

# Estate Planning

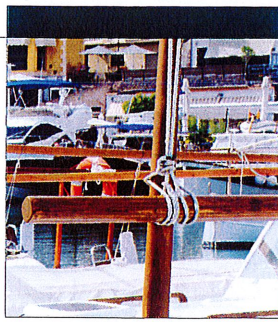


## Tax Strategy for Net Income CRUTs

Donations of Private Equity Interests

Trust Ownership of S Corporations





# New Valuation Rules for NICRUT/NIMCRUT Early Termination

PATH 2015 amends Section 664(e), negating a historical IRS position and leveling the playing field, although questions remain if the early termination results in payments to noncharitable beneficiaries.

RICHARD L. FOX AND JONATHAN G. BLATTMACHR

**A**fter years of having no statutory or regulatory authority on the issue and IRS guidance that was inconsistent with regulations governing the calculation of the allowable charitable income tax deduction for contributions to a charitable remainder unitrust (CRUT) subject to a net-income limitation, section 344 of the Protecting Americans from Tax Hikes Act of 2015 (PATH 2015),<sup>1</sup> signed by the President on 12/18/2015, amends Section 664(e) to level the playing field in valuing the charitable remainder interest in the case of an early termination of a net-income CRUT with no make-up provision (NICRUT) and a net-income CRUT with a make-up provision (NIMCRUT).

Consistent with the methodology for calculating the value of the charitable remainder interest in determining the available charitable income tax deduction upon the funding of a CRUT having a net-income limitation, under the amendment made by PATH 2015 to Sec-

tion 664(e), the net-income limitation is disregarded in determining the value of the charitable remainder interest in the case of an early termination of a NICRUT or NIMCRUT. In light of today's record-low interest rate environment,<sup>2</sup> this amendment has the potential effect of dramatically increasing the charitable income tax deduction where the early termination is the result of the unitrust interest being contributed by the noncharitable ben-

eficiary to the charitable remainder beneficiary.

Although the amendment appears to have the similar effect of increasing the amount to be paid to a non-charitable beneficiary of the unitrust interest where the early termination is the result of a proportionate distribution of trust assets to both the noncharitable and charitable remainder beneficiaries, questions remain as to whether the amendment can actually be relied upon in this context. Without further guidance in this area from the IRS, taxpayers should act with caution in valuing the beneficial interests of a NICRUT and NIMCRUT upon their early termination where the assets of the trust are distributed to the noncharitable and charitable remainder beneficiaries.<sup>3</sup>

## Background on charitable remainder trusts

A charitable remainder trust (CRT) is a widely used charitable planning arrangement that is often rec-

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ommended for individuals with substantially appreciated capital gain property, a charitable intent,<sup>4</sup> and a need for a stream of payments during their lifetimes.<sup>5</sup> The basic concept of a CRT involves a transfer of property to an irrevocable trust, the terms of which provide for the payment of an annuity or a unitrust amount (i.e., an amount equal to a fixed percentage of the annual value of the trust) to the settlor (or other designated noncharitable beneficiary) for life or another predetermined period of up to 20 years. The amount remaining in the CRT after the expiration of the annuity or unitrust payments must be transferred to one or more qualified charitable organizations or continue to be held in the trust for the benefit of such organizations. Unlike an outright gift to charity, a CRT, therefore, may blend the philanthropic intentions of a donor with his or her

financial needs or the financial needs of others.<sup>6</sup>

Generally, no gain is recognized on the contribution of appreciated property to a CRT, and because it is exempt from income tax (except to the extent of unrelated business income), the CRT may sell the transferred property on an income tax-free basis and reinvest the proceeds in other assets. For an *inter vivos* CRT, a charitable income tax deduction is available for the present value of the charitable remainder interest. Therefore, in addition to providing a source of future payments to the settlor (or to one or more other or additional noncharitable beneficiaries), the CRT provides the dual benefit of an upfront charitable income tax deduction and the tax-free sale of appreciated property by the CRT.

While the CRT itself is exempt from income tax, the annual annu-

ity or unitrust payments carry out income to the noncharitable beneficiary or beneficiaries based on specified ordering rules under a special four-tier system, generally treating the most highly taxed income of the trust as being distributed first.<sup>7</sup> Therefore, income realized by the CRT, although tax-free to the CRT, is ultimately taxable, albeit on a deferred basis, when and if it passes into the hands of a noncharitable beneficiary of the CRT.

**CRATs and CRUTs.** Before the Tax Reform Act of 1969 ("1969 Act"),<sup>8</sup> a charitable deduction was allowed even though the charitable remainder interest was contingent, as long as the probability of the charity not receiving the remainder was sufficiently remote when measured at the time of creation. This standard led to case-by-case litigation over trust instruments containing con-

<sup>1</sup> PATH 2015 is Division Q of the Consolidated Appropriations Act of 2015, H.R. 2029, P.L. 114-113 (12/18/2015).

<sup>2</sup> In February and March 2016, for example, the Section 7520 rates were 2.2% and 1.8%, respectively. Rev. Ruls. 2016-4, 2016-6 IRB 299, and 2016-7, 2016-10 IRB 391.

<sup>3</sup> In a 3/1/2016 letter to the IRS, Richard L. Fox (a co-author of this article) has requested that the IRS add a project to its 2016-2017 Priority Guidance Plan to clarify the scope and application of the amendment to Section 664(e). See Bloomberg BNA Daily Tax Report, No. 41, 3/2/2016.

<sup>4</sup> See Abbin, "No More 'Gravy Train': 1997 Law Revisions Dramatically Affect the Economics of CRTs—Only Those With True Charitable Motivation Should Create Them," 34 Phillip E. Heckerling Inst. on Est. Plan., Ch. 14 (2000).

<sup>5</sup> For a complete discussion of CRTs, including the tax issues associated with the use of these vehicles, see Fox, *Charitable Giving: Taxation, Planning, and Strategies*, 2nd Ed. (Thomson Reuters, 2014), Volume 2, Chapter 25. For an article discussing the tax benefits of CRTs, see Rogers, Blattmachr, and Rivlin, "Charitable Trusts Can Avoid Loss of Benefits," 18 ETPL 292 (September/October 1991).

<sup>6</sup> In *Estate of Boeshore*, 78 TC 523 (1982), *acq.* in result 1987-2 CB 1, the court specifically noted that donors often desire to mix private objectives with philanthropy and that it is common for interests in the same property to pass for both charitable and noncharitable purposes.

<sup>7</sup> Reg. 1.664-1(d)(1)(ii).

<sup>8</sup> Pub. L. No. 91-172.

<sup>9</sup> See, e.g., *Provident Trust Co.*, 291 U.S. 272, 13 AFTR 861 (1934) (deduction allowed for charitable remainder, which was contingent

on the life tenant's death without issue because evidence indicated that it was plainly impossible for her to have children because of age and health issues); *Hamilton Nat'l Bank of Chattanooga*, 236 F. Supp. 1005, 15 AFTR2d 1373 (DC Tenn., 1965), *aff'd per curiam* 367 F.2d 554, 18 AFTR2d 6290 (CA-6, 1966); *Merchants Nat'l Bank of Boston*, 320 U.S. 256, 31 AFTR 753 (1943); *Henslee v. Union Planters Nat'l Bank & Trust Co.*, 335 U.S. 595, 37 AFTR 826 (1949); *Estate of Stewart*, 436 F.2d 1281 (CA-3, 1971).

<sup>10</sup> See, e.g., Rev. Rul. 54-285, 1954-2 CB 302 ("In view of the foregoing it is held that a charitable deduction under section 812(d) of the Internal Revenue Code [of 1939, as amended] may be allowed on account of bequests or gifts of remainder interests to charity in cases where the will or instrument authorizes invasion of corpus for the comfortable maintenance and support of life beneficiaries if (1) there is an ascertainable standard covering comfort and support, which may be either express or implied, and (2) the probability of invasion is remote or the extent of the invasion is calculable in accordance with some ascertainable standard"); Rev. Rul. 70-450, 1970-2 CB 195 ("[i]n order for a charitable remainder interest to be ascertainable, and hence severable, a power to vary that interest by invasion of corpus must be limited by a fixed, objective standard calculable in money"); *Merchants Nat'l Bank of Boston*, 320 U.S. 256, 31 AFTR 753 (1943); and *Estate of Sternberger*, 348 U.S. 187 (1955).

<sup>11</sup> See *Hipp*, 11 AFTR2d 1787 (DC S.Car., 1962).

<sup>12</sup> H. Rep't No. 413, 91st Cong., 1st Sess. (1969), 1969-3 CB 200, 237; *Estate of Gillespie*, 75 TC 374 (1980) (discussing the history and purposes of the rules pertaining to CRTs). See also *Estate of Boeshore*, *supra* note 6.

<sup>13</sup> H. Rep't No. 413, *supra* note 12. In *Estate of Gillespie*, *supra* note 12, the court recognized these perceived abuses in the context of pre-1969 law applicable to split-interest trusts, stating that "the assets of such a trust might be invested in a manner so as to maximize the income interest with the result that there would be little relationship between the interest assumptions used in calculating the present value of the charitable remainder and the present value received by the charity." The court also stated that "a deduction was often allowed for a conditional bequest to charity even though it was not probable that the full amount of the bequest would ultimately be received by the charity."

<sup>14</sup> See, e.g., *Estate of Boeshore*, *supra* note 6; *Estate of Blackford*, 77 TC 1246 (1981); *Estate of Edgar*, 74 TC 983 (1980).

<sup>15</sup> In effect, all the income earned by the trust is combined with principal in a single fund and, for purposes of determining the payout to the noncharitable beneficiary, no distinction is made between "income" and "principal" under the normal fiduciary accounting principles. Under this format, a trustee is encouraged to exercise sound business judgment because neither the noncharitable or charitable beneficiary is benefited to the detriment of the other by investment decisions. *Estate of Boeshore*, *supra* note 6.

<sup>16</sup> The statutory framework for CRATs and CRUTs are set forth, respectively, at Sections 664(d)(1) (annuity trust) and 664(d)(2) (unitrust). The IRS has issued sample forms for both CRATs and CRUTs. See Fox, "A Guide to the IRS Sample Charitable Remainder Trust Forms," 33 ETPL 13 (January 2006).

