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Final CRT Regulations—Trick or Treat?
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On December 10, 1998, the Treasury Department and the IRS issued final regulations under Code §664 and §2702 as outlined in Treasury Decision 8791. In addition to the explanatory material discussing the proposed regulations in the Notice of Proposed Rulemaking published in the Federal Register on April 18, 1997, the IRS included a discussion of the proposed regulations in the 1999 CPE Text. (The CPE Text is an IRS document used for internal professional education.) These background materials indicate that the IRS developed the new regulations in part to deal with concerns about the abuse of CRTs, including the "accelerated" charitable remainder trust, which was the target of IRS Notice 94-78,[1] as well as certain self-dealing issues.

Most gift planners agree that the final regulations provide an opportunity for charitable gift planning *problem solving* and add clarity to several technical issues. However, there may be a few nuances in the final regulations that, if not fully considered, could erupt into a stewardship nightmare or even potential liability.

The more one analyzes the final regulations, the more questions arise. Although the concepts underlying the final regulations are reasonably clear, the practical implications may not be so apparent. Although some of the practical issues will be irrelevant to a majority of CRTs, given that more than 75,000 CRTs exist (at last count), many of these issues will be critical for a large number of them.

FlipCrut

The creation of the FlipCrut[2] under the proposed regulations and its re-engineering in the final regulations provide the most intriguing and favorable "treat" for gift planners. Both proposed and final Regulation §1.664-3(a)(1)(i)(c) include provisions allowing an income exception CRUT to "flip" into a SCRUT, if specific conditions are met. The conditions have been dramatically simplified and expanded under the final regulations.

Proposed Regulations. The IRS had publicly taken the position that the FlipCrut, in any form, caused the trust to fail to function exclusively as a CRT and constituted an act of self-dealing.[3] In response to a unified request from the charitable community, the IRS liberalized its prior stance in permitting a FlipCrut in the proposed regulations.

Under the proposed regulations, a complex percentage test (90/50) had to be met in order for the FlipCrut rule to apply. For instance, immediately after the initial contribution to the trust (or after any subsequent contribution prior to the "flip"), at least 90% of the fair market value of the trust assets had to consist of unmarketable assets. In addition, the trust instrument had to *require* that the flip from an income exception CRUT to a SCRUT occur by the earlier of: 1) the sale or exchange of sufficient unmarketable assets to bring the fair market value of the remaining unmarketable assets in the trust down to 50% or less of the total fair market value of the trust assets; or 2) the sale or exchange of a specified group of assets or a specified asset that was contributed to the trust at its creation.

In essence, the IRS limited the application of the FlipCrut to a very narrow event—when substantially

all of the assets contributed to or held by an income exception CRUT were illiquid (unmarketable). Upon the sale of a significant portion of the unmarketable asset(s), the flip to a SCRUT would have to occur.

Comments from the Charitable Gift Planning Community. A regulatory hearing was held in Washington, DC, on November 18, 1997. Most of the participants expressed appreciation for the FlipCrut option, but also had concerns regarding the ambiguities associated with the 90/50-percentage test. For instance, the 90% component did not take into account significant costs that could be associated with the upkeep of the contributed asset. In addition, valuing unmarketable assets, like real estate and closely held stock, is tricky business. Valuation determinations are based upon unique facts and circumstances, and experts may disagree on value. In addition, the case law on valuation is constantly evolving to take into account new factors.[4] Finally, if the valuation of an unmarketable asset owned by a FlipCrut were contested after the flip, the validity of the FlipCrut would, in hindsight, have been placed in jeopardy.

Representatives from the National Committee on Planned Giving were among the participants at the regulatory hearing. In an attempt to avoid the inherent complications of the proposed flip structure, NCPG presented an alternative plan. NCPG pointed out that a literal reading of §664 and the regulations specifically permit the "flip" concept. However, the IRS was quick to point out that legislative history indicates that the trustee should not have discretion to change the method used to calculate the unitrust amount.[5]

In response, NCPG offered a simplified plan as follows:

> "In the alternative, NCPG respectfully requests that consideration be given to a one-time 'FLIP' for any purpose, so long as the triggering event is specifically stated in the governing instrument. Thus, the 'FLIP' will not be within the discretion of the trustee. In addition, the 'FLIP' should be permitted whether converting from a NIMCRUT or a NIOCRUT into a SCRUT or from a SCRUT into a NIMCRUT or NIOCRUT. However, if the trust 'FLIPs' from a NIMCRUT to a SCRUT, the makeup account is forfeited. Such a provision is akin to a qualified contingency and will greatly simplify the proposal."

Final Regulations. Treasury and the IRS adopted, in significant part, NCPG's simplified plan. The final regulations permit a "one-time" flip. The "triggering event" that causes the change in the unitrust method must: 1) be stated in the governing instrument; and 2) arise on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other person.[6] However, the initial unitrust method can only be an income exception method that flips into a SCRUT, and the flip to the SCRUT must take effect at the beginning of the taxable year following the year in which the triggering event occurs.[7] Finally, as a consequence of the flip, any NIMCRUT make-up account will be forfeited.[8]

The final regulations provide 10 examples of permissible and impermissible triggering events. The permissible triggering events are generally those events that are outside the control of any person. For instance, the IRS has stated that the sale of an unmarketable asset as defined in Regulation §1.664-1(a)(7)(ii), such as the sale of the donor's personal residence, is a permissible triggering event. In addition, if an unregistered security for which there is no available exemption permitting public sale is used to fund a FlipCrut, a permissible triggering event is the earlier to occur of the date when the stock

is sold, or the time the restrictions on its public sale lapse or are otherwise lifted.[9]

The IRS also provides the following permissible triggering events: When the income beneficiary reaches a certain age; when the donor gets married; when the donor divorces; when the income beneficiary's first child is born; and when the income beneficiary's father dies.[10] It does not appear that these safe harbors are exclusionary in nature.

