



# **ETHICS OF CHARITABLE REMAINDER TRUST PLANNING**

**PROFESSIONAL ADVISORS WORKSHOP V**

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## **Ethics of Charitable Remainder Trust Planning**

By Gregory W. Baker, J.D., ChFC<sup>®</sup>, CFP<sup>®</sup>, CAP

### **Baker's Dozen of CRT Traps**

1. Not knowing what you are doing and not getting competent help
2. Transferring S-corporation shares to a CRT or Transferring an IRA to a CRT during your client's life
3. Forgetting that CRTs are (mostly) IRREVOCABLE
4. Failing to build sufficient flexibility in your client's CRT
5. Placing too much emphasis on high payout rates
6. Failing to Properly Match the CRT format with the proposed contributed asset or investment plan
7. Using the Grantor's EIN for the CRT
8. Failing to understand when a Step-Transaction does and does not apply
9. Self-Dealing
10. Blindly using documents or Giving "sample" CRT documents to a charity or client
11. Blindly adding children, ex-spouses, etc. as income beneficiaries
12. Naming a noncharitable beneficiary class that lasts for a lifetime
13. Failing to recognize a CRT opportunity when it is staring you in the face

# ETHICS OF CHARITABLE REMAINDER TRUST PLANNING

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## I. Problems with IRS' Sample Charitable Remainder Trust Forms

### A. Ensure the Document Drafted Supports the Plan Design

It is important to remember that a Charitable Remainder Trust (CRT) is irrevocable. Therefore, it is critical to draft the document correctly the first time. An example is when the donor wants a SCRUT and the document is drafted as a CRAT. Another example is when the donor desires the flexibility to request that the trustee make accelerated distributions of trust principal to the charitable remainder beneficiary and that provision is omitted.<sup>1</sup> This is an even greater danger when the attorney engaged to draft the CRT governing instrument was not involved in the entire planning process.

### B. Brief History of the IRS' Sample CRT Forms

The IRS first published a series of sample Charitable Remainder Trust (CRT) documents in 1989 and 1990. They updated the Charitable Remainder Annuity Trust (CRAT) versions in August 2003. Subsequently, the IRS issued revised Charitable Remainder Unitrust (CRUT) forms in August 2005. The 2003 and 2005 versions supersede and replace the earlier versions.

The current versions of the IRS' Sample CRT forms are far more robust than their predecessors. Nevertheless, their improper use can still create traps for the unwary.

### C. Overview of the IRS' Sample CRT Forms

In August 2005, the IRS issued eight sample CRUT versions via Revenue Procedures.<sup>2</sup> See Table 1-1 for the eight types of CRUTs and corresponding Revenue Procedures. There are four lifetime CRUTs and four testamentary CRUTs.

<b>Type of CRUT</b>	<b>Revenue Procedure</b>
Lifetime CRUT for 1 Life	2005-52
Lifetime Term of Years CRUT	2005-53

<sup>1</sup> See Treasury Regulations §§1.664-2(a)(4) and 1.664-3(a)(4).

<sup>2</sup> The eight Revenue Procedures are available from the IRS website at: [www.irs.gov/pub/irs-irbs/irb05-34.pdf](http://www.irs.gov/pub/irs-irbs/irb05-34.pdf).

<b>Table 1-1 Sample CRUT Forms</b>	
<b>Type of CRUT</b>	<b>Revenue Procedure</b>
Lifetime CRUT for 2 Consecutive Lives	2005-54
Lifetime CRUT for 2 Joint and Survivor Lives	2005-55
Testamentary CRUT for 1 Life	2005-56
Testamentary Term of Years CRUT	2005-57
Testamentary CRUT for 2 Consecutive Lives	2005-58
Testamentary CRUT for 2 Joint and Survivor Lives	2005-59

In August 2003, the IRS issued eight sample CRAT versions via eight Revenue Procedures.<sup>3</sup> See Table 1-2 for the eight types of CRATs and corresponding Revenue Procedures. There are four lifetime CRATs and four testamentary CRATs.

<b>Table 1-2 Sample CRAT Forms</b>	
<b>Type of CRAT</b>	<b>Revenue Procedure</b>
Lifetime CRAT for 1 Life	2003-53
Lifetime Term of Years CRAT	2003-54
Lifetime CRAT for 2 Consecutive Lives	2003-55
Lifetime CRAT for 2 Joint and Survivor Lives	2003-56
Testamentary CRAT for 1 Life	2003-57
Testamentary Term of Years CRAT	2003-58
Testamentary CRAT for 2 Consecutive Lives	2003-59
Testamentary CRAT for 2 Joint and Survivor Lives	2003-60

#### D. Structure of the IRS' Sample CRT Forms

The 16 Revenue Procedures follow the same basic format. There are usually seven sections: Purpose; Background; Scope and Objective; Sample Form; Annotations Regarding the Sample Form; Alternative Provisions; and Effect on Other Revenue Procedures.