<sup>17</sup> Section 664(d)(1)(A); Reg. 1.664-1(a)(1)(i).



tingencies.<sup>9</sup> The trust instrument could also authorize the invasion of trust principal for noncharitable beneficiaries if it was governed by an ascertainable standard, also determined case by case depending on the facts of each particular case.<sup>10</sup> For purposes of calculating the charitable deduction, notwithstanding that the actual income to be distributed to the noncharitable beneficiaries could be substantially greater, it was assumed that the income of the CRT to be distributed to the noncharitable beneficiaries would be 3.5% per year, which was also the discount rate used in determining the present value of the charitable remainder interest.<sup>11</sup>

Congress perceived certain abuses that could result from this methodology because the assets of the trust could be invested in a manner so as to maximize the income interest of the noncharitable beneficiary, with the result that the charitable deduction taken for the present value of the charitable remainder, as calculated on the basis of the 3.5% income and interest rate assumptions, bore little relation to the present value of the amount actually received by the charity.<sup>12</sup> Given the potential to manipulate the income interest of the noncharitable beneficiary, there was a perceived lack of correlation between the charitable deductions claimed for transfers to a CRT and the actual amount that the charity ultimately received. These perceived abuses were summarized in the House Report accompanying the 1969 Act as follows:

The rules of present law for determining the amount of the charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the

result that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity. For example, the trust corpus can be invested in high-income, high-risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest. Your committee does not believe that a taxpayer should be allowed to obtain a charitable contribution deduction for a gift of a remainder interest in trust to a charity which is substantially in excess of the amount the charity may ultimately receive.<sup>13</sup>

Under the 1969 Act, Congress made various amendments to the Code and added Section 664, the effect of which was to create a new and extremely complex set of rules governing charitable deductions for contributions of remainder interests in trust to charity, intended to assure that the amount actually received by the charity will accord with the charitable deduction allowed to the donor on the creation of the trust.<sup>14</sup> Under these rules, a deduction for the contribution of a remainder interest in trust to a charity is permissible only, among other requirements, where the remainder interest is transferred by way of either a CRAT, which provides a payment of a fixed amount to the noncharitable beneficiary, or a CRUT, which provides for the payment of a fixed percentage of the trust assets revalued annually. Further, the CRAT and unitrust cannot be subject to any power to invade, alter, amend, or revoke for the benefit of any noncharitable beneficiary.


Congress determined that the charitable remainder interest would be protected from abuse if cast in these prescribed forms as any incentive to manipulate the income stream would be removed, as the payout to the noncharitable beneficiary is a fixed amount and is not a function of the actual income generated by the trust.<sup>15</sup> The 1969 Act, under which the pri-

vate foundation excise tax rules contained in Chapter 42 of the Code were enacted, also enacted Section 4947, which makes the private foundation excise tax rules, including the self-dealing rules of Section 4941, generally applicable to CRTs.


There are two basic types of CRTs available under Section 664:

1. A charitable remainder annuity trust (CRAT).
2. A charitable remainder unitrust (CRUT).<sup>16</sup>

A CRAT provides for a fixed payment of a specified dollar amount at least annually to the noncharitable beneficiary or beneficiaries. The annual payment must be equal to at least 5% but not more than 50% of the initial net fair market value (FMV) of all of the assets transferred to the trust.<sup>17</sup> A CRUT provides for a payment at least annually to the non-



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charitable beneficiary or beneficiaries of a fixed percentage of the FMV of the trust principal revalued on an annual basis. Similar to the CRAT regime, the fixed percentage for a CRUT must be equal to at least 5% but not more than 50% of the net FMV of the assets of the trust as revalued annually.<sup>18</sup>

While the annual payment under a CRAT is determined upon the funding of the trust and remains constant throughout its term, the annual payment under a CRUT fluctuates from year to year based on the FMV of the trust assets. When the value of the trust assets appreciates, unitrust payments will increase, and when the value of the trust assets depreciates, unitrust payments will decrease.

**Variations of CRUTs based on net-income limitations.** While a CRAT comes in one basic form, a CRUT can take a variety of forms. Under the standard CRUT, the payment to the noncharitable beneficiary or beneficiaries is equal to a fixed percentage of the value of the trust assets revalued annually.<sup>19</sup>

The payment is made even when the net fiduciary accounting income of the trust is less than the fixed percentage payout amount, in which case a portion of the payment would necessarily come from the corpus of the trust. When CRTs were first being considered in the context of the Tax Reform Act of

1969, the Senate Finance Committee amended the House bill to allow distributions for both CRATs and CRUTs to be limited to the net income of the trust, under the following rationale:

Allowing a charitable remainder trust to distribute to the income beneficiary the lesser of the trust income or the stated payout will prevent a trust from having to invade corpus when the income for a year is below that originally contemplated.<sup>20</sup>

The Conference Committee, without explanation, applied this income limitation only to CRUTs. In the context of CRUTs, but not CRATs, therefore, the trust document may contain a provision limiting the distribution to the fiduciary accounting income (hereinafter "net income") of the trust in any year in which the net income is less than the fixed percentage payout amount otherwise required to be distributed if the trust were a standard CRUT.<sup>21</sup> As a result, the governing instrument of a CRUT (but not a CRAT) may limit annual payments to the lesser of the computed unitrust amount (equal to the specified percentage multiplied by the annual fair market value of the trust assets) or the trust's net income as defined in Section 643(b).

