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CRT TRAPS ATTORNEYS MUST AVOID

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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

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A friend of mine used to recommend CRTs so often, that when her daughter was relating her troubles with a boyfriend, the daughter concluded by saying, “Mom, a CRT will not solve this problem.” While neither she nor I think that CRTs are the answer to every problem, I fully believe that, when used properly, CRTs are an important piece of both planned giving and estate planning. My goal in this paper is to discourage imprudent CRT planning by describing a few problems I have encountered in my travels while working with over 17,000 CRTs.

This paper is not intended to be a complete description of all the possible CRT problems. However, this paper will cover several traps in the Design, Drafting, Operation and Investment of CRTs.

I. Basic Background and Key Terms

A CRT is an irrevocable agreement in which a donor[1] transfers assets to a trust in exchange for an income interest[2]. The trust’s remainder interest is designated for the benefit of one or more charitable beneficiaries, including public charities, donor-advised funds and private foundations.

A. Types of CRTs

In order to qualify as a tax-exempt trust and provide the donor with an income tax deduction, the trust must specify that the income interest will be paid as a *fixed amount* (a **C**haritable **R**emainder ***A****nnuity* **T**rust or CRAT) or paid as a *fixed percentage* of the trust’s assets revalued annually (a **C**haritable **R**emainder ***U****ni****t****rust* or CRUT).

Within the unitrust format, there are three varieties:

- **S**tandard **C**haritable **R**emainder **U**ni**t**rust (SCRUT). As described above, a SCRUT must pay a *fixed percentage* of the trust’s assets revalued annually. Therefore, as the value of the trust’s assets rises and/or falls, payments to the trust beneficiaries will rise and fall.
- **N**et **I**ncome with **M**ake-up **C**haritable **R**emainder **U**ni**t**rust (NIMCRUT).[3] A NIMCRUT differs from a SCRUT in three key aspects. First, in determining the amount of the payments to the income beneficiaries, the trustee must compare the fixed percentage unitrust amount to the trust’s accounting

[1] For purposes of this paper, the terms donor and client will be used interchangeably.
[2] In some cases, the income interest may be designated to a person or persons other than the donor and the donor’s spouse. See below for a discussion of the gift tax implications of this choice.
[3] Technically, another variation is the **N**et **I**ncome **C**haritable **R**emainder **U**ni**t**rust (NICRUT). Note that this version has no make-up provision. In the author’s experience, most of the relatively few examples of this format were due to plan design and/or drafting errors. Nevertheless, valid uses of the NICRUT do exist.

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income[4] and pay the *lesser* of these two amounts to the current income beneficiaries.[5] Second, for each year that the trust's accounting income is less than the unitrust amount, the difference (or deficiency) is accumulated as an amount that might be "made up" (i.e., the "make-up amount") in future years.[6] Third, for each year, payments of the make-up amount *must* be made to the extent that the trust's accounting income in any year exceeds the fixed percentage unitrust amount.

- **Flip C**haritable **R**emainder **U**ni**t**rust (Flip-CRUT). The life cycle of a Flip-CRUT is generally characterized by two phases. In the initial phase, a Flip-CRUT acts like a NIMCRUT and only distributes the trust's accounting income to the income beneficiaries. In the second phase, following the occurrence of a predetermined triggering event,[7] the trust switches or "Flips," to a SCRUT and pays out a fixed percentage of the trust's annual fair market value. The change in the payout method commences on January 1st of the year following the triggering event. A charitable remainder trust can flip only once; and then, only from a NIMCRUT[8] form into a SCRUT form.

For example, if the triggering event is July 4, 2020, then the trust will act as a NIMCRUT until December 31 of 2020. It operates as a SCRUT starting the next year (January 1, 2021). Also, any NIMCRUT "make-up amount balance" that is not paid to the income beneficiary before the end of the year in which the triggering event occurs is "lost" forever when the trust becomes a SCRUT. [9]

See the enclosed tables for a summary of IRS statistics on CRTs. Based on these statistics, approximately 80% of all CRTs use the unitrust format. Note that the CRUT values include both Book Values and Market Values while the CRAT values include only Book Values because each type of trust reports slightly different numbers to the IRS.

[4] See IRC §643(b) for a definition of trust accounting income.
[5] See IRC §664(d)(3) and Treas. Reg. §1.664-3(a)(1)(i)(b).
[6] See IRC §664(d)(3) and Treas. Reg. §1.664-3(a)(1)(i)(b)(2).
[7] See Treas. Reg. §1.664-3(a)(1)(i)(d) for the permissible triggering events.
[8] Again, a NICRUT could be used during the initial phase of a Flip-CRUT instead of a NIMCRUT. See note 3 above.
[9] See Treas. Reg. §1.664-3(a)(1)(i)(c)(3). Note that the trustee could make a payment after the end of the year to the income beneficiary under the make-up provision rules, but only if such payment is with regard to the time when the CRT was governed by the NIMCRUT rules. For example, if the CRT converts to a SCRUT starting with the year 2010 and the CRT earns sufficient excess income during 2009, the CRT trustee must distribute such excess income to the income beneficiary. This is true even if the CRT trustee does not learn about the excess income until 2010.

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IRS CRT Statistics (for Tax Years 2002 through 2005)[10]

Money amounts are in thousands of dollars

	2005	2004	2003	2002
Number of CRUTs (all types)	94,767	94,779	93,329	91,371
Market Value of CRUTs	$96,835,553	$95,053,618	$89,573,997	$84,697,749
Book Value of CRUTs	$81,121,949	$79,845,710	$77,368,620	$81,564,412
Percentage of Total Number	81.65%	81.39%	80.49%	80.04%
Number of CRATs	21,296	21,667	22,626	22,783
Book Value of CRATs	$9,041,175	$9,540,935	$9,464,536	$9,596,835
Percentage of Total Number	18.35%	18.61%	19.51%	19.96%
TOTAL NUMBER OF CRTs	116,063	116,446	115,955	114,154
Total Book Value of CRTs	$90,163,124	$89,386,645	$86,833,156	$91,161,247

IRS CRT Statistics (for Tax Years 1998 through 2001)

Money amounts are in thousands of dollars

	2001	2000	1999	1998
Number of CRUTs (all types)	89,874	84,201	78,239	64,923
Market Value of CRUTs	$100,268,578	$88,462,299	$81,181,933	$64,304,568
Book Value of CRUTs	$84,282,040	$71,008,793	$67,208,886	$54,283,685
Percentage of Total Number	79.65%	78.79%	78.34%	76.33%
Number of CRATs	22,958	22,669	21,630	20,137
Book Value of CRATs	$10,177,555	$10,547,242	$9,706,993	$8,648,497
Percentage of Total Number	20.35%	21.21%	21.66%	23.67%
TOTAL NUMBER OF CRTs	112,832	106,870	99,869	85,060
Total Book Value of CRTs	$94,459,595	$81,556,035	$76,915,879	$62,932,182

B. How the CRT Works

In its most basic form, a charitable remainder trust consists of an arrangement between four parties: 1) a donor; 2) a trustee; 3) an income beneficiary; and 4) a

[10] Sources: Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2000-2001, "Charitable Remainder Trusts, 1998," Washington D.C. www.irs.gov/pub/irs-soi/98chrmtr.pdf; Internal Revenue Service, *Statistics of Income Bulletin*, Summer 2002, "Charitable Remainder Trusts, 1999," Washington D.C. www.irs.gov/pub/irs-soi/99chretr.pdf; Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2003, "Split-Interest Trusts, 2000," Washington D.C. www.irs.gov/pub/irs-soi/00spintr.pdf; Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2003-2004, "Split-Interest Trusts, 2001," Washington D.C. www.irs.gov/pub/irs-soi/01trust.pdf; Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2004-2005, "Split-Interest Trusts, 2002," Washington D.C. www.irs.gov/pub/irs-soi/02eorust.pdf; Internal Revenue Service, *Statistics of Income Bulletin*, Spring 2006, "Split-Interest Trusts, Filing Year 2004," Washington D.C. www.irs.gov/pub/irs-soi/04spintr.pdf; Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2006-2007, "Split-Interest Trusts, Filing Year 2005," Washington D.C. www.irs.gov/pub/irs-soi/05spintr.pdf; and Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2008, "Split-Interest Trusts, Filing Year 2006," Washington D.C. www.irs.gov/pub/irs-soi/06sptrust.pdf.

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charitable remainder beneficiary. While all four parties can be separate entities, it is possible for the donor, trustee and income beneficiary to be the same person. It is also possible for the charitable remainder beneficiary to serve as the trustee. The donor enters into a trust agreement with the trustee to transfer certain assets to be managed and maintained by the trustee. In accepting the assets, the trustee agrees to pay from the trust's assets an income stream to one or more designated income beneficiaries for a specified period of time. At the expiration of the trust term, the trustee delivers the remaining trust assets to the charitable remainder beneficiary. From 1969 through December 31, 2006, the CRT's tax-exempt status was preserved so long as the CRT did not produce "unrelated business taxable income."[11] As discussed elsewhere in this paper, the interplay between UBI and CRTs changed on January 1, 2007.

The Donor. Any individual, corporation, partnership, LLC or trust can be a donor. An individual donor can create a CRT during life or at death. Transfers to a CRT may qualify for a charitable deduction for income, gift, estate and generation-skipping transfer (GST) taxes.

The Trustee. The CRT trustee may be an individual or an institution such as a bank or charity. The donor may serve as trustee[12] 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 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.

The Income Beneficiary. At least one CRT income beneficiary must be a person[13], which includes individuals, corporations, partnerships, LLCs or trusts. Typically, the donor and the donor's spouse will be named as the only income beneficiaries for their joint lifetimes. In this case, the transfer to the CRT effectively removes the contributed asset and all growth in value of the asset from each donor's taxable estate.

Alternatively, the donor may elect to include one or more charities as co-income beneficiaries.[14, 15] This may be desirable when the donor wishes to currently benefit the charity or lower the payout below the 5% minimum payout rate permitted.

Occasionally, CRTs are established for a beneficiary other than the donor and the donor's spouse. Designing such a CRT creates significant gift, estate and/or GST tax ramifications that are discussed more fully below.

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[11] See IRC §664(c) and §§511 through 514.
[12] See Rev. Rul. 77-285.
[13] See IRC §7701(a)(1).
[14] See PLR 200108035 for a discussion of the issues surrounding naming a charity as a CRT income beneficiary.
[15] If a charity is named as an income beneficiary, then the application of IRC §§4943 (excess business holdings) and 4944 (jeopardizing investments) must be required by either the trust's governing instrument or state law. IRC §4947(b)(3).

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The Charitable Remainder Beneficiary. The charitable remainder interest in a CRT may benefit a public charity (e.g., alma mater, a religious institution, United Way, etc.) or a privately-controlled charity (e.g., a private foundation). A third possibility is to split the remainder interest among several charities such as "2/3 to my alma mater and 1/3 to my private foundation." In many CRTs, donors retain the power to change the charitable remainder beneficiaries. Naming the initial charitable remainder beneficiaries and retaining the power to change the charitable remainder beneficiaries should be guided by the donor's charitable goals.

The Heirs. Often the seemingly neglected fifth party to a CRT transaction is the donor's heirs. Because most CRTs are created for the benefit of the donor and the donor's spouse, heirs are left out of the equation without additional planning. This neglect can be, and often is, easily remedied by purchasing life insurance within an Irrevocable Life Insurance Trust (ILIT) to replace the assets transferred to the CRT.

C. Benefits to Donors

CRTs are flexible enough to solve a myriad of donor charitable, financial and non-financial problems. A best practice is to use a CRT to accomplish multiple donor goals. For example, CRTs can:

- Increase cash flow
- Avoid capital gain taxes
- Reduce income, gift and/or estate taxes
- Plan the donor's estate
- Transfer money to heirs
- Maximize charitable giving
- Diversify concentrated stock or other illiquid assets
- Preserve wealth for the family

Much of the power behind the CRT is based on its tax-exempt status and irrevocable nature. CRTs can be funded with a variety of assets including stocks, bonds, mutual funds, restricted securities, exchange funds, real estate in various forms, partnership interests, limited liability companies (LLCs), C-corporations, art and other tangible property. When combined with an ILIT, the CRT can solve many of your donor's noncharitable problems within a charitable context.

A CRT can enable donors to realize charitable goals that seem beyond their reach. For example, making a current gift to endow a chair in the donors' name at their *alma mater* may be infeasible, but by utilizing a CRT, this goal can be brought within the donors' grasp.

Often the same or multiple CRTs can be used again and again to address a donor's charitable, financial and non-financial goals.

D. Benefits to Charities

CRTs are a bread-and-butter workhorse of any full-service planned giving program. The most obvious benefit for the charity is the charitable remainder distribution after the noncharitable term expires. Other benefits include enhanced donor relations (with the prospect of other current gifts), possible income

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beneficiary opportunities, testimonials, creating opportunities to engage donors with new and exciting programs, etc.

E. Brief Observations on Gifts of Selected Assets

Obviously, some assets work more compatibly with a CRT than others. For example, cash and publicly traded assets (that can be freely traded) work extremely well both as a gift to a CRT and as an investment by a CRT. On the other hand, gifts of real estate, partnership interests, LLCs and C-corporations require a much greater analysis and may ultimately be a poor choice of asset as either a gift to or investment by a CRT. Thoughtful analysis should always include a review of whether the asset is encumbered by debt. In the case of partnerships and LLCs, their pass-through nature requires the attorney to review the debt characteristics inside the business as well as the actual business operations. Any debt on the asset given will reduce the client's income tax deduction, cause recognition of income due to the transfer, potentially make the CRT owed unexpected taxes and potentially turn the trust into a grantor trust. The same concern holds true for debt or certain business operations that occur within a partnership or LLC.

It is important to recognize that a gift of S-corporation stock will immediately terminate the subchapter S status of the S-corporation because a CRT is not an eligible shareholder under IRC §1361(c). Nevertheless, some clients who own S-corporations do create CRTs. Most commonly, the S-corporation will create the CRT and fund it with assets the corporation is ready to sell for a capital gain. In such a situation, the S-corporation is typically named as the income beneficiary, which means the noncharitable term is limited to a term that cannot exceed 20 years. Another rare possibility is for shareholder clients to transfer stock in the corporation to a CRT. For situations when this makes sense, I always recommend that the S-corporation's board vote affirmatively to terminate the S status *before transferring* stock to the CRT. At the very least, the board will be forced to consider the ramifications of terminating the S-election as opposed to an automatic, inadvertent termination that would occur if a shareholder simply transferred stock of an S-corporation to an ineligible shareholder. As a final note on this topic, CRTs cannot qualify as either a Qualified Subchapter S Trust (QSST) under IRC §1361(d) or an Electing Small Business Trust (ESBT) under IRC §1361(e).

Gifts of restricted securities create another set of concerns. While securities can be subject to a myriad of restrictions, they typically involve some restriction on the transfer of title to the securities. In some cases, the restriction will expire a certain number of months after an initial public offering. In other cases, the restriction simply requires the shareholder to disclose any transfers. In other cases, the restriction does not limit a transfer but does limit the overall number of shares that can be traded in a certain timeframe. As a result, the type of restriction must be reviewed carefully before contributing (or considering a contribution of) these assets.

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Another possibility is employee options. There are two basic types of employee options. Qualified options (also called Incentive Stock Options or ISOs) require the holder to meet several tests. While an in-depth discussion of ISO planning is beyond the scope of this article, one of the tests to retain ISO status is that the shareholder/employee may not transfer the shares until more than one (1) year after the option is exercised. Also, the exercise of an ISO option creates Alternative Minimum Tax. This is a tax on phantom cash flow since cash is not actually generated when an ISO option is exercised. One strategy for working with ISOs is to exercise the option early in the tax year. If the share price drops after exercising the option, the employee can dispose of the stock near the end of the year in a disqualifying disposition. If the disposition is during the same year as the exercise, then the AMT issue is retained in the same tax year and may be eliminated. On the other hand, if the employee exercises the option near the end of the year, it will be harder for the employee to determine whether to purposefully disqualify the ISO status via an early disposition.

Assuming the employee has not disqualified the ISO status of the shares, then a transfer of the shares to a CRT (after various holding periods are met including waiting more than one (1) year after the ISO option exercise date) can provide considerable benefit to the client. These benefits are the same as for most other gifts of long-term capital gain assets including being eligible to claim an income tax charitable deduction, making a charitable gift, deferring capital gain taxation and providing a lifetime cash flow.

Gifts of art and other tangible property to a CRT involve additional considerations which were recently made more difficult with the signing of the American Jobs Creation Act on October 22, 2004. Generally, the income tax deduction for such gifts is limited to the client's cost basis in the property. Additionally, each piece of art or tangible property may require special handling while the CRT owns it such as insurance, shipping costs, temperature controlled rooms, etc. The expenses associated with such special handling may outweigh the benefits of giving it to the CRT.

II. Traps in CRT Design

The CRT Design phase is where the discussions about the shape of the CRT start to form. Typically, the donor has had some initial discussions with advisors or reviewed written materials on CRTs. Further, the client has already decided that she is interested in learning more about a CRT.