As should be expected, the impermissible events relate to occurrences that are within the discretion of some person. For instance, the sale of publicly traded stock is not a permissible triggering event because that decision is within the discretion of the trustee.[11] In addition, a request by the income beneficiary, or his/her financial advisor will likewise not be permissible events.[12]

If the liberalization of the FlipCrut triggering event was a sumptuous "treat," the reformation possibilities are a real delicacy. The IRS recognized that many donors may have avoided the FlipCrut because of the regulatory uncertainty created by the IRS's published positions, while other "aggressive" donors may have established a FlipCrut that would not qualify under the new rules. For this reason, the IRS has provided a limited opportunity for an income exception CRUT and a noncompliant FlipCrut to convert into a compliant FlipCrut.

Three different scenarios are presented in the reformation provisions.[13] First, if a noncompliant FlipCrut was created on or after December 10, 1998, the trust will qualify as a CRT if the trust is amended or reformed only to use the initial method for computing the unitrust amount throughout its term, or is reformed into a compliant FlipCrut under the June 8th Rule. Second, if a noncompliant FlipCrut was created before December 10, 1998, the trust may be reformed to use the initial method for computing the unitrust amount throughout its term or may be reformed in accordance with the June 8th Rule. Third, *any* income exception CRUT may be reformed to take advantage of the June 8th Rule. However, failure to comply with these new rules will raise qualification and self-dealing issues.[14]

So, what is the June 8th Rule? The regulations require the trustee to **begin** legal proceedings to reform a noncompliant FlipCrut or an income exception CRUT by **June 8, 1999**. In addition, the triggering event under the reformed governing instrument may not occur in a year prior to the year in which the court issues the order reforming the trust. One exception does apply where the governing instrument prior to reformation already provided for payment of the unitrust amount under a combination of methods that is not permitted under these rules and the triggering event occurred prior to the reformation.

Time for Paying the Annuity Amount or Unitrust Amount

Under prior law, the payment of the annuity amount, or a unitrust amount, may have been made after the close of the taxable year provided that such payment was made within a reasonable time after the close of the taxable year.[15] This grace period generally extended until the time required for filing the tax return for the trust (including extensions). The intention of this grace period was to provide the trustee with some flexibility in managing the trust's assets and the actual distribution of funds to the income beneficiaries. As a matter of administrative convenience, all CRTs were provided with this flexibility.

A planning technique that gained infamous notoriety was the "accelerated" CRT, which depended upon the treatment of the sale of an appreciated asset in the second year of a two-year, 80% SCRUT, to be treated as a return of principal (tier 4) in Year One. In these cases, the donor/income beneficiary would avoid the taxable gain on the sale of the appreciated assets and receive a significant portion of the cash proceeds back on a tax-free basis as return of principal. However, if the trustee is required to

either make a distribution in cash or in kind in Year One, or sell the appreciated capital assets in Year One and distribute the cash within the grace period, the income beneficiary will incur a capital gains tax in Year One. A distribution in kind generates capital gains because a sale is deemed to occur at the trust level.[16]

IRS Responses. The IRS took a shotgun approach in Notice 94-78 at combatting the accelerated CRT. An additional response to the accelerated CRT came from Congress in the form of the new 10% minimum charitable remainder requirement.[17]

In the Notice of Proposed Rulemaking, the IRS attacked the accelerated CRT by annually forcing the payment to the income beneficiaries. Since the accelerated CRT works only with either a CRAT or a SCRUT, the proposed regulations would have eliminated the post-year-end grace period for the payment of the annuity amount with respect to CRATs, and for the payment of the unitrust amount from a SCRUT for taxable years ending after April 18, 1997.

The aftermath of the IRS's response to the accelerated CRT left many trustees and administrators of generic SCRUTs and CRATs increasingly nervous as 1997 came to a close. In the interim, the IRS issued Notice 97-68,[18] providing significant immediate relief for distributions relating to 1997. That Notice provided that a SCRUT or a CRAT created before January 1, 1998, be permitted to pay out the annuity or unitrust amount within the grace period under certain circumstances. So long as in 1997, the trust is: 1) a CRAT under which the sum certain to be paid each year to one or more persons is 15% or less of the initial net fair market value of all property placed in the trust; 2) a SCRUT under which the fixed percentage of the net fair market value of the unitrust's assets to be paid each year to one or more persons is 15% or less; or 3) a CRAT or SCRUT from which all of the annuity amounts or unitrust amounts paid for 1997 are characterized in the hands of the beneficiary from the categories described in §664(b)(1), (2) and (3) and not as trust corpus.

Final Regulations. Treasury adopted the circumstances mentioned in Notice 97-68 and added one more.[19] For SCRUTs and CRATs created before December 10, 1998, the 15% payout exception is retained.[20] A second exception relates to the tax character of the distribution in the hands of the income beneficiary. To the extent the entire annuity or unitrust amount in the hands of the income beneficiary is characterized as tier 1 (ordinary income), tier 2 (capital gains), or tier 3 (tax-exempt income), the grace period will be permitted.[21]

The new exception that was not included in Notice 97-68 allows an asset owned by the trust at the close of the taxable year to be distributed in kind to the income beneficiary after the close of that taxable year but within the grace period. If the trustee elects to treat any income generated from such distribution as occurring on the last day of the taxable year in which the annuity or unitrust amount is due, the grace period will be permitted.

The final regulations provide an example to highlight the application of these rules.[22] In the example, a CRAT (or a SCRUT) is required to make a $100 distribution to the income beneficiary in Year One. The trust distributes on April 15th of Year Two $95 cash and a capital asset worth $5, with a $2 tax basis. The asset was owned by the trust at the end of the prior year. The distribution is treated as a sale by the trust resulting in a $3 capital gains. The trustee elects to treat the gain as occurring on the last day of Year One. In this example, the distribution after the close of the taxable year is in compliance with the new grace period rule.

Prohibition on Allocating Precontribution Gain to Trust Income and Make-up Amount as a Liability

Proposed Regulation §1.664-3(a)(1)(i)(b)(3) requires precontribution gain in an income exception CRUT to be allocated to principal for sales and exchanges occurring after April 18, 1997.

