Accelerating the Remainder Gift: Two Case Studies

Ongoing stewardship of a donor who has already committed to a life income gift can sometimes include revisiting, from time to time, whether the cashflow from a remainder trust or a gift annuity is still meaningful within the donor's larger financial picture, or whether that income stream might itself be the source of a further deductible gift.

We are working with two basic scenarios here. In each, you have a donor who has already made a commitment to your org with a life income gift. In the first scenario, this is a charitable remainder trust. In the second, it is a gift annuity.

In each case, we are looking at how the holder of the income interest might make a further gift to your org of a portion or all of that interest, under what circumstances such a gift might be indicated, and what are the tax implications of such a transfer.

We might get pretty deep into the weeds on some of the tax law stuff, but that's okay, this is the "planned gift tech" track.

Case Study One

Let's say Jane set up a five pct. straight unitrust ten years ago at the age of 68. And let's say she funded the trust with $200k in marketable securities in which she had some unrealized appreciation.

Something like two-thirds of remainder trusts fall into roughly this category. You might have wanted me to say she funded the trust at $500k, but part of my premise here is that Jane may have been testing the waters. You can always add to a unitrust.

So in the first year, just as the markets were crashing, Jane received a payout of $10k. We are going to say the trust has experienced an average return of nine pct. per year net of fees, which might actually be a little high, depending. After distribution of the unitrust amount, this would translate to net growth of four pct. per year, so over the past ten years the trust corpus has grown to $296.05k, and the current payout to Jane has grown to $14.8k.

As a point of comparison, inflation over the past ten years has been averaging something like one and a quarter pct. A dollar in 2008 would buy you about a dollar fifteen today. So we are running about 28.7 pct. ahead. of inflation.

Current yields in the trust have been let's say something like 1.5 pct., so the payouts to Jane over the years have carried out a good portion of the gains realized on the repositioning of the portfolio on day one, maybe as much as $44k. She may also have reported some short-term

gains along the way. But some portion of what she is receiving now might actually be fourth tier, return of principal.

Of course, your mileage may differ. I am just trying to build a plain vanilla case.

Back in mid-2008 when Jane set this up, 7520 rates had begun to fall from a peak of 6.2 pct. in August 2007. After a dip to 3.2 pct. in May 2008, there was a three-month crest at 4.2 pct. in July through September. We have not seen that rate since. The rate has bottomed out at 1.0 pct. three times, most recently in January 2013, and has been stumbling upward since.

As I write this in early September 2018, the rate seems to have plateaued at 3.4 pct., but we are up sixty basis points from January.

The present value of the remainder when Jane set up the trust at age 68 was a little under half, so her deduction at the time was about $99.04k. The present value of her remaining life interest today, at age 78, is just over 35 pct., or about $103.74k. According to the tables, Jane should be around for another 12.7 years.

Cultivation, stewardship

Under what circumstances might Jane want to consider making a further gift to the remainder org of some portion or all of her income interest in the trust?

The most obvious scenario would be that she no longer "needs" the taxable cash flow, or at least not all of it.

Or the trust may have underperformed her expectations. The stated unitrust percentage may have been considerably higher and/or investment returns may have been somewhat lower than what we have just sketched. Net returns after distribution of the unitrust amount might even be negative, which would mean the unitrust payout has actually been trending down.

If at the outset Jane had named a contingent successor noncharitable beneficiary, that individual may have since died, or there may have been a divorce, or someone might be looking at a reduced life expectancy.

If the trust was set up as an "income exception" trust with "makeup," and/or with a mechanism to "flip" to a straight unitrust upon the occurrence of a triggering event other than the sale of unmarketable assets, it might now appear that the circumstances are unlikely to arise that would allow the trust to pay out the accumulated deficiencies or to "flip."

In other words, something may have happened in the intervening years that has weakened or defeated the expectations under which Jane created the trust.

Or not. The larger point here is that her retained income interest is itself a capital asset that you will not want to overlook in your cultivation and stewardship efforts.