For many donors and advisors, this phase is formally entered into by preparing or reviewing a numbers illustration. For more information about illustration software, the reader is directed to several long-time exhibitors at the National Conference on Planned Giving including Crescendo, PG Calc and PhilanthroTec. A sampling of additional providers of CRT illustration software includes CharitablePlanning.com, NumberCruncher, Tiger Tables and zCalc.

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Company	Website
Crescendo	www.crescendointeractive.com
PG Calc	www.pgcalc.com
PhilanthroTec	www.ptec.com
Charitable Planning	www.CharitablePlanning.com
NumberCruncher	www.leimberg.com
Tiger Tables	www.tigertables.com/
zCalc	www.fasttax.thomson.com/zcalc_estateplanning.asp

The three biggest problems I tend to see in illustrations are: investment return assumptions; using outdated tax rates; and not addressing transfer taxes at all. To a lesser extent, I also see use of the wrong AFR. A similar concern is illustrations that use the wrong mortality table to calculate the life expectancy factors. The IRS is required to update these tables every 10 years, which means the IRS must publish the next update before May 2009.

A. *Investment Return Assumptions*. The most common trap in the sphere of investment return assumptions is illustrating a single rate of return that is excessively high compared to what would reasonably be available given the time horizon of the CRT as well as the risk tolerance of all the CRT beneficiaries.

As a simple example of how recent investment experience changes the client's mindset, I still remember when a financial advisor scheduled a telephone call with me in Spring 1999 to discuss charitable planning options for one of his clients. The advisor's assistant subsequently postponed the call. I learned later that the planner had to take an emergency call from a client who was angry that her portfolio only returned 42% during the previous year instead of the 45% return she saw on a competitor mutual fund's website.

Another example is that during the go-go days of the mid- to late- 1990s, many CRT illustrations used average investment returns of 12 to 15% even though the long-term return on common stocks has averaged 8 to 10 percent annually over the past 70 years.

However, most CRTs will invest in more than just common stocks. Many CRTs also invest in bonds as well as hold a portion of its assets in cash or a money market. Therefore, it makes sense to illustrate a blended rate that encompasses the various asset classes in which the trust is likely to invest.

However, we know that no investment portfolio will experience the same investment return each and every year that it exists. Some people resolve this issue in illustrations by providing multiple illustrations: one version uses a low investment return rate such as three percent; a second might include a middle average return such eight percent; a third illustration would use a high return rate.

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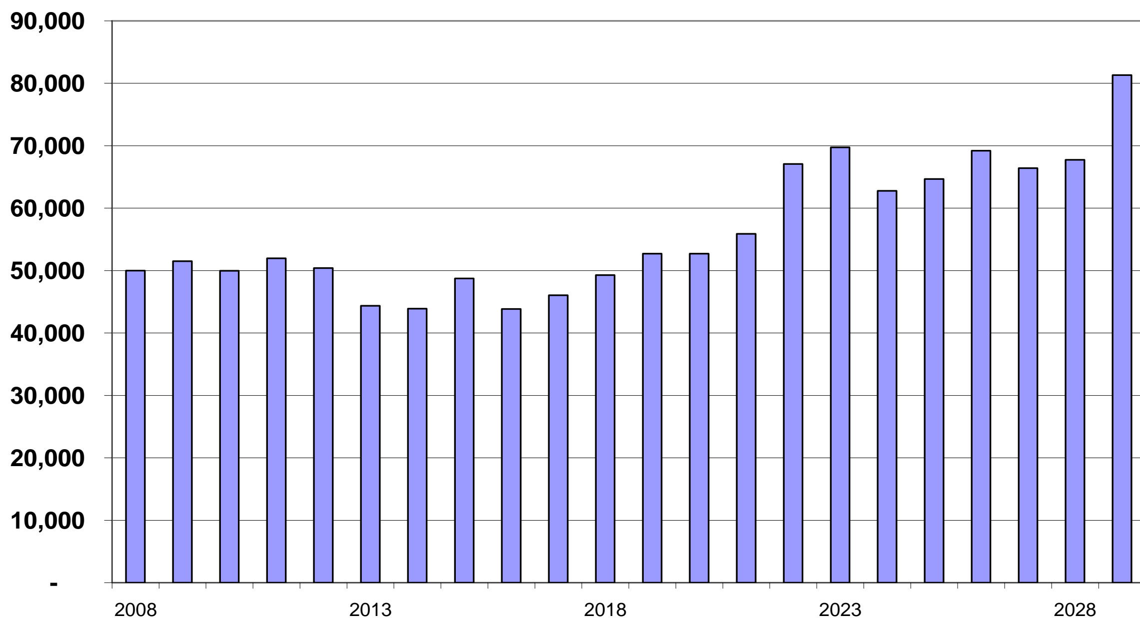
Does this really solve the problem? Each of us is (perhaps painfully) aware of portfolios that experienced negative rates of return particularly during the early years of this century. Another possibility is to include more than one investment return in each illustration. Many of the CRT illustration software programs permit multiple investment return rates in the illustration. For example, the program can illustrate a 7% return in year 1; 12% in year 2; -4% in year 3; etc. See the sample chart for a charitable remainder unitrust with a varying investment return.

B. *Select the Appropriate Payout Rate.* When selecting the payout rate for a CRT, it is important to keep several key points in mind. First, the annual payout rate of all CRTs must be between 5% and 50%. Second, the payout rate is an integral part of the calculation of the actuarial present value of the remainder interest (APVRI).[16] Since July 29, 1997, the APVRI for qualified transfers to all CRTs must be 10% or greater[17] of the fair market value of the asset transferred. This



requirement also applies to additional contributions to all unitrusts.[18] Third, the payout rate selected should take into account the income beneficiary's current and future cash flow requirements. A payout rate greater than the actual investment return will cause unitrust payments to decrease with time. Fourth, the higher the payout rate, the lower the income tax deduction. Note that for the same

[16] The payout rate is a key factor in determining if a CRAT will pass the 5% probability test of Rev. Rul. 77-374.
[17] See IRC §§664(d)(1)(D) and 664(d)(2)(D).
[18] CRUTs may be drafted to permit additional contributions, but CRATS may not.

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payout rate, the deduction allowed for a SCRUT is equal to the deduction allowed for a NIMCRUT or Flip-CRUT. This is true despite the fact that the actual charitable remainder of a SCRUT will *typically* be less than the actual charitable remainder of a NIMCRUT.

C. *Match the CRT Format to the Income Beneficiary's Needs*. The range of payout rates that satisfies all the requirements for qualification is only the jumping off point in designing the CRT. The CRT format selected has a significant impact on the amount and regularity of the income beneficiary payments. For example, if the SCRUT format is selected, the annual payments will vary in amount as the trust value fluctuates, but must be made regardless of trust's income. If the NIMCRUT format is selected, the annual payments will vary in amount as the trust value and income fluctuate and may be nonexistent during one or more years if the trust does not generate accounting income during the year in question.

If the CRAT format is selected, payments of the same amount will occur like clockwork until the earlier of the end of the noncharitable interest or when the CRAT runs out of assets. For older income beneficiaries, this level payment stream is attractive, but the longer the trust term the less purchasing power available with each payment. If the SCRUT format is selected, then it is possible for payments to increase each year—thereby keeping pace with inflation.[19] If the NIMCRUT or Flip-CRUT format is selected, then it is possible to create an accumulation phase followed by a distribution phase. This scenario might benefit a younger beneficiary who wishes to postpone income until retirement.

D. *Match the CRT Term to the Income Beneficiary's Needs*. The trust term may be for a fixed period of time up to 20 years or, where the income beneficiaries are individuals, the term may last for their lives so long as all are living at the time of funding. The most common use of a term interest is when an entity (e.g., LLC,[20] S-Corporation,[21] C-Corporation,[22] Partnership,[23] Trust, etc.) is the income beneficiary. Two other uses of a fixed term are when the donor wishes to benefit a class of beneficiaries (e.g., "my grandchildren") all of whom may not be yet living, when the income stream is intended to fund a specific purpose for a limited time (e.g., pay college expenses or underwrite a mortgage payment). Another variation is to combine a life interest with a term interest using one of the limited number of permissible combinations of lives and terms.[24]

E. *Match the CRT Format to the Contemplated Contribution Asset*. Some assets cannot be sold due to imposed restrictions; other assets cannot be sold for a reasonable price due to market conditions. If such an asset is transferred to a CRT, then the trust could have considerable difficulty in making a required distribution. If the asset is owned by a CRT that does require a distribution each year based on value (e.g., a CRAT or SCRUT) and if the CRT does not produce

[19] For this to occur, the spread between the payout rate and the net investment return must exceed the inflation rate.
[20] See PLRs 199952071 and 9419021.
[21] See PLRs 9340043 and 200644013.
[22] See PLRs 8102093 and 9205031.
[23] See PLR 9419021.
[24] See Treas. Reg. §§1.664-2(a)(5) and 1.664-3(a)(5).