What is precontribution gain? Let's assume a donor paid $10 to acquire a capital asset and the asset is now worth $100. The donor now desires to contribute the appreciated asset to a NIMCRUT. If the NIMCRUT sells the asset immediately, the NIMCRUT will incur a gain equal to $90. That $90 gain will relate entirely to the appreciation in the asset that occurred prior to the contribution to the NIMCRUT. If the NIMCRUT sells the asset in 10 years for $200, it will have incurred $190 gain, $90 of which relates to the precontribution gain and $100 of which relates to the post-contribution gain.

In the Notice of Proposed Rulemaking, the IRS states that the amount of a donor's charitable deduction for a contribution to a CRT is based partially upon the fair market value of the property on the date of transfer. With an income exception CRUT, the charitable deduction is calculated as if the fixed percentage is distributed annually. The IRS indicates that it would not be consistent with the legislative intent of §664 to allocate part of the initial fair market value of the trust assets to fiduciary income.[23] In enacting the Tax Reform Act of 1969, Congress desired to make sure that charitable deductions were consistent with the amount charity was expected to ultimately receive.[24]

Some participants at the regulations hearing were concerned that prohibiting the allocation of precontribution gain to income would usurp the authority of the trustee, who should retain discretion in that regard. Since a NIMCRUT and a SCRUT calculate the income tax deduction in the same fashion and the SCRUT can distribute principal to meet the unitrust amount, this argument has merit. However, other participants expressed concern that if precontribution gain could be allocated to income the charitable remainderman may receive less in a NIMCRUT than in a SCRUT.

Allocation of Precontribution Gain—Final Regulations. The final regulations absolutely prohibit the allocation of precontribution gain to income in an income exception CRUT. Thus, the proceeds from a post-April 18, 1997 sale or exchange of any assets contributed to the trust must be allocated to principal and not to income, at least to the extent of the fair market value of those assets on the date of contribution.[25] Although not contained in the text of the regulations, but rather in the explanation of the regulations contained in T.D. 8791, it is clarified that an income exception CRUT's governing instrument may, if permitted under applicable local law, allocate *post*-contribution gains to income.

Make-up Amount as a Liability. T.D. 8791 also provides that, "Taxpayers do not have to treat the make-up amount as a liability when valuing the assets of a NIMCRUT." The IRS had previously stated in several private letter rulings (i.e., PLR 9511007 and PLR 9511029) that a NIMCRUT governing instrument must require the trustee to treat as a liability any deficiencies in the unitrust amount for prior years, as computed under §664(d)(3)(B), in determining the fair market value of the trust assets on the annual valuation date, if realized capital gains are allocated to income under the governing instrument and applicable local law.[26]

The IRS, however, limited the amount of this liability "to the trust's unrealized appreciation that would be trust income under the terms of the governing instrument and applicable local law if the trustee sold all the assets on the valuation date." The IRS was concerned that the timing of the realization of gain by the trustee might be manipulated to the detriment of charity. Essentially, the IRS was attempting to prohibit the compounding growth of the NIMCRUT's "make-up" account.

Since private letter rulings are issued to individual taxpayers and cannot be relied upon by any other taxpayer, the general effect of this new IRS imposed governing instrument requirement was unclear. Some practitioners recommended optional language, for instance requiring that in the event the law

mandated the "make-up account as a liability" in order to qualify the trust as a CRT then it must be followed, while other practitioners recommended mandatory compliance. In general, NIMCRUT trustees no longer need worry about having to treat the make-up account as a liability.

Application of §2702 to Certain Charitable Remainder Unitrusts

IRS Concern. The IRS was concerned that some taxpayers were establishing income exception CRUTs to take advantage of the exclusion granted to CRTs under §2702 and were passing substantial amounts of wealth to family members with little gift tax cost.

In the Notice of Proposed Rulemaking, the IRS gave an example of a donor who created a NIMCRUT and who retained the unitrust interest for the shorter of his life or 15 years (Near Zero CRUT). At the end of that time, the unitrust amount would be payable to his daughter for her life. Under the §7520 tables, the value of the donor's retained interest would cause the value of the gift to the daughter to be small relative to what she may actually receive from the trust. The IRS notes that this would be especially true if the trustee invests in assets that produce little or no income until the end of the donor's interest and then converts those assets to income-producing assets. The daughter will receive the unitrust amount for her life and the make-up account accumulated while the donor was the unitrust recipient. The small gift (and corresponding gift tax) attributable to the daughter's interest in the trust will likely have no relation to the real economic benefit that the daughter will receive from the trust.

IRS Solutions. If the donor's interest in the Near Zero CRUT is valued at zero, then the entire present value of the unitrust interest will be attributable to the daughter and subject to gift tax. Or, if the donor dies during the initial term of years, the trust's assets will be includable in the donor's gross estate under §2036, and thus, the entire present value of the unitrust interest at the date of death will be attributable to the daughter and subject to estate tax.

How IRS Accomplished the Solution. Code §2702 causes certain interests in trust to be valued at zero for federal gift tax purposes, and provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust.[27] Three statutory exceptions can be found in §2702(a)(3) and the third includes transfers that are not inconsistent with the purpose of this Section as promulgated in regulations. One of the exceptions included in the regulations applies to a donor's retained interest in a CRT.[28] The Small Business Job Protection Act of 1996 made certain technical corrections to §2702 and the Committee Reports indicated that the Regulatory authority granted in §2702(a)(3)(iii) could be used to except a CRT that does not otherwise create an opportunity for transferring property to a family member free of transfer tax.

Since killing the donor was not considered to be a viable option, Treasury exercised its authority in promulgating changes to the regulations under §2702, and exempted transfers made after May 18, 1997 to certain income exception CRUTs. An income exception CRUT (and a FlipCrut) will be exempt from the application of §2702 only if: 1) the only noncharitable beneficiaries of the income exception CRUT are the donor and/or the donor's spouse and the spouse is a United States citizen; or 2) there are only two consecutive noncharitable unitrust interests and the donor holds the second interest.[29] This regulation effectively converts a Near Zero CRUT created after (or a transfer made after) May 18, 1997 into a 100% Gift Tax CRUT.