State law issues

What mechanically needs to be done to accelerate part or all of the remainder to your org is largely a matter of state law. If your org is irrevocably designated to receive the remainder at the death of the income beneficiary or after a term of years, it may be possible to modify or terminate the trust by consent of the interested parties, though in most states this will still require the approval of a local court, and in some states it may be necessary to secure the consent of the state attorney general.[fn. 1]

If the settlor has reserved a power to change the remainder beneficiary designation, she will need to renounce that power. If she has reserved a testamentary power to revoke a successive income interest in a spouse or some other individual, you will need to enlist the cooperation of that beneficiary. A renunciation of the power to revoke would complete a taxable gift.[fn. 2]

If the income beneficiary is someone other than the settlor -- a spouse or a child for example --, there might be "spendthrift" language in the trust document that would appear to prevent the beneficiary from assigning her income interest to the remainder org. But some state statutes will allow the court, in approving a modification or termination by consent, to disregard a "spendthrift" clause for this purpose.[fn. 3]

Acceleration versus commutation

Alternatively, the income beneficiary might in effect sell her interest to the remainder org. In a "commutation," the remainder org would receive the present value of the remainder and the income beneficiary would receive the present value of the unexpired life or term interest.[fn. 4]

In the scenario we have sketched above, where the trust corpus is $296.05k and the present value of Jane's income interest is $103.74k, the remainder org would receive $192.31k, but this would not be treated as an additional gift. For her part, Jane would be treated as having sold a capital asset in which her basis was zero, and the entire $103.74k would be taxed to her as long-term gain.[fn. 5]

Or Jane might exchange her income interest in the unitrust for a gift annuity issued by the remainder org. This would be treated as a "bargain" sale, in which Jane would be taxed only

on that portion of the gain allocated to the sale element, and she would recognize that gain ratably over the expected return multiple, rather than immediately.[fn. 6]

Jane could claim a deduction for the present value of the residuum to the issuing charity, but this would be subject to the 30 pct. limitation, because this is treated as a gift of appreciated property in which she has unrealized long-term gain.[fn. 7]

Running the numbers

Again assuming we are looking at a straight five pct. unitrust, the math is pretty straightforward. If Jane simply accelerates the remainder, she can claim a charitable contribution deduction of $103.74k, the present value of her unexpired unitrust interest, again subject to the 30 pct. limitation.[fn. 8] If instead she enters into a commutation, she would recognize long-term gain in that same amount.

If Jane is in, say, the 24 pct. marginal rate bracket, with long-term gains taxed at 15 pct., we are looking at a tax benefit of $24.9k on the one hand versus a tax cost of $15.6k on the other.

But of course it does not have to be all or nothing. Jane might consider accelerating only a portion of the remainder, maybe skimming the net appreciation of $96.05k, taking a tax benefit at 24 pct. of $23.1k, and dropping her unitrust payout back to $10k.[fn. 9] And she could revisit this strategy at intervals.

Or she might combine a partial acceleration with a partial commutation -- a strategy somewhat analogous to exchanging her income interest in the unitrust for a gift annuity, except that she recognizes the gain element immediately.[fn. 10]

More numbers

The scenario in which Jane exchanges her income interest for a gift annuity issued by the remainder org is slightly more complicated, as it features elements of both an acceleration and a commutation.

The ACGA recommended maximum payout rate for an annuitant aged 78 is 6.8 pct. If Jane exchanges the entire $103.74k in value for a gift annuity, she will be looking at a payout of $7.05k going forward, slightly less than half the amount the unitrust is currently paying.[fn. 11]

About $5.17k of this amount will be taxed as long-term gain and about $1.88k as ordinary income through an expected return multiple of 10.5 years. After that, if Jane is still around, the entire amount of the annuity payout will be taxed as ordinary income.

The present value of residuum to the issuing org is about $49.8k, which Jane can deduct for a tax benefit in the 24 pct. marginal rate bracket of about $11.9k.

Alternatively, Jane might take the opportunity to exchange her income interest in the unitrust for a gift annuity payable to a third party. She would calculate her deduction for the present value of the residuum with reference to the annuitant's life expectancy, and she would immediately recognize gain on the entire amount of the sale element.

The net income limitation

In a series of letter rulings starting with PLR 200725044, IRS took the position that it could not rule favorably on the commutation of a net income trust unless the transferor agreed to value the income interest at the lesser of the then-current 7520 rate or the stated unitrust payout percentage -- as though it were a given that the accumulated deficiencies would never be made up.

The somewhat strained logic of these rulings was that to allow the income beneficiary to receive a distribution from amounts that might otherwise go to the remainder org -- even though no charitable deduction had been claimed for these amounts -- would be to countenance an act of self-dealing.[fn. 12]

As noted in footnote 4, IRS stopped issuing letter rulings on commutations altogether in January 2008.