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sufficient cash flow to make the distribution, then the CRT will need to make the distribution by transferring some assets via an in-kind distribution. Such a distribution requires an appraisal of the asset transferred (which might require a minority or lack of marketability discount valuation). Additionally, an in-kind transfer to the income beneficiary is treated for income tax purposes as though the CRT sold that asset. In most circumstances, this means the income beneficiary will owe capital gain tax on the distribution even though she did not receive payment in liquid assets.

One solution to this particular problem is to ensure that sufficient other liquid assets are held by the CRT. This can be accomplished by transferring the other liquid assets at the same time as the contribution of the illiquid asset. In the case of a SCRUT, the liquid assets could be contributed later in the taxable year and/or in a subsequent year.

A better solution for most clients when there is a possible danger that the asset won't be sold in time to make the distribution is to design the CRT using either a NIMCRUT or Flip-CRUT format. Either one of these CRT formats requires the CRT to make distributions based on a more flexible standard of the lesser of the fixed percentage unitrust amount or the trust's accounting income. Because illiquid assets typically produce minimal accounting income, this likely means the required distribution will be mirrored by the actual net cash flow. For clients seeking a more dependable cash flow after the CRT no longer owns an illiquid asset, the Flip-CRUT version is recommended.

F. *Match the CRT Format to the Charity's Needs*. Because CRATs and SCRUTs must make their income beneficiary payments regardless of the level of trust accounting income, there is a greater probability that the charity's interest will be reduced to make those payments. CRAT payout rates that exceed the actual investment return will not only result in a reduced remainder to the charity, but also create the potential that the trust will run out of money. CRUT payout rates that exceed the actual investment return will result in declining income payments to the income beneficiaries as well as a reduced remainder to the charity. Extended bear markets, such as that of the last few years, bring this problem to light. In the author's experience, the highest donor and charity satisfaction seems to come from CRTs with payout ranges between 5 and 7 percent.

Conversely, because NIMCRUT income beneficiary payments are limited to trust accounting income, there is a greater probability that the charity's interest will not be reduced because of distributions to the income recipients. The same can be said for the early years of a Flip-CRUT with a delayed trigger.

G. *Consider the Danger of a Step-Transaction.*[25] In the CRT context, step-transactions or assignments of income occur when the client transfers an asset to the CRT after an enforceable deal has already been struck for the sale of the asset. If this occurs, the client is treated as making the sale and is therefore responsible for the capital gain tax created by the sale. This is true even if the

[25] For an excellent overview of this topic, see Kallina, Emanuel and Temple, Philip, How Far Is Too Far?, posted June 1, 1998 on Planned Giving Design Center at www.pgdc.com/pgdc/article/1999/07/how-far-too-far.

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actual sales proceeds were transferred directly to the CRT instead of the client. The following two key questions should help in the analysis of potential step-transaction situations:

- Is the CRT required to sell to a particular party for particular terms when the CRT is funded?
- Was the transfer made to the CRT too close to the eventual sale by the CRT?

It is a basic principle of federal income tax law that income is taxed to the taxpayer who earns it, regardless of whether or not the taxpayer chooses to divert the receipt of such income to a third party (such as a CRT because a CRT is generally not a grantor trust). The courts have consistently held that such transfers are considered an anticipatory assignment of income.[26] On the other hand, if the CRT was not obligated to sell the asset when it was given to the CRT, then no step-transaction would occur.[27]

H. *Anticipate Selling Expenses and Carrying Costs.* The sale of an unmarketable asset often entails considerable work and therefore a hefty commission can be expected. When considering the financial benefits of a CRT, it is easy to think of the entire asset. However, if a 10 or 15 per cent commission will be charged to sell the asset, then the overall dollar value that actually remains in the CRT to produce a lifetime cash flow for the client must be considered when creating or reviewing any cash flow illustrations. A similar drop in value could occur due to changes in the market for the asset or due to excessive carrying costs that are not offset by cash flows from this or other assets owned by the CRT.

I. *Watch out of Self-Dealing Transactions*. IRC §4947(a)(2) prohibits CRTs from engaging in self-dealing transactions with disqualified persons. In general, a disqualified person includes the donor, the donor's family, the trustee, the trustee's family and each business entity in which these parties hold a greater than 35% interest. Self-dealing transactions include purchases, sales, leases, loans, excess compensation and use of trust property. Several exceptions apply.

Some common examples of prohibited activities include:

- The donor continuing to reside in a home she has transferred to a CRT;
- The donor's child purchasing property from the CRT; and
- The trustee's making a loan from the CRT to a business enterprise he owns and operates.

When it comes to self-dealing, it is sometimes too easy to rely on simply checking the names of the parties on both sides of the transaction. The danger with that

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[26] See Francine Schuster v. Comm., Doc. No. 20396-82, 84 TC --, No. 51, 84 TC 764, (Filed April 29, 1985); Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940), 1940-2 C.B. 206; Helvering v. Eubank, 311 U.S. 122 (1940), 1940-2 C.B. 209; Allen Leavell v. Comm., (January 30, 1995) Doc. No. 29996-91., 104 TC 140; Rev. Rul. 77-290, 1977-2 C.B. 26; and Private Letter Ruling 8624007.

[27] See Gerald A. Rauenhorst, et ux. v. Commissioner; 119 T.C. No. 9; No. 1982-00 (7 Oct 2002); Palmer v. Commissioner, 62 T.C. 684 (1974), and Revenue Ruling 78-197, 1978-1 C.B. 83.

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strategy is that the names, while helpful, are not the important consideration. The key question is whether the party that engages in the transaction with the CRT is a disqualified person with respect to that CRT. In addition to the donor and trustee, certain members of these persons' families are also disqualified persons. These members include:

- A spouse;
- Ancestors;
- Children, grandchildren and great-grandchildren; and
- Spouses of children, grandchildren and great-grandchildren [28].

A legally adopted child is treated the same as a child by blood[29]. The implication is that step-children and foster children who are not legally adopted are not considered disqualified persons under this rule.

> Example: Rhonda establishes a charitable remainder unitrust (the Help Me Family CRUT) naming herself as trustee. Rhonda funds the Help Me Family CRUT with 75% of the outstanding stock of Help Me Corp. As trustee, Rhonda subsequently sells the stock to two other parties:
>
> - Brian, Rhonda's brother, and
> - Steve and Joy Ride, Rhonda's son and daughter-in-law.
>
> Rhonda (as the foundation manager), Steve Ride (as Rhonda's child), and Joy Ride (as the spouse of Rhonda's child) are all disqualified persons with respect to the Help Me Family CRUT. Brian, on the other hand, is not a disqualified person, because his only relationship to the CRUT is that he is Rhonda's brother.

J. *Consider the Danger of Unrelated Business Taxable Income*. Certain types of assets are unsuitable for transfer to or investment by a CRT because they produce Unrelated Business Taxable Income (UBTI). Common examples of UBTI-producing assets include:

- An interest in an active trade or business (regardless of whether it is classified as a sole proprietorship, a general partnership interest, a limited partnership interest or an interest in an LLC taxed as a partnership);
- A working interest in an oil and gas well; and
- Unrelated debt-financed income created by trading on margin or other borrowing.

As noted elsewhere, the rules changed for tax years beginning January 1, 2007 for CRTs that generate UBTI. On December 20, 2006, President Bush signed the Tax Relief and Health Care Act of 2006 ("TRHCA") into law. Buried in TRHCA is a short provision that significantly alters the tax treatment of unrelated business taxable income received by a CRT for tax years ending after December 31, 2006.

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[28] IRC §4946(d) and Treas. Reg. §53.4946-1(h). Note there is a discrepancy between the language of IRC §4946(d) and Treas. Reg. §53.4946-1(h) that dates to 1984 when IRC §4946(d) was amended to read as above by the Deficit Reduction Act of 1984. Prior to January 1, 1985, the IRC included all lineal descendants and their spouses.

[29] Treas. Reg. §53.4946-1(h).

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The new statute radically altered UBTI treatment within a CRT. Under new IRC §664(c), CRTs will now pay an excise tax equal to 100% of the UBTI amount, rather than lose its exempt status. Depending upon the facts and circumstances, this may make a significant difference in the outcome. Instead of potentially exposing all of the trust's taxable income to tax, it is now possible that only a portion will be subject to tax.