Appraising Unmarketable Assets

As a matter of historical background, the Code does not contain a provision regarding the valuation of

unmarketable assets. However, the legislative history to §664 suggests that Congress believed an independent trustee would be needed to value unmarketable assets if the donor was to obtain a charitable deduction.[30] Since the computation for the annuity and unitrust payout depends upon the fair market value of the trust's assets, Congress may also have been concerned about the possibility for manipulation of the payout to the income beneficiaries. Based upon legislative history, many practitioners required in the governing instrument that an independent trustee be employed to value unmarketable assets.

Nevertheless, the IRS acknowledged that with the income tax deduction substantiation rules passed subsequent to the 1969 Tax Reform Act (that created the CRT), appointing an independent trustee to value trust assets was no longer necessary so long as the trustee obtained a qualified appraisal. According to the IRS, the purpose of the proposed regulation was to clarify how unmarketable assets were to be valued. The final regulations have accomplished that stated purpose.

Final Regulation §1.664-1(a)(7) provides special rules when unmarketable assets are transferred to, or held by, a CRT. The final regulations clarify that a CRT holding unmarketable assets will be disqualified (with no corresponding charitable deduction allowed) unless, whenever the trust is required to value such assets, the valuation is: 1) performed exclusively by an independent trustee; or 2) determined by a current qualified appraisal under Regulation §1.170A-13(c)(3) performed by a qualified appraiser defined under Regulation §1.170A-13(c)(5).[31] These qualified appraiser rules are the same as the income tax deduction substantiation rules.

The final regulations also clarify the definition of an "independent trustee" and "unmarketable assets." An independent trustee is a person who is not the grantor of the trust, a noncharitable beneficiary, or a related or subordinate party (within the meaning of §672(c) and the applicable regulations) to the grantor, the grantor's spouse or a noncharitable beneficiary.[32] Based upon the traditional definition of "independent" in the grantor trust rules, the noncharitable beneficiary would not be included in this list unless such beneficiary was otherwise "related or subordinate" to the donor. However, the IRS expands upon this traditional definition in the context of a CRT.

Unmarketable assets are assets that are not cash, cash equivalents or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely held stock and an unregistered security for which there is no available exemption permitting public sale.[33] Thus, stock subject to SEC restrictions on resale, such as Rules 144 and 145, will generally be an unmarketable asset.

Finally, Regulation §1.664-1(f)(4) states that these rules are applicable for trusts created on or after December 10, 1998. For a trust that is in existence on such date and whose governing instrument requires that an independent trustee value the trust's unmarketable assets, the trust may be amended or reformed to permit a valuation method that satisfies the requirements of these rules for taxable years beginning on or after December 10, 1998.

Example Illustrating Rule for Characterizing Distributions from Charitable Remainder Unitrusts

Final Regulation §1.664-1(d)(1)(iii) includes an example of how the payout is characterized for a NIMCRUT with undistributed capital gains. The example illustrates the method for calculating the unitrust amount for a NIMCRUT and the tax character of the income received by the income beneficiaries based upon the four-tier system. In the example, a NIMCRUT has a payout of the lesser of trust income or 6% of the net fair market value of the trust assets valued annually. During 1996, the

trust has a net income of $7,500, all of which consists of tax-exempt income. The net fair market of the trust assets is $150,000 on the 1996 valuation date. The trust has undistributed capital gains (tier 2) of $30,000 and undistributed tax-exempt income (tier 3) of $2,500 from prior years.

The example states that the payout to the income beneficiaries for 1996 is equal to the net income of $7,500—because the net income for the year was less than $9,000 (6% X $150,000). All of the $7,500 distribution was characterized as capital gains because the payout was less than the $30,000 of undistributed capital gains from prior years. At the beginning of 1997, the trust had undistributed capital gains (tier 2) of $22,500 ($30,000 – $7,500) and undistributed tax-exempt income (tier 3) of $10,000 ($7,500 + $2,500).

How do these Regulations Trick or Treat Gift Planners?

The final regulations create stewardship and marketing opportunities for gift planners but may also impose some unexpected liabilities. For instance, the opportunity to reform into a compliant FlipCrut may create a tremendous benefit to your donor/client base, but a strict deadline must be met. In addition, the imposition of some of the technical requirements under the final regulations will require strict compliance, even if those requirements sometimes prove to be difficult or impractical.

Treats

Stewardship. Having the opportunity to notify your donor/client base about a new change in the law that could directly benefit them, or better serve their needs, is indeed unique. The gift planner will become a proactive member of the donor's team of advisors.

Marketing. With the FlipCrut, new strategies can be considered to tailor a trust to specifically meet the donor's needs. A donor may contemplate any number of uses for the FlipCrut, which provides the gift planner with a greater incentive (or obligation) to delve deeper into the donor's unique circumstances.

In general, the NIMCRUT may be invested for total growth. When the trust converts into a SCRUT, the income beneficiary will be entitled to a consistent flow of cash based upon the trust's increased value. Such a scenario would be perfectly suited for retirement planning, i.e., the triggering event would be when the income beneficiary reaches age 65 (or some other definitive age or date). This structure may also prove to be valuable in funding a child's college tuition costs.

Non-liquid Asset Distributions and Payout Woes. Donors who chose the NIMCRUT structure primarily because they were concerned about having to distribute non-liquid assets in kind to make the unitrust payouts if a quick sale could not be arranged may find the concept of reforming their existing NIMCRUTs into a FlipCrut appealing. If the donors or the income beneficiaries are not satisfied with the annual payout from an income exception CRUT or fear that the payout may not be adequate to meet their future needs, a reformation to a FlipCrut may be a much-appreciated change. In fact, beneficiaries may have expressed concern to charities and trust administrators about the inadequacy of the payout from an income exception CRUT. Charities can initiate contact with those beneficiaries and solidify a good relationship or improve a challenging one.