Nearly eight years later, as part of an extenders bill enacted at the eleventh hour in December 2015, a sentence was added to section 664(e) which apparently was intended to override the position asserted in these rulings, by providing that in the case of an "early termination" of a net income unitrust, the income and remainder interests are to be valued "under rules similar to" those that apply to valuing remainder interests in annuity trusts or straight unitrusts.[fn. 13]

The reasonably straightforward inference is that the interests in a net income trust are to be valued "without reference to the net income limitation," but for whatever reason this is not made explicit in the legislative text.

To date IRS has issued no guidance construing this measure, and it has not been identified as a guidance priority.[fn. 14]

Successive interests

Suppose Jane had named a successor noncharitable beneficiary and reserved a testamentary power to revoke. Can we still get this done? Short answer yes, but. We need to get the successor beneficiary on board, first of all, and then we have a choice to make. Either

> (a) Jane can renounce her reserved testamentary power, which would complete a reportable gift of a future interest to the successor, contingent on her surviving Jane, and the successor can then join in accelerating the remainder[fn. 15] or in commuting the trust, or
>
> (b) if Jane does not complete the gift by renouncing her power to revoke, the successor would still as a practical matter have to join in an acceleration, but she would not be in a position to claim a charitable deduction for her interest, as it is not only contingent on surviving Jane but also subject to defeasance by Jane exercising her power to revoke, and thus has no actuarial value.

In scenario (a), Jane consumes a portion of her applicable exclusion amount, but the successor can claim a deduction for the present value of her contingent interest. In scenario (b), the amount deductible by Jane is still calculated with reference only to her own life expectancy, but the successor gets no tax benefit.[fn. 16]

Forensics

Some of the complexities we have encountered here might have been simplified by drafting some flexibility into the trust document back on day one. For example,

> - while it may be desirable, if the annuity or unitrust payout in a remainder trust is to someone other than the settlor,[fn. 17] to include a "spendthrift" clause, this should be drafted in such a way as not to preclude the beneficiary assigning part or all of her income interest to the remainder org.
>
> - it might be desirable to include language in the trust document, per reg. section 1.664-3(a)(4), permitting or directing the trustee to make current distributions, apart from the annuity or unitrust payout, to an exempt entity selected by the income beneficiary.[fn. 18]

This latter would at least arguably obviate the necessity of securing the consent of the state attorney general, at least as to an acceleration, and it has the effect of planting the idea in the settlor's mind at the outset that she might at some point decide to accelerate her income interest.

[Another reason for the remainder org to try to be present at the creation and to check in with the income beneficiary at intervals is to forestall errors in drafting and/or implementation that might have the effect of disqualifying the trust and/or causing the trustee or the income beneficiary to incur penalties. The stories your correspondent could tell.]

Case Study Two

Let's say Richard set up a charitable gift annuity with your org five years ago at age 73, payable to himself for life and then to his spouse, Jane, also then aged 73, if she survived him. And let's say he reserved a power to revoke the annuity to Jane.[fn. 19]

At the time he set this up, the ACGA recommended maximum payout rate for an annuity payable over two lives, both aged 73, was 4.8 pct. Nowadays the recommended rate would 5.3 pct. for two annuitants both aged 73, but the rate for two annuitants both aged 78 is 5.9 pct.

As in the previous example, let's say Richard funded the annuity with $200k in appreciated property. The deduction at the time would have been something short of half this amount, again subject to the 30 pct. limitation. The annuity is paying $9.6k per year.

Because Richard funded the annuity from his separate property, he has been recovering his basis and recognizing gain over an expected return multiple measured by his life only, not the joint lives. He still has a few years to go.[fn. 20]

Cultivation, stewardship

The reasons Richard might choose to assign some portion or all of his interest in the annuity to the issuing org are of course similar to those we mentioned earlier in connection with accelerating a remainder trust. He no longer "needs" the taxable cash flow. Jane has died or is unlikely to survive Richard, or there has been a divorce.

Or, again, none of the above. The point is that Richard's interest in the annuity is a capital asset that you will not want to overlook in your cultivation and stewardship efforts.

Some numbers

The present value of a $9.6k annuity payable over two lives, both aged 78, is somewhere around $74k. The present value of an annuity payable only over Richard's life is actually not a lot less.[fn. 21] But in either event, a deduction for the assignment of the annuity to the issuing org will be limited to Richard's unrecovered basis in the contract.[fn. 22] And to the

extent that includes unrealized gain, his deduction will be limited to 30 pct. of adjusted gross income.[fn. 23]

We might also look at having Richard assign only a portion of his annuity, or we might look at having him exchange his annuity for another, much smaller annuity payable to a third party. In the latter case, the math will be quite similar to what we have already seen in connection with the commutation of a remainder trust in exchange for a gift annuity. And he would recognize gain immediately.

Again the successive interest

Because of the way this annuity was set up, we again have the problem of a revocable successive interest. At first glance it would appear we have two choices, but really only one choice works.

> (a) If Richard renounces his reserved power to revoke the annuity to Jane, this will complete the gift, which is not eligible for a marital deduction.[fn. 24] Jane would then be in a position to assign her interest, but her unrecovered basis in an annuity that would have taken effect only at Richard's death is zero. [fn. 25] So that looks like a nonstarter.
>
> (b) If Richard instead exercises the power, revoking the annuity to Jane, this in itself would appear to create an additional gift to the issuing org, in the amount of the present value of an annuity to Jane for the interval by which she might have survived Richard. And it would appear that a deduction for this component of the transaction, taken separately from the assignment of Richard's own annuity, might not be limited to unrecovered basis.[fn. 26]

Forensics

Again, looking at the transaction from the back end, we learn a a couple of things that might have been done differently at the outset. Specifically,

> - Because Richard funded this annuity with his separate property, we were burning through realized gains at a faster clip than if these had been allocated pro rata over an expected return multiple calculated on joint life expectancies. As a result, a larger portion of each payment that was allocated to return of basis was taxed as long-term gain. This may or may not have been an

optimal strategy for Richard, but it is also possible no one asked the relevant questions when he was setting this up.

- If neither spouse has assets anywhere near the applicable exclusion amount, it was not strictly necessary for Richard to render the gift to Jane incomplete by reserving a power to revoke -- except of course for nontax reasons.

- But a related question is whether it might have made sense for Richard to convert the property with which he was funding the annuity to joint or entireties property, and for both spouses to then join in funding a joint and survivor annuity. If nothing else, they could have been recovering unrealized gain over a longer expected return multiple.

- By having Richard exercise his reserved power to revoke the annuity to Jane, we at least arguably created a somewhat more favorable reporting position. If the power had been exerciseable only by will, we would not have been able to do this. As noted at footnote 19, we are not concerned here with "grantor" trust issues. Again, the time to have that conversation -- inter vivos or testamentary -- is at the outset.

Conclusion

What we have been looking at for the past hour are tools you might use to help an existing donor accomplish some nontax objectives while benefiting your org. A tool does not, or should not, define the task. Your task here is to cultivate and steward a relationship with a human being who is invested in the mission of your org. One aspect of that task is to take responsibility to see that the structures that have already been put in place are continuing to serve their purposes.

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footnotes:

[fn. 1] The Uniform Trust Code, on which statutes in about two-thirds of the states are modeled, provides a mechanism at section 411(a) for modification or termination of an irrevocable "noncharitable trust." The quoted phrase is not defined, except by negative inference from the definition of "charitable trust" at section 103(4), which seems to apply only to what we might think of as a section 4747(a)(1) nonexempt trust. But the drafters' commentary does indicate that the remainder interest in a split-interest trust is itself treated as a "charitable trust."

It would appear, then, that the mechanism at section 411(a) applies to a split-interest trust, treating an irrevocably designated remainder org and/or the state attorney general as a beneficiary whose consent would be required. And it would therefore appear that the parties might accomplish the same result through a nonjudicial settlement under section 111(b) -- though an argument can be made that the state attorney general would have standing to petition the court to reopen the matter if she was not already involved.

Since a modification or termination by consent is typically a walkthrough, with the judge simply signing off on the proposed order, it would seem the better practice to secure consent of the state attorney general in every case.

[fn. 2] Section 2523(g) provides an exception to the general rule that an inter vivos trust for the benefit of a spouse, with the remainder over, will not qualify for a gift tax marital deduction unless it can be qualified as QTIP -- which a deferred interest cannot. The exception applies where "the donee spouse is the only noncharitable beneficiary (other than the donor) of a qualified charitable remainder trust."

Interestingly, the statute does not require that the income interest for the spouse be immediate, *i.e.*, a successive interest will qualify. A term of years trust would qualify, as would a trust in which the spouse's interest might terminate upon the occurrence of a "qualified contingency," for example divorce.

A successive interest to a nonspouse beneficiary will not qualify for the gift tax annual exclusion under section 2503(b) because it is not a "present interest." And even if Jane had set up a remainder trust for the immediate benefit of a nonspouse, the present value of the income interest would likely exceed the annual exclusion, presently $15k.

In either case, spouse or nonspouse, Jane would likely reserve a testamentary power to revoke the interest of a third party beneficiary. The reason the reserved power must be testamentary is that a power exerciseable inter vivos would cause the trust to be treated as a "grantor" trust under section 674(a), and this would disqualify the trust under section 664(d).

On the other hand, the reserved power will cause the trust to be included in Jane's taxable estate under section 2038(a)(1), unless she releases the power more than three years prior to her death, see section 2035(a). If Jane herself is an income beneficiary, the trust would be included in her estate under section 2036 anyway.

The trust document should include a mechanism assuring that estate or inheritance taxes apportioned to an unexpired income interest will not be paid from the trust itself, as this would disqualify the trust. Per Rev. Rul. 82-128, this is typically accomplished by making the continued payment to the noncharitable beneficiary contingent on her paying the tax from her own pocket.

[fn. 3] What section 411(c) of the uniform code literally says is that a spendthrift provision "is not presumed to constitute a material purpose of the trust" for purposes of the so-called "Claflin" doctrine, which limits the court's authority to modify or terminate an irrevocable trust where this would frustrate a "material purpose" of the settlor in establishing the trust.

[fn. 4] In a number of letter rulings spanning about ten years, IRS took the position that the commutation of a remainder trust should be treated as a sale or exchange of a capital assert in which the income beneficiary had a basis of zero.

Most of these rulings cited Rev. Rul. 72-243, which says a life tenant's sale of her interest in a testamentary trust to the remainderman is the sale of a capital asset. That revenue ruling was itself a belated acquiescence in *Beulah Eaton McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), cert. den., 330 U.S. 826 (1946). *McAllister* was a defeat for the Commissioner, who had argued the transaction was an anticipatory assignment of income.

In January 2008, in Rev. Proc. 2008-3, IRS announced it would no longer "ordinarily" issue an advance determination whether the commutation of a remainder trust would be treated as the sale of a capital asset.

In the same revenue procedure, IRS also said the question whether a commutation might disqualify the trust under section 664(d) was "under study," and no further letter rulings would be issued pending issuance of formal guidance -- which has not been forthcoming.

In Rev. Proc. 2010-3, this latter issue was also moved to the "no rule" list, and in Rev. Proc. 2015-3, an item was added to the list saying IRS would simply not give advance determinations on any potential tax consequences to a commutation, at all.

To some extent, this may have been a matter of IRS not wanting to defend a controversial position it had taken on valuing the income interest in the commutation of a net income trust, see the discussion below accompanying footnote 9.

[fn. 5] Before placing this transaction on its "no rule" list, see footnote 4 above, IRS had issued more than half a dozen letter rulings to this effect, of which perhaps the earliest was PLR 200127023 and the last was PLR 200846037.

[fn. 6] Provided the gift annuity is nonassignable, except to the issuing charity, per reg. section 1.1011-2(a)(4)(ii).

The tax implications of this transaction are detailed in PLR 200152018. Of course a letter ruling is not precedent, but it is among the types of authority mentioned at Reg. section 1.6662-4(d)(3)(iii) that can be cited in support of a defense against the assessment of penalties for a substantial understatement of income tax.

[fn. 7] Long-term because presumably the trust has been up and running more than a year. The seminal ruling on the acceleration of a remainder trust is Rev. Rul. 86-60, which sketched two scenarios in which the acceleration of an annuity trust would yield a charitable deduction. In each scenario, the favorable ruling was expressly conditioned on the assumption that the taxpayer had not initially created the annuity trust for the purpose of evading the partial interest rule at section 170(f)(2).

[fn. 8] Code section 664(e).

[fn. 9] Actually the formula should be fractional, 96.05/296.05 or about 32.4 pct., and if noncash assets are to be allocated other than pro rata, the adjusted basis of property distributed to the remainder org should be "fairly representative" of the adjusted basis of all assets held by the trust.

The quoted language is from Reg. section 1.664-3(a)(4), which permits the trust instrument itself to provide for current distributions, apart from the unitrust payout, to an exempt entity, provided that if a distribution is made in kind, "the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment."

