

The More Things Change

Charitable Gift Planning in an Altered Landscape

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Hour One:

Recent Developments

the 2017 tax bill

- top marginal rate reduced from 39.6 to 37 pct.
- standard deduction doubled
- personal exemption repealed
- SALT deduction capped at 10k
- misc. itemized deductions suspended

- "Pease" limitation suspended

- applicable gift/estate tax exclusion doubled

[all sunset after 2025]

the 2017 tax bill, cont'd

- cash contributions to (b)(1)(A)s deductible to 60 pct. of AGI
 - but still count against 50 pct. limitation, incl. carryforwards, etc.

<https://info.pgcalc.com/new-deduction-limit-on-cash-gifts>

[permanent]

the 2017 tax bill, cont'd

- 21 pct. excise tax on comp over \$1M to top five highly compensated employees
- UBTI calculated separately for separate "lines" of business
- 1.4 pct. excise tax on private college endowment income
- no deduction for college athletic event seating rights

[permanent]

the 2017 tax bill, cont'd

- charitable contributions by ESBT determined w/r/t section 170, rather than section 642(c)
- section 1031 limited to real property
- repeal of alimony deduction, incl. section 682 trust
 - delayed effective date

[permanent]

"tax reform 2.0"

H.R. 6760 would make permanent

- marginal rate structure
- doubled standard deduction
- 10k cap on SALT deduction, etc.

would also extend reduced threshold for deductibility of medical expenses through 2021

passed House 09/28, no action yet in Senate on related bill S. 2687

other tax legislation

- "Newman's Own amendment," included in stopgap spending measure signed February 09
- S. 3471 (114th Congress) re five-year payout on inherited plans [not enacted]
- H.R. 1337 re charitable IRA "rollover" [introduced 03/02/17, no action yet]

other tax legislation, cont'd

"Newman's Own amendment"

- exception to excess business holdings
- all interests held by foundation, acquired from decedent
- profits distributed w/in 120 days of close of tax year
- independent operation (i.e., no family members)

[introduced in at least three previous sessions]

other tax legislation, cont'd

S. 3471 (114th Congress)

- complete distribution of defined contribution plan w/in five years after account holder's death
- except where designated bene is surviving spouse, minor child, not more than ten years younger
- would apply only to excess over \$450k

bipartisan support, SFC unanimous

other tax legislation, cont'd

re S. 3471 (114th Congress), cont'd

- would eliminate "stretch" IRA
- JCT estimates \$3.2 bil. over ten years \$536.6 mil./yr. in outlying
- strong incentive for using CRT or PIF to replicate "stretch"
- statistics suggest \$450k threshold implies AGI over \$1 million

other tax legislation, cont'd

H.R. 1337 [not yet reported][*]

- would allow QCDs to fund "split-interest entities," i.e., CRTs and CGAs
- from age 65 [cf. H.R. 5171 from 114th]
- up to \$400k per year
- entire payout taxed as ordinary income
- would sunset after 2021
- JCT estimates cost at \$106 mil. [frontloaded]

[*] primary sponsor Kevin Cramer

other tax legislation, cont'd

re H.R. 1337, cont'd

per IRS stats from 2015,

- 50.7 million taxpayers aged 60 and over
- 25.1 million w/ nonzero balances in IRAs
- aggregate assets approx. \$5.096 trillion

EBRI says

- 14.1 pct. of IRA account holders have balances of \$250k or more

formal guidance

Notice 2017-10

- "syndicated" conservation easement identified as listed transaction
 - passthrough entity
 - investors solicited on premise deduction might be 2.5x
 - or "substantially similar" transaction

[aside]

- section 47-05-02.1 of the North Dakota statutes limits the duration of a nonappurtenant easement to ninety-nine years

- in *Wachter v. Comm'r*, 142 T.C. No. 7 (2014), the Tax Court disallowed a claimed deduction for the bargain sale of a nominally perpetual easement to a land trust,

- rejecting argument that possibility of reversion was "so remote as to be negligible"

formal guidance, cont'd

Notice 2017-10, cont'd

- IRS will challenge on overvaluation, disproportionate allocations, disguised sale, economic substance, etc.

House appropriations bill H.R. 3280 would have forbidden IRS to expend funds to enforce

H.R. 4459, S. 2436, would enact Notice into law [neither assigned to committee]

formal guidance, cont'd

Notice 2017-10, cont'd

Land Trust Alliance forbids its members to participate (02/01/18)

Koskinen ltr. to Wyden 07/13/17

- 200 Forms 8886 filed, 104 processed
- only 40 reporting both amount of investment and claimed deduction
- avg. claimed deduction 9x investment
- outliers would skew higher

formal guidance, cont'd

Notice 2017-10, cont'd

Kautter ltr. to Hatch 07/12/18

- 238 "top tier" passthrough entities filed disclosures re 2016 transactions
- another ten nonfilers identified
- "enforcement activity begun" as to forty
- total 22,638 disclosures filed
 - avg. return ratio 4.74
 - top ten pct. avg. 8.23, median 6.69
 - \$7.53 billion claimed

formal guidance, cont'd

Notice 2017-73

re excise tax under 4967(d) on advice regarding distribution from DAF resulting in "more than incidental benefit" to disqualified person

- subsidizing donor/advisor's participation in sponsored event
- distribution in satisfaction of pledge
 - "don't ask, don't tell"
 - difficulty of determining whether enforceable

formal guidance, cont'd

Notice 2018-37

re effective date of repeal of section 682, conforming w/ repeal of alimony deduction

- exception to grantor trust rules for "alimony trusts"
- distributions to former spouse treated as though made from "complex" trust

will continue to apply if decree entered on or before 12/31/18

formal guidance, cont'd

Rev. Proc. 2018-38

re sch. B disclosure of major donor info no longer required for other than (c) (3) orgs for tax years ending on or after 12/31/18

- stated authority reg. section 1.6033-2(g)
- reporting requirement at section 6033(b) (5) expressly mentions only (c) (3)s
- reg. section 1.6033-2(a) (1) extends to all 501(a) orgs [under what authority not stated]

formal guidance, cont'd

re SALT deduction cap workarounds

Notice 2018-54

- substance over form

proposed regs issued 08/23,

REG-112176-18, FR Doc. 2018-18377

- state tax credit in exchange for deductible contribution is quid pro quo
- proposed de minimis exception 15 pct.