Change Investment Mix. With the relatively low current yields available for interest bearing and other fixed income investments, the NIMCRUT structure may cause investment challenges for trustees, administrators and investment advisors. In particular, trustees have to determine how to invest the proceeds from the sale of trust assets in a manner sufficient to earn enough interest and dividends to cover the unitrust payout. Generating greater than a 5% income return without threatening principal

or being perceived as investing imprudently has been very difficult in recent years. If the parties desire to alter the investment mix and possibly generate a higher unitrust amount payout, an income exception CRUT could flip into a SCRUT beginning as early as January 1, 2000. Such conversion will permit the trustee to invest for either total return or total growth. Such an investment mix will likely produce greater growth in principal for the ultimate benefit of charity and a larger current unitrust payout. In addition, considering the four-tier system of characterizing the payments made to the income beneficiaries, an investment mix that generates capital gains income, instead of ordinary interest and dividend income, can provide the income beneficiary with more after tax dollars in his/her pocket.

Timing of Payment Issues. The administration of most SCRUTs and CRATs has been made easier by virtue of the grace period clarification in the final regulations. Most SCRUTs (and CRATs) created prior to December 10, 1998 have a percentage payout rate (or sum certain) of 15% or less. Most SCRUTs and CRATs will have significant undistributed capital gains from the sale of the contributed assets and will distribute either tier 1, 2 or 3 income to the income beneficiary.

Independent Trustee/Qualified Appraisal. The IRS has taken a common sense approach. First, it clarifies the requirements for valuing an unmarketable asset. If the donor desires to be the trustee, the donor can either appoint an independent trustee or obtain a qualified appraisal. If a financial institution is not chosen, locating an independent trustee can sometimes be difficult because an individual acting as a fiduciary will have liability for its actions on behalf of the trust. However, a qualified appraisal may be costly. Since the governing instrument can (and should) include provisions allowing either mechanism for valuing an unmarketable asset to be used, the choice can be made on a case-by-case basis and not necessarily handled in a consistent fashion from year-to-year. Thus, it may prove useful to obtain a qualified appraisal in the year of the gift for both income tax deduction purposes and initial trust asset valuation purposes, and subsequently appoint an independent trustee to update that value annually. In addition, the independent trustee should be preferred where grantor trust or self-dealing issues may be implicated.

Post-Contribution Gain and Make-Up Account Liability. The NIMCRUT continues to be an important planning vehicle because post-contribution gain can be allocated to income. It is also a great relief to have the IRS's assurance that the "make-up account as a liability rule" no longer has vitality.

Addressing Abuses. After seeing the IRS direct most of its attention toward addressing gift planning abuses (i.e., the accelerated CRT and the Near Zero CRUT), the FlipCrut and other provisions in the final regulations indicate that the IRS may now be showing some acceptance of proactive uses of planned giving vehicles in a non-abusive, yet creative, fashion.

Tricks

FlipCrut Notification. Every trustee and administrator of an income exception CRUT or a noncompliant FlipCrut should, at a minimum, notify the income beneficiaries of the change in the law. Otherwise, breaches of fiduciary duties are at stake with a corresponding risk of liability. Every charity that has knowledge of an income exception CRUT or a noncompliant FlipCrut for its ultimate benefit should notify the income beneficiaries of the new rules.

The nature of the notification, however, must be very carefully worded. The notice should clearly, but generally, state the change in the law and its effect. If there was ever a time to place words in extra large caps and bold, this is it.

THE NOTICE MUST CLEARLY WARN THE INCOME BENEFICIARIES OF THE CRITICAL TIME DEADLINES AND THE NECESSITY TO ACT QUICKLY.

However, the notice should not create potential liability. In that regard, it should require the income beneficiaries to seek independent counsel to determine whether the "flip" is required or even desirable in their particular case.

FlipCrut Reformation Process. When does a reformation proceeding *begin*? Unfortunately, the rules regarding how a reformation proceeding is commenced, and what has to be accomplished to successfully reform a CRT, are not uniform. The reformation process will depend upon each state's laws and the different procedural and substantive rules among counties within each state, as well as the vagaries of a particular judge's handling of such a proceeding. In general, the following steps will be required:

- After considering all of the issues involved, if the income beneficiaries desire to convert the income exception CRUT into a FlipCrut or are fixing a noncompliant FlipCrut, the trustee will file a petition for reformation in the appropriate court by the June 8, 1999 deadline. If a pre-December 10, 1998 CRT contains an invalid flip provision, such as one giving the trustee the unfettered discretion to flip at any time or to flip more than once, the initiation of reformation proceedings by June 8, 1999 is the most prudent course of action for all parties. (If any other position is taken, the trustee should be prepared to argue that the final regulations are unreasonable and thus invalid.)

- The original trust instrument will need to be reviewed and the desired amendment prepared and approved. Care should be exercised in complying with the new FlipCrut regulations (i.e., selecting a proper triggering event), and in assuring that the other existing provisions of the trust instrument are not inconsistent with the flip provision. Upon a review of the trust, the trustee may have to address other issues, if raised, including possible qualification issues. For example, this might be an opportunity for discussion in the reformation of the independent trustee/qualified appraiser issue.

- Consideration must be given to the proper parties to the petition for reformation. For instance, many jurisdictions require that each income beneficiary consent to the reformation. Given that the CRT was originally created to meet the intent of the donor—each donor, if not an income beneficiary, might also need the reformation. Each irrevocably designated charitable remainder beneficiary could also need to consent to the reformation. An affidavit, filed with the petition to reform, will probably be required to establish consent. While many of these reformation cases should be relatively straightforward, as more consideration is given to this consent issue, more questions may arise. What if the income beneficiary is out of the country for an extended period? What if the income beneficiary is a minor or incompetent? What if a donor or an income beneficiary is not cooperative? Will consent be required prior to filing the petition? What if a charitable remainder beneficiary does not consent? Does it matter if the charitable remainder beneficiary is vested or nonvested? Why did the IRS create such a short window of opportunity? The June 8, 1999 deadline will prove to be very short in some cases.

- Consideration must also be given to the necessity to notify and obtain the consent of the Attorney General of the relevant state regarding the reformation action. In many states, the Attorney General has an interest in charitable trusts including CRTs. In addition, any judge could independently require the Attorney General's involvement, even if the trustee believes that the

Attorney General's involvement is unnecessary because all interested parties have consented to the reformation.