> Example: Under new IRC §664(c), On February 10, 2008, Stan Jackson funded a charitable remainder trust with $600,000 of appreciated securities with a basis of $125,000. The trustee liquidated the securities on February 14, 2008 for $625,000, realizing a long-term capital gain of $500,000. The trustee then invested $100,000 of the proceeds in a real estate investment partnership and the balance in a diversified portfolio of stocks and bonds. The trustee made the real estate investment because she wanted to follow modern asset allocation theory. During the year, the CRT received $20,000 of dividends, interest and partnership distributions—all of which was distributable to Stan under the terms of the trust. At the end of the year, the real estate investment partnership's Schedule K-1 disclosed that the CRT's allocable share of the partnership income was $2,500, all of which was unrelated business taxable income.

As a result of receiving $2,500 UBTI from the partnership, Stan's CRT owes an excise tax of $2,500—100% of the UBTI amount. Under the new law, the UBTI penalty of $2,500 is directly proportional to the infraction.

K. *Consider the Grantor Trust Rules.* While a CRT is generally exempt from the grantor trust rules,[30] the improper operation of a CRT can result in the application of one or more of the grantor trust rules. Two ways that a CRT can afoul of the grantor trust rules are using the CRT's income or assets (in excess of the guaranteed annuity or unitrust amount) either for the benefit of a grantor or to pay life insurance premiums on a policy on the life of the donor or donor's spouse that is not owned by the CRT[31]. For example, if, in addition to paying the guaranteed annuity or unitrust amount, the CRT makes a grantor's mortgage payment, then the CRT would be treated as a grantor trust. Note that the payment of a grantor's obligation would also create a self-dealing problem.

III. Traps in CRT Drafting

A. *Ensure the Document Drafted Supports the Plan Design.* It is important to remember that a 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. Or, 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.[32] This is an even greater danger when the attorney engaged to draft the CRT governing instrument was not involved in the entire planning process.

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[30] See IRC §664(a) and Treas. Reg. §1.664-1(a)(4).
[31] See IRC §677(a)(3).
[32] See Treasury Regulations §§1.664-2(a)(4) and 1.664-3(a)(4).

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B. *Beware of Using Generic Form Documents.* Numerous sample CRT documents are available from a variety of sources. Most books of trust forms have one or more samples—many based on the IRS sample documents. 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.

The IRS first published a series of sample CRT documents in 1989 and 1990. They updated the CRAT versions in August 2003 and the CRUT versions in August 2005. The 2003 and 2005 versions supersede and replace the earlier versions. While the current versions of the IRS sample forms are far more robust than their predecessors, their improper use can still create traps for the unwary.

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. The author has 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;
- 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.

Twenty-Six Reasons Not to Use the IRS Sample Trust Forms.

Although the following is a summary of 26 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:

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1) No mention is made of the Spousal Waiver described in Revenue Procedure 2005-24[33].

2) Independent Special Trustee language is missing.

3) 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.**

4) The language for a qualified appraisal versus using an Independent Trustee's valuation is missing from the CRAT versions.

5) The provision for an acceleration of the remainder interest to charity is missing from the CRAT versions.

6) Successor Trustee provisions are missing.

7) Trustee removal provisions are missing.

8) The savings clause for the 10% Remainder Interest Test for the initial gift is missing.

9) The savings clause for the 10% Remainder Interest Test automatically severs the additional gift.

10) A savings clause for the 5% Probability Test is missing in the CRATs.

11) A savings clause for the minimum 5% and maximum 50% Unitrust or Annuity Amount is missing.

12) Reckless inclusion of a sprinkle clause is now much easier.

13) 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.

14) 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.

15) Change of situs language is missing.

16) There is no spendthrift clause.

17) Provisions to have the trust created by anyone other than individuals are missing. Corporations, LLCs and partnerships may create CRTs.

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[33] 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.

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18) No provision for Capital Gains = Income for years when the CRT has unrelated business income.

19) Lack of Authority to Not Diversify Assets.

20) No Qualified Domestic Trust provisions.

21) Ancillary Trustee provisions are missing.

22) Authority to pledge assets as collateral for another's loan to charity is missing.

23) Permissible combinations of lifetime and term of years CRTs are missing.

24) The definition of "incompetency" is missing. The trusts contain no provisions instructing the trustee how to make distributions to an incompetent beneficiary.

25) 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.

26) 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.

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.

CRTs that are designed without a high degree of administrative flexibility and versatility can lead to unhappy clients. However, adding unnecessary and overly complex "bells and whistles" to a CRT can also be a mistake. The best CRT documents strike a balance between simplicity and complexity and always address the unique financial, estate and philanthropic plans and purposes of your clients.

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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The definition of trust accounting income is a function of the language of the trust's governing instrument and the principal and income statute[34] 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.[35]

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. Gift, Estate and GST Tax Considerations

General Comments. A charitable remainder trust should not pay the transfer tax of the donor. In addition to creating potential self-dealing issues, the payment of 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.

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 $12,000 or less.[36] To the extent that the gift is greater than $12,000, then the donor's lifetime gift tax applicable exclusion amount is reduced or gift tax is due.[37]

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 planning technique, it does produce a challenging gift tax result. The inclusion of a

[34] See 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.

[35] 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].

[36] 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 and will remain there for gifts through 2008. This number is highly likely to increase to $13,000 for gifts during and after 2008.

[37] 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.

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non-spousal recipient nullifies any gift tax marital deduction for the spouse's interest.[38] 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[39] 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.[40] 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.[41] 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 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 changing estate, gift and generation skipping transfer tax applicable exclusion amounts and tax rates created by the Economic Growth and Tax Relief Reconciliation Act of 2001.

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[38] IRC §2523(g)

[39] The IRS issued Final Treasury Regulation §20.2036-1 effective on July 14, 2008.

[40] 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.

[41] See IRC §2056(b)(8).

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Table 3-1. Gift, Estate and GST Tax Rates and Exclusion Amounts					
Year	**Highest Estate and GST Tax Rate**	**Estate Tax Applicable Exclusion Amount**	**GST Exemption Amount**	**Maximum Gift Tax Rate**	**Gift Tax Applicable Exclusion Amount**
2008	45%	$2,000,000	$2,000,000	45%	$1,000,000
2009	45%	$3,500,000	$3,500,000	45%	$1,000,000
2010	N.A – Repealed	N/A – Repealed	N/A – Repealed	35% (Top Marginal Income Tax Rate)	$1,000,000
2011+	55%	$1,000,000	$1,000,000*	55%	$1,000,000

- * Actual number determined by index.

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[42] 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. Table 3-1 above summarizes the current GST tax rates and exemption amounts through 2011. Assuming no further legislative changes (a big if!!!), the sunset provision of EGTRRA will cause the GSTT rules to revert to the pre-June 2001 system. At that time, the GST exemption amount will presumably reflect the inflation adjustments for the years 2004-2010.

E. *Spousal Election*. On April 18, 2005, the IRS issued Revenue Procedure 2005-24 which brought to light an issue which few people previously considered.

As noted above, CRTs created during the donor's lifetime will be included in the donor's gross estate when she dies if the donor retained certain interests in, or powers over, the trust. These powers include any of the following: a retained lifetime interest in the trust such as the right to the unitrust or annuity payments, the power to change the charity or the power to revoke a surviving noncharitable interest by will. Some commentators also believe that the mere power to remove or change a trustee would be sufficient to include the CRT's FMV in her estate. For most estates and most CRTs, the estate inclusion does not mean that the CRT will be included in the donor's taxable estate. This is because the great majority of CRTs either name only one noncharitable income beneficiary (i.e., the donor) or name the donor and the donor's spouse as the only two noncharitable

[42] See IRC §2613 for the definition of a skip person.

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income beneficiaries. When the donor's spouse is the only surviving noncharitable income beneficiary, the donor's estate receives a *charitable deduction*[43] for the present value of the remainder interest and a *marital deduction*[44] for the present value of the income interest. These two interests effectively eliminate the entire value of the CRT from the donor's taxable estate.

Before we get too deeply into the spousal election issue, there is one more key CRT requirement that is so basic that it is easily overlooked. CRTs are prohibited from using their assets for purposes other than making a payment to the income beneficiary (i.e., the proper unitrust or annuity amount), making a payment to the charitable remainder beneficiary and making a payment for which the CRT receives full and adequate consideration. An example of the last item would be a reasonable payment for trustee, administrative, legal or investments services.[45]

Let's step back and review a short history of the spousal election laws. Americans are generally able to freely control their assets and make gifts to charities and other heirs in any amount they wish. However, state governments decided long ago as a matter of policy that marriage is an important institution that should be protected and supported. One result is that decedent spouses should not be able to disinherit their surviving spouse.