formal guidance, cont'd

re SALT deduction cap workarounds, cont'd

compare CCA 201105010

- 170(c) deduction allowed, i.e., no quid pro quo reduction, but
- credit not deductible as state tax payment

"clarifying" press release IR 2018-178 (09/05)

- no effect on section 162 deduction for "ordinary and necessary" business expense

court decisions

Estate of Dieringer v. Comm'r

146 T.C. No. 8 (03/30/16), on appeal to 9th Circuit, No. 16-72640, argued 05/15/18

- estate tax deduction for residuary gift to family foundation sharply reduced
- limited to price paid in redemption of closely held stock, in exchange for unsecured notes
- price reflected steep discounts for lack of marketability, control not claimed on 706

court decisions, cont'd

Estate of Dieringer, cont'd

- decedent held 4/5 of voting stock
- executor, sole trustee of foundation acquired control in redemption, cross-purchase

- reg. section 20.2055-2(b)(1) limits deduction to portion not subject to "power to divert"
- Tax Court cited reg. only by analogy

here, the diversion was arguably *ultra vires*

court decisions, cont'd

RERI Holdings I, LLC v. Comm'r

149 T.C. No. 1 (07/03/17), on appeal to D.C. Circuit, No. 17-1266, argued 11/09/18

- no deduction where basis not disclosed on Form 8283
- 40 pct. gross valuation misstatement penalty on claimed deduction of \$32.94 mil. [despite disallowance on compliance ground]

court decisions, cont'd

RERI Holdings, cont'd

- Notice 2007-72 identifies contribution of "successor member interest" as "transaction of interest"
 - discrepancy in amount paid for SMS vs. amount claimed as deduction
 - 7520 rate, underlying fee interest
 - recipient charity agreeing not to sell for stated period
 - ultimate sale to related party

court decisions, cont'd

Rutkoske v. Comm'r
149 T.C. No. 6 (08/07/17)

- enhanced deduction for easement not available where taxpayers not "qualified farmers" per 170(b)(1)(E)(v)
- requires more than half of gross income be from "trade or business of farming," defined by cross-reference to 2032A(e)(5)
- proceeds of bargain sale, sale of underlying land not w/in defn.
- income to passthrough entity was from rents

court decisions, cont'd

Bosque Canyon Ranch, LP v. Comm'r
5th Cir. No. 16-60068 (08/11/17)

- vacates T.C. Memo 2015-130, disallowing deduction for "floating" easement
- arguable conflict w/ *Belk v. Comm'r*, 774 F.3d 221 (4th Cir. 2014), *aff'g* 140 T.C. 1 (2013)
- "exterior" boundaries of servient estate
- note also "disguised sale" issue, cf. Notice 2017-10, discussed above

court decisions, cont'd

Palmolive Bldg. Investors LLC v. Comm'r
149 T.C. 18 (10/10/17)

- facade easement deduction denied where mortgage not subordinated
- reg. sec. 1.170A-14(g)(6)(ii) requires that donee org. have property right in pro rata share of proceeds of sale/exchange/conversion

court decisions, cont'd

Palmolive Bldg. Investors, cont'd

- appealable to 7th Circuit, therefore Tax Court not bound by *Kaufman v. Comm'r*, 687 F.3d 21 (1st Cir. 2012), vacating 136 T.C. 294 (2011)
- motion to certify interlocutory appeal denied

court decisions, cont'd

Green v. United States

880 F.3d 519 (10th Cir. 01/12/18), rev'g No. 13-CV-01237 (W.D. Okla. 11/04/15)

- deduction under section 642(c) for noncash distribution limited to adjusted basis
- see CCA 201042023, unrealized appreciation not sourced to "gross income"

https://www.plannedgiftdesign.com/uploads/2/4/6/6/24661337/volume_one_number_two.pdf

court decisions, cont'd

Sveen v. Melin

584 U.S. ---, No. 16-1432 (06/11/18), rev'g 853 F.3d 410 (8th Cir. 04/03/17)

- state statute automatically revoking beneficiary designation to former spouse in event of divorce does not violate Commerce Clause
- section 524.2-804 of Minnesota statutes
- section 30.1-10-04 of North Dakota statutes

court decisions, cont'd

PBBM-Rose Hill, Ltd. v. Comm'r
No. 17-60276 (5th Cir. 08/14/18), aff'g
transcript opinion

- conservation easement deduction disallowed due to "improvements" clause
- reg. section 1.170A-14(g)(6)(ii) requires "proportionate value"
- but cf. PLR 200836014

court decisions, cont'd

Harbor Lofts Associates
151 T.C. No. 3 (08/27/18)

- long-term lessee cannot claim deduction for joining w/ lessor in granting facade easement
- "commercial" lease not real property interest
- holder of term of years cannot grant perpetual easement

court decisions, cont'd

Americans for Prosperity v. Becerra
No. 16-55727 (9th Cir. 09/11/18)

Citizens United v. Schneiderman
No. 16-3310 (2nd Cir. 02/15/18)

state requirement that (c)(3) org submit copy of its 990 sch. B does not impermissibly burden right to free association

disclosing info re "substantial contributors"

court decisions, cont'd

Americans for Prosperity, cont'd

- "exacting scrutiny" rather than "strict"
- "substantial" relation betw. disclosure requirement and "important" gov't interest
 - policing fraud
- "commensurate" w/ "actual burden" on 1st Amendment rights
 - economic reprisal, physical coercion

court decisions, cont'd

Chrem v. Comm'r

T.C. Memo 2018-164 (09/26/18)

contribution of closely held stock to foundation in connection w/ buyout by related corp.

- assignment of income
 - pre-arrangement, whether "virtually certain"
- qualified appraisal

cross-motions for partial summary judgment

letter rulings

PLRs 201713002/003

- CRT not subject to private foundation rules if no deduction claimed
 - literal reading of 4947(a)(2), "amounts for which deduction was allowed"
 - note reg. 53.4947-1(a) presumption
 - reg. 1.664-1(a)(1)(iii)(A) requires only that deduction be "allowable"

letter rulings, cont'd

PLRs 201713002/003, cont'd

- potentially relevant excise tax provisions incl.
 - 4941, self-dealing
 - 4943, excess business holdings[*]
 - 4944, jeopardizing investments[*]

[*] but only as to income interests for which deduction was allowed

letter rulings, cont'd

PLRs 201713002/003, cont'd

- note: 664(d) does not require claim or allowance of deduction to qualify, i.e.,
 - trust is exempt from income tax, not treated as "grantor" trust
 - income and realized gains taxed only as distributed
 - cf. net income trust

letter rulings, cont'd

PLRs 201723005/006

- nonvoting interest in LLC shields private foundation from self-dealing
 - promissory note from irrevocable trust
 - transferred to LLC held in revocable trust
 - both trusts would be "disqualified persons" as to foundation
 - because foundation holds only nonvoting interests, it does not "control" LLC, therefore no "indirect" self-dealing

letter rulings, cont'd

PLRs 201730012/017/18

- converting non-grantor CLAT to grantor CLAT
 - amend to give third party substitution power per 675(4)
 - Rev. Proc. 2007-45 specimen form suggests exercise by settlor might be self-dealing
- per Rev. Rul. 77-402, conversion from grantor to nongrantor is recognition event
- Rev. Rul. 85-13 stopped short of reaching similar conclusion on reverse

letter rulings, cont'd

PLR 201825003

- gift to two foreign museums of remainder after reserved life estate in artwork incomplete
 - conditioned on "favorable" ruling from IRS, i.e., that the gift was incomplete
 - but IRS says the gift is "otherwise" complete, therefore
- multiple conditions subsequent

letter rulings, cont'd

PLR 201835014

- set-aside request denied
 - reg. section 53.4942(a)-3(b)(9) allows "contingent" set-aside pending litigation where court order forbids distribution
 - but here no court order

letter rulings, cont'd

PLR 201845014

- permissible features of remainder trust
 - independent trustee discretion to allocate unitrust amount betw. noncharitable and charitable beneficiaries
 - settlor reserved power to designate charitable "class"
- gift of unitrust amount not complete until actual distribution

Hour Two:

Gift Planning 103

what is (deductible) charitable gift?

- voluntary transfer of
- entire interest in property [not services] to
- qualified charitable recipient in
- appropriate form w/
- no expectation of "commensurate" financial benefit
- reported on appropriate form(s) and
- supported by required disclosures and substantiation

completed gift

- control relinquished
- condition(s) precedent met
[e.g., post-dated check]
- condition(s) subsequent "so remote as to be negligible," reg. section 1.170A-1(e)
 - less than five pct., Rev. Rul. 70-452
["probability of exhaustion" test for charitable remainder annuity trust]

partial interests

section 170(f) (3) (B)

- vertical slice, i.e., undivided fractional interest
- split-interest trust
annuity, unitrust, pooled income fund
- legal remainder in residence or farm
- conservation or facade easement

[not qualified, e.g., leasehold]

"commensurate" benefit

"quid pro quo"

- Rev. Rul. 67-246
 - value transferred exceeds value received
 - intention that excess be gift
- *American Bar Endowment*, 477 U.S. 105,
106 S.Ct. 2426 (1986)

the bargain sale

the sale of property to qualified charity
at less than fair market value

appreciated property

- section 1101(b)
 - adjusted basis allocated betw. sale and gift elements
 - compare pre- TRA '69
- reg. section 1.1011-2(c) examples
 - ex. 1, basic principle
 - sale price 4k, FMV 10k, adj. basis 4k
 - gift element 6k
 - allocate basis 4/10 to sale element
 - $.4 \times 4k = 1.6k$, from 4k is 2.4k gain

appreciated property, cont'd

- reg. section 1.1011-2(c) examples, cont'd
 - ex. 2, ordering rule
 - long-term gain property
 - no step-down election
 - third tier after cash

in the particular case, gain element recognized immediately, deduction carried forward

appreciated property, cont'd

- reg. section 1.1011-2(c) examples, cont'd
 - ex. 4, etc., reduction rule
 - short-term gain property
 - reduction applied pro rata
 - again, 10k FMV, adj. basis 4k
 - if sale price is 2k, basis in sale element is 800, gain is 1.2k, gift reduced to 3.2k

debt-encumbered property

- reg. section 1.1011-2(a)(3)
- transferor treated as having received amount of mortgage debt, regardless

- Rev. Rul. 81-163
- capital asset FMV 25x, adj. basis 15x, debt 10x
 - treated as realization of 10k
 - gift element 15k[*]
 - basis allocated 2/5 to sale element

[*] step down election or 30 pct. limit

acquisition indebtedness

- recipient charity may be exposed to tax on unrelated business taxable income (UBTI)

- section 514(c)(2)(B) exceptions
- property acquired by bequest, not treated as acq. debt for ten years
 - property acquired by gift, ditto if "five and five"
 - unless recipient charity assumes debt

note: transferor's payments on debt are additional gifts

the charitable gift annuity

section 514(c)(5)

- exception to acquisition indebtedness rule
 - present value of annuity less than 90 pct. of amount transferred
 - no guarantee re number of payments
 - no adjustment to annuity payout based on income generated by transferred -- "or any other" -- property

valuing the annuity stream

section 7520(a)

- annuitant's life expectancy per tables
- prevailing rate of interest determined, per section 1274(d) (1), w/ ref. to avg. market yield on mid-term Treasuries
- two-month "lookback" per reg. section 1.7520-2(a) (2)

taxation of annuity payout

section 72(b)

- investment recovered ratably over "expected return multiple"
- the balance of each payment taxed as ordinary income
- if annuitant outlives life expectancy, further payments entirely ordinary income
- if she dies early, itemized deduction[*] for unrecovered investment

[*] not subject to two pct. floor

taxation of annuity payout, cont'd

- where annuity issued in exchange for appreciated property,
 - bargain sale
 - reduction rule, step down election

per reg. section 1.1011-2(a) (4) (ii) ,

- gain recovered ratably if
 - annuity not assignable, except to issuing charity, and
 - payable only to transferor or transferor and one survivor

taxation of annuity payout, cont'd

reg. section 1.514(c)-1(e) (1) (ii)

- present value of annuity stream determined w/ ref. to transferor's "equity"
- re encumbered property, this would appear to imply gain attributable to deemed assumption of debt recognized immediately, rather than ratably

gift annuity f/b/o nonspouse

- if funded w/ appreciated property, transferor recognizes gain immediately
- present interest gift
- if present value of annuity stream exceeds annual exclusion, transferor may want to render gift incomplete by retaining power to revoke
- if power not released more than three years prior to transferor's death, estate tax inclusion per 2038/2035

gift annuity f/b/o spouse

immediate, spouse only

- again, if funded w/ appreciated property, transferor recognizes gain immediately
- qualifies for gift tax marital deduction

joint and survivor

- gain recognized over transferor's life expectancy
- qualifies for gift tax marital deduction

gift annuity f/b/o spouse

annuity to spouse deferred[*]

- does not qualify for gift tax marital deduction
- again, transferor may want to reserve power to revoke
- estate tax inclusion per 2038/2035, but offset by marital deduction

[*] either a deferred annuity contract, or annuity payable to transferor alone, then to survivor

the charitable remainder trust

- irrevocable trust
 - inter vivos or testamentary
- "income" to noncharitable beneficiary
- remainder to qualified charities

- fixed annuity or
 - unitrust
 - straight or
 - net income
 - w/ makeup or
 - w/out

"income" interest

- at least five pct. but not more than fifty pct. of
 - initial corpus (annuity trust)
 - corpus revalued annually (unitrust)

- distributed to one or more beneficiaries
 - at least one of which is not a section 170(c) org.
 - if an individual, must be alive at the time the trust is created

net income unitrust

- pays lesser of unitrust amount or current net fiduciary accounting income
- if "w/ makeup" (NIMCRUT), pays net income in excess of unitrust amount to make up for shortfalls in previous years
- further variants
 - "flip" trust, "spigot" trust

ten pct. remainder

present value of remainder at least ten pct.

life expectancy per tables

- prevailing rate of interest determined, per section 1274(d) (1), w/ ref. to avg. market yield on mid-term Treasuries
- two-month "lookback" per reg. section 1.7520-2(a) (2)

pre-TRA '69

deduction for present value of remainder after straight income trust

abuses:

- corpus invested for current yield at expense of growth
- short-term gains treated as income
- invasion of principal

other changes per TRA '69

- four-tier "worst in, first out" allocation to annuity or unitrust distributions
- trust itself exempt from income tax, except unrelated business taxable income
- subject to private foundation rules, excise taxes per section 4947(a)(2)

TRA '97

- ten pct. minimum remainder value,
- fifty pct. maximum payout

responding to "accelerated CRT" abuse

Notice 94-78

- property sold early in year two
no income in year one
- distribution w/in "reasonable time" after close of year one treated as from corpus

"accelerated CRT" example

- two year term, 80 pct. payout
- funded w/ \$1 mil. property, zero basis
- deductible remainder, say, \$30k
- sale early year two

- \$800k distribution treated as corpus, [*]
- year two payout .80 x \$200k is \$160k, taxed as gain
- remainder \$40k to charity deductible against ordinary income

[*] tax saving at 20 pct. is \$160k

implementing regs

- reg. section 1.664-3(a)(1)(g)
- distribution from straight unitrust made after close of year
 - will not be act of self-dealing, and
 - will not cause trust to incur unrelated debt-financed income, only if
 - characterized as income, or
 - if characterized as corpus, is either
 - treated as recognition event at close of year, or
 - contributed cash,
 - return of basis on contributed property

implementing regs, cont'd

- special rule for trusts created prior to 12/10/98, date regs finalized
- distribution w/in "reasonable time" after close of year, etc. only if
 - stated unitrust payout is 15 pct. or less
- [proposed regs would have required payout by close of tax year]

other section 664(d) requirements

- annuity or unitrust payment at least annual
 - term limited to 20 years or lives of individual benes[*]
 - individual benes must be alive at inception
- [*] other scenarios incl.
- remainder trust funded by S corp., w/ tax characteristics passing through
 - annuity or unitrust paying over to special needs trust for disabled bene
 - but see Rev. Rul. 2002-20, amplifying and superseding Rev. Rul. 76-270

lives in being and/or term of years

reg. section 1.664-2(a) (5) and -3(a) (5)

- term of years may not extend beyond lives of individual benes

- "to A for life and then to B for a term of years" does not qualify, but
- "to A for life and then to B for life or for a term of years," not to exceed twenty, does qualify

qualified contingency

section 664(f)

- trust instrument may provide for early termination on occurrence of contingency, accelerating remainder to charity
- contingency does not factor into valuation of income or remainder interests

[e.g., divorce, remarriage, leave school, etc.]

must qualify from inception

reg. section 1.664-1(a) (4)

- trust "deemed created" at earliest time neither settlor nor any other person "treated as owner of entire trust" under subpart E

Estate of Atkinson, 115 T.C. 26 (2000),
aff'd, 309 F.3d 1290, (11th Cir. 2002)

- abuse of formalities

deferral pending administration

reg. section 1.664-1(a) (5)

- testamentary trust treated as created at decedent's death, provided --
- trust document or state law requires, and trustee actually does make adjustments
 - w/in "reasonable" period,
 - w/ interest at then-current 7520 rate, compounded annually

tax apportionment

reg. section 1.664-1(a) (6), example 3

- no estate tax deduction if trust vulnerable to liability for federal estate or state succession taxes

Rev. Rul. 82-128, situation 2

- noncharitable interest takes effect only if beneficiary pays incremental taxes

Rev. Proc. 2005-24

- if state law would include assets of inter vivos remainder trust in settlor's "augmented estate," from which surviving spouse might satisfy elective share,
 - trust not qualified unless spouse waives by due date of 5227 for year in which later of
 - trust created,
 - settlor marries,
 - settlor moves to state that would allow election against trust assets, or
 - state enacts statute to that effect

Rev. Proc. 2005-24, cont'd

- trust created prior to June 28, 2005 grandfathered, unless spouse actually exercises election right

- grandfathering date extended indefinitely by Notice 2006-15

- rev. proc. not withdrawn

valuation of unmarketable assets

reg. section 1.664-1(a) (7)

- trust holding "unmarketable assets"[*] not qualified unless
 - independent trustee[+] or qualified appraisal[-]

[*] defn. anything other than cash, equivalents, or assets that can readily be sold
[+] cross ref. section 672(c)
[-] cross ref. reg. section 1.170A-13(c) (3)

specimen language

- CRAT specimens at Rev. Proc. 2003-53 through 2003-60
- CRUT specimens at Rev. Proc. 2005-52 through 2005-59

- "no rule" position, Rev. Proc. 2018-3, section 4.01, paragraph (39)
 - except for possible effect of other substantive provisions
 - e.g., PLR 201117005
 - installments, remarriage contingency

specimen language, cont'd

some items not included --

- "stub" income at death of bene
- specify 170(b)(1)(A) remainderman
- spendthrift clause (?)
- reserve testamentary power to revoke interest of third party bene
 - incl. spouse, despite 2523(g)

"worst in, first out"

section 664(b)

- distributions taxed in four tiers
 - net ordinary income
 - net capital gain
 - "other" income, e.g., exempt interest
 - corpus

reg. section 1.664-1(d) ordering rule

- "classes" of income w/in each tier ranked by highest to lowest federal rate
- e.g., short-term gain before long-term

unrelated business taxable income

section 664(c)

- as enacted in TRA '69, receipt of UBTI would disqualify trust for current year
 - in effect, converting to "complex" trust
 - net income pro rata
 - accumulated income and capital gains taxed to trust
- as amended effective January 01, 2007, UBTI taxed at 100 pct.
 - but still also distributed by tier

what is UBTI?

- does not include "passive" income, such as dividends, interest, rents, royalties, etc.
- does include passthroughs from a partnership or a limited liability company taxed as a partnership[*], engaged in an active trade or business

[*] a charitable remainder trust is not a permitted holder of stock in an S corp

3.8 pct. Medicare surtax

- section 1411, enacted in 2010
- surtax of 3.8 pct. on "net investment income" of taxpayer w/ "modified" adjusted gross income over stated thresholds
- reg. section 1.1411-3(d)(2)
- current and accumulated "net investment income" w/in each income tier treated as distributed ahead of other current or accumulated income w/in that tier
 - optional, "simplified" method

quick review

- overview of charitable remainder trust
- five pct. minimum payout
 - fifty pct. maximum
 - ten pct. minimum present value remainder
 - lives in being or term of years not more than twenty
- two additional requirements for annuity trust

requirements specific to CRAT

- no additions

reg. section 1.664-2(b) requires that the trust instrument expressly forbid additional contributions

- probability of exhaustion

less than five pct. likelihood annuitant will outlive interval over which annuity will exhaust trust

probability of exhaustion

Rev. Rul. 70-452

- pre-TRA '69 law
- inter vivos annuity trust for life individual aged 62
- annuity would exhaust in 27 years
- 7.2 pct. probability annuitant would survive

probability of exhaustion, cont'd

Rev. Rul. 70-452, cont'd

- reg. section 25.2522(a)-2(b) condition subsequent not "so remote as to be negligible"
- analogy to section 2037, which includes reversion valued at more than five pct.

probability of exhaustion, cont'd

Rev. Rul. 77-374

- reformation to bring annuity trust into compliance ineffective b/c
- not among defects for which section 2055(e) allows reformation

probability of exhaustion, cont'd

historically low 7520 rates

- lower expected rate of return
- lower value to remainder after fixed annuity
- w/ 7520 rate at 3.6 pct.,
 - five pct. annuity payable at year end would fail if annuitant younger than 62
 - for two-life annuity, minimum age 64

probability of exhaustion, cont'd

Rev. Proc. 2016-42

- qualified contingency per section 664(f) [*]
- remainder accelerated if next annuity payment would bring corpus below five pct. of initial value
- specimen language, safe harbor

[note, preamble somewhat overstates effect of Rev. Rul. 77-374]

[*] does not affect calculation of remainder value, but cf. reg. section 25.7520-3(b)(2)(v)

the charitable remainder unitrust

no analogous rules re
additions, probability of exhaustion

- additions simply increase corpus from which unitrust payout is annually calculated
- unitrust by its nature cannot exhaust[*]

[*] Zeno's paradox, but cf. admin. expense

the "straight" unitrust

- fixed pct. of corpus, revalued annually
- if fiduciary account income not sufficient, portion of payment is from corpus
- if trust holds unmarketable assets, calculation each year will require qualified appraisal

the net income unitrust

- pays lesser of unitrust amount or current net fiduciary accounting income
- per reg. section 1.664-3(a)(1)(i)(b)(3),
 - "income" defined w/ ref. to section 643(b) and regs
 - pre-contribution gains allocated to corpus

[note: may need qualified appraisal to establish income is less than stated unitrust amount]

the net income unitrust w/ makeup

- pays net income in excess of unitrust amount to make up for shortfalls in previous years

[note: section 664(d)(3) says "and," while reg. section 1.664-3(a)(1)(i)(b) says "or"]

- variants:
 - "flip" CRUT
 - "spigot" trust

the "flip" CRUT

per 1998 regs, "combination of methods"

- initially net income trust
- "flips" to straight CRUT on occurrence of "triggering event"

unstated policy rationale --

absent "flip," after sale of unmarketable asset, trustee would be under pressure to invest for current yield

the "flip" CRUT, cont'd

final regs require

- "triggering event" not within discretion or control of trustee or "any other person"

proposed regs would have required

- "triggering event" limited to sale of unmarketable assets comprising 90 pct. of value of corpus

the "flip" CRUT, cont'd

final regs

- "flip" occurs at start of year following "triggering event"
- undistributed makeup amounts "forfeited"

[but if trust instrument defines income to include post-contribution gains, these could be distributed before "flip" took effect]

[note net income and "flip" features can allow initial distribution to occur after year end]

the "spigot" trust

- NIMCRUT, but w/ mechanism to control receipt of fiduciary accounting income
- typically, single-member limited liability company treated as disregarded entity
- variant: deferred annuity contract

no formal guidance

IRS will not give advance determination
see, Rev. Proc. 2017-3, paragraph 4.01(40)

remainder trust f/b/o third party

nonspouse, immediate

- "income" interest eligible for gift tax annual exclusion, but
- if present value exceeds 15k, settlor may want to render gift incomplete

- reserved power to revoke
- if exerciseable inter vivos, would trigger "grantor" trust status, disqualifying
see, section 674(b)(3)

f/b/o third party, cont'd

nonspouse, immediate, cont'd

- but reserved testamentary power will cause estate tax inclusion per section 2038 (or 2035 if released w/in three years)
- inclusion only partly offset by deduction for charitable remainder
- incremental tax must be paid from other sources, see Rev. Rul. 82-128

f/b/o third party, cont'd

nonspouse, immediate, cont'd

- reserved power also renders transfer incomplete for purposes of generation-skipping transfer tax, but
- holds open estate tax inclusion period until settlor's death or release
- GST exemption cannot be allocated until ETIP closes

f/b/o third party, cont'd

nonspouse, deferred

- not eligible for annual exclusion,
- if settlor does not reserve testamentary power to revoke, gift of successive interest discounted by present value of intervening interest, but
- per section 2702, not in the case of a net income trust

f/b/o third party, cont'd

nonspouse, deferred, cont'd

- section 2702 values retained interest in trust at zero unless annuity or (straight) unitrust
- per reg. section 25.2702-1(c)(3), rule does not apply if it is the settlor's interest that is deferred

f/b/o third party, cont'd

spouse, immediate

- does not qualify as QTIP, but
- specific exception at section 2523(g) [section 2056(b)(8) for estate tax]
- per reg. section 25.2523(g)-1(a)(3), spouse's interest need not be for life
- term of years no longer than twenty
- qualified contingency, e.g., divorce, remarriage

f/b/o third party, cont'd

spouse, immediate, cont'd

comparisons w/ QTIP

- term of years or qualified contingency
- spouse must have power to require trustee of QTIP to invest for income[*]
- charitable remainder trust cannot permit encroachments

[*] but note TD 9102 allows unitrust betw. three and five pct. to qualify as QTIP

f/b/o third party, cont'd

spouse, immediate, cont'd

settlement of marital property rights

prenup

- per reg. section 25.2512-8, relinquishment of marital rights not treated as taxable "exchange," therefore impliedly gift
- no gift tax marital deduction unless parties already married

f/b/o third party, cont'd

spouse, immediate, cont'd

settlement of marital property rights, cont'd

divorce settlement

- per section 2516, transfer as part of divorce settlement made w/in two years before or one year after date of decree deemed exchanged for "full and adequate consideration," i.e., not a gift

f/b/o third party, cont'd

spouse, immediate, cont'd

settlement of marital property rights, cont'd

divorce settlement, cont'd

- per section 1041(a), transfer "incident to divorce" not a recognition event
- no stated time limit, but presumed if w/in one year after decree
- transferee takes carryover basis

f/b/o third party, cont'd

spouse, immediate, cont'd

noncitizen spouse

- per section 2523(i)(1), no gift tax marital deduction for transfer to noncitizen spouse, but
- per section 2523(i)(2), annual exclusion for present interest gift to noncitizen spouse is \$152k (indexed), but

f/b/o third party, cont'd

spouse, immediate, cont'd

noncitizen spouse, cont'd

- only if transfer would otherwise have qualified for gift tax marital deduction, w/out necessity of QTIP election, see reg. section 25.2523(i)-1(d), example 4
- per section 2523(g), charitable remainder trust does meet this requirement

f/b/o third party, cont'd

spouse, immediate, cont'd

noncitizen spouse, cont'd

- if present value of annuity or unitrust payout will exceed 152k, settlor will want to reserve testamentary power to revoke
- if settlor predeceases noncitizen spouse, per reg. section 20.2056A-2(b), trust is QDOT, eligible for estate tax marital deduction

**Hour Three:
Accelerating the Remainder Gift**

the premise:

existing donor, life income gift

- charitable remainder trust or
- gift annuity

gift of part or all of income stream

- stewardship
 - second bite
 - testing the waters

stewardship, cultivation

second bite

- the income stream is itself an asset
- does she still "need" the cash flow

testing the waters

- performance vs. expectation
- unanticipated contingencies

stewardship, cont'd

how did we get here

- who cultivated the initial gift
- hindsight, were mistakes made

what has happened since

- investment performance
- life events

Case Study One: the Remainder Trust

the scenario

- straight unitrust paying five pct.
 - funded September 2008 at 200k
 - one life, Jane then aged 68

 - deduction 101.5k, payout 10k
[7520 rate 4.2 pct.]
 - avg. return net of fees eight pct.
 - net after unitrust payout three pct.
- $1.03^{10} = 1.349316 \times 200k = 268,783.20$
current payout $268.8k \times .05 = 13.4k$

case one scenario, cont'd

what is the value of Jane's unexpired "income" interest?

per section 664(e), [*]

- straight unitrust paying five pct.
- funded September 2018 at 268.8k [7520 rate 3.4 pct.]
- one life, Jane now aged 78

remainder factor 65.479 pct.

life interest factor 34.521 pct.

[*] see, e.g., PLR 200140027

case one scenario, cont'd

value of "income" interest, cont'd

$$268.8k \times 0.34521 = 92.8k$$

table 2000CM life expectancy for individual aged 78 is 11.4 years

"your mileage may differ"

case one scenario, cont'd

"your mileage may differ"

- higher payout, lower returns
- net income w/o makeup and/or "flip"
- successor bene has died
- shortened life expectancies
- other issues . . .

SOI data from 2012

91,250 CRUTs holding 85.2 bn. net assets

- 4/5 pay betw. five and nine pct.
- about 1/8 pay betw. ten and twenty pct.

- about 1/6 net income w/ makeup,
about 1/3 where assets 3 mil. or more

- about 1/25 net income only

SOI data from 2012, cont'd

14,616 CRATs holding 6.4 bn. net assets

- 4/5 holding 500k or less
- tiny handful holding 1/5 of total

- distributions about 1/3 from corpus

SOI data from 2012, cont'd

1,324 PIFs holding 1.25 bn. net assets

- 3/4 holding 500k or less
- tiny handful holding 2/5 of total

- that group receives 29.5 pct. of
all PIF income, 7.1 pct. from rents

SOI data from 2012, cont'd

6,498 lead trusts holding 23.7 bn. net

- about 2/3 in handful of trusts holding ten mil. or more

[transfer tax leveraging]

see PLR 200225045 re early termination

tax apportionment

reg. section 1.664-1(a)(6), example 3

- no estate tax deduction if trust vulnerable to liability for federal estate or state succession taxes

Rev. Rul. 82-128, situation 2

- noncharitable interest takes effect only if beneficiary pays incremental taxes

deferral pending administration

reg. section 1.664-1(a)(5)

testamentary trust treated as created at decedent's death, provided --

- trust document or state law requires, and trustee actually does make adjustments
- w/in "reasonable" period,
- w/ interest at then-current 7520 rate, compounded annually

what about net income trust?

adjustment for deferral, cont'd

what about net income trust?

Rev. Rul. 80-123 requires that the governing instrument include language "conforming to" reg. section 1.664-1(a)(5)

specimen language in both Rev. Rul. 97-57 and Rev. Proc. 2005-56 reference "the unitrust amount," w/ no mention of net income

arguments pro and con . . .

adjustment for deferral, cont'd

pro and con

- a flat payout rule relieves the executor of responsibility for balancing portfolio during administration and settlement of estate

- if stated unitrust amount is high and actual income during delay is low, flat unitrust payout arguably injures remainderman

- but deduction calculated as though flat payout

case one scenario, cont'd

is the acceleration to the remainderman a transfer of a capital asset?

or an assignment of income?

if a capital asset, what is Jane's basis?

before IRS took a "no rule" position on commutations, the letter rulings said . . .

Rev. Rul. 72-243

sale by life tenant of her interest in testamentary trust to remainderman is sale of capital asset

acquiescing in *McAllister*, 157 F.2d 235 (2d Cir. 1946), cert. den., 330 U.S. 826 (1946),

which cited *Blair*, 300 U.S. 5 (1937), re gifts of portions of life interest in trust

zero basis

what section 1001(e)(1) says

portion of adjusted basis in term interest determined pursuant to section 1014, 1015, or 1041 "shall be disregarded"

- sec. 1014, property acquired from decedent
- sec. 1015, property acquired by gift
- sec. 1041, transfer incident to divorce

brief aside re commutation

since Rev. Proc. 2008-3, IRS has declined to issue advance determinations on whether a commutation

- is sale of capital asset
- might disqualify trust

after at least eight letter rulings on straight CRUTs, most citing Rev. Rul. 72-243, but also

commutation, cont'd

after at least eight rulings, starting w/
PLR 200725004,

requiring that the "income" interest in a net
income trust be valued w/ reference to the then-
current section 7520 rate, rather than the
stated unitrust payout

[lengthy critique elsewhere]

commutation, cont'd

sentence added to section 664(e) in December
2015 extenders bill

on "early termination" of net income unitrust,
income and remainder interests to be valued
"under rules similar to" those that apply in
valuing remainder interest in straight unitrust

not a guidance priority

commutation, cont'd

Notice 2008-99 identified as a "transaction of
interest"

the "coordinated" sale of income and remainder
interests to unrelated third party, where
appreciated assets contributed to the trust had
been sold and proceeds reinvested

exploiting exception at section 1001(e) (3)

Rev. Rul. 86-60

situation 1

- A creates CRAT reserving annuity to self for life, remainder to 170(c) org

- several years later, transfers annuity interest to remainderman

- transfer qualifies for charitable deduction, [*] but

[*] both income and gift tax

Rev. Rul. 86-60

situation 1, cont'd

- reg. section 1.170-7(a)(2)(i) would disallow if A had created split interest to avoid partial interest rule

- also, because there was no prior transfer for a private purpose, transfer of "entire" annuity interest need not meet requirements for lead trust [though in fact it does]

Rev. Rul. 86-60

situation 2

- A creates CRAT reserving annuity to self for life, successive annuity to B for life, remainder to 170(c) org

- several years later, both transfer annuity interests to remainderman

- transfer qualifies for charitable deduction, [*] but

Rev. Rul. 86-60

situation 2

- reg. section 1.170-7(a)(2)(i) would disallow if A had created split interest to avoid partial interest rule
- although there was a prior transfer for a private purpose, transfer of "entire" annuity interest meets requirements for lead trust
- B is transferring the only interest he ever had

re valuation of annuity interest

Reg. 25.7520-3(b)(2)(v), example 5

- where annuity payout as percentage of initial value is higher than 7520 rate,
- "the annuity must be valued as an annuity payable for a term of years or until the prior death of the annuitant, with the term of years determined by when the fund will be exhausted by the annuity payments."

probability of exhaustion

Rev. Rul. 70-452

- pre-TRA '69 law
- inter vivos annuity trust for life individual aged 62
- annuity would exhaust in 27 years
- 7.2 pct. probability annuitant would survive

probability of exhaustion, cont'd

Rev. Rul. 70-452, cont'd

- reg. section 25.2522(a)-2(b)
condition subsequent not "so remote
as to be negligible"
- analogy to section 2037, which includes
reversion valued at more than five pct.

probability of exhaustion, cont'd

Rev. Rul. 77-374

- reformation to bring annuity trust
into compliance ineffective b/c
- not among defects for which section 2055(e)
allows reformation

probability of exhaustion, cont'd

historically low 7520 rates

- lower expected rate of return
- lower value to remainder after fixed
annuity
- w/ 7520 rate at 3.4 pct.,
 - five pct. annuity payable at year end
would fail if annuitant younger than 64
 - for two-life annuity, minimum age 66

probability of exhaustion, cont'd

Rev. Proc. 2016-42

- qualified contingency per section 664(f) [*]
- remainder accelerated if
next annuity payment would bring corpus
below five pct. of initial value
- specimen language, safe harbor

[note, preamble somewhat overstates effect of
Rev. Rul. 77-374]

state law issues

Uniform Trust Code, section 411(b)
judicial modification of noncharitable trust

defn. "charitable trust" at sec. 103(4)
seems to refer to section 4947(a)(1) nonexempt
trust, commentary suggests remainder in split-
interest trust is itself "charitable trust"

- consent of "all interested parties"
- not inconsistent w/ "material purpose"

consent of state AG may be required

state law issues, cont'd

Uniform Trust Code, section 111(b)
nonjudicial settlement

fewer than all "interested persons" may enter
into agreement binding among themselves

but per section 111(e), any "interested person"
may ask the court to review

so the state AG could reopen

state law issues, cont'd

did Jane reserve a power to redesignate the remainder?

- doctrine of merger
[not mentioned in Rev. Rul. 86-60]

did she reserve a testamentary[*] power to revoke the income interest of a successor?

- incomplete gift per reg. sec. 25.2511-2(c),
- but per state law, completed contingent,
subject to defeasance

if she renounces, she completes a deferred gift

state law issues, cont'd

did she reserve a testamentary power, etc.

- why testamentary?

if exercisable inter vivos, would cause trust to be treated as "grantor" trust per section 674(a)

cf. PLR 200813006, independent trustee holding power to designate portion of unitrust payout to charities

state law issues, cont'd

reserved power, cont'd

- estate tax inclusion per section 2038(a)(1) unless
- per section 2035(a)(1), renounced at least three years before death

- includible per section 2036(a)(1) anyway, but again three year rule

state law issues, cont'd

reserved power, cont'd

- if Jane renounces, she completes a deferred gift to the successor
- if the successor then joins in accelerating remainder, s/he also makes a deductible gift
 - method of calculation, probability s/he would survive Jane
- if Jane does not renounce, successor "should" still join, but present value of contingent, defeasible interest is zero

case one scenario, cont'd

to summarize:

- value of Jane's "income" interest
 $268.8k \times 0.34521 = 92.8k$
- treated as capital asset w/ zero basis

assuming long-term, and
assuming remainderman is section 170(b)(1)(A),
deductible to 30 pct. of adjusted gross

case one scenario, cont'd

ACGA recommended max. rate for individual aged 78 is 6.8 pct.

$.068 \times 92.8k = 6.3k$
less than half current unitrust payout

expected return multiple 10.6 years
present value of residuum 44.6k

present value annuity stream 48.2k
all gain, realized 4.5k per year . . .

case one scenario, cont'd

similar thinking

- partial acceleration, partial commutation
- commute to smaller remainder trust w/
higher payout
 - to self for life
 - to third party for term of years
- commute to gift annuity f/b/o third party

case one scenario, cont'd

"forensics"

- if spendthrift language re third party beneficiary, consider excepting acceleration
 - section 411(c) of uniform code says spendthrift "not presumed" to be "material purpose" per *Claflin* rule
- consider including language per reg. section 1.664-3(a)(4), allowing current distributions to exempt orgs selected by bene

Case Study Two: the Gift Annuity

the scenario

- two-life gift annuity
- funded September 2013 at 200k
- Richard and Jane both then aged 73
[7520 rate 2.0 pct.]

- deduction 68.8k, payout 4.8 pct. or 9.6k
of which 2.3k ordinary[*]
- expected return multiple
 - 13.8 years Richard only
 - 18.0 years joint

case two scenario, cont'd

what is the value of the unexpired annuity?

- 9.6k annuity payable over two lives,
both age 78, funded September 2018
[7520 rate 3.4 pct.]
 - annuity factor $9.9342 \times 9.6k = 95.4k$

- 9.6k annuity payable over one life,
age 78, funded September 2018
[7520 rate 3.4 pct.]
 - annuity factor $7.5453 \times 9.6k = 72.4k$

however,

case two scenario, cont'd

deduction limited to unrecovered basis[*]
i.e., per section 170(e), no deduction for
assignment of ordinary income component

- 68.8k allocated to residuum day one
- investment in annuity contract 131.2k
- expected return $9.6k \times 18.0$ is 172.8k
- exclusion ratio $131.2/172.8$ is 76 pct.

- 7.3k per year x five years 36.5k recovered
- leaves 94.7k unrecovered

case two scenario, cont'd

deduction limited, cont'd

if we are recovering basis only over Richard's life expectancy

- investment in annuity contract 101.1k
- expected return $9.6k \times 13.8$ is 132.5k
- exclusion ratio $101.1/132.5$ is 76.3 pct.

- 7.33k per year x five years 36.6k recovered
- leaves 64.5k unrecovered

case two scenario, cont'd

deduction limited, cont'd

"forensics"

- investment in joint annuity by one spouse yields faster recovery of basis, lower ordinary component, but
- more quickly reduces amount of unrecovered basis available for deductible assignment

[testing the waters]

case two scenario, cont'd

portion that would have been long-term gain subject to 30 pct. AGI limitation

if Richard funded contract w/ separate property in which his basis was 50k, i.e., 25 pct.

- investment in annuity contract 101.1k
- $101.1k/4 = 25.28k / 13.8 = 1.83k$
- $\times 5 = 9.16k$ recovered, leaving 16.12k

- from 64.5k, leaves 48.38k gain element

case two scenario, cont'd

is the value assigned to Jane's deferred annuity also deductible?

- present value joint annuity 95.4k,
unrecovered basis 94.7k[*]
- present value one life 72.4k,
unrecovered basis 64.5k
- difference 30.2k

case two scenario, cont'd

the deferred annuity to Jane is

- contingent on her surviving Richard, and
- defeasible by the exercise of his power to revoke

therefore it has no value in her hands

if Richard renounces his reserved power, he completes a taxable gift, but Jane's unrecovered basis is zero

case two scenario, cont'd

if Richard instead exercises his reserved power to revoke the contingent annuity to Jane,

does this not in itself increase the value of the residuum to the issuing charity?

note also:

- Richard has not been recovering basis in this portion of the contract

case two scenario, cont'd

deduction limited, cont'd

"forensics"

- consider whether to convey assets to joint or entireties tenancy prior to funding annuity payable over both lives

case two scenario, cont'd

similar thinking

- partial assignment
- assignment in exchange for another annuity
 - payable to self
 - payable to third party

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