Such a "net-income" CRUT may, but is not required to, provide for the excess of the unitrust amounts computed over the net income earned in the trust to be dis-

tributed if and when the net income of the CRUT exceeds the unitrust amount for the year. In other words, the trust may permit a make-up of the shortfall of the unitrust amounts over the net income. If the trust does not provide for the make-up, it is known as a net-income CRUT or NICRUT. If it does provide for the make-up, it is known as a net income with makeup CRUT or NIMCRUT.

The use of a net-income limitation has resulted in the following variations of the standard CRUT:

- A NIMCRUT pays a fixed percentage of the value of trust assets each year, or if less, the net income of the trust for the year, with any deficiencies due to the income limitation to be made up in later years to the extent the trust net income exceeds the amount determined using the fixed percentage payout rate.
- A NICRUT pays a fixed percentage of the value of trust assets each year, or if less, the net income of the trust for the year. Any deficiencies due to the income limitation are not made up in later years, however, even if in later years the trust net income exceeds the amount determined using the fixed percentage payout rate.
- A NICRUT or NIMCRUT that flips to a standard CRUT,

<sup>18</sup> Section 664(d)(2)(A); Reg. 1.664-1(a)(1)(i).

<sup>19</sup> Reg. 1.664-3(a)(1)(i).

<sup>20</sup> U.S. Code Congressional and Administrative News, 91st Cong., P.L. 91-172, S. Rep't, page A-477.

<sup>21</sup> NICRUTs and NIMCRUTs are permitted under Section 664(d)(3). FLIP CRUTs are authorized under Reg. 1.664-3(a)(1)(i)(c).

<sup>22</sup> *Id.*

<sup>23</sup> Regs. 1.664-4(a)(3) and -3(a)(1)(i)(a).

<sup>24</sup> Regs. 1.664-4(a)(3) and -3(a)(1)(i)(a). For charitable income tax deduction purposes, it is assumed, therefore, that notwithstanding the net-income limitation, the noncharitable beneficiary will receive the entire unitrust payments as if the NICRUT or NIMCRUT were a standard CRUT.

<sup>25</sup> Section 4947(a)(2). Note that Section 4947(a)(2)(A) provides that the self-dealing rules do not apply with respect to amounts payable under the terms of the trust instrument to a noncharitable beneficiary. Absent this exception, the periodic payments to the noncharitable beneficiaries of a CRT would violate the self-dealing rules and, therefore, imposition of excise tax would occur under Section 4941.

<sup>26</sup> See, e.g., Ltr. Ruls. 200208039, 200912036, and 201325018.

<sup>27</sup> This assumes that the noncharitable beneficiaries receiving funds upon the early termination of the CRT are "disqualified persons" under Section 4946, which most likely will be the case as, for purposes of Section

4941, a "disqualified person" includes the settlor of the trust and members of the family of the settlor. Members of a family include a spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren (Section 4946(d)). When the noncharitable beneficiary is not a "disqualified person," such as a nephew or friend of the settlor, Section 4941 should not apply except, perhaps, when the trustee is a disqualified person other than solely by virtue of being a trustee (such as when the trustee is the settlor of the trust).

<sup>28</sup> Under Section 6110(k)(3), a private letter ruling may not be cited or used as precedent.



known as a FLIP CRUT, which begins with a net-income limitation, either in the form of a NICRUT or NIMCRUT, and then, upon the occurrence of a permissible triggering event, flips to a standard unitrust and, therefore, makes payments based on the fixed percentage payout rate without regard to the trust's net income.<sup>22</sup>

**Valuation at trust creation.** A taxpayer who during lifetime creates a "qualifying" CRT, i.e., one that meets the criteria of Section 664, is entitled to a gift tax charitable deduction for the value committed to charity in the trust, which must be at least 10% when the trust is created or any additional contribution (permitted only for CRUTs that authorize additional contributions) is made. The estate of a taxpayer who creates one at death is entitled to an estate tax charitable deduction for the value of the charitable remainder interest, again if the value committed to charity is at least 10%. In addition, a taxpayer who during his or her lifetime creates such a trust may also be entitled to a charitable income tax deduction for the value of the charitable remainder interest.