<sup>3</sup> The eight Revenue Procedures are available from the IRS website at: [www.irs.gov/pub/irs-irbs/irb03-31.pdf](http://www.irs.gov/pub/irs-irbs/irb03-31.pdf).

Section Three (Scope and Objective) states that a trust that follows the sample form (with or without the alternate provisions) will be treated as a qualified CRT. It further states that the inclusion of other provisions won't necessarily disqualify the CRT.

Section Four (Sample Form) provides a bare bones CRT document. In theory, the Sample Form provides a document that is sufficient to pass muster as a valid CRT. In practice, additional customization will be desired by most practitioners and clients. For example, the addition of specific references to trustee powers and the selection of successor trustee provisions.

Section Five (Annotations) explains several of the key provisions of the sample form. Each annotation refers to a specific paragraph of the Sample Form. Many of the annotations include references to Internal Revenue Code (IRC) sections, Treasury Regulations, or other authoritative material.

Section Six (Alternative Provisions) contains several pieces of alternative CRT language as well as instructions regarding which part of the Sample Form that the alternative language replaces. The alternative provisions for the CRUT forms are significantly more extensive and complex than the CRAT forms. This should be expected since the CRUT forms include sample language for Standard CRUTs (SCRUTs); Net Income with Makeup CRUTs (NIMCRUTs); Flip CRUTs; and the rarely used Net Income CRUTs (NICRUTs). Some of the language in the Alternative Provisions portrays good drafting, while other language characterizes poor drafting.

#### E. Twenty-Five Reasons Not to Use the IRS' Sample CRT Forms

Although the following is a summary of several items to consider before using the IRS' Sample Charitable Remainder Trust forms, many of them also apply any time you consider using a sample form from any source:

- 1) Provisions to have the trust created by persons other than individuals are missing. Corporations, LLCs and partnerships may create CRTs.
- 2) Permissible combinations of lifetime and term of years CRTs are missing.
- 3) The restriction on using CRT assets to pay transfer taxes is missing on the lifetime CRTs for one life and term of years. The language is not even an alternative provision despite the fact that this is a qualification issue.
- 4) Provisions regarding additional contributions vary considerably from form to form. Some of the unitrust forms do not permit additional contributions (even in the alternative provisions). Other forms do not include language permitting testamentary contributions for the *inter vivos* CRTs. The sample testamentary additional contribution language restricts its application to testamentary gifts from the trust's creator.

Some people create a CRT during their life and subsequently fund it at death. Other people make a bequest to someone else's lifetime CRT.

- 5) Charitable Beneficiary Options are limited.
  - i. For example, there is no sample provision to designate the first \$500,000 to ABC Charity with the rest split equally between the Library and the University.
- 6) Authority to pledge assets as collateral for another's loan to charity is missing.
- 7) A savings clause for the 10% Remainder Interest Test for the initial gift is missing.
- 8) A savings clause for the 10% Remainder Interest Test automatically severs the additional gift.
- 9) A savings clause for the 5% Probability Test is missing in the CRATs.
- 10) A savings clause for the minimum 5% and maximum 50% Unitrust or Annuity Amount is missing.
- 11) The definition of "incompetency" is missing. The trusts contain no provisions instructing the trustee how to make distributions to an incompetent beneficiary.
- 12) There is no provision to use one state's law for determining the trustee's authority and a second state's principal and income provisions.
- 13) Special definitions of principal and income rules are missing. These provisions are a critical design factor in the successful implementation of NIMCRUTs and Flip-CRUTs.
- 14) The provision for an acceleration of the remainder interest to charity is missing from the CRAT versions.
- 15) The language for a qualified appraisal versus using an Independent Trustee's valuation is missing from the CRAT versions.
- 16) Successor Trustee provisions are missing.
- 17) Trustee removal provisions are missing.
- 18) Independent Special Trustee language is missing.
- 19) Ancillary Trustee provisions are missing.
- 20) The reckless inclusion of a sprinkle clause is now much easier than ever before.
- 21) Change of situs language is missing.
- 22) There is no spendthrift clause.

- 23) Lack of Authority to Not Diversify Assets.
- 24) No Qualified Domestic Trust provisions.
- 25) No mention is made of the Spousal Waiver described in Revenue Procedure 2005-24<sup>4</sup>.

#### F. Five Reasons You Should Use the IRS' Sample CRT Forms

It's easy to be picky about somebody else's document forms and it seems to be a national pastime to pick on the government (especially the IRS). However, there are times in which using the IRS' sample form may be the best decision.

- 1) When you need a bare bones document;
- 2) When your client is considering a tricky transaction that may require IRS approval;
- 3) When seeking a Private Letter Ruling;
- 4) When reforming / amending a CRT; and
- 5) When the 2 income beneficiaries are married to each other.

#### G. Beware of Using Generic Form Documents

Numerous sample CRT documents are available from a variety of sources. In addition to the IRS' Sample form documents, most books of trust forms have one or more samples. Often, Continuing Legal Education seminars will include a copy of the presenter's standard form document. Alternatively, it is common to borrow from colleagues who have previously drafted CRTs for their clients.

While it is tempting to use a document from one of the above sources and only change the names of the parties, the payout rate and the term; the multitude of design variables (including trust format) makes this practice a significant trap for attorneys. In my work on over 19,000 CRT documents drafted by over 4,000 attorneys, I have seen hundreds of CRTs that include conflicting provisions (such as a SCRUT that required payment of the NIMCRUT make-up amount) because the drafter failed to identify all of the edits necessary to convert a sample trust to one that conforms to the plan design. Other examples of errors include trust documents that:

- Reference a different client and/or the wrong charitable remainder beneficiary;
- Incorrectly specify multiple payout rates;
- Fail to properly address the gift tax ramifications of naming someone other than the donor or the donor's spouse as a successor income beneficiary;

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<sup>4</sup> Revenue Procedure 2005-24, 2005-16 I.R.B. 1. The implications of this Revenue Procedure and its temporary withdrawal are treated more fully elsewhere in this publication.

- Prohibit the trustee from accepting specific types of assets—including the asset actually transferred to the CRT;
- Explicitly authorize acts of self-dealing;
- Omit the power to change the charitable remainder beneficiary when the donor desires this power;
- Include the power to change the charitable remainder beneficiary when the donor doesn't desire this power, for example to qualify for donor recognition or gift matching at the charity;
- Restrict the charitable remainder interest to public charities when the donor intends to create a private family foundation; and
- Permit the charitable remainder interest to be paid to a private foundation, thereby limiting the donor's income tax charitable deduction to cost basis when the donor is not a suitable match for, and never intended to create, a private foundation.

Even with the instructions contained in the Revenue Procedures, it can be confusing to prepare a CRT document that uses more than the basic provisions found in Section Four of the prototypes. For example, inserting the clients' names correctly in all of the appropriate places can be a dangerous task for some attorneys and paralegals. A more dangerous trap with the IRS forms occurs with regard to the critical component of whether a private foundation may be a beneficiary of the CRT or whether the charities must be restricted to publicly-supported charities. Section 6.05(2) contains the following guidance:

(2) Instructions for use. To restrict the charitable remainderman to a public charity, each and every time the phrase "an organization described in §§ 170(c), 2055(a), and 2522(a) of the Code" appears in the sample trust, replace it with the phrase "an organization described in §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Code."

While the instruction is accurate, the difficulty is that these Code sections appear two times in the Sample Form (albeit in close proximity). Depending on which other alternative provisions were added, these Code sections could appear up to five times in the trust. The more times that a drafter needs to make the same change in a trust document, the greater the danger for a conflicting provision. A better drafting solution is to list the Code sections once and then define them as a term of art. The drafter can then use that term of art as needed throughout the rest of the document. Even with the "search and replace" capabilities of modern word processors, operator errors still occur all too frequently. If possible, the preferred method for creating documents is to use a drafting system that is thoroughly tested.

Additionally, even with the annotations, there is enough information to be dangerous. As an example, Section 6.03 of some of the forms is entitled "Retaining the Right to Revoke the Interest of the Successor Recipient". This

Alternative Provision contains sample language to include this power and uses 109 words to describe when its use might be appropriate. However, since the inclusion or exclusion of this provision potentially affects estate, gift and generation skipping transfer tax issues, this provision demands a more thoughtful discussion.

## **II. Applying Selected Indiana Rules of Professional Conduct to Charitable Remainder Trust Planning**

### **A. Rule 1.1 Competence.**

#### **Rule 1.1. Competence**

A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.<sup>5</sup>

In drafting CRTs for a client, the attorney must competently represent the client by researching the relevant authority for the CRT design. For some lawyers, this work involves adding to her existing body of knowledge. For others, preparing thoroughly for the task requires significant research and expense. Each lawyer must assess whether drafting the CRT is a task which the lawyer can (or should) accept or whether the CRT work should be completed by another lawyer who represents the client solely with regard to that CRT.

### **B. Rule 1.2. Scope of Representation.**

#### **Rule 1.2. Scope of Representation and Allocation of Authority Between Client and Lawyer**

(c) A lawyer may limit the scope and objectives of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.<sup>6</sup>

As noted above and highlighted in Rule 1.2(c), a lawyer may limit the scope of representation solely to work surrounding the CRT design and drafting, while another lawyer represents the client for the rest of his or her estate planning documents. Prudence dictates (and Comment 6 recommends) that the lawyer clarify the limited scope of representation in a written agreement with the client.

### **C. Rule 1.3. Diligence.**

#### **Rule 1.3. Diligence**

A lawyer shall act with reasonable diligence and promptness in representing a client.<sup>7</sup>

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<sup>5</sup> Indiana Rules of Court, Rules of Professional Conduct, Rule 1.1.

<sup>6</sup> Indiana Rules of Court, Rules of Professional Conduct, Rule 1.2(c).

<sup>7</sup> Indiana Rules of Court, Rules of Professional Conduct, Rule 1.3.

As lawyers, we need to represent our clients with reasonable promptness to complete the task. In some cases, the client's goals may change based on our advice or based on their conversation with other advisors such as the proposed charitable beneficiaries, family members, accountants or financial advisors. Lawyers need to be ready to "carry through to conclusion all matters undertaken for a client"<sup>8</sup> even if the client's goals change mid-stream.

### **III. Charitable Remainder Trust Drafting Observations**

#### **A. Starting Point**

The design and drafting of CRUTs and CRATs can range from simple to complex. As a rule, the simpler the form, the less flexible and versatile the trust. The Prototype CRUT and CRAT forms published in 2003 and 2005 contain most of the bare essentials (and some additional optional provisions) for creating a tax-qualifying CRT. However, these sample forms also contain some provisions that could get the drafter into trouble if they are included unnecessarily or used irresponsibly. To the extent the Prototypes provide guidance with respect to the minimum essential requirements that most CRTs must possess, they are helpful guides, but drafters can provide greater flexibility for their clients by digging a little deeper.

The best use of sample form documents is as a foundation upon which to build a flexible, versatile CRT that will meet a host of financial, estate and philanthropic needs. Optional features that do not appear in a Prototype but have support in the law should be used without reservation if they will serve the goals, needs and objectives of your client.

#### **B. Consider Desirable Optional Provisions**

A number of desirable optional provisions exist that can increase the utility and flexibility of a CRT. For example, the donor may retain the power to change the charitable remainder beneficiary. The document may provide the trustee with the ability to accelerate the distribution of principal to the charitable remainder beneficiary. The trust might have a spendthrift clause designed to restrict the income beneficiary's ability to alienate his or her interest, while still giving the income beneficiary the flexibility to make a charitable gift of his or her income interest.

#### **C. Adequately Define Principal and Income**

Many charitable plans call for the use of a NIMCRUT or Flip-CRUT. As described above, these CRT formats must pay out the lesser of the trust's accounting income and the unitrust amount (note that for Flip-CRUTs, this paper is describing the "pre-flip" period).

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<sup>8</sup> Comment 4 to Rule 1.3.

The definition of trust accounting income is a function of the language of the trust's governing instrument and the principal and income statute<sup>9</sup> of the applicable state. Where one or more provisions of the trust's governing instrument are in conflict with the principal and income statute, the trust's governing instrument takes precedence.<sup>10</sup>

It is sometimes the case that the trustee will select investment assets that do not produce income under the default provisions of the applicable principal and income statute. For example, realized capital gains are generally not considered income (but rather are treated as principal) under most state statutes. Therefore, it is desirable in the course of designing and drafting the trust's governing instrument to consider provisions that will match the anticipated investment practice with a definition of income that meets the plan design.

#### D. Trustee Powers

Most attorneys either rely on the Trustee Powers section in the applicable governing law<sup>11</sup> or they simply insert the Trustee Powers they typically use in their other trust documents. This practice does make sense in that either of these options provide broad discretion for the Trustee in exercising its duties and the drafting attorney can more easily and readily answer questions the trustee may ask the attorney regarding its authority.

However, if a CRT trustee exercises certain powers, the trustee could cause the CRT to owe excise taxes. In certain cases, the CRT trustee could be charged with a self-dealing excise tax. Normal trustee powers that create these problems include: the power to borrow and the power (of disqualified persons<sup>12</sup>) to purchase trust assets.

#### E. Bifurcating Trustee Powers

Another optional provision to consider including in a CRT is the explicit bifurcation of certain Trustee powers. The starting point in this analysis is the understanding that a CRT cannot be a grantor trust. However, there are certain Trustee powers that might be nice to include in a CRT.

The CRT trustee may be an individual or an institution such as a bank or charity. The donor may serve as Trustee<sup>13</sup> so long as the donor-trustee cannot exercise a grantor trust power such as a power to sprinkle income. The option of the donor to serve as Trustee unbundles traditional trustee services (fiduciary decision-making, investment management and CRT administration), permitting

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<sup>9</sup> See [www.law.upenn.edu/bll/archives/ulc/upaia/2000final.htm](http://www.law.upenn.edu/bll/archives/ulc/upaia/2000final.htm) for the Uniform Principal and Income Act suggested by the National Conference of Commissioners on Uniform State Laws.

<sup>10</sup> See §103(a)(1) which states that a fiduciary “shall administer a trust or estate **in accordance with the terms of the trust** or the will, even if there is a different provision in this [Act].” [Emphasis added].

<sup>11</sup> See Indiana Code §30-4-3-3.

<sup>12</sup> See IRC §§4941 and 4946.

<sup>13</sup> See Rev. Rul. 77-285.

the donor to hire best-in-class service providers for those services. Charities and banks can utilize this same outsourcing approach for investment management and CRT administration.

However, if the donor-trustee has a power over the CRT that would be considered a grantor trust power,<sup>14</sup> then the CRT would lose its CRT status. One example of such a power is the power to sprinkle trust distributions among the income beneficiaries.<sup>15</sup>

This strategy could help the Trustee make sure only certain of the client's children will receive the unitrust or annuity amount. Creditor avoidance is another objective that motivates some CRT clients to seek an income sprinkling/spraying power in their trust. The hope here is to protect the income interest of an income beneficiary who gets in trouble with creditors by spraying that recipient's unitrust or annuity interest to his co-income recipients.

The CRT Trustee *may* be given the power to sprinkle an annuity or unitrust amount among named income beneficiaries (or a class of living recipients) provided the trust does not thereby become a grantor trust.<sup>16</sup> Grantor trust status can be avoided if the only fiduciary who can exercise the income sprinkling power is an "independent" trustee. It is imperative that neither the settlor nor a person acting under the settlor's control be given this power (if) when serving as trustee.<sup>17</sup>

The fact that neither the CRT donor nor a related party can be given an income sprinkling power without disqualifying the trust under Code §664 should *not* preclude such person from serving as the "primary" trustees if an "independent special trustee" has been designated *from the inception of the trust* as the sole Trustee with authority to exercise the sprinkling power. The "independent trustee" exception to Code §674(a) is contained in Code §674(c). This exception: (i) contemplates multiple trustees; (ii) explicitly addresses powers to apportion or "sprinkle" trust income among two or more income recipients; (iii) does not preclude the donor from being one of several trustees; and (iv) merely requires the independence of the trustee who is authorized to exercise the sprinkling power.<sup>18</sup>

Before inserting an independent special trustee income sprinkling clause into a CRT, the primary trustee of which will (or can) be the donor or a related or subordinate party, the drafter should be certain state law permits the establishment

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<sup>14</sup> See IRC §§671 – 679.

<sup>15</sup> See IRC §67.

<sup>16</sup> See Code §674(c); Treas. Regs. §§1.664-2(a)(3)(ii) and 1.664-2(a)(3)(ii); Rev. Rul. 72-395, 1972-2, C.B. 340, §§5.03 and 7.03; Rev. Rul. 77- 73, 1977-1, C.B. 175; and PLRs 9511029, 9423020, 9052038 (sprinkling power in a testamentary CRT), 8003047 (right to sprinkle unitrust amount among named *successor* income recipients only), 7926029 and 7938127.

<sup>17</sup> Rev. Rul. 77-285, 1977-2 C.B. 213.

<sup>18</sup> This interpretation is supported by Rev. Rul. 77-73, 1977-1 C.B. 175; Rev. Rul. 77-285, 1977-2 C.B. 213; and Priv. Ltr. Rul. 9423020.

of a second and segregated class of "independent" trustees. Indiana Code §30-4-3-4(a) states:

Unless the terms of the trust provide otherwise (a) Any power vested in two (2) trustees must be exercised by them jointly; any power vested in three (3) or more trustees must be exercised by a majority.

So long as the terms of the CRT are explicit and clear regarding the powers delegated to specific Trustees, this Code section authorizes the segregation of duties among classes of Trustees in a manner that will avoid grantor trust status for powers delegated to an independent Trustee.

#### F. Gift, Estate and GST Tax Considerations

*General Comments.* Even in an era of \$5,000,000 transfer tax exemptions that are indexed for inflation, it is a trap for persons who create a CRT to be unaware of the impact of transfer taxes in CRT planning. A CRT should not pay the donor's transfer tax. In addition to creating potential self-dealing issues, the CRT's payment of the donor's transfer taxes is expressly prohibited by Revenue Ruling 82-128. The best practice is for all CRT governing instruments to explicitly prohibit the payment of such taxes. In fact, the vast majority of CRTs do not create gift, estate or GST taxes.