Timing of Payment Issues. If a SCRUT or CRAT does not fit into one of the two most common categories permitting it to use the post-year-end grace period, the trustee will have to take steps to ensure that the trust fits the third category if it wants to use the grace period. Under the third category, the trustee must: 1) distribute property in kind (not cash) that it owned at the end of the year to the income beneficiary; and 2) elect to treat any taxable income generated by the distribution as occurring on the last day of the taxable year in which the annuity or unitrust amount is due. A distribution of property in kind may not always be easy or desirable, depending upon the nature of the asset and its value. Perhaps an actual sale would be the best course. However, commentators have raised the concern that the final regulations do not specifically permit a sale and subsequent distribution of the cash proceeds even though, in essence, the results are the same.[34]

Providing a trustee with many months to sell an asset seems preferable to forcing a distribution in kind of an undivided interest in real estate or a fractional interest in stock. For example, during this time the blackout period under SEC Rule 144 may end and the resale restrictions on stock may lapse allowing the asset to be sold and the proceeds treated as having been received by the income beneficiary in the prior year. However, the alternative may, in unusual circumstances, produce impossible results—a distribution of stock that is subject to contractual restrictions on resale, by-law restrictions on fractional interests or SEC limitations. For these reasons, the nature of the asset must be fully considered prior to its contribution to a SCRUT or a CRAT. If the grace period rules are violated, the consequences can be devastating—the trustee could disqualify the trust, incur self-dealing excise taxes, generate unrelated debt financed income and cause an additional contribution.[35] For a newly created CRT, the FlipCrut is the obvious choice.

Reformation City. Enough has been said about the FlipCrut reformation. However, it is also important to consider reformation generally. Gift planners will be reviewing sample forms and client documents to determine whether other changes will be necessitated by the final regulations. Reformation or amendment will be needed to eliminate in a NIMCRUT governing instrument any ability to allocate precontribution gain to income. In addition, reformation or amendment should be considered on a case-by-case basis for the possible inclusion of provisions on the independent trustee/qualified appraisal alternative and the possible elimination of any clause requiring the make-up account as a liability.

Questions and Answers

Craig Wruck: Jon, it has been suggested that a NIMCRUT may be reformed into a SCRUT for virtually any reason. Is that your opinion, and if not, on what basis may a reformation of a NIMCRUT be made?

Jonathan D. Ackerman: As long as the technical requirements of the final regulations are met, any income exception CRUT can convert into a FlipCrut. The IRS has not limited a FlipCrut reformation to certain factual scenarios. To the contrary, the IRS has provided several safe harbor-triggering events. However, the appropriate local court (or the Attorney General) could require some basis or specific justification for the reformation.

Wruck: What types of events other than those specifically mentioned in the final regulations are

qualifying events for flip unitrust reformations? Retirement? Entry of a reformation order?

Ackerman: The conversion must be triggered either: 1) on a specific date; or 2) by a single event whose occurrence is not discretionary with, or within the control of, the trustee or other persons. A specific date, i.e., December 31, 1999, qualifies as a permissible triggering event (of course, the actual conversion into a SCRUT would begin in the year 2000). In addition to the marriage, divorce, death or birth of a child with respect to an individual and the sale of an unmarketable asset, it appears that other permissible triggering events include reaching a specific birthday or the involuntary loss of employment. It also appears that the entry of a reformation order would be suitably nondiscretionary. However, care should be used when drafting governing instrument language if the triggering event is retirement. Simply stating that the unitrust method will flip when the income beneficiary retires may not be appropriate because retirement could be deemed to be within his/her discretion. In addition, how one defines "retire" is subject to differing opinions. It may be prudent (without a private letter ruling) to provide in the governing instrument that the flip will occur on a specific date that represents the anticipated retirement date.

Wruck: Must the reformation proceeding be instituted in court or can the trustee simply amend the trust to comply with the FlipCrut rules?

Ackerman: It would appear that a court action is required with respect to the June 8th Rule. The trustee must begin "legal proceedings" to reform by June 8, 1999. The regulations also specifically require that the flip may not occur in a year prior to the year in which the "court issued the order reforming the trust… ." However, states may have rules of their own. For instance, Maryland law permits an amendment to a CRT to conform to the provisions of §664 without the application to a court of law.[36] It would not, however, be prudent to rely on state law for this purpose. The regulations clearly contemplate a court's involvement, and in that regard, the IRS may have contemplated the direct interaction of a court in each case to assure that all interests in the trust are considered (i.e., what is meaningful consent or the need to involve the Attorney General in any particular case). Remember, the IRS is not requiring that the reformation order be issued by June 8th—just that the proceeding begin by that date.

Wruck: Why are income beneficiaries in NIMCRUTs unhappy with their payouts?

Ackerman: Many NIMCRUTs do not permit capital gains to be allocated to income. As a result, capital gains income generated from the sales of appreciated capital assets is not available for the unitrust payout and the income beneficiaries are limited to interest and dividend income. Interest rates may have been higher when many of these trusts were established, and so the income beneficiaries may have expected that a higher payout would be available from the trust's investment in bonds and other fixed income investments. Given the current relatively low interest rates available, it may be difficult for a trustee to generate sufficient income to achieve the desired payout. Receiving a payment that is less than one expects can cause considerable unhappiness. Charities may likewise be unhappy with these NIMCRUTs in that the investments are not producing principal growth for their ultimate benefit.

Wruck: Is the NIMCRUT dead? If the SCRUT is so superior to a NIMCRUT in treatment for both the income and remainder beneficiaries, why would anyone create a NIMCRUT? If you desire some tax deferred growth for a period of time, or contribute an illiquid asset, why not just create a FlipCrut?

Ackerman: The NIMCRUT is not dead. It is not even on its deathbed. The NIMCRUT and the SCRUT are two different statutory creatures and serve donors in different ways. Yet, each is valid in its own right. However, one threshold question will play a major role in the future creation of

NIMCRUTs or the immediate conversion of a NIMCRUT into a FlipCrut: How is income defined?