A key factor, therefore, is the calculation for tax purposes of the value of the charitable remainder. The principles used in making the calculation are set forth in Section 7520. For gift, estate tax, and income tax purposes, the calculation is the same for a standard CRUT and for a net-income CRUT. In all cases, the charitable deduction is determined based on the assumption that a stated unitrust payout will be made each year to the noncharitable unitrust recipient, i.e., without regard to the net-income limitation.<sup>23</sup>

For charitable income tax deduction purposes, it is assumed, there-

fore, that notwithstanding the net-income limitation, the non-charitable unitrust beneficiary will receive the entire amount of the unitrust payments as though the NICRUT or NIMCRUT were a standard CRUT. Therefore, for purposes of calculating the available charitable tax deduction, the value of the remainder interest passing to charity under a NICRUT or NIMCRUT is made without regard to the fact that the annual distributions to the noncharitable beneficiary may be limited in those years where the net income of the trust is less than the fixed percentage payout amount otherwise required to be distributed.<sup>24</sup> As a result, in the case of a NICRUT and NIMCRUT, the net-income limitation is disregarded and the available charitable income tax deduction for the funding of a NICRUT or NIMCRUT is, therefore, not affected by the net-income limitation, notwithstanding that such limitation may result in the charitable remainder beneficiary ultimately receiving more funds (and the noncharitable beneficiary ultimately receiving less funds) than when, as in the case of a standard CRUT, distributions are not subject to a net income limitation.

For example, if the unitrust percentage is 5% for a NICRUT or NIMCRUT, the deduction is based upon the assumption that 5% will be paid to the unitrust recipient each year even if the net-income percentage is lower (e.g., around 2% as it has been for many of the recent months). In other words, although the projection, based upon Section 7520, is that the unitrust recipient will receive less than the unitrust percentage each year, the deduction is based on the assumption that the unitrust percentage amount will be paid annually which, of course, would produce a smaller income tax deduction than if the net-income per-

centage were used to determine the value of the remainder and, therefore, the charitable deduction.

### Valuation at trust's early termination

Because transactions involving a CRT are subject to the self-dealing rules of Section 4941,<sup>25</sup> where a CRT is terminated early as a result of the proportionate distribution of trust assets to the noncharitable and charitable remainder beneficiaries, the IRS has ruled that the charitable remainder beneficiaries must receive the actuarial present value of their remainder interests, with the remaining funds paid out to the noncharitable beneficiaries of the trust holding the term interests.<sup>26</sup> Otherwise, an act of self-dealing under Section 4941 will be considered to have occurred.<sup>27</sup>

In Ltr. Rul. 200252092,<sup>28</sup> for example, in the context of address-

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ing the self-dealing issue upon the early termination of a CRT, the IRS stated that the “critical question is whether early termination may reasonably be expected to result in a greater allocation of the trust assets to the income beneficiary, to the detriment of the charitable beneficiary.” The IRS ruled that when the actuarial values of the shares of the income and charitable remainder beneficiary are determined using the discount rate in effect under Section 7520 on the date of termination and the methodology under Reg. 1.664-4 for valuing interests in charitable remainder trusts, “the early termination ... will not be to the detriment of the charitable beneficiary” and, as a result, there will be no act of self-dealing.

***Pre-PATH 2015 valuation approach involving distribution of trust assets.*** In the context of the early termination of a NICRUT or NIMCRUT resulting from a distribution of trust assets to the non-charitable and charitable remainder beneficiaries, an issue arises as to how the net-income limitation affects the actuarial valuation of interests held by the noncharitable and charitable remainder beneficiaries. Given that the payout by a NIMCRUT and NICRUT is limited to net fiduciary accounting income<sup>29</sup> (subject to a makeup payment in the case of a NIMCRUT), special consideration must be given in determining the appropriate amount of the distribution to a non-charitable beneficiary, because an overpayment to a noncharitable beneficiary in this context, according to the IRS, results in an act of self-dealing.

Prior to the enactment of PATH section 344, there was no statutory or regulatory authority on the effect of a net-income limitation on valuing the term and remainder

interests in a NICRUT or NIMCRUT upon the trust’s early termination, although private letter rulings did address this issue in the context of a NIMCRUT, which were equally applicable to a NICRUT.<sup>30</sup> The IRS rulings provide that the appropriate calculation of the actuarial value of noncharitable interests in a NIMCRUT must take into account the net-income provisions, so as to ensure that there is no a greater allocation of assets to the noncharitable beneficiaries.

These rulings, therefore, required the use of a reasonable method for the calculation that does not inappropriately inflate the value of noncharitable interests to the detriment of the charitable remainder beneficiary. The rulings stated that “one reasonable method to calculate the actuarial value of the income and remainder interests” upon the early termination of a NIMCRUT is to use the lesser of the stated percentage distribution rate of the NIMCRUT or the Section 7520 rate in effect for the month of termination, with the Section 7520 rate representing the deemed rate of income to be earned by the trust.<sup>31</sup>

Using this approach in the current near-record low Section 7520 rate environment has the effect of dramatically reducing the value of the term interest in a NIMCRUT and NICRUT, thereby resulting in a much lesser distribution to the noncharitable beneficiary upon an early termination than if the net-income limitation were not considered.<sup>32</sup> In Ltr. Rul. 201325021, for example, the distribution of funds to the noncharitable beneficiaries upon the early termination of a NIMCRUT, which was to occur in either March or April 2013, was based on the Section 7520 rate of 1.40% in effect for those months, substantially less than the unitrust payout percentage provided under the trust. The IRS ruled favorably on the Section 4941 self-dealing issue, stating that as a result of this methodology, “the income beneficiaries are not expected to receive more than they would during the full term of Trust under the above-described methodology for valuing their interests in a charitable remainder trust with a net-income make-up feature.”