> Example: If Steve died and left his entire $6,000,000 estate to the Regular Charitable Foundation (RCF), this could mean that Ashley, his surviving spouse, would be destitute. By exercising her spousal election, Ashley could claim one-third of the $6,000,000 estate, which would mean that she receives $2,000,000 and RCF receives the remaining $4,000,000.

The spousal election refers to the power a surviving spouse has under state law to elect to disregard the decedent spouse's estate plan. In exchange, the surviving spouse is paid a percentage of the decedent's estate. When a surviving spouse makes this election, it tends to disrupt the existing estate plan.

Although the percentage of the estate paid to the surviving spouse varies from state to state, typically, this percentage is either one-third or one-half. The real question for purposes of our discussion is "One-third of what?" The states have different ways of answering this question. For decades, most states determined that the spousal election applied exclusively to the items directly owned by the decedent spouse when she died. As estate planning solutions grew more complex with the addition of various types of trusts and contracts such as IRAs and life insurance policies, some states changed their philosophy regarding how much of the decedent's estate to which the spousal election applied. Some states consciously adopted an "augmented estate" approach in which the spousal election applied to all assets in the decedent's gross estate. The assets in the augmented estate included IRAs, life insurance contracts and trusts in which the

[43] See IRC §2055(a).
[44] See IRC §2056(b)(8).
[45] See Treas. Reg. §1.644-2(a)(4) and Treas. Reg. §1.644-3(a)(4).

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decedent retained certain powers. The spousal election applied to these assets even if for example, the spouse was not a beneficiary listed in the trust document.

By now, it should be clear that if our donor, Steve, created a CRT during his life, the CRT will be included in Steve's gross estate. If Steve died in an "augmented estate" state that extends the spousal election to include Steve's CRT, and if Ashley exercised the spousal election, then assets from the CRT could potentially be paid to Ashley even though she is clearly not the charitable beneficiary. Further, the payment to Ashley would not be a qualifying unitrust or annuity amount; nor would the payment be made for full and adequate consideration. Therefore, the payment to Ashley would violate the Treasury Regulation and disqualify the CRT. One result would be that Steve's estate would not receive a estate tax charitable deduction for the charitable remainder interest in the disqualified CRT that passes to the charity, RCF. By the way, self-dealing penalties would also apply because Ashley is a disqualified person[46].

The IRS further stated in Revenue Procedure 2005-24 that the mere possibility of the spousal election means the CRT was never qualified as a CRT. This means that every tax return filed by the CRT for the past several years was an incorrect filing. In other words, the trust never filed a correct return. Also, the income tax charitable deduction that Steve claimed for funding the CRT was improper. Furthermore, the CRT was not a tax-exempt trust; nor was it subject to the troublesome four-tier accounting rules.

The IRS offered possible solutions[47] to this disastrous problem by providing a safe harbor for CRTs from the danger of a decedent's spouse electing to claim assets of the CRT. First, CRTs created before June 28, 2005 are exempt from this problem so long as the surviving spouse does not actually exercise the spousal election. Additionally, all CRTs are exempt from this problem so long as the applicable state law does not permit a spousal election against CRT assets. This latter option could be troublesome because the applicable state is the state in which the surviving spouse has the right to make the election. In today's society, donors move with much greater frequency than ever before. They could easily create the CRT in one state and die in another state. Of course, they could live in several states in between.

The final solution permitted by the IRS in Revenue Procedure 2005-24 is for the potential surviving spouse to sign a waiver of his or her right to exercise the spousal election with regard to the CRT. This waiver needs to be valid under state law. (Remember that the applicable state law under which the waiver needs to be valid could change when the laws change or when the client moves to another state.) Additionally, the waiver must be in writing and kept by the trustee with the official trust records.

The waiver must be executed on or before six months after the CRT is required to file Form 5227 (not including extensions) for the year in which the last of the following occurs:

[46] See IRC §4946(d).
[47] Revenue Procedure 2005-24.

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- the creation of the trust;
- the date of their marriage;
- the date the donor is first domiciled or a resident in a jurisdiction whose law provides a right of election that could be satisfied from assets of the trust; or
- the effective date of applicable state law creating a right of election.

Note that if the clients move to two different states and remarries after creating the CRT, then the client's spouse(s) may have to sign four different waivers for the same CRT.

While there are several issues yet to be resolved in this matter, the author will highlight three additional points:

i. The effectiveness of a waiver could easily be disqualified years later for a number of reasons including the fact that the spouse did not receive separate legal counsel regarding the matter.

ii. I have personally reviewed several waiver forms and have yet to see a sample form that would correctly and adequately apply to the majority of CRTs. Due to the differences in state law requirements regarding the execution of a valid waiver, it is unlikely that a "one size fits all" waiver could be created. Further, a waiver provision inside a CRT document is also unlikely to completely solve this issue under the guidance of the Revenue Procedure.

iii. It is an open question whether CRTs created and funded before the June 28, 2005 safe harbor can rely on that safe harbor if the donor makes an additional contribution to the CRT after that date.

There should be no argument that the improper withdrawal of assets from a CRT should be punished. However, the vast majority of commentators believe the punishment proposed by the IRS does not fit the crime. In the great majority of the situations to which this punishment could apply, no crime has been committed. While the IRS has stated privately that it is not trying to apply these rules in a draconian manner, this is nevertheless a potentially explosive matter.

A sampling of organizations that protested Revenue Procedure 2005-24 and the Spousal Waiver solution proposed by the IRS included the National Committee on Planned Giving, the American Council on Gift Annuities, the American Bar Association, the American Institute of Certified Public Accountants, as well as several local bar associations.

Fortunately, the IRS conceded in the Spring of 2006 with Notice 2006-15. With regard to charitable remainder trusts created before June 28, 2005, 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. More importantly, the IRS extended the grandfather period to include not only the CRTs created before June 28, 2005 but also CRTs subsequently created. Again, the IRS will disregard the right of election regardless of any other safe harbor (i.e.,

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the Spousal Waiver previously described) unless the surviving spouse actually exercises the right of election with regard to the CRT.

On April 13, 2008, the IRS requested additional comments on the Spousal Election issue. The National Committee on Planned Giving again responded.[48]

F. *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 donor 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.

IV. Traps in CRT Operation

A. *Making Proper Payments.* Several potential traps exist regarding the proper amount to pay the income beneficiary. For example, a CRT must use the calendar year as its tax year.[49] As a result, it will have a short tax year in the first and last years of the trust. It is easy to forget that, for any short year, it is necessary to prorate the annuity or unitrust payment. The proration is done on a daily basis. The proration factor has as its numerator the number of days in the short year, including the first and last days of the year in question. The denominator is 365, or 366 if February 29 is included in the numerator.[50]

Examples of other similar traps include:

- Assuming that the current year's unitrust payment will be the same as the prior year's unitrust payment, and
- Paying the income beneficiary of a NIMCRUT or a pre-Flip Flip-CRUT the full fixed percentage amount without regard to the trust's accounting income.

It is important that the CRT trustee must actually make the payments to the income beneficiary. Similarly, it is important for the income beneficiary to be able to prove that he or she took possession of the payments (e.g., deposit the checks in a personal account). In *Estate of Melvine B. Atkinson v. Commissioner*[51] the 11th Circuit Court of Appeals affirmed the Tax Court's ruling that the failure of the trustee to make the annuity payments of a CRAT caused it to fail to qualify for treatment as a CRT on operational grounds.

Where a CRT is a NIMCRUT or a Flip-CRUT (pre-flip), then it is necessary to properly track the make-up amount. Note that additions to this amount occur each year that the trust accounting income is less than the unitrust amount. Deductions from this amount occur each year in which trust accounting income exceeds the

[48] For the NCPG's comments, see www.ncpg.org/gov_relations/Rev%20Proc%202005-24%20Letter-e.pdf.
[49] See IRC §644.
[50] See Treas. Reg. §1.664-2(a)(1)(iv)(a) and (b) and Treas. Reg. §1.664-3(a)(1)(v)(a) and (b).
[51] *Estate of Melvine B. Atkinson v. Commissioner*, 309 F.3d 1290; 90 A.F.T.R.2d 2002-6845; 2002-2 U.S.T.C. ¶ 60449 (11th Cir.).

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unitrust amount. *Payments of the excess of trust accounting income over the unitrust amount must be made to the extent of the make-up amount.*

One of the elements used to compute the actuarial present value of the remainder interest is the frequency with which income beneficiary payments are to be made. While payments must be made at least annually, the trust's governing instrument may specify that payments are to occur more frequently than annually. However, making payments more frequently than specified in the trust's governing instrument is a prohibited act of self-dealing, violate a key assumption used in computing the amount of the income tax charitable deduction and may call into question the validity of the deduction. In addition, failure to observe and respect the provisions of the trust's governing instrument may open the trustee to liability for breach of his or her fiduciary duty. It is therefore clearly advisable to not make payments on a greater frequency than that specified in the trust agreement.

