Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trust

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In preventing the application of the uniform basis rules to a combined sale of both the term and remainder interests in a charitable remainder trust, the proposed regulations thwart a planning technique previously identified by the IRS as a “transaction of interest” aimed at allowing an annuity or unitrust interest in a CRT to be sold on a tax-free basis.

The Treasury Department has issued proposed regulations (REG-154890-05, 1/16/2014) that provide rules for determining the income tax basis of a noncharitable beneficiary’s annuity or unitrust interest in a charitable remainder trust (CRT) when the noncharitable beneficiary and charitable remainder beneficiary join together in the sale of their respective interests to a third party. The proposed regulations were issued in response to a transactions designed to allow a taxpayer to contribute substantially appreciated assets to a CRT, have those assets sold by the CRT on an income tax-free basis and reinvested in newly acquired assets with an income tax basis equal to their purchase price, and later sell the annuity or unitrust interest in the CRT at little or no taxable gain. The transaction is structured to avoid the application of Section 1001(e)(1), under which the annuity or unitrust interest (referred to in the section as a “term interest”) would otherwise have a zero income tax basis if sold alone, and takes advantage of the uniform basis rules applicable to trusts when there is a combined sale of both the term and remainder interests to a third party. The result sought to be achieved is much more favorable than where only the annuity or unitrust interest is sold by a noncharitable beneficiary, separate and apart from the remainder interest, when any gain recognized on the sale is equal to the total amount of the proceeds because the interest sold in such a case has a zero income tax basis under Section 1001(e)(1).

The very transaction targeted by the proposed regulations was previously identified as a “transaction of
gain property, a charitable intent, and a need for a stream of income during their lifetimes. 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 unitrust amount to the settlor or other designated noncharitable beneficiary for life or another predetermined period of time up to twenty years. The amount remaining in the CRT at 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, therefore, a CRT blends the philanthropic intentions of a donor with his or her financial needs or the financial needs of others.

There is generally no gain recognition on the contribution of appreciated property to a CRT, and because it is exempt from income tax, the CRT may sell the transferred property on a 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 annuity 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. Therefore, income realized by the CRT, although tax-free to the CRT, is ultimately taxable, albeit on a deferred basis, when it passes into the hands of a noncharitable beneficiary of the CRT.

**CRATs and CRUTs**

There are two basic types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT). A CRAT provides for a fixed payment of a specified dollar amount at least annually to the noncharitable beneficiary or beneficiaries. The amount of 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. A CRUT provides for a payment at least annually to the noncharitable 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.
ally. While the amount of the annual payment under a CRAT is determined upon the funding of the trust and remains constant throughout its term, the amount of 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 amount of the payment to the noncharitable beneficiary or beneficiaries is equal to a fixed percentage of the value of the trust assets revalued on an annual basis. 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 CRUs 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.

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 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.

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

- Net income CRUT with make-up provision (NICRUT): 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, 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.
- Net income CRUT with no make-up provision (NICRUT): 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 (FLIP CRUT): A FLIP CRUT 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.

For purposes of calculating the available charitable tax deduction, the calculation of 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 in which the net income of the trust is less than the fixed percentage payout amount otherwise required to be distributed. As a result, the available charitable income tax deduction for the funding of a NICRUT or NIMCRUT is not reduced by virtue of the net income limitation, although 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.

Perceived Abuses of CRTs and Legislative and Regulatory Responses.

Interestingly, there is a history chock-full of taxpayers using CRTs in a manner that has been perceived by Congress or the Treasury Department as abusive and, in response, there have been a number of legislative and regulatory changes over the years to the tax rules governing CRTs. Therefore, the recent issuance of the proposed regulations is just one more response in a long line of responses by the government to curb perceived abusive transactions involving CRTs. Prior to the enactment of Section 664 under the Tax Reform Act of 1969, a CRT could be established to provide simply for the payment of all of the trust net fiduciary accounting income to the donor or other designated noncharitable beneficiary for life or a term of years and for the principal remaining on the termination of the trust to be paid to the charitable remainder beneficiary. 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. As a result, at its inception, Section 664 provided that a deduction for the contribution of a remainder interest in trust to charity is permissible.

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only when the remainder interest is transferred in the form of either a CRAT or a CRUT. Accordingly, when the settlor of a trust retains a life estate (rather than a payout in the form of an annuity or unitrust, or a unitrust interest limited by the amount of fiduciary accounting income the trust experiences), with the remainder passing to charity, the trust will not qualify as a CRT under Section 664. Prior to the Taxpayer Relief Act of 1997, there was no maximum limitation imposed on the amount of the annual distributions payable by a CRT and there was no minimum imposed on the value of the charitable remainder interest. This led to certain perceived abuses associated with the use of short-term CRUTs with high-percentage payouts, otherwise known as "accelerated CRUTs," as summarized in the Senate Finance Committee Report:

The Committee is concerned that the interplay of the rules governing the timing of income from distributions from charitable remainder trusts ... and the rules governing the character of distributions ... have created opportunities for abuse where a large portion of the trust's realized income and gain can be postponed until a year later than the actual receipt of such large payments. For example, some taxpayers have been creating charitable remainder unitrusts with a required annual payout of 80 percent of the trust's assets and then funding the trust with highly appreciated non-dividend paying stock, which the trust sells in a year subsequent to when the required distribution is includable in the beneficiary's income, and using proceeds from that sale to pay the required distribution attributable to the prior year. Thus, taxpayers have treated the distribution of 80 percent of the trust's assets attributable to the trust's first required distribution as non-taxable distributions of corpus because the trust had not realized any income in its first taxable year. The Committee believes that such treatment is abusive and is inconsistent with the purpose of the charitable remainder trust rules.

As a result of the perceived abuse associated with accelerated CRUTs, Section 664 was amended to provide that the payout to the noncharitable beneficiary may not exceed 50% of the initial FMV of the trust assets (in the case of a CRAT) or 50% of the annual net FMV of the trust assets (in the case of a CRUT) and the actuarial present value of the remainder interest passing to charity must be equal to at least 10% of the initial net FMV of the assets transferred to the trust. Subsequent to the Taxpayer Relief Act of 1997, the IRS issued regulations intended to further thwart the abusive use of "accelerated CRUTs" by not allowing payments in certain cases to be made after the close of the tax year to which the payments relate.

ALLOCATING BASIS BETWEEN TERM AND REMAINDER INTERESTS UNDER UNIFORM BASIS RULE

Property acquired by a trust from a decedent or as a gift has a uniform basis in the hands of every person having an interest in the trust. The principle of uniform basis means that the basis of the property will be the

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12 Rev. Rul. 1664-f(2)101
13 U.S. Code Congressional and Administrative News, 56th Cong., 2d Sess. 3145, 3146, 3147
14 A net income limitation may be particularly useful situation where a trust created a CRT or a CRUT is a variable or the property is productive or on the income that it produces is substantially less than the standard unitrust payment. It is anticipated that the property will produce significant income at a future point of time.
15 Non-CRUTs and Non-CRUTs are permitted under Section 664(f)(2). FLIP CRUTs are authorized under Rev. Rul. 1664-f(13)18v.
16 Rev. Rul. 1664-f(16)331 and 332(1981), for charitable income tax deduction purposes, it is assumed, therefore, that notwithstanding the net income limitation, the noncharitable beneficiary will receive the entