

# Accelerating the Remainder Gift

## Two Case Studies

Russell A. Willis III, J.D., LL.M.

<http://www.plannedgiftdesign.com>

### 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

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**Case Study One: the Remainder Trust**

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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  $268.8k \times .05 = 13.4k$

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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

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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"

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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 . . .

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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

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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

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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

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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

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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

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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?

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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 . . .

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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

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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 . . .

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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]

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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

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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)

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**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

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**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]

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**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

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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.

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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

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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

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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

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state law issues, cont'd

did she reserve a testamentary power, etc.

- why testamentary?

if exerciseable 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

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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

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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

remainder trust f/b/o third party

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 in the form of an 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

[\*] where third party bene is "family" per section 2704(c)(2)

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

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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

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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

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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

divorce settlement, cont'd

contrast section 682, "alimony trust"

- overrides provisions that would otherwise tax income to settlor
- treats distributions to recipient former spouse as though made from "complex" trust

repealed in 2017 tax bill

- conforming to repeal of section 215
- delayed effective date next January
- permanent



case one scenario, cont'd

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

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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 . . .

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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

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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

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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. 2017-3, section 4.10, paragraph (39)
  - except for possible effect of other substantive provisions
  - e.g., PLR 201117005
    - installments, remarriage contingency

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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)

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## Case Study Two: the Gift Annuity

### 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

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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

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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)

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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

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

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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,

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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

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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 x 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

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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]

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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

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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

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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

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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

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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

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

case two scenario, cont'd

similar thinking

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

Russell A. Willis III, J.D., LL.M.

director, The Greystocke Project  
<http://www.plannedgiftdesign.com>

314.566.3386  
[rawillis3@plannedgiftdesign.com](mailto:rawillis3@plannedgiftdesign.com)