The IRS ruling’s approach to valuing the noncharitable term

<sup>29</sup> Fiduciary accounting income for charitable remainder trust and other purposes is defined in Section 643(b) and fleshed out under Regs. 1.643(b)-1 and -2, with special rules for net-income CRUTs. See, e.g., Reg. 1.664-3(b)(3).

<sup>30</sup> Ltr. Ruls. 201325018 through 201325021, 200733014, 200725044, and 200833012. Before issuing these rulings, the IRS had issued rulings in the context of an early termination of a CRUT where the valuation of the term interest of a noncharitable beneficiary of a CRUT having a net-income limitation was determined without regard to such limitation. See, e.g., Ltr. Ruls. 200208039, 200304025, and 200525014.

<sup>31</sup> Of course, when the unitrust payout rate is not in excess of the Section 7520 rate for the month of the early termination, no special valuation method is required. See, e.g., Ltr. Rul. 200912036.

<sup>32</sup> The minimum unitrust percentage payout is 5% (Section 664(d)(2)(A); Reg. 1.664-1(a)(1)(i)), but the deemed annual amount of income will equal the Section 7520 rate, which in recent years has been significantly below 5%. Under Section 7520(a), if an income, estate, or gift tax charitable contribution deduction is allowable for any part of the property transferred, the taxpayer may

elect to use the Section 7520 rate for the current month or either of the two months preceding the month in which the valuation date falls, thereby allowing the taxpayer to elect the most favorable Section 7520 rate among three months, the month in which the transaction occurs and the two immediately preceding prior months. Because no charitable contribution deduction is allowable upon the early termination of a CRUT, the Section 7520 rate in effect in the month of termination must be used, which is consistent with IRS early CRUT termination rulings, when the Section 7520 rate in the month of termination has always been used by the IRS. See, e.g., Ltr. Ruls. 201325018 through 201325021 (“the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust’s stated payout percentage or the § 7520 rate for the month of termination”).

<sup>33</sup> Regs. 1.664-4(a)(3) and 1.664-3(a)(1)(i)(a).

<sup>34</sup> Ltr. Ruls. 201325018 through 201325021.

<sup>35</sup> [www.pgdc.com/pgdc/ny-city-bar-calls-guidance-valuing-income-interests-when-terminating-crts-early](http://www.pgdc.com/pgdc/ny-city-bar-calls-guidance-valuing-income-interests-when-terminating-crts-early).

<sup>36</sup> This assumes that the Section 7520 rate is less than the stated unitrust payout rate in the month of termination.



uation methods arguably should be applied upon an early termination of a CRUT containing a net-income limitation, depending on whether it is a NICRUT, a NIMCRUT, or a FLIP CRUT, adding even more complexity to this issue. The calculation method used by the IRS in private letter rulings in the context of NIMCRUT early terminations was labeled as "one reasonable method," an indication that the IRS may consider other calculation methods to be reasonable.

**The CRT provides the dual benefit of an upfront charitable income tax deduction and the tax-free sale of appreciated property by the CRT.**

*Pre-PATH 2015 valuation approach involving contribution to charitable remainder beneficiary.* Where the early termination of a CRUT subject to a net-income limitation is the result of the unitrust interest being contributed by the non-charitable beneficiary to the charitable remainder beneficiary, the IRS private letter ruling approach has been inconsistent as to whether the net-income limitation should be applied in determining the value of the charitable income tax deduction, although the more recent rulings have ignored the limitation.

In Ltr. Rul. 200205008, the noncharitable beneficiary of a NIMCRUT donated a portion of his unitrust interest to the charitable remainder beneficiary. Noting that the donor was entitled to receive annually only the lesser of the stated unitrust payout or the net income of the trust, the IRS, taking the net-income limitation into account, ruled that the income

tax charitable deduction allowable is the lesser of:

1. The present value of the right of the noncharitable beneficiary to receive annually the stated unitrust payout.
2. The present value of the right to receive trust net income.

More recent rulings have disregarded the net-income limitation in these circumstances. In Ltr. Rul. 200524014, the noncharitable beneficiary contributed his unitrust interest in a NIMCRUT to the charitable remainder beneficiary. For purposes of determining the value of the charitable income tax deduction, the IRS ignored the net-income limitation feature of the NIMCRUT, ruling that the "Taxpayer will be entitled to a charitable income tax deduction under § 170(a)(1) to the extent of the present value of the unitrust interest transferred as of the date of transfer, calculated as provided in §§ 664 and 7520 and § 25.2512-5 of the Gift Tax Regulations." The same approach was applied by the IRS in Ltr. Ruls. 200525008 and 200808018, where the net-income limitation of a NIMCRUT was disregarded for purposes of computing the allowable charitable income tax deduction for the contribution of the unitrust interest to the charitable remainder beneficiary.

The approach used in more recent IRS letter rulings in disregarding the net-income limitation seems appropriate. Unlike a termination where the noncharitable beneficiaries are receiving a distribution of assets, a termination based on a contribution of the unitrust interest to the charitable remainder beneficiary results in all of the trust assets being distributed to the charity. In that situation, the noncharitable beneficiary is not receiving assets, but is receiving only a charitable deduction.