If income does not include capital gains (post-contribution, of course), the NIMCRUT trustee, in the current investment environment, will have a difficult time investing in accordance with the best interests of all beneficiaries: Total growth produces no income; total return produces insufficient income; and total income produces no growth. However, if income includes post-contribution capital gains, a NIMCRUT has a great deal of viability. The trustee can invest for total return or growth, the benefit of which will inure to all beneficiaries. In addition, the donor may desire flexibility in the timing of receipt of the unitrust payouts. The donor may not need the income currently, but wants to retain the flexibility to determine when he/she may need an influx of cash (i.e., a medical emergency, a child's tuition cost or an outright gift to charity).

The SCRUT, on the other hand, provides a guaranteed annual stream of income based upon a percentage of the net fair market value of the trust's assets, valued annually. A NIMCRUT will only make a payment if income is generated. Even if income includes post-contribution gains, a NIMCRUT will only pay out if the trust's assets appreciate in value. While the NIMCRUT may provide greater flexibility in determining when an income beneficiary can receive a payment, the SCRUT provides a guaranteed annual payment. The NIMCRUT and SCRUT serve distinctly different goals for the donor.

Wruck: Will the make-up account always be forfeited at the time the FlipCrut converts into a SCRUT?

Ackerman: Technically—yes. Once the FlipCrut converts into a SCRUT, no payment can be made to the income beneficiaries to reimburse them for any lost payments from prior NIMCRUT years. However, if the NIMCRUT document permits the allocation of post-contribution gain to income and an asset is sold or an investment otherwise liquidated, the appreciation in that asset or investment from the date of contribution may be allocated to income and distributed to the income beneficiaries prior to the end of the final NIMCRUT year. Whether such a sale and distribution is even desirable must be determined on a case-by-case basis.

Wruck: What is the status of an income exception CRUT that invests in a deferred annuity contract or a partnership for the purpose of timing the unitrust payout?

Ackerman: In the Notice of Proposed Rulemaking, the IRS requested comments on whether such a trust would fail to function exclusively as a CRT under Treasury Regulation §1.664-1(a)(4). Unfortunately, the IRS has not yet completed its study and is unwilling to privately rule on the issue.[37] The final regulations provide no solace.

The §664 legislative history indicates that the Joint Committee staff did not think that an income exception CRUT posed any danger to charity because the trustee could not invade principal for payments to the noncharitable beneficiary.[38] This argument is especially powerful now that the IRS has clarified that precontribution gain cannot be allocated to income, thus ensuring that the charitable deduction will reflect the amount ultimately going to charity at the termination of the trust based upon the IRS's present value computations. The distribution from an income exception CRUT will never hurt charity because the trust must generate income in order to make a unitrust payment, and the income beneficiary of a NIMCRUT can never receive more than he/she is statutorily permitted (i.e., the unitrust amount).

Controlling the timing of the payout does not appear to be the IRS's concern. Instead, the interest appears to be in the nature of the investment allowing such control. The IRS raises a narrow issue with the use of an annuity contract or a partnership investment. However, a substantially similar result can

be achieved with a number of other investments. For instance, a limited number of individual stocks, an index fund and a tax-managed fund may provide control over the timing of the receipt of income.

It would seem that the IRS should permit the use of any investment vehicle within a CRT so long as a fiduciary makes the investment decisions for the best interest of all beneficiaries. For instance, the trustee's investment strategy must, under Section 232 of the Restatement of Trusts (Third)(1992), take into account the needs and circumstances of the income beneficiaries. The trustee's discretion should not be limited, except by his/her fiduciary, so long as the charity cannot be harmed. In fact, Regulation §1.664-1(a)(3) specifically prohibits the governing instrument from limiting the trustee's ability to realize a reasonable amount of income or gain from a sale of the trust's assets.

The charitable gift planning community has made every attempt to raise and answer all of the technical questions involved in this analysis. The latest IRS pronouncement on this issue is TAM 9825001, in which a NIMCRUT is invested in an annuity contract. The IRS questions the qualification and self-dealing issues on audit. The highest levels of the IRS resolved these issues in favor of the taxpayer. The IRS also described the TAM in the 1999 CPE Text and resolved all of the self-dealing issues except in egregious situations. The IRS stated that, as a practical matter, "the vast majority of income deferral NIMCRUTs adhering to ordinary fiduciary standards under state law will not run afoul of this problem." With respect to the qualification issue, the IRS should make public its approval of this strategy based upon its ruling in TAM 9825001.

The IRS mentioned in the 1999 CPE Text that a resolution of the qualification issue should not be expected in the final regulations, but that perhaps there may be some resolution of the IRS study on this issue in the following year (1999). Although the IRS may soon resolve the qualification issue, care should be exercised prior to utilizing this technique and the donor/income beneficiary should be made aware of the potential risks until such time as the IRS concludes its study.

Wruck: What obligation, if any, does the trustee of an income exception CRUT have to recover funds paid out since April 18, 1997 (or attributable to gains on sales or exchanges after that date), under an over-broad definition of income that includes capital gains from precontribution appreciation?

Ackerman: The rule that precontribution gain may not be allocated to income is effective for sales and exchanges occurring after April 18, 1997, even though the final regulations were not issued until December of 1998. Presumably, the IRS is taking the position that the proposed regulations, which were issued on April 18, 1997, would have put people on notice of its position in this regard. To date, the IRS has not specifically indicated what might be required to correct the treatment (or whether the trust could still be qualified) when trust distributions have not followed the position taken in the proposed and final regulations. However, the precontribution gain prohibition rises to the level of a governing instrument requirement. If the trust instrument includes an allocation provision that is inconsistent with the final regulations, the trust must be reformed. It also may be necessary for the income beneficiary to reimburse the trust for any distribution based upon such an allocation received since April 18, 1997.

Wruck: One final question, Jon: Assuming state law permits, is it permissible under the final regulations to define income to include capital gains attributable to precontribution appreciation, so long as the gains were realized on or before April 18, 1997?

Ackerman: In the Notice of Proposed Rulemaking, Treasury indicated that, for sales and exchanges before the date of enactment of the regulations, "the Service will continue to challenge any attempt to allocate precontribution gain to trust income as being fundamentally inconsistent with applicable local

law and with the amount of the charitable deduction claimed." The final regulations make no similar promise to challenge and clearly apply only to sales and exchanges after April 18, 1997. Even though, as a practical matter, the IRS may not be likely to challenge a pre-April 18, 1997 allocation, in no event should any action be taken that would be detrimental to the charitable remainder beneficiary.

ENDNOTES

1. IRS Notice 94-78, I.R.B. 1994-32, 15. In July of 1994, the IRS issued Notice 94-78 targeting charitable remainder trusts designed "to convert appreciated assets into cash while avoiding a substantial portion of the tax on the gain." The charitable remainder trust described in the Notice was an intervivos SCRUT with a two-year term and an 80% unitrust amount. The term was unusually short and the unitrust payout rate was unusually high. Because of these features, the unitrust described in the Notice is known as an "accelerated" CRT.

2. Some definitions are in order. The Code refers to the Internal Revenue Code of 1986, as amended from time to time. Regulations shall refer to the treasury regulations published pursuant to 26 Code of Federal Regulations. CRAT shall refer to a charitable remainder annuity trust as described in Code §664(d)(1). SCRUT shall refer to a charitable remainder unitrust as described in Code §664(d)(2). NIOCRUT shall refer to a net income only charitable remainder unitrust as described in Code §664(d)(2) and (3). NIMCRUT shall refer to a net income with make-up charitable remainder unitrust as described in Code §664(d)(2) and (3). An income exception CRUT shall refer to a NIOCRUT and a NIMCRUT. FlipCrut shall refer to a NIOCRUT or NIMCRUT that converts into a SCRUT as permitted under the final regulations. CRUT shall refer to a SCRUT, a NIMCRUT or a NIOCRUT. CRT shall refer to a CRAT and a CRUT.

3. PLR 9506015 and PLR 9522021.

4. Two recent court decisions took into account the potential for "built-in-gain" tax liabilities in determining the valuation discount of closely held stock, *Eisenberg v. Commissioner*, 155 F. 3d 50 (2d Cir. 1998) and *Estate of Helen Bolton Jameson v. Commissioner*, T.C. Memo 1999-43 (February 9, 1999).

5. H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 296 (1969), 1969-3 C.B. 644.

6. Regulation §1.664-3(c)(1).

7. Regulation §1.664-3(c)(2).

8. Regulation §1.664-3(c)(3).

9. Example (2) of Regulation §1.664-3(e).

10. Regulation §1.664-3(d).

11. Example (3) of Regulation §1.664-3(e).

12. Examples (9) and (10) of Regulation §1.664-3(e).

13. Regulation §1.664-3(f).

14. Id.

15. Prior Regulation §1.664-2(a)(1)(i) and –3(a)(1)(i)(a).

16. Regulation §1.664-1(d)(5).

17. Section 1089 of the Taxpayer Relief Act of 1997 (amending §664 to generally limit the payout rate for a CRT to 50% and requiring the value of the charitable remainder to be at least 10%).

18. 1997-48 I.R.B. 11.

19. Regulation §1.664-2(a)(1)(i)(a) and –3(g).

20. Regulation §1.664-2(a)(1)(i)(b) and –3(h).

21. Regulation §1.664-2(a)(1)(i)(a) and –3(g).

22. Regulation §1.664-2(a)(1)(i)(d) and –3(i).

23. Except where the context otherwise requires, "income" shall refer to fiduciary income as under §643(b) and the applicable regulations, Regulation §1.664-3(b)(3).

24. H.R. Rep. No. 413, 91st Cong., 1st Sess. 58-59 (1969), 1969-3 C.B. 423.

25. Regulation §1.664-3(b)(4).

26. PLR 9442017 (the IRS approved a NIMCRUT's allocation of capital gains to fiduciary income where local law permitted gains from unproductive assets to be allocated to income if required by the trust agreement), and PLR 9609009 (the IRS imposed the make-up account as a liability language where only post-contribution gains are allocated to fiduciary income).

27. Regulation §25.2702-1(a). "Family Member" includes the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual and any spouse of the foregoing, Regulation §25.2702-2(a)(1). "Applicable family member" includes the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor, Regulation §§25.2702-1(a) and 2701-1(d)(2).

28. Regulation §25.2702-1(c)(3).

29. Regulation §25.2702-1(c)(3)(i).

30. H.R. Rep. No. 413, 91st Cong., 1st Sess. 60 (1969), 1969-3 C.B. 200.

31. Regulation §1.664-1(a)(7)(i).

32. Regulation §1.664-1(a)(7)(iii).

33. Regulation §1.664-1(a)(7)(ii).

34. Teitell, *Taxwise Giving*, December 1998/January 1999.

35. Regulation §1.664-2(a)(1)(i)(a) and –3(g).

36. Notwithstanding any provisions to the contrary in the governing instrument, the trustee or trustees of any charitable remainder trust created after July 31, 1969, with the consent of each beneficiary named in the governing instrument, without application to any court, may amend the governing instrument to conform to the provisions of Section 664 of the Internal Revenue Code by executing a written amendment to the trust for the purpose. Consent is not required as to individual named beneficiaries not living at the time of amendment. In the case of an individual beneficiary not competent to give consent, the consent of a guardian, appointed by a court of competent jurisdiction, shall be treated as consent of the beneficiary. In the case of an amendment to a trust created by will, the amendment, if provided in the amendment, may be considered to apply as of the date of death of the testator." Section 14-304 of the Estates and Trusts Article of the Annotated Code of Maryland.

37. Section 5.21, Revenue Procedure 99-3, 1999-1 I.R.B 103 (January 4, 1999).

38. General Explanation of the Tax Reform Act of 1969, p.85.

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SIDEBAR: Amy, please place as close to the front of the article as possible

Definitions

CRAT:	Charitable Remainder Annuity Trust
CRT:	Charitable Remainder Trust
CRUT:	Charitable Remainder Unitrust that includes a SCRUT as well as a NIOCRUT or a NIMCRUT.
FlipCrut:	NIOCRUT or NIMCRUT that converts into a SCRUT as permitted under

	the final regulations.
NIMCRUT:	Net Income with Make-Up Charitable Remainder Unitrust
NIOCRUT:	Net Income Only Charitable Remainder Unitrust
SCRUT:	Standard Charitable Remainder Unitrust