*Gift Tax.* The creation of an income interest for a person other than the donor creates a gift equal to the value of the property transferred less the APVRI. If the donor's spouse is the only person other than the donor to receive an income interest, then the gift tax marital deduction (IRC §2523(g)) eliminates most gift tax concerns. If the CRT is properly designed, no tax will be due for the gift of the charitable interest.

If the donor or the donor's spouse is not a recipient of any income interest (e.g., the donor's child is the only noncharitable recipient of the CRT), then the donor has made a taxable gift to the income beneficiary. Because the child has an immediate present value interest in the CRT, this gift will qualify for the annual gift tax exclusion to the extent the entire income interest is valued at \$14,000 or less.<sup>19</sup> To the extent that the gift is greater than \$14,000, then the donor's lifetime gift tax applicable exclusion amount is reduced or gift tax is due.<sup>20</sup>

A third variation is to create an income interest for the donor succeeded by his or her spouse succeeded by one or more children. While this can be a powerful

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<sup>19</sup> This number is indexed for inflation. For gifts made from 2002 through 2005, the annual gift tax exclusion for a present interest gift was \$11,000. The annual gift tax exclusion increased to \$12,000 for gifts during 2006 through 2008. It increased \$13,000 for gifts from 2009 through 2012. It increased to \$14,000 for gifts made during or after 2013.

<sup>20</sup> Retention of a testamentary right to revoke an income interest will complicate determining the gift tax. See PLR 8637084 in which the IRS ruled that each year's unitrust payments to the child would separately qualify as annual exclusion gifts.

planning technique, it does produce a challenging gift tax result. The inclusion of a non-spousal recipient nullifies any gift tax marital deduction for the spouse's interest.<sup>21</sup> This means that both the children and the spouse's interests are presently subject to gift tax. By retaining a testamentary right to revoke all income interests (but his or her own), a donor can eliminate the gift tax. However, at the donor's death, the donor will only receive an estate tax charitable deduction for the remainder interest—there will not be a marital deduction for the spousal interest.

*Estate Tax.* It is common for the assets of a CRT to be included in the donor's gross estate. This can occur for a variety of reasons including:

*Retaining an Income Interest.* IRC §2036<sup>22</sup> requires estate inclusion of trust assets created by the donor if the donor retained a lifetime income interest.

*Retaining a Right to Revoke a Surviving Income Recipient.* IRC §§2036 and 2038 require estate inclusion of trust assets for trusts created by the donor if the donor retained a power to designate a beneficiary. The power to revoke a surviving income recipient fits this category.

*Retaining a Right to Change the Charitable Beneficiary.* IRC §§2036 and 2038 require estate inclusion of trust assets for trusts created by the donor if the donor retained a power to designate a beneficiary. The power to change the charitable beneficiary fits this category.

As a reminder, any one of these items—by itself—is sufficient to cause the assets to be included in the donor's gross estate. However, this does not mean that there is a tax due for single-life or spousal CRTs. Between the estate tax charitable deduction and (for spousal CRTs) the estate tax marital deduction, the value of the CRT assets included in the donor's estate is effectively eliminated.<sup>23</sup> As with gift taxes, the marital deduction for a surviving spouse's interest in a CRT may not be claimed by an estate if any one other than the surviving spouse has a noncharitable interest in the trust.<sup>24</sup> However, the fact that the gross estate net of the available deductions is less than the estate tax applicable exclusion amount does not eliminate the requirement to file Form 706.

As with all estate tax computations, if the gross estate (including the CRT assets and other lifetime gifts) is valued at less than the estate tax applicable exclusion amount, the inclusion of the CRT assets will not create an estate tax liability. For estates whose value exceeds the estate tax applicable exclusion amount, a

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<sup>21</sup> IRC §2523(g).

<sup>22</sup> The IRS issued Final Treasury Regulation §20.2036-1, which was effective on July 14, 2008.

<sup>23</sup> For a limited number of estates, inclusion of the value of the CRT's assets in the donor's gross estate may limit the estate's eligibility to claim a special use valuation, IRC §6166 deferral of tax or IRC §303 redemption.

<sup>24</sup> See IRC §2056(b)(8).

testamentary CRT may be a strategy for reducing the value of the estate below the limit, while providing a benefit to the donor's spouse, heirs and charity.