It is possible for a CRT (primarily CRATs) to exhaust. When a CRT created for the benefit of a key donor exhausts, it is tempting for a charity serving as trustee to continue to make payments to the donor from its general fund—much in the same manner as the charity is required to pay its charitable gift annuity obligations. However, this is a path to a bigger problem. Such payments constitute private inurement and may subject the charity to the Intermediate Sanctions found in IRC §4958.

B. *Income Beneficiary Distributions.* CRT distributions to income beneficiaries are taxed under a unique system commonly called "4-tier accounting." This system employs a "worst-in-first-out" method for characterizing income distributions in the hands of the income beneficiaries. Each item of income earned by the trust must be separately tracked according to type (e.g., interest, dividends, capital gains, tax-exempt interest, etc.). Then, each type of income is "used up" generally starting with items taxed at the highest rate and moving to items that are taxed at the next lower rate.

The result is that ordinary income items (starting with interest and then Qualified Dividends) are passed out first, followed by short-term capital gains, then long-term capital gains, then tax-exempt interest and finally trust principal. Any CRT earnings in excess of the mandatory income beneficiary distributions are retained in the trust in a tax-free environment and combined with future transactions for characterizing future income beneficiary distributions. Note that while the CRT avoids taxation on capital gains realized from the sale of appreciated assets, such gains may be used to characterize future income beneficiary distributions.

C. *Tax Reporting by the Donor.*

In general, the donor may be required to prepare two forms with respect to his or her transfer to a CRT. Form 8283 *Noncash Charitable Contributions* is attached to the donor's Form 1040 to report the income tax charitable deduction claimed by the donor for their gift of non-cash property to a CRT.

Form 709 *United States Gift (and Generation-Skipping Transfer) Tax Return* is used to report the charitable gift for gift tax purposes. The same form is

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also used to report taxable gifts to the spouse and/or other income recipients. Note that since August 6, 1997, it is clear that IRC §6019 does not exempt charitable contributions to a CRT from the gift tax filing requirement. However, this is not without benefit because filing Form 709 starts the running of the statute of limitations on the valuation of the contributed asset for gift tax purposes (not for annuity or unitrust valuation purposes).

Funding of a testamentary CRT requires filing Form 706 *United States Estate (and Generation-Skipping Transfer) Tax Return* to claim the estate tax charitable deduction.

D. Tax Reporting by the CRT.

Proper 4-Tier Classification. The key to accurate tax reporting by the CRT is the proper classification of all trust activity according to the 4-tier classification scheme unique to CRTs.[52] The scheme requires the tracking of trust activity according to income type (e.g., interest, royalties, rents, dividends, Qualified Dividends, etc.) and tax rate (e.g., short-term capital gains, 28% rate gains, unrecaptured §1250 gain subject to the 25% rate, 15% long-term capital gains, etc.). In effect, these refined classifications act as "sub-tiers" within the more broadly defined 4-tiers (ordinary income, capital gains, tax-free income and corpus). As described above, income beneficiary payments result in relieving each sub-tier within a tier on a pro-rata basis—beginning with the ordinary income tier until it is exhausted, continuing through the capital gain tier until it is exhausted, and so on. Further, within each tier, the sub-tiers are relieved first from sub-tiers that have higher tax rates.

Filing the Proper Form. Revenue Procedure 83-32 listed the filing requirements for CRTs. In general, a CRT only needs to annually file Form 5227 *Split-Interest Trust Information Return*. As a result of the Pension Protection Act of 2006, starting with tax year 2007 CRTs no longer need to file Form 1041-A *U.S. Information Return Trust Accumulation of Charitable Amounts*. If a CRT has UBTI, it must also file Form 1041 *U.S. Income Tax Return for Estates and Trusts* for that year. A copy of the trust instrument accompanied by a certification of its conformity to the original must be submitted with the initial Form 5227.

Form 5227 (except for Schedule A) is open to public inspection by requesting it from the IRS. However, in order to request the Form, the requesting party must know the name and address of the Trustee and the CRT's name.

Other potential filing requirements include:

Form 8283 *Noncash Charitable Contributions*. The CRT trustee should sign the donee acknowledgement section of Form 8283.

Form 8282 *Donee Information Return*. If Form 8283 was prepared for the contribution to the CRT and the contributed asset is sold within 3 years after the gift, then the CRT trustee must file Form 8282 to report the sale

[52] See IRC §664(b) and Treas. Reg. §1.664-1(d).

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price of the asset. Form 8282 must be filed within 125 days of the disposition of the contributed property. Note that this provides a way for the IRS to compare the value used to claim the deduction with the amount realized by the CRT.

Form 4720 *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*. As previously noted, a CRT is subject to the private foundation rules regarding self-dealing. If a CRT has engaged in an act of self-dealing with a disqualified person, then Form 4720 is used to disclose the act, describe the corrective action taken and compute the excise taxes on the foundation manager (i.e., the trustee) and the disqualified person.

E. *State Reporting Requirements.* Taxation by the states is unique to each state. Some states (such as New Jersey and Pennsylvania) do not exempt the CRT from taxation. Other states (such as Indiana) exempt CRTs from taxation, but require that the CRT's Form 5227 be filed with the state's taxing authority.

F. *State Registration Requirements.* Some states (for example, Illinois and Oregon) require that CRTs register as charitable trusts with the state Attorney General's office. Some states require an annual filing, while others require a single filing. This state registration requirement is in addition to the Federal information return requirements and any state income tax reporting requirements.

G. *Valuation.* Unmarketable assets provide the greatest challenge in valuing a trust's assets. A CRT trustee will need to know the value of the trust's assets in a number of situations. For example:

- Valuing the initial contribution to the trust;
- Determining the annual valuation of the trust's assets and liabilities required to compute the unitrust amount;
- Valuing additional contributions for the incremental change in the unitrust amount; and
- Computing how much of an asset to transfer to make an in-kind distribution.

Treasury Regulation §1.664-1(a)(7) provides the trustee with two alternative methods for determining the value of a CRT's unmarketable assets. First, the valuation can be performed exclusively by an independent trustee. Second, the value can be determined by a current qualified appraisal.[53]

H. *Compliance.* In order to ensure the continued qualification of a CRT, it is important for the trustee, the investment manager, the administrator, the attorney and any other professional advisor to be familiar with the laws and regulations governing CRTs and the terms of the governing instrument. All of the parties to a CRT must continually monitor the activity of the trust for compliance. Among the specific areas of concern are trustee powers, principal and income allocations, prohibited investments, self-dealing activities and other transactions that could produce UBTI.

[53] A qualified appraisal is defined at Treas. Reg. §1.170A-13(c)(3).

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I. *Annual Reporting.* In some states, the trustee is required to make a periodic statement or accounting to the income beneficiaries, remainder beneficiaries and/or a court. Charities that prepare financial statements in accordance with generally accepted accounting principles (GAAP) are required to include certain information about CRTs on the charity's financial statements. The type of information to be included depends on whether the charity serves as trustee (or not) and whether the charity's interest is revocable or irrevocable.

J. *Accelerations of the Charitable Remainder Interest.* Sometimes, the CRT income beneficiary no longer needs his or her CRT distributions. At other times, the income beneficiary wants to see the charities use the CRT's assets for current charitable programs. As a result, they seek to terminate the CRT early and distribute all of the CRT's assets to the charitable remainder beneficiaries. This type of early termination is sometimes referred to as an "acceleration" of the charitable remainder interest.

When a CRT acceleration is desired, it helps if the document contains explicit authority to effect those wishes. A CRT may include language explicitly authorizing the trustee to accelerate the remainder interest.[54] Such a provision is commonly located near the charitable remainder designation provisions. A sample clause is:

> **Acceleration of Charitable Remainder Distributions**. Notwithstanding any limitations imposed by the spendthrift provision, the Trustee may distribute from time to time and/or upon the death of a Recipient a portion of the trust assets to Qualified Charities selected by the Trustors pursuant to a separate Written Document (hereinafter "Written Document") which expressly references this Article and is provided to the Trustee in accordance with this Article; provided, however, any vested interest of a Qualified Charity named in this trust shall not be divested by the exercise of this power. If any charitable organization so named is not a Qualified Charity, the distribution thereto shall lapse and the assets that would have been distributed to such charity shall remain instead in this trust. In the case of any distribution in kind, the adjusted basis of the property distributed must be fairly representative of the adjusted basis of the property available for payment on the date of payment. After any distribution pursuant to this provision, the Unitrust Amount shall thereafter be calculated based on the remaining net fair market value of the trust assets as of the next succeeding Valuation Date.

