should be apportioned between the charitable remainderman and the income beneficiary on the basis of the value of the assets of the CRT on termination, the annuity amount or payout rate, and the remaining term of the income interest. If early terminations were not to be permitted, this language would implausibly be rendered meaningless.[43] Moreover, although the direct statutory language addresses only NICRUTs and NIMCRUTs, given the Introductory Statement, it would be illogical to limit early terminations to those types of CRUTs only. Accordingly, the statute should be read to permit early terminations of all types of CRTs, with the consequences as discussed below.

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[42] Id. See also STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015 (JCS-1-16) p. 311 n.180.

[43] See Stone v. Immigr'n & Naturaliz'n Serv., 514 U.S. 386, 397 (1995) ("When Congress acts to amend a statute, we presume it intends its amendment to have real and substantive effect"). See also Montclair v. Ransdell, 107 U.S. 147, 152 (1883). Some have argued that the statutory language is sufficiently ambiguous such that the 2015 PATH Act amendment should only apply to nongratuitous early terminations. The Introductory Statement clearly states that the sponsors of the Bill intended to encourage nongratuitous early terminations, rendering this argument moot. The balance of the Introductory Statement, providing how the value of the CRT is apportioned between the income beneficiary and the remainderman and how the income beneficiary recognizes and calculates gain, further supports this conclusion. Accordingly, it would be inappropriate to limit the effects of this provision to gratuitous early terminations.

First, as the Introductory Statement provides, the receipt on an early termination by the income beneficiary of a distribution or other payment representing its share of the CRT should not constitute self-dealing.[44] In this regard, the Committee considered whether, in order for an early termination to qualify for this exception to self-dealing, there should be a "quiet" period between formation and early termination in order to prevent any potential abuse if an income beneficiary forms a CRT, the CRT engages in a gain recognition transaction, and the CRT then terminates. Given that the charitable remainderman would have to agree to any such termination, and subject to the discussion below regarding private foundation remaindermen, we believe that the potential for abuse under these circumstances is at most negligible. After all, the income beneficiary will recognize full gain, without offset for any basis in its CRT interest.[45] It is difficult to imagine any abuse in such a situation.[46] This result is consistent with the treatment of the early termination as an anticipatory payment of the distributions that would otherwise be made over the term of the income interest.

Consistent with the consequences on the sale of other trust interests, the income beneficiary should recognize capital gain equal to the amount received by it on the early termination. In keeping with the concerns expressed by the Service previously,[47] the income beneficiary should not be entitled to offset the amount realized by any basis in its interest in the CRT or the assets of the CRT.[48] An early termination of a CRT should not

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[44] See *supra* notes 28 and 29 and accompanying text.

[45] See discussion *infra* note 48 and accompanying text.

[46] One could imagine a situation where, if the income beneficiary sold the asset, the income beneficiary would recognize ordinary income when, on the sale of the income interest, the income beneficiary would recognize capital gain. Given the limited circumstances where such a result would ensue and the absence of basis offset, we believe that the likelihood of such abuse is practically nonexistent.

[47] See Notice 2008-99, 2008-2 C.B. 1194.

[48] Under section 1001(e)(1), the portion of a holder's basis that is determined under section 1014, 1015, or 1041 is disregarded for certain term interests (including income interests in CRTs). See § 1001(e)(2). Section 1001(e)(3) excepts certain transfers from section 1001(e)(1), thus entitling the holder to "use" any basis determined under sections 1014, 1015, or 1041 in such transfers. This exception applies only to transfers of an entire interest in a trust to third parties, however, and does not apply to an early termination of a CRT where there is no third party buyer, regardless of whether the trust terminates and distributes assets directly to the income and remainder beneficiaries or whether one beneficiary sells its interest to the other. See, e.g., PLR 200833012 (May 9, 2008) (section 1001(e)(3) exception did not apply to the early termination of a CRT in which the trustee terminated the trust and directly distributed assets to the income and remainder beneficiaries); PLR 200733014 (April 26, 2007) (section 1001(e)(3) exception did not apply to an early CRT termination in which the income beneficiary transferred its CRT interest to the remainderman in exchange for which the trustee transferred the present value of the income interest to the income beneficiary from the trust's assets and subsequently terminated and distributed the remaining assets to the remainderman); PLR 200152018 (Sept. 26, 2001) (early

result in the disqualification of the trust as a CRT under section 664. Finally, the CRT should not be subject to the tax under section 507.

Furthermore, these consequences should apply, and the tax consequences to the income beneficiary, the charitable remainderman, and the trust should be the same, regardless of the form in which the early termination is effected.[49] Accordingly, as discussed below, the tax consequences should be similar whether the charitable remainderman purchases the income beneficiary's interest or the CRT distributes to the income beneficiary and the charitable remainderman amounts equal to their share of the fair market value of the CRT's assets.

A. Remove "Standard" Early Terminations from the No Rule List

As discussed above, the Service had previously placed a number of matters relating to early terminations on the "no rule" list. In light of the 2015 PATH Act amendment, we recommend that the Service remove from its "no rule" list certain simple non-gratuitous early terminations that present no potential for abuse or other complicating factors ("Standard Early Terminations") and consider what type of guidance would be appropriate for it to issue in these and other circumstances.

Specifically, we believe that, if the remainderman is a public charity (and not a private foundation)[50] and the CRT terminates early, using any of the forms described above, such Standard Early Termination should result in the tax consequences described above, as long as the value received by the charitable remainderman is at least equal to the value of the remainderman's interest determined by apportioning the fair market value of the CRT's assets based on the annuity amount or payout rate and the anticipated remaining term of the income interest.[51] In addition, it would be appropriate for the

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termination accomplished by a sale of the income beneficiary's interest to the remainderman, with consideration transferred directly from the remainderman to the income beneficiary, did not qualify for the section 1001(e)(3) exception "because the remainder beneficiary is not receiving the entire interest in Trust in a single transaction").

[49] See *supra* Part I, Section B.

[50] Where the remainderman is a public charity, there are two independent parties with the opportunity to "validate" the early termination: the remainderman – which will determine whether or not the early termination is in its best interests – and the state attorney general (or other similar entity) in the remainderman's jurisdiction of organization – which has the option to engage in a second review of the transaction with the charity's interests in mind. As discussed below, we believe that a private foundation with respect to which the income beneficiary is not a DQP should be treated in the same manner as a public charity as the same safeguards are present.

Service to require that, if each asset of the CRT is not distributed *pro rata*, the value must be apportioned pursuant to a qualified appraisal (as defined in section 170(f)(11)(E)).

Under this approach, Standard Early Terminations would be treated as follows. First, a non-gratuitous Standard Early Termination of a CRT would not constitute self-dealing. This is consistent with the Service's prior conclusion that the distribution or other transfer to the income beneficiary on an early termination did not constitute self-dealing as it was merely an anticipatory distribution of future unitrust amounts which the income beneficiary would have received and which would have been exempt from self-dealing.[52]

Second, a Standard Early Termination of a trust that has previously qualified as a CRT would not result in the trust being disqualified under section 664. Third, the gain recognized by the income beneficiary on a Standard Early Termination would be capital in nature and would equal the amount realized without any reduction for such beneficiary's basis in its CRT interest or for the beneficiary's share of the basis in the CRT's assets (adjusted pursuant to Treas. Reg. § 1.1014-5(c)). Thus, the income beneficiary would not be entitled to reduce the amount realized by any basis in its trust interest or the assets of the trust.[53] This result is consistent with the decision in *McAllister*,[54] as previously applied by the Service.[55]

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[51] Specifically, the portion distributed to each beneficiary should be calculated using the methodology under Treas. Reg. § 1.664-4 and the actuarial tables published periodically by the Service. If the income beneficiary is willing to transfer additional value to the remainderman, this should not affect qualification of the early termination under these rules. This should result in an additional charitable deduction to the income beneficiary in the amount of the income interest surrendered.

[52] § 4947(a)(2)(A). See also Treas. Reg. § 53.4947-1(c)(2)(i); PLR 200152018 (Sept. 26, 2001) (termination of charitable remainder unitrust where donor retained a portion of value of his interest); PLR 200127023 (Apr. 4, 2001) (termination of charitable remainder unitrust by sale of interest to charity).

[53] This is consistent with the Service's view. See *supra* note 48 and accompanying text.

[54] McAllister v. Comm'r, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947), acq., Rev. Rul. 72-243, 1972-1 C.B. 233.