Table 3-1 below lists the estate, gift, and generation skipping transfer tax rates and applicable exclusion amounts. The Gift, Estate, and GST tax rates and Exclusion Amounts will continue to be indexed for inflation each year.

<b>Year</b>	<b>Highest Estate and GST Tax Rates</b>	<b>Estate Tax Applicable Exclusion Amount</b>	<b>GST Exemption Amount</b>	<b>Highest Gift Tax Rate</b>	<b>Gift Tax Applicable Exclusion Amount</b>
2011	35%	\$5,000,000	\$5,000,000	35%	\$5,000,000
2012	35%	\$5,120,000	\$5,120,000	35%	\$5,120,000
2013	40%	\$5,250,000	\$5,250,000	40%	\$5,250,000
2014	40%	\$5,340,000	\$5,340,000	40%	\$5,340,000
2015	40%	\$5,430,000	\$5,430,000	40%	\$5,430,000

*Generation-Skipping Transfer Tax (GSTT).* The enactment of the 10% remainder test in 1997 significantly reduced the danger that a CRT will create generation skipping transfer tax (GSTT) concerns. Nevertheless, any CRT that names a skip person<sup>25</sup> as an income beneficiary must address the GSTT. Some examples of CRTs that have a higher probability of GSTT complications include term of years CRTs, CRTs that combine lives and terms, CRTs that benefit non-direct descendants (e.g., nieces, nephews, non-spousal May-December relationships) where the donor is more than 37½ years older than a CRT beneficiary. Note that GSTT concerns exist *whenever* a skip person is named, *even if* there is an intervening non-skip beneficiary.

*Allocation of GST Exemption.* Even though a transfer to a CRT may be a generation-skipping transfer, it is possible for the donor to allocate all or a portion of his or her GST Exemption to the transfer.

#### G. Spousal Election

On April 18, 2005, the IRS issued Revenue Procedure 2005-24<sup>26</sup>, which brought to light an issue that few planners previously considered. If the surviving spouse of a CRT donor could elect under state law to disregard the decedent spouse's estate plan, then potentially that election could include the withdrawal of assets from the CRT. In Revenue Procedure 2005-24, the IRS stated that a CRT would be disqualified if a surviving spouse could make that election and proposed a safe harbor that the spouse of every CRT donor must irrevocably waive in writing any power to elect against the state (at least with regard to the CRT). On

<sup>25</sup> See IRC §2613 for the definition of a skip person.

<sup>26</sup> Revenue Procedure 2005-24, 2005-16 I.R.B. 1.

February 3, 2006, the IRS released Notice 2006-15<sup>27</sup>, which stated that the IRS will disregard the right of election, even without a waiver, but only if the surviving spouse does not actually exercise the right of election with regard to the CRT.

#### H. Assignment of Income

It is a basic principle of federal income tax law that income is taxed to the taxpayer who earned it.<sup>28</sup> The *assignment of income* doctrine prohibits a party whose right to income (or gain) has matured from shifting the income tax liability associated with that income or gain to a third party. Clients contemplating a complex charitable gift of a business interest or real estate to a charitable organization most often encounter an assignment of income problem where the sale of the asset is largely completed before they convey title to the charity. Courts have considered a number of fact patterns in determining whether a contribution resulted in an assignment of income. A sampling of these cases is described below.

***Kinsey v. Comm'r.***<sup>29</sup> The Second Circuit ruled that where a plan of liquidation was adopted prior to the transfer of stock to a charity, the subsequent transfer of stock was ineffective in transferring the tax liability on the associated gain away from the donor to the charity.

***Salvatore v. Comm'r.***<sup>30</sup> Similarly, the Second Circuit held that the transfer of stock in a corporation to a child, after a formal sales agreement with a third party had already been signed, violated the assignment of income doctrine and was ineffective to transfer the tax liability on the sale of the stock to the donor's child.

***Jorgl v. Comm'r.***<sup>31</sup> The Eleventh Circuit held that where a charitable remainder trust sold shares of a corporation and the sales agreement included a covenant not to compete, the value of the noncompete agreement was properly assignable as income to the party bound by the covenant, notwithstanding the fact that the consideration for the covenant was paid to the charitable remainder trust.

***Greene v. Comm'r.***<sup>32</sup> Alternatively, the Second Circuit held that where the recipient charity was expressly and solely in control of the decision of when to sell, the donor's right to the gain had not sufficiently matured and the donor was therefore not liable for tax on the gain. The court found this to be true, even though the donor was a member of the donee charity's board of directors; because a trustee

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<sup>27</sup> Notice 2006-15, 2006-1 CB 501.

<sup>28</sup> See *Lucas v. Earl*, 281 U.S. 111, 8 A.F.T.R. (RIA) 10287 (1930).