At least two letter rulings -- PLR 200304025, approving a partial commutation, and PLR 200524014, approving a partial acceleration -- have cited this regulation as at least impliedly requiring a pro rata or "fairly representative" distribution in these contexts.

[fn. 10] For purposes of the present discussion, we will disregard the "coordinated sale" of the income and remainder interests to a third party, which would arguably result, per section 1011(e)(3), in the holder of the income interest recognizing little if any gain.

In Notice 2008-99, IRS identified this as a "transaction of interest," requiring disclosures by participants and material advisors.

[fn. 11] If she has reserved a power to redesignate the remainder charity, Jane might argue that her making the designation irrevocable should be seen as an additional contribution, justifying a somewhat higher annuity payout rate.

Even taking into account the ACGA policy that the present value of the residuum should be at least twenty pct., there is quite a bit of room here to maneuver. But your correspondent is not aware of any issuing charity that is interested in having this discussion.

[fn. 12] Literally what the author of the initial ruling said was that in order to bring the distribution to the noncharitable beneficiary within the exception at Reg. section 53.4947-1(c)(2)(i) from self-dealing, it would be necessary to use a "reasonable method" of calculating the actuarial value of his interest that "does not inappropriately inflate" that value "to the detriment of the charitable remaindermen." And that "[o]ne reasonable method" would be to use a "special factor," modifying the methodology of Reg. 1.664-4(a)(3) to assume that the stated payout was "a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the section 7520 rate for the month of termination."

The use of this "special factor," the author suggested, was "indicated" by Reg. 1.7520-3(b)(1)(ii), which says the standard section 7520 rate may not be used to value a "restricted beneficial interest," defined as

> an annuity, income, remainder, or reversionary interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances.

All of this reasoning was pasted essentially verbatim into later rulings attributed to other authors, which may suggest it came from the general counsel's office.

I have argued elsewhere that this reasoning was flawed, but that discussion is beyond the scope of our present concerns.

[fn. 13] The full text of the revision to section 664(e) is as follows:

> In the case of the early termination of a trust which is a charitable remainder unitrust by reason of subsection (d)(3), the valuation of interests in such trust for purposes of this section shall be made under rules similar to the rules of the preceding sentence[,]

which "preceding sentence" states the general rule that a remainder interest in an annuity or unitrust is to be valued as though five pct., or a greater amount if specified in the instrument, is to be distributed each year. It is not clear what function the phrase "for purposes of this section" serves here.

This particular provision of the extenders legislation had been introduced as H.R. 4192 by then Rep. Patrick Tiberi (R-OH), who sat on the tax policy subcommittee of the Ways and Means Committee, with bipartisan support from within the subcommittee.

In introducing the measure on the House floor, Rep. Tiberi said a "lack of certainty regarding the tax consequences" had "deterred early terminations" of net income trusts, but that these "should be encouraged" because they put trust assets into the hands of the remainder orgs "earlier than otherwise would be the case."

The Joint Committee on Taxation estimated the measure would have a modest positive revenue effect, mostly in the first three years after enactment, presumably reflecting a pent up demand for commutations.

[fn. 14] In *Estate of Schaefer v. Commissioner*, 145 T.C. No. 4 (2015), the government argued, and the Tax Court agreed, that the present value of the remainder of a net income unitrust should be calculated as though the trust were paying the stated unitrust amount. This was without reference to the 2015 amendment to section 664(e).

The consequence in that case, which involved net income trusts with stated unitrust amounts of ten and eleven pct., was to disallow an estate tax deduction on the ground that the remainder values were less than ten pct., as required by section 664(d)(2)(D).

In the course of making its determination, the court unearthed some interesting legislative history from the Tax Reform Act of 1969.

The House bill had not made provision for net income trusts. The Senate bill added both paragraph (d)(3), allowing for a net income limitation, and paragraph (e), specifying how remainder interests were to be valued -- for purposes of determining the amount of the charitable deduction at inception.

Although the court found the statutory language itself to be ambiguous, the Senate report was clear that the remainder in a net income unitrust was to be valued as though the income beneficiary would receive "the higher of" net income or the stated unitrust amount. And as the court noted, this is how IRS itself had construed the statute in comments to specimen language at Rev. Rul. 72-295 and Rev. Proc. 2005-54.