Alternatively, some CRTs contain a spendthrift provision, which may permit a voluntary assignment of the income interest to the designated charitable beneficiaries. A sample spendthrift clause with this provision is:

> **Limitations on Claims and Encumbrances**. The interest of a beneficiary in this trust shall not be subject to the claims of any creditor, any spouse for alimony or support, or others, or to legal process, and may not be voluntarily or involuntarily encumbered or alienated, other than by assignment by the

[54] See Treas. Reg. §§1.664-2(a)(4) and -3(a)(4).

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Recipients of the income interest to the Qualified Charities designated in or in accordance with this Trust.

An acceleration of the charity's interest in a CRT may still be possible even when there is no clear authority in the trust document to make an acceleration so long as there is no direct prohibition against a voluntary assignment of the income interest,. However, an attorney representing the parties (e.g., the trust, the charity, the trustee or the income beneficiary) should review applicable state law to determine if any guidance exists (e.g., which parties should be notified and whether the doctrine of merger will apply to terminate some or all of the trust after the acceleration).

In many states, the Attorney General is the guardian of charities. This role typically includes the oversight of CRTs as well. Thus, it would not be uncommon for the Attorney General to be a party to a CRT acceleration. Traditionally, the Attorney General's oversight is to protect the charities; however, in situations where the charity will receive the entire interest in the CRT, it seems that the need for oversight is diminished.

Based on IRC §1001(e), a trust interest is a capital asset. The holding period for that capital asset will be long-term if the income interest was created more than one year before this transaction is consummated. In a pure acceleration transaction, the income beneficiary is making a charitable gift of long-term capital gain property.

The steps needed to produce an acceleration include: (1) Determine the Client's Goals; (2) Clean-up the CRT; (3) Assess the CRT and State Law; (4) Calculate the present value of the income interest; (5) Decide on the Strategy; (6) Obtain Consents; (7) Draft the Final Documents; and (8) Implement the Transaction.

K. *CRT Split-Ups.* Sometimes, the CRT income beneficiary prefers to receive a lump sum from the CRT instead of a lifetime payment stream. If the income beneficiary, charitable remainder beneficiary and a court (and maybe the state Attorney General) agree, the income and remainder interest can be split *pro rata* between the beneficiaries.

The income beneficiary's interest in the CRT must be calculated based on his or her remaining life expectancy.[55] This number varies with the market value of the trust. It may also change every month when the Applicable Federal Rate changes (See IRC §7520). The present value also changes dramatically at least once each year when the income beneficiary's life expectancy changes. Over the recent years, for Split-ups of NIMCRUTs (and presumably Flip-CRUTs before they Flip), the IRS has required that the calculation use the smaller of the CRUT's payout rate or the AFR for the month of termination in determining the income beneficiary's interest.

[55] Both prudence and the IRS dictate that each income beneficiary should obtain a doctor's affidavit that they know of no medical condition that would result in a shorter life expectancy than that used by the actuarial tables under Treas. Reg. §1.664-4.

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The IRS has ruled in multiple Private Letter Rulings that the trust interest is a capital asset.[56] Further, the holding period for that capital asset will be long-term if the income interest was created more than one year before this transaction is consummated. In a "Split-up" transaction, the income beneficiary's interest is treated as the payment of a long-term capital gain asset with zero basis.

L. *Divorces.* Sometimes, the income beneficiaries of a CRT divorce. If divorcing spouses are joint income beneficiaries of a CRT, they typically want to split that CRT into two CRTs. Situation 2 of Revenue Ruling 2008-41 permits such a CRT to split into two relatively identical CRTs. The main difference between the original CRT and the two new CRTs is that the original CRT had two income beneficiaries. One of those income beneficiaries will be the sole income beneficiary of the first new CRT, while the other spouse will be the sole income beneficiary of the second new CRT. Otherwise, all other terms of the CRT remain the same. Further, the two new CRTs will equally split each asset of the original CRT as well as the amounts in each of the "4-tiers". In additional to Revenue Ruling 2008-41, the IRS has issued numerous Private Letter Rulings on this topic.[57]

V. Traps in CRT Investment

A. *Prudent Investor Standard.* In selecting a CRT's investment portfolio, the trustee must be aware of the standard under which his or her decisions may be evaluated. Since its promulgation in 1994, approximately 45 states have enacted a version of the Uniform Prudent Investor Act.[58] This act permits a trustee to invest for total return based on Modern Portfolio Theory. A trustee is therefore evaluated on the performance of a portfolio considered as a whole, rather than the performance of each individual asset.

Warning: "Total Return Unitrust" (TRU)[59] provisions alter the definition of trust accounting income. The IRS issued a regulation that a NIMCRUT may not make use of a TRU definition of income—even if permitted by state law.[60]

B. *Don't Be Slave to the Payout Rate.* It is not necessary, and is often dangerous, to simply match the investment return to the payout rate. For example, if a CRT uses a 12% payout rate, it would not be necessary to invest speculatively to achieve a 12% or greater investment return. Similarly, if the payout rate were 5%, it is not necessarily correct (or prudent) to merely purchase a fixed rate portfolio returning 5%. Rather, a CRT trustee should generally invest for total return while keeping in mind all of the relevant factors (e.g., the risk/reward profile, the trust format, liquidity requirements, etc.).

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[56] See IRC §1001(e).
[57] See PLRs 200824022, 200814003, 200744019, 200616008, 200524013, 200502037, 200340022, 200333013, 200301020, 200221042, 200143028, 200120016 and 200109006.
[58] See www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upria.asp for updated information.
[59] As applied to non-CRT trusts, the "Total Return Unitrust" concept creates an environment that permits trustees of those trusts to invest for total return without the necessity for computing an income beneficiary's payment on traditional definitions of trust accounting income.
[60] See Treas. Reg. §1.664-3(a)(1)(i)(b)(3).

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C. *Make Sure the Investment Philosophy (i.e., the Risk Profile) is that of the CRT—not Just the Income Beneficiary and not Just the Charity.* By definition, a CRT is a split-interest trust. As such, the trustee has a duty to impartially balance the interests of the income and remainder beneficiaries. This duty extends to the identification of a risk profile that blends the relative risk profiles of the income and remainder beneficiaries. In identifying the CRT's risk profile, the trustee should consider such factors as the remaining term of the trust, the sophistication of the income and remainder beneficiaries, prevailing economic conditions, inflation, the required trust payout, the trust format and liquidity needs, tax efficiency as relates to the income beneficiary distributions and restrictions in the governing instrument. Because these factors may differ from CRT to CRT, it follows that not all CRTs should be invested in the same way.

D. *Make Sure the Person Picking the Investments Knows the Rules.* The person selecting a CRT's investment portfolio must be aware of certain rules peculiar to CRTs. For example, the trustee and/or investment manager should avoid: purchasing assets that produce UBTI; purchasing securities on margin or otherwise borrowing funds to avoid unrelated debt-financed income; and entering into transactions that are subject to the IRC §4941 excise taxes on self-dealing. If there is a charitable income interest, then the trust must avoid excess business holdings (IRC §4943) and jeopardizing investments (IRC §4944).[61]

   Because a CRT's distributions to the income beneficiaries are taxed under the quasi-passthrough "4-tier" system,[62] it is important for the trustee and investment manager to understand how the investment portfolio selected interacts with the 4 tiers. For example, the tiers segregate earnings by income class and the tax rate imposed on the beneficiary. If the investments selected produce income that populates lower tax rate tiers, then it is possible for income beneficiary distributions to be taxed at a lower rate. However, the carryover nature of the tiers, means that carryovers within a higher tax rate tier will override current year income that is otherwise taxed at a lower rate. The classic example of this phenomenon is that a large capital gain carryover (typically from the sale of a contributed asset in a prior year) overrides the current production of tax-free municipal bond interest in determining the tax character of income beneficiary distributions.

Concluding Remarks

The forgoing discussion highlighted some of the problem issues I have seen in the past 20 years of drafting, illustrating, reviewing and providing services to over 17,000 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 deed is done, we all need to recognize that:

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[61] Also, if the CRT continues as a private foundation, then these provisions must be included to take effect at the end of the CRT term.
[62] See IRC §664(b) and Treas. Reg. §1.664-1(d).

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- 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

Your clients' estate plans should reflect their interests. The overwhelming majority of Americans do make charitable gifts. Charitable Remainder Trusts are one of several common charitable tools that can be used with many of your clients. Because your clients give to charity, attorneys need to provide sound advice based on a thoughtful analysis of the opportunities and drawbacks of a gift plan. An attorney's duty to her clients should purposefully include a strategic plan that addresses charitable giving using Charitable Remainder Trusts while avoiding the Traps discussed in this paper.

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