Given that the initial charitable deduction upon funding of the NICRUT or NIMCRUT is valued without regard to the net-income limitation, similarly ignoring the net-income limitation upon a subsequent contribution of the unitrust interest to the charitable remainder beneficiary upon an early termination offers a consistent approach for charitable deduction purposes. This seems particularly appropriate because, upon the contribution of the unitrust interest, the charity is to receive all remaining assets of the trust at such time.

*Valuation approach under amendment made by PATH 2015.* PATH section 344 provides as follows:

SEC. 344. CLARIFICATION OF VALUATION RULE FOR EARLY TERMINATION OF CERTAIN CHARITABLE REMAINDER UNITRUSTS.

(a) IN GENERAL.—Section 664(e) is amended—

(1) by adding at the end the following: "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", and

(2) by striking "FOR PURPOSES OF CHARITABLE CONTRIBUTION" in the heading thereof and inserting "OF INTERESTS".

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to terminations of trusts occurring after the date of the enactment of this Act.

Under this amendment, which adds one sentence to the end of existing Section 664(e), in the case of an early termination of a NICRUT or NIMCRUT, the remainder interest is valued using rules similar to the rules for valuing the remainder interest of a charitable remainder trust when determining the amount of the grantor's charitable contribution deduction.



Contrary to the multitude of IRS letter rulings issued in this context, therefore, the value of the remainder interest is computed without regard to the existence of any net-income limitation.

Therefore, the valuation of a present value of the noncharitable and charitable remainder interests upon the early termination of a NICRUT or NIMCRUT is made based on the stated unitrust percentage otherwise required to be distributed to the noncharitable beneficiaries, and the net-income limitation contained in such trusts is disregarded. In light of today's record-low interest rate environment, this change has the potential effect of drastically increasing the distribution to the noncharitable beneficiaries upon the early termination of a NICRUT or NIMCRUT or the amount allowed as an income tax charitable deduction if the unitrust interest is contributed to charity.

**Example.** Anne creates a CRUT that provides for her to receive the lesser of net income or a 10% annual unitrust payment. The taxpayer and the charitable remainder beneficiary agree to terminate the trust (and state law does not prohibit the termination) when 15 years remain for the CRUT and it has a value of \$1 million. The Section 7520 rate at the time of termination is 1.8%. Under the IRS's historical private letter ruling methodology, which generally assumes that the beneficiary will receive only the 1.80% Section 7520 rate over the remaining term

of the CRUT, the value of the non-charitable unitrust interest upon termination would be about \$238,000. But under Section 664(e), as amended by PATH 2015, where the net-income limitation is disregarded and it is assumed that the taxpayer will receive the 10% annuity unitrust payment, the value of the noncharitable unitrust interest at such time would be equal to about \$794,000.

By disregarding the net-income limitation for purposes of computing the value of the remainder interest pursuant to Section 664(e) as amended, depending on the unitrust percentage interest and the anticipated net income of a NICRUT or NIMCRUT, a non-charitable beneficiary may realize more of an economic benefit if, in lieu of continuing to receiving payments that are limited by a net-income limitation, he or she contributes the unitrust interest to the charitable remainder beneficiary, thereby attaining the current benefit of a charitable income tax deduction computed without regard to the net-income limitation.<sup>37</sup>

**Questions remain regarding reliance on PATH valuation method.** As discussed above, disregarding the net-income limitation pursuant to the amendment to Section 664(e) certainly appears appropriate where the unitrust interest is contributed to the charitable remainder beneficiary and, in fact, is consistent with the most recently issued IRS private letter rulings in this area. Questions remain, however, as to whether the amendment can actually be relied on to disregard the net-income limitation where the early termination of a NICRUT or NIMCRUT results in the distribution of trust assets to the noncharitable and charitable remainder beneficiaries.

It is interesting that the term "early termination" within the language of the amendment to Section 664(e) is not defined, so that the scope of the amendment is not entirely clear. Query, therefore, whether the scope of the amendment is limited only to the situation where an early termination occurs as a result of the noncharitable beneficiary contributing the entire unitrust interest to the charitable remainder beneficiary. In its explanation of PATH 2015 section 344, the Joint Committee on Taxation ("Joint Committee"), in its discussion of "Present Law," addresses the charitable deduction only upon the funding of a CRT, specifically noting that "in the case of a NICRUT or a NIMCRUT, the net-income limitation is disregarded" and "the Code does not provide a rule for valuing the interests in a charitable remainder trust in the event of an early termination of the trust."<sup>38</sup> Under its "Explanation of Provision," the Joint Committee states only as follows:

Under the provision, in the case of the early termination of a NICRUT or NIMCRUT, the remainder interest is valued using rules similar to the rules for valuing the remainder interest of a charitable remainder trust when determining the amount of the grantor's charitable contribution deduction. In other words, the remainder interest is computed on the basis that an amount equal to five percent of the net fair market value of the trust assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year, with any net-income limit being disregarded.