One might quarrel that section 664(d)(2)(D) deals with determining the actuarial value of the remainder, without reference to calculating the amount of a charitable deduction, while section 664(e), until its amendment as part of the 2015 extenders bill, by its express terms dealt only with calculating the charitable deduction -- which could be apples and oranges.

From the text of the Tax Court decision it is not entirely clear the taxpayer framed her argument in these terms, but in any event she did not appeal.

[fn. 15] This is essentially the scenario described in "situation 2" in Rev. Rul. 80-60. See also PLR 200802024.

Because Jane herself had previously transferred a partial interest when she set up the trust, her gift now of an "income" interest the same property would not qualify for a charitable deduction except that it is in the form of a unitrust, see reg. section 25.2522(c)-3(c)(2)(vii). The successor beneficiary is transferring the only interest she ever had in the property, and so the partial interest rule is not implicated.

[fn. 16] See PLR 8805024. The settlor had created a five pct. straight unitrust payable to him for his life, then to his spouse if she survived, but he reserved a testamentary power to revoke her successive interest. They each proposed to transfer a portion of their respective unitrust interests to the remainder org.

IRS ruled the spouse could not claim a deduction for the acceleration of her contingent, defeasible interest, because there was no "ascertainable assurance" her interest "will ever pass to charity."

It is not entirely clear what that means. Obviously the spouse does hold a transferable interest. Absent the assignment of this interest, if she survived the settlor and he did not exercise his power to revoke, she would step into the income stream -- even if the settlor had assigned his unitrust interest to the remainder org long ago.

So it is necessary for her to participate in the transaction to effect a merger of the income and remainder interests, and her assignment does "assure" that her interest will pass to the remainder org, not at some future date, but immediately.

The text of the ruling suggests that the assignment of her interest is a reportable, but nondeductible gift. But the reportable value ought to be zero.

On day one, when the settlor created the trust, his deduction for the present value of the remainder would have included a factor for the present value of the successive interest to the spouse, and if no deduction is available for an acceleration of her contingent, defeasible interest, we have slippage.

[fn. 17] Cf. *In re Mack*, 269 B.R. 392 (2001) (the settlor's income interest in a remainder trust is an asset of his bankrupcty estate).

[fn. 18] Per section 674(b)(4), a power to allocate distributions from amounts already irrevocably designated to charity, regardless by whom the power is held, will not cause the trust to be treated as a "grantor" trust for income tax purposes. See PLR 200245058.

[fn. 19] The exception at section 2523(g) allowing a gift tax marital deduction for a successive interest in a charitable remainder trusts does not apply here. But by reserving a power to revoke, Richard has rendered the gift of a deferred annuity incomplete. The present value of the annuity to Jane will be includible in his estate, but at that point the payout to her will be immediate, and the inclusion will be offset by an estate tax marital deduction.

Note that Richard's reserved power to revoke need not be testamentary, as we are not concerned here with the "grantor" trust rules. And since it need not, it probably should not.

[fn. 20] Assuming of course that the annuity is not assignable, except to the issuing charity, per reg. section 1.1011-2(a)(4)(ii).

This has meant that a somewhat smaller portion of each annuity payment has been taxed as ordinary income than would have been the case if the annuity had been funded from joint or entireties property and payable over the couple's joint lives.

If Richard were to die before recovering his basis, and without having revoked Jane's interest, she would continue to report gain until the expiration of his expected return multiple. If Jane had predeceased, or if Richard had revoked her interest, any unrecovered basis would be deducted on his final 1040, per section 72(b)(3).

This is not a "miscellaneous" itemized deduction, and is therefore not suspended by the 2017 tax bill.

[fn. 21] Wait. Why would be looking at only Richard's life? We will get to that in a moment.

[fn. 22] Another way of looking at this is that Richard will not be allowed a deduction for the ordinary income component of the present value of the annuity stream, per section 170(e).

[fn. 23] Section 170(b)(1)(C). If we wait long enough, and Richard fully recovers his basis over the expected return multiple, he gets no deduction at all for assigning the annuity to the issuing org.

[fn. 24] See footnote 19 above.

[fn. 25] Either Richard would have fully recovered his basis during his lifetime, or his unrecovered basis would be claimed as an itemized deduction on his final 1040.

[fn. 26] Your correspondent is not aware of any formal or informal authority for these reporting positions.

Note, however, we would still want Jane to sign off on the transaction, waiving any claim she might have had as a surviving spouse.