Income and Transfer Tax Issues
Arising from Split Interest Gifts

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The present paper grew out of a short piece I wrote some years ago for Stelter's quarterly newsletter for planning professionals. Nineteen hundred words at x per word on the income and transfer tax implications of setting up a charitable remainder trust where the annuity or unitrust payout was to someone other than yourself.

It is of course not possible to cover all that ground in just under two thousand words, so I adopted a narrative strategy that allowed me to condense a lot of material into fewer words and relegate the details to footnoted citations to the Code and the regs and a couple of letter rulings.

I addressed the reader in the second person, and I supposed that "you" were advising a particular individual with respect to a particular set of contemplated transactions. The client was "Oliver W.," age 62, whom I described as an "industrialist and philanthropist," not to say a war profiteer. He had an adopted daughter, "Annie B.," age 18, and a "longtime personal assistant, Grace F.," age 34, whom he was considering marrying. Punjab and the Asp were not mentioned.

To the extent the present paper derives from that article, of course I would like to thank Stelter for the permission they have extended to me to reproduce the copyrighted material.

Today we will be covering quite a bit more ground, getting into lead trusts and gift annuities, and we will be getting into considerably more detail, but we will be referring here and there to the scenarios put forward in the Stelter piece, as these can help bring the issues into sharper focus.

Remainder trust basics

Each of these three vehicles -- the charitable remainder trust, the charitable lead trust, and the charitable gift annuity -- is a creature of the Tax Reform Act of 1969, and in each case, the rules with which we have become familiar over the past forty-odd years were designed to curb abuses. We are not going to go into any significant detail today on what was the landscape before 1969. There were dragons.

So for example with the remainder trust. You can have a fixed annuity, section 664(d)(1), or a unitrust payout, section 664(d)(2), or you can have the lesser of a unitrust or a net income payout, with or without makeup, section 664(d)(3). What you cannot have is a straight income payout or discretionary encroachments on principal.

The fixed annuity must be at least five pct. of the initial fair market value of the trust corpus, and the stated unitrust amount must be at least five pct. of the net fair value of the trust corpus, revalued annually. Since 1997, the maximum payout has been capped at fifty pct.

The trust cannot continue for the longer of lives in being or a term of twenty years. And since 1997, there has been a requirement that the present value of the remainder to charity be at least ten pct. at the inception of the trust.

In the case of an annuity trust for the life of an individual, Rev. Rul. 77-374 imposes the additional requirement that the actuarial probability that the annuitant might survive the exhaustion of the trust be not more than five pct.

[Also, Reg. 25.7520-3(b)(2)(v), example 5, says if the annuity would exhaust the trust were the annuitant to survive to age 110, the annuity is to be valued as though it were for the shorter of her life or the term over which the trust would exhaust. Query whether this implies that the term of the trust must be thus limited.]

If the trust conforms to the statutory requirements, as implemented or interpreted through regulations and other formal guidance, you get the favorable tax treatment, otherwise not.

And what exactly is the favorable tax treatment.

You get a charitable deduction for income tax purposes in the amount of the present value of the remainder. In the case of a net income unitrust, no adjustment is made for the possibility that the remainder charity may receive the benefit of any shortfall in the unitrust payout.

If you have reserved a power to redesignate the charitable remainderman, the gift of the remainder is incomplete for transfer tax purposes. If you have not reserved such a power, the present value of the remainder qualifies for a charitable deduction for gift tax purposes.

The trust is treated as an exempt entity, which means that no tax is imposed at the trust level on ordinary income or capital gains. Instead, these are taxed to the annuitant or

unitrust distributee, to the extent of current distributions, under a four tier ordering rule sometimes referred to colloquially as "worst in, first out."

Over the years, the "worst in, first out" ordering rule has been refined to require ordering within income classes, so that for example net short term gains are distributed ahead of net long term gains, etc. The proposed regs implementing the 3.8 pct. Medicare surtax would treat annuity or unitrust distributions as carrying out current or accumulated "net investment income," without reference to the ordering rules.

Under the statute as enacted in 1969, the receipt of a single dollar of "unrelated business taxable income" would cause the trust to lose its exempt status for that year. In 2007, the statute was amended to provide instead that any UBTI is taxed at one hundred pct., payable from corpus, even though it may also be treated as having been distributed to, and taxed in the hands of, the annuitant or unitrust distributee.

Remainder trust f/b/o nonspouse

So those are the basics, assuming you are retaining the annuity or unitrust payout for yourself. But what if you are setting up a remainder trust for the benefit of someone else.

Let's start with the case of a nonspouse, in our example Annie B., age 18. Note incidentally that given the age difference, if Oliver W. had not adopted her, she would be a skip person with respect to him. Note also that even using the minimum five pct. payout, it is not possible to set up an annuity or unitrust for her life and get a remainder value anywhere near ten pct. So we are stuck with a term of years.

According to Reg. 25.2503-3, the gift of a current income interest in a trust is eligible for the annual gift tax exclusion. But the present value of a five pct. annuity for twenty years, with the 7520 rate at 2.0 pct., is almost 81.8 pct. If we set this up as a unitrust, we are still looking at a present value of over 63.4 pct. To the extent the present value of the annuity or unitrust interest exceeds the $14k annual exclusion, we are eating away at our $5.25 million lifetime credit equivalent.

"Is there a way around that," Oliver asks. Yes, you can reserve a testamentary power to revoke the annuity or unitrust payout. Testamentary because if you could exercise the power inter vivos, the trust would be a "grantor" trust for income tax purposes, and would not qualify as a charitable remainder trust.

If Oliver reserves the testamentary power, the gift to Annie is complete only as each distribution is actually made to her. But reserving the power would cause the value of the trust corpus to be included in Oliver's taxable estate under section 2038, if he predeceased the term, unless he released the power more than three years prior to his death.

The present value of the remainder to charity would only partially offset this inclusion, and some mechanism would have to be put in place to assure that estate taxes apportioned to the unexpired annuity or unitrust interest would not be paid from the trust itself, as this would disqualify the trust. According to Rev. Rul. 82-128, this should be accomplished by making the continued payment to Annie contingent on her paying the apportioned tax from her own pocket.

If Annie were in fact a skip person, the reserved power would also function to bring 14k per year of the annuity or unitrust payout within the annual exclusion for generation-skipping transfer tax purposes. Absent the reserved power, it would be necessary to allocate GST tax exemption amounts to the trust if a zero inclusion ratio were desired. Reserving the power creates an "estate tax inclusion period," and it will not be possible to allocate exemption amounts to the trust until the ETIP closes, i.e., at Oliver's death.

<u>Remainder trust f/b/o spouse</u>

Because Grace F. is age 34, we could set up a five pct. unitrust for her benefit and still get a remainder value over the minimum ten pct., even if the 7520 rate fell to zero. With the 7520 rate at 2.0 pct., we could push the payout up to a just little under six pct.

If Oliver were already married to Grace, her unitrust interest would qualify for a gift tax marital deduction under section 2523(g)(1), provided there were no other noncharitable beneficiaries, except possibly Oliver himself. And according to Reg. 25.2523(g)-1(a)(3), Grace's interest need not be for life, so long as it is not for a term of years longer than twenty. So we might think of putting in a qualified contingency that would cause her interest to fail if, for example, there were a divorce.

If, as Oliver himself suggests, we reserve a successive unitrust interest to him in the event he survives Grace, the effect on the present value of the remainder to charity is actually modest, because the likelihood that Oliver will survive Grace is slight. Then if Oliver in fact survived Grace, he could choose to accelerate the remainder to Hard Knocks and claim an income tax deduction for the present value of his unexpired unitrust interest.

Oliver might instead set up an inter vivos QTIP trust for Grace, reserving a successive income interest in the event he survived her, with the remainder after both lives to Hard Knocks. The trustee might be permitted to make encroachments on principal for Grace's benefit.

Incidentally, in TD 9102, effective January 2, 2004 the regulations were revised to permit a unitrust payout of between three and five pct. on a straight QTIP trust, provided state law permits a trustee who is investing for "total return" to convert to a unitrust payout rather than trying to apportion receipts and expenses between income and principal in a manner that balances the interests of the income and remainder beneficiaries. My understanding is that Minnesota has not adopted this provision of the Uniform Principal and Income Act.

In the piece I wrote for Stelter, "you" advised Oliver that in the event he survived Grace he might disclaim his successive income interest in an inter vivos QTIP trust.

Possibly "you" were thinking you could give Grace a limited power to appoint the remainder after her life interest and make Oliver's successive income interest contingent on the nonexercise of that power, and since the trust corpus would be taxable in Grace's estate under section 2044, a disclaimer could be made within nine months of her death. But Reg. 25.2518-2(c)(3) says even in that circumstance, the disclaimer must have been made within nine months of the transfer creating the contingent interest. So "you" were mistaken.

It is true, though, as "you" also advised him, that if Oliver survived Grace he might accelerate his income interest to Hard Knocks, and under sections 2519 and 2511 this would be treated as a deductible gift of the entire trust corpus.

The question would then be whether this would violate the "partial interest rule" at section 170(f)(3). At that moment, the income interest is all Oliver has, but he did once hold the fee simple, and it was he who created all these partial interests. But it would be difficult to make the case that he did all this for the purpose of evading the rule.

Or he could simply turn the unitrust payments over to Hard Knocks as they were received, possibly not a wash if he is already up against his adjusted gross income limits or is subject to the "Pease" limitation on itemized deductions.

Side note re Chapter 14

If Oliver wanted to set up a two-life unitrust with the payout initially to himself and then a successive interest to Grace, section 2523(g)(1) appears to say the successive interest would be eligible for a marital deduction, despite the fact it is deferred. If they were married.

If they were not married, and if for some reason Oliver wanted to complete the gift, i.e., not reserve the testamentary power to revoke, and report the gift to Grace as discounted by the intervening unitrust payout to him, then Reg. 25.2702-1(c)(3) says he cannot use a net income trust, with or without makeup. If he does, his retained interest will be valued at zero.

And that is about as far into Chapter 14 as we are going to go today.

<u>The remainder trust in prenup and divorce planning</u>

Oliver asks, can we set up the charitable remainder trust or the QTIP for Grace as part of a prenuptial agreement. Reg. 25.2512-8 says a relinquishment of marital rights is not consideration "in money or money's worth," meaning this would not be treated as a taxable exchange, therefore impliedly a gift. But it would not be eligible for a marital deduction unless they were already married when the transfer actually occurred.

So, short answer yes, but you need to be careful on the timing. But what about at the other end. Can we use the remainder trust or the QTIP as part of a divorce settlement.

On the one hand, section 2516 says property transferred as part of a divorce settlement entered into within two years before or one year after the decree is deemed to have been exchanged for "full and adequate consideration in money or money's worth," i.e., not a gift. On the other hand, section 1041(a) says no gain or loss is recognized on a transfer to a spouse, nor to a former spouse "incident to a divorce." No stated time limit, though the transfer is presumed to be "incident to a divorce" if it occurs within one year after the decree. And then section 1041(b) says the transferee takes carryover basis, as though this were a gift.

<u>A brief aside</u>

Rev. Proc. 2005-24 would invalidate, apparently prospectively, a remainder trust Oliver might set up for his own benefit if the elective share of a surviving spouse could be satisfied in part from assets of the trust unless Grace waived her right to elect against the trust. The waiver would have to be made within six months after the due date -- not including any extensions -- of the information return for the year in which

- the trust was created, or
- in which they married, or
- in which Oliver established domicile in a state whose law provided Grace the right of election, or
- in which the state law providing the right of election became effective,

whichever occurred later. A remainder trust created prior to June 28, 2005 would be grandfathered. That date has been moved back indefinitely by Notice 2006-15.