[55] See PLR 200739004 (June 21, 2007); PLR 200314021 (Dec. 24, 2002); PLR 200127023 (April 4, 2001). These PLRs conclude that the ordering rules of section 664 that generally apply to determine the character of funds distributed from a CRT should not apply to CRT terminations, reasoning that the terminating payments are not true distributions of annual unitrust amounts, but "[r]ather, the Beneficiaries are disposing of their interests in the Trust in exchange for money and property in a transaction that is governed by § 1001." See PLR 200739004 (June 21, 2007). This is consistent with the treatment of sales of interests in entities (including pass-through or quasi-pass-through entities). See, e.g., § 741 (partner generally recognizes capital gain on the disposition of a partnership interest).

Finally, a CRT should not be subject to tax under section 507 as a result of a Standard Early Termination.[56] This result is also consistent with the Service's prior rulings[57] and the 2015 PATH Act amendment.

If the Service believes that it would assist in the proper administration of the tax laws, the Service could consider issuing a notice providing for the treatment of Standard Early Terminations. Such notice could mitigate the burden to the Service of taxpayers seeking private rulings with respect to Standard Early Terminations and would also provide the Service with the opportunity to impose certain basic requirements (e.g., a qualified appraisal) and to address those early terminations where the tax consequences discussed above would not be appropriate.[58]

B. Termination of CRTs other than Standard Early Terminations

In amending section 664(e), Congress clearly intended to authorize and facilitate early terminations of CRTs. Nevertheless, we recognize that certain early terminations present unique complicating circumstances for which the above consequences may not be warranted.

Specifically, an early termination of a CRT that has a private foundation remainderman and an income beneficiary that is a DQP[59] with respect to the private foundation[60] (a "DQP Early Termination") is fundamentally different from an early termination of a CRT that has only public charity remaindermen (or a private foundation with respect to which the income beneficiary is not a DQP). The presence of an independent remainderman that must approve the termination ensures that the termination is properly and fairly administered and that the decision to terminate is made by the remainderman with its own interests in mind.[61] Thus, we believe that, if the income

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[56] As described above, section 507 imposes a tax on a private foundation upon the termination of its private foundation status under certain specified circumstances. For this purpose, charitable remainder annuity trusts and charitable remainder unitrusts are treated as private foundations.

[57] See, e.g., PLR 200314021 (Dec. 24, 2002); PLR 200127023 (Apr. 4, 2001).

[58] See *infra* Part II, Section B.

[59] The income beneficiary could be the grantor of the CRT or related to the grantor. See *supra* note 5.

[60] The trustee is also potentially a DQP as it is a foundation manager. See § 4946(a). It seems unlikely, however, that the trustee and the trust would engage in any transactions during the course of an early termination that would lead to any self-dealing concerns.

[61] That the independent charitable remainderman has to approve the early termination provides a sufficient safeguard to ensure not only that the apportionment of value in such termination pursuant to the formula in section 664(e) is appropriate, but also that the early termination itself is in the

beneficiary of a CRT is not a DQP with respect to the private foundation charitable remainderman of such CRT, the early termination of the CRT should be classified as a Standard Early Termination and treated in the same manner as if the remainderman were a public charity. In contrast, if the income beneficiary is a DQP of the remainderman, the "checks-and-balances" represented by a third-party remainderman are absent, giving weight to concerns that the private foundation remainderman may not always act in its best interests.

Moreover, if the income beneficiary is a DQP, the self-dealing rules may arguably apply to more than the makeup of the termination payment by the CRT to the income beneficiary on the early termination. In an early termination, if the remainderman is a public charity, the self-dealing rules are relevant only to transactions between the CRT and the income beneficiary[62] and, regardless of the manner in which an early termination is effected, the only issue is whether the transfer of the termination payment by the CRT to the income beneficiary constitutes self-dealing.[63] In such instances, as discussed above, the Service has logically extended the exception to self-dealing for annuity and unitrust payments made to the income beneficiary by the CRT during the term of the CRT to the "anticipatory" payment of such amounts on an early termination of a CRT.[64]

For a DQP Early Termination, however, the anticipatory payment exception to self-dealing is no longer sufficient to address all potential self-dealing considerations.[65] For example, if the income beneficiary is a DQP with respect to the remainderman, the form of the early termination may be relevant as a sale or exchange by the income beneficiary of its interest in the CRT to a private foundation remainderman would

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remainderman's best interests. Further, the potential for oversight by the state attorney general (or other similar entity) in the remainderman's jurisdiction of organization provides an additional layer of protection that the early termination is being undertaken in the best interests of the remainderman. See also discussion *supra* note 50.

62 The income beneficiary would be the substantial contributor to the CRT or related to the substantial contributor. See §§ 4946(a)(1)(A), (D).

63 As discussed above, the Service has generally disregarded the form of the early termination and analyzed the transaction as if the CRT were making a payment to the income beneficiary. See *supra* note 32.

64 See discussion *supra* note 31 and accompanying text.

65 Under these circumstances, the charitable remainderman may not be furthering solely its best interests, and the independent third-party validation is absent. As discussed in note 61, *supra*, the attorney general or other relevant state official may provide independent oversight, reducing concerns about improper dealings.

typically constitute *per se* self-dealing.[66] In contrast, if the early termination is effected by a commutation of the CRT and the income beneficiary and the private foundation charitable remainderman each receives its *pro rata* share of each of the CRT's assets, there is arguably no transaction between the income beneficiary and the remainderman and, thus, no direct self-dealing. The Service should consider whether the self-dealing rules of section 4941 justify treating DQP Early Terminations differently based on their form, or whether it is more appropriate to treat all DQP Early Terminations in the same manner, regardless of form. If the latter, then the form of the DQP Early Termination will be irrelevant.

Even if the form of the DQP Early Termination presents no direct self-dealing issue (e.g., a *pro rata* commutation), a DQP Early Termination could, nevertheless, constitute indirect self-dealing.[67] An early termination in and of itself could be less favorable to the remainderman than not terminating and could result in value being improperly diverted to the income beneficiary by a remainderman that feels pressured to consent to the early termination.[68] Based on this possibility, the Service could decide that all DQP Early Terminations (regardless of form) are *per se* acts of self-dealing.

On the other hand, section 4941 itself recognizes that not all transactions between a private foundation and a DQP should be prohibited as self-dealing. Thus, for example, the section 4941(d)(1)(C) prohibition on furnishing goods to a DQP does not apply if the goods are "fundamentally related" to the private foundation's charitable purpose and are offered on a least as favorable a basis to the general public.[69] Likewise, the section

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[66] § 4941(d)(1)(D), (E). Although one could argue that, if the funds for such purchase were "sourced" from the CRT, there should be no self-dealing as the remainderman is not the "true" purchaser. Such an argument is unlikely to be successful (nor is it clear that it should be) as the form of the transaction clearly violates the self-dealing rules.

[67] § 4941(d)(1)(E). Disregarding the form of the early termination to analyze the self-dealing consequences would be consistent with prior Service letter rulings, which applied the same treatment under the self-dealing rules to CRT early terminations, regardless of the form of the transaction under review. Compare, e.g., PLR 200846037 (Nov. 14, 2008) (in which the CRT terminated early by distributing lump sums directly to the income and remainder beneficiaries equal to the present value of their respective interests and the Service found that there was no self-dealing by application of the exception under Treas. Reg. § 53.4947-1(c)(2)(i)), with PLR 200912036 (March 20, 2009) (in which the income beneficiary of a CRT sold its interest in the trust to the remainderman for the present value of the income interests and the Service found that there was no self-dealing by application of the exception under Treas. Reg. § 53.4947-1(c)(2)(i)).

[68] The Treasury Regulations acknowledge that a private foundation's actions could benefit a DQPs without any direct transfer of value from the private foundation to a DQP. For example, if a private foundation purchases securities in an attempt to manipulate the price for the benefit of a DQP, this is treated as an act of self-dealing. § 4941(d)(2)(D); Treas. Reg. § 53.4941(d)-2(f)(1).

[69] Treas. Reg. § 53.4941(d)-3(b)(1).

4941(d)(1)(D) restriction on compensating DQPs for services (or reimbursing for expenses) is allowed under section 4941(d)(2)(E) as long as the personal services are reasonable and necessary to carry out the private foundation's charitable purpose and the compensation or reimbursement is not excessive. In the case of CRTs, the valuation methodology approved under section 664(e) (i.e., determined by apportioning the fair market value of the CRT's assets based on the annuity amount or payout rate and the anticipated remaining term of the income interest, as required on formation) could be considered similarly curative. The self-dealing exceptions referred to above are statutory, however, and it is not clear that the Service has the authority to extend this type of exception to DQP Early Terminations. On the other hand, the valuation methodology of section 664(e) could be considered statutory authority, notwithstanding that it does not directly address self-dealing.

Other factors could mitigate self-dealing concerns regarding DQP Early Terminations. For example, although there may be no independent public charity policing a DQP Early Termination, the relevant state authority with oversight power over the private foundation would be able to challenge any early termination as not being in the remainderman's best interests. Similarly, if the distribution on an early termination is made *pro rata* with respect to each of the assets of the CRT, the potential for mischief is reduced. Alternatively, a qualified appraisal can reduce the opportunities for inappropriate diversion of value to the income beneficiary because an independent party would verify that the assets received by the income beneficiary are fairly and accurately valued. Under these circumstances, the Service could conclude that the "checks and balances" are sufficient to eliminate self-dealing concerns.

Notwithstanding, it may be appropriate for any initial general guidance issued by the Service not to apply to DQP Early Terminations, given the competing considerations. The Committee suggests that the Service consider the following alternative approaches for DQP Early Terminations.

1. Safe Harbor for *Pro Rata* Division of All Assets

Assuming that the form of the early termination does not constitute direct self-dealing (i.e., not a sale to the remainderman), the Service could consider providing the following safe harbor for DQP Early Terminations: if each of the CRT's assets is apportioned *pro rata* between the income beneficiary and the remainderman and the remainderman receives an amount that is at least equal to the value of the remainderman's interest (determined as discussed above),[70] each beneficiary could be presumed to have received its fair share of the CRT's value. As discussed above, the opportunity for abuse in such a case is significantly reduced. Accordingly, the Service could provide for a rebuttable presumption that such an early termination would be treated as a Standard Early Termination subject to the consequences discussed above.

[70] See *supra* note 51.

In addition, the Service could extend this safe harbor to DQP Early Terminations where each asset is not being distributed *pro rata* if the parties obtain a qualified appraisal of the CRT's assets. This would, in effect, treat such an early termination of a CRT in the same manner as Standard Early Terminations (discussed above).

2. Case by Case Evaluation with Limited Exceptions for Special Circumstances

Alternatively, the Service could continue evaluating DQP Early Terminations on a case by case basis or prohibit DQP Early Terminations entirely. The Committee does not believe that the 2015 PATH Act necessarily authorizes DQP Early Terminations. Given the absence of any specific statutory language regarding self-dealing, the Committee believes that the 2015 PATH Act could more logically be considered to have addressed the fundamental self-dealing issue associated with all early terminations, i.e., the "anticipatory" termination payment to the income beneficiary.

Another approach that addresses the self-dealing concerns discussed above without relying on creating a new exception to self-dealing would be to require that the income beneficiary in a DQP Early Termination not be a DQP with respect to the majority[71] of the charitable remaindermen of the CRT (i.e., that the private foundation be one of several remaindermen) and that the form of the transaction not be a sale by the income beneficiary to the remaindermen[72] but instead be a distribution by the CRT of the income beneficiary's and remainderman's *pro rata* share of each asset of the CRT.[73] In such instance, any self-dealing concerns are arguably absent, given the checks-and-balances provided by the non-related remainderman majority.

C. Special Rules for Interests Measured on a Life

Finally, the Service should clarify that the provisions in the regulations under section 7520 relating to measuring lives of terminally ill persons should apply to early terminations of CRTs. Regulations under section 7520 already provide rules to determine whether or not a measuring life is based on a terminally ill person, and similar

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[71] The majority would be determined based on share of the interests.

[72] Such a sale would constitute a *per se* act of self-dealing. § 4941(d)(1)(A).

[73] This "similar" treatment approach is consistent with some exceptions to self-dealing. For example, under the current rules, a statutory exception allows a private foundation to receive a liquidating distribution from a corporation as long as other holders of securities of the same class held by the foundation receive distributions on the same terms and the foundation receives at least fair market value. § 4941(d)(2)(F).

rules could easily be adopted here.[74] If the Service issues such guidance, we believe that it would be appropriate to include a safe harbor providing that a person who survives the early termination of a CRT by eighteen months could be presumed not to have been "terminally ill" at the time of the termination unless the contrary is established by clear and convincing evidence.

We appreciate your consideration of our recommendations.

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[74] See Treas. Reg. § 1.7520-3(b)(3). For example, the Service could require that the charitable remainderman and the trustee obtain the representations from the income beneficiary that the income beneficiary does not know and has no reason to know that the income beneficiary is terminally ill.