<sup>29</sup> *Kinsey v. Comm'r.*, 477 F.2d 1058, 31 A.F.T.R. 2d (RIA) 73-1262 (2d Cir. 1973).

<sup>30</sup> *Salvatore v. Comm'r.*, 434 F.2d 600, 26 A.F.T.R. 2d (RIA) 70-5857 (2d Cir. 1970).

<sup>31</sup> *Jorgl v. Comm'r.*, 264 F.3d 1145, 88 A.F.T.R. 2d (RIA) 2001-5182 (11th Cir. 2001).

<sup>32</sup> *Greene v. United States*, 13 F.3d 577, 73 A.F.T.R. 2d (RIA) 94-746 (2d Cir. 1994).

other than the donor had control over the sale of assets contributed by the donor.

***Palmer v. Comm'r.***<sup>33</sup> The Tax Court ruled that a contribution of stock in a corporation to a private foundation, followed by the corporation's independent offer to redeem the stock, followed by the foundation's acceptance of the redemption offer did not violate the assignment of income doctrine. This was found to be true, even though the donor had voting control of both the corporation and the recipient private foundation. One key to the court's favorable ruling was that each decision made by the respective parties was arrived at independently of the other decisions (i.e., the decisions were not part of an integrated plan that would create grounds for a finding that a step transaction had occurred). The IRS issued Rev. Rul. 78-197 acquiescing to the outcome of the Palmer case stating:

The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

Where negotiations have already commenced prior to a charitable gift, prudence dictates that negotiations be halted, complete the gift, and then, resume negotiations by the new owners. Where the CRT is the controlling party after the transfer, the CRT trustee should control the negotiations (either directly or through a duly authorized agent). Where the CRT trustee is not the controlling party (e.g., in the case of a minority interest transfer), the CRT trustee should take care to exercise all appropriate rights and duties of ownership. In addition, it is generally prudent for an independent trustee<sup>34</sup> (or independent special trustee) to represent the CRT in all negotiations and the sale closing.

As a final note, a finding that there has been an Assignment of Income does not disqualify the charitable gift. For example, the CRT continues to be a validly created trust under state law, is still a tax-exempt entity under IRC §664, the contributed assets are still effectively removed (in most cases) from the donor's taxable estate and the donor still receives an income tax deduction.<sup>35</sup>

#### I. Intentional Interference with an Expected Inheritance

The Restatement (Second) Torts §744B (1979) recognizes the intentional interference with an expected inheritance as a valid tort. Nevertheless, 30 years later, the states remain split regarding whether or when they will recognize the

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<sup>33</sup> *Palmer v. Comm'r.*, 62 T.C. 684 (1974), *aff'd* on another issue, 523 F.2d 1308 (8th Cir. 1975).

<sup>34</sup> For the definition of an independent trustee, see IRC §674(c) and Treas. Reg. §1.664-1(a)(7).

<sup>35</sup> Arguably in this case, the deduction should properly be treated as a cash contribution. This will result in an enhanced deduction (higher AGI limitation) that can be used to partially offset the newly assigned income.

tort. Some states have rejected the tort outright. Most states appear to be leaning toward allowing the tort when another recognized cause of action is insufficient to correct the wrong.

Proponents of the tort claim that the tort is needed because a will contest, breach of trust, duress, or claim for undue influence will not make the plaintiff whole. For example, in In Re Estate of Ellis, 2009 WL 3471069 (Ill., 2009), the Illinois supreme court allowed the tort because a mere will contest would not provide sufficient relief to the plaintiffs since the core complaint was regarding assets transferred during the decedent's life.

Steps to Ensure Against the Tort Claim. While the law remains unsettled, it will be difficult to fully ensure against a claim for intentional interference with an expected inheritance. However, we do have options.

For example, if we are concerned about our client's capacity to sign an estate planning document, we can take steps ranging from asking the client to personally write the reasons they are making these distribution decisions, to video taping an interview of the client during the document signing event or even getting a diagnosis from a reputable mental professional. Any of those steps could also be used as supporting documentation against a claim of intentional interference with an expected inheritance.

### **Concluding Remarks**

The forgoing discussion highlighted some of the problem issues I have seen during 20 years of drafting, illustrating, reviewing and providing services to over 19,000 charitable remainder trusts. In my work with over 4,000 attorneys who represented clients for these CRTs, I have learned that it is far too easy to sit back and judge their work product. While it is easy to consider a wide range of alternative solutions after the plan is implemented, we all need to recognize that:

- Your best plan for a donor may differ considerably from the plan created by someone else
- Donors don't always (maybe rarely) act on the entire plan that was originally proposed
- Legitimate Professional Differences of Opinion are Okay