<u>Footnote re the noncitizen spouse</u>

As "you" observed in the article I wrote for Stelter, the marital deduction for a gift in trust for a noncitizen spouse that would qualify for a marital deduction only if a QTIP election were made -- which it cannot be for a noncitizen spouse -- is capped at $14k. Reg. 25.2523(i)-1(d), example 4.

But if the transfer were structured as a charitable remainder trust, because an election is not required to qualify a charitable remainder trust for the marital deduction, the deduction would instead be capped at $143k. Reg. 25.2523(i)-1(d), example 3. Reference is made to PLR 9244013, though of course one cannot rely on a private letter ruling as precedent.

<u>Lead trust basics</u>

Again, the charitable lead trust is a creature of the Tax Reform Act of 1969. And again, you can set up the lead trust to pay a fixed annuity or a unitrust amount, section 170(f)(2)(B). You cannot have a net income feature if you want the lead interest to qualify for a charitable deduction for income and/or transfer tax purposes.

There is no minimum five pct. payout and no limit on the term, though regs finalized in TD 8923, effective April 4, 2000, require that measuring lives be limited to the settlor, the settlor's spouse, or a lineal ancestor or the spouse of a lineal ancestor of all remainder beneficiaries.

These regs were issued in response to an abusive practice, the so-called "ghoul CLAT," in which a transferor would use as a measuring life a stranger whose life expectancy was significantly shorter than the 7520 table factors would indicate. The regs do permit alternative contingent remainders to nonlineals, provided the actuarial probability that someone who is not a lineal descendant of a measuring life will receive any portion of the remainder be less than fifteen pct.

The "grantor" lead trust

An inter vivos lead trust can be set up as a "grantor" trust for income tax purposes, in which case you can claim an income tax charitable deduction up front for the present value of the annuity or unitrust payout, accelerating what might otherwise be x number of years of deductions into a single year, with of course a five year carryforward.

Because the gift is "for the use of" rather than "to" charity, the deduction is subject to the thirty pct. limitation, per section 170(b)(1)(B). And then because this is a "grantor trust," you report the income on your individual return even though you are not receiving any distributions.

There are various mechanisms one might use to secure "grantor" trust status. Oliver might reserve a contingent reversion the actuarial value of which is greater than five pct., per section 673(a), though this would also cause the value of the trust corpus to be included in his taxable estate under section 2037(a)(2) if he did not survive the contingency.

Or he might reserve a power to change the charitable beneficiary, per section 674(b)(4), or a "swap" power to exchange assets of equivalent value, per section 675(4)(C), though either of these would cause estate tax inclusion under section 2038. But if either of these powers are held by a "nonadverse party," you get "grantor" trust treatment without estate tax inclusion.

If at some point the trust loses its "grantor" trust status -- say, Oliver dies or he releases the relevant power --, Reg. 1.170A-6(c)(4) says the settlor is treated as having received as income the amount by which the up front charitable deduction exceeds the discounted value of the amounts actually paid out.

The non-"grantor" lead trust

Alternatively, an inter vivos lead trust can be set up as a non-"grantor" trust, in which case you get no income tax deduction, but the trust itself is taxed as a complex trust, and it can claim an income tax deductions under section 642(c) for the amounts it distributes to charity from income, "pursuant to the terms of the governing instrument."

Typically, the trust document will specify that the annuity or unitrust amount is to be paid first from ordinary income, etc. But TD 9582, effective April 16, 2012, finalized a change to Reg. 1.642(c)-3(b)(2) that says an ordering rule in the governing instrument or under state law will be disregarded unless it has "economic effect independent of income tax consequences."

The default rule, according to the reg, is pro rata across all income classes, apparently including realized gains, though this is not made clear, and a cross reference to Reg. 1.652(b)-2(b) might suggest otherwise. Common law principles of trust accounting do, after all, allocate gains to corpus.