As in the case of the statute itself, the Joint Committee's explanation provides no indication of the scope of the amendment to Section 664(e) or any definition of the term "early termination" as used in the amendment. Nor does it provide any indication that Section 664(e) is intended to apply where a NICRUT or NIMCRUT terminates as a result of

<sup>37</sup> For a further discussion of this issue, see Evans, "The Valuation of Terminating NIMCRUTs After Section 344 of the Protecting Americans from Tax Hikes Act of 2015," Steve Leimberg's Charitable Planning Newsletter #242 (1/16/2016).

<sup>38</sup> Technical Explanation of the Protecting Americans from Tax Hikes Act of 2014, House Amendment #2 to the Senate Amendment to H.R. 2029, 12/17/2015, JCX-144-15.



the trustee making a distribution of all the trust assets to the noncharitable and charitable remainder beneficiaries prior to the end of the term stated in the trust instrument.

There are other concerns raised about reliance on the valuation method under the amendment to Section 664(e) where a NICRUT or NIMCRUT terminates as a result of the distribution of assets to noncharitable and charitable beneficiaries. A CRT is subject to the self-dealing rules of Section 4941 and, as prior IRS rulings have indicated, no act of self-dealing results where the distribution of assets upon the early termination of a CRT "will not be to the detriment of the charitable beneficiary." As demonstrated above, in today's low interest rate environment, disregarding the net-income limitation in valuing the unitrust interest in a NICRUT or NIMCRUT can drastically increase the distribution made to the noncharitable beneficiaries upon the early termination of a NICRUT or NIMCRUT. Yet, the application of the valuation rule contained in Section 664(e), as amended, is, by its very terms, limited to "the valuation of interests in such trust for purposes of this section [664]."

No reference is made under the amendment to Section 664(e) on its effect under the self-dealing rules of Section 4941 and whether reliance on the valuation rule contained in Section 664(e) will avoid an act of self-dealing. As a result, there is no assurance that following the new valuation method under Section 664(e)—which results in the noncharitable beneficiary perhaps getting more than he or she would ever receive if the trust ran its course—does not result in an act of self-dealing under Section 4941. As noted, under its pre-PATH 2015 ruling regime, the IRS would rule only that no act of self-dealing under Section 4941 occurs in this situation

if the unitrust interest is valued by taking into account the net-income limitation. Absent taking into account the net-income limitation, the IRS would have found an act of self-dealing to occur.

It is not clear whether a charitable remainder beneficiary, or the state attorney general or court having jurisdiction over the trust, would or should agree that the net-income limitation should be ignored in computing the payout to a noncharitable beneficiary simply because a federal income tax provision ignores the limitation for purposes of computing a charitable income tax deduction. Also, there is a question whether the trustee of a CRT, having a duty of loyalty to both the noncharitable and charitable beneficiaries, can apply a valuation method that, although consistent with a federal income tax valuation method, results in a charitable beneficiary receiving less than what it might otherwise be entitled.

Interestingly, Rev. Proc. 2016-3,<sup>39</sup> section 3(71) specifically provides that the IRS will no longer issue rulings pertaining to the tax consequences of the early termination of a CRT in a transaction in which the trust beneficiaries receive their respective shares of the value of the trust assets, the precise subject matter of the amendment to Section 664(e) under PATH 2015. As a result of this "no ruling" position of the IRS in this area, taxpayers will be unable to obtain a private letter ruling in connection with valuation issues raised under the amendment to Section 664(e) unless the no ruling position is changed, or other guidance is issued by the IRS.<sup>40</sup> Given the questions raised by the amendment to Section 664(e) under PATH 2015, it would appear that the no IRS ruling policy upon an early termination of a NICRUT or NIMCRUT should now be eliminated.

## Conclusion

Consistent with the treatment of taxpayers upon the funding of a NICRUT or NIMCRUT, the amendment to Section 664(e) provides the unitrust interest is to be valued without regard the net-income limitation. This assures that taxpayers contributing their entire unitrust interest in a NICRUT or NIMCRUT will receive the full deduction. It does not appear certain that the amendment to Section 664(e) should be applied in the context of a termination of a NICRUT or NIMCRUT where trust assets are distributed to charitable and the noncharitable remainder beneficiaries. Even assuming that it does apply, a question may remain as to whether the application of the valuation method under Section 664(e) will result in an act of self-dealing in a low interest rate environment, where the noncharitable beneficiary, perhaps, will receive more than he or she would have ever received had the trust run its course and not terminated early.

Without further guidance in this area from the IRS, taxpayers should act with caution in valuing the beneficial interests of a NICRUT and NIMCRUT upon their early termination where the assets of the trusts are distributed to the noncharitable and charitable remainder beneficiaries. Further, given the potential of Section 664(e) to significantly increase the distribution to the noncharitable beneficiary in such context, reliance on this valuation method may not be accepted by the charitable remainder beneficiary, the State Attorney General, local courts, or the trustee administering the trust. ■

<sup>39</sup> 2016-1 IRB 126.

<sup>40</sup> As indicated in note 3, *supra*, in a 3/1/2016 letter to the IRS, Richard L. Fox requested that the IRS add a project to its 2016-2017 Priority Guidance Plan to clarify the scope and application of the amendment to Section 664(e).