Transfer tax leverage

In either case, "grantor" or non-"grantor," the lead interest is deductible for transfer tax purposes, and this has the effect of leveraging the transfer tax value of the remainder gift to let's say Annie. With 7520 rates at historic lows, this leverage is especially strong with an annuity trust. When the rate hit 1.0 pct. a few months back, it would have been possible to "zero out" the remainder gift in a lead annuity trust over a twenty year term with a payout of less than 5.6 pct. Before the crash, when the 7520 rate was 4.2 pct., you would have had to set the annuity at about 7.5 pct. to "zero out" the remainder.

Of course, Oliver will want to get creative and fund the annuity trust with interests in a limited partnership, discounted for lack of marketability, etc. by thirty pct. or whatever, so that as a practical matter the 5.6 pct. payout is more like 3.92 pct. on underlying asset values.

[Incidentally, because a non-"grantor" lead trust is taxable as a complex trust anyway, you could consider a non-qualifying payout, e.g., straight income. What you lose is the transfer tax leverage.]

Lead trust f/b/o nonspouse

The remainder gift in a lead trust is of course not a present interest gift, so it is not eligible for the annual exclusion, and we are looking at consuming some portion of the lifetime credit equivalent. Unless, again, Oliver reserves a testamentary power to revoke the remainder gift to Annie, in which case, again, we are looking at estate tax inclusion under section 2038.

If Oliver did not reserve a testamentary power to revoke, the remainder gift to Annie would be complete. And if Annie were a skip person, there would be no "estate tax inclusion period" for purposes of section 2642(f), and we would be looking at leveraging the remainder value for GST tax purposes.

But per section 2642(e), you cannot allocate GST tax exemption amounts to a lead annuity trust until the end of the annuity term. You can allocate exemption amounts to a unitrust, but that is not where the leverage is.

Lead trust f/b/o spouse

A future interest does not qualify for a marital deduction, period. So if Oliver were to name Grace as the remainder beneficiary of a lead trust, he might reserve a testamentary power to revoke and accept the estate tax inclusion under section 2038, but if he died before the expiration of the annuity term this still would not solve the problem, unless he set the term at the shorter of a stated term of years or his life.

Gift annuity basics

The charitable gift annuity is, yet again, a creature of the 1969 statute, section 514(c)(5), an exception to the acquisition indebtedness rule.

The transaction is treated as a "bargain sale," in which the present value of the annuity payout must be less than ninety pct. of the value of the property given in exchange. The property cannot be subject to a mortgage placed within the preceding five years. The annuity is to be paid over one or two lives, i.e., not a term of years, and the contract must not be assignable except to the issuing charity.

Gift annuity f/b/o nonspouse

If the donor is at least one of the annuitants, long term gain is reported ratably over her life expectancy. However, if Oliver sets up a gift annuity for Annie, contributing appreciated property, he will recognize the gain immediately.

The gift is a present interest, but to the extent the present value of the annuity exceeds the $14k annual exclusion Oliver may want to reserve a testamentary power to revoke in order to make the gift incomplete. Again, risking estate tax inclusion under Section 2038 if he does not survive Annie.

Gift annuity f/b/o spouse

If Oliver sets up a gift annuity for Grace alone, he gets a gift tax marital deduction, but again the gain is recognized immediately. If he sets it up for himself and Grace jointly, and if she would continue to receive the annuity if he predeceased her, he still gets the marital deduction, and the gain is recognized only over his life expectancy. Joint life expectancy only if the annuity is funded with joint property.

If Oliver alone is the annuitant, with Grace getting the annuity only if she survives him, her deferred interest does not qualify for a gift tax marital deduction. Oliver could reserve a testamentary power to revoke, and then if Grace did survive him

the gift would become complete only at his death, and would qualify for an estate tax marital deduction. The present value of her annuity would be includible in his estate under section 2038, but would be offset by a marital deduction.

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A transportational bicyclist and sometime bike mechanic, Russ was a founding board member of the St. Louis Regional Bicycle Federation and chaired its policy and advocacy committee before moving to Portland in 2008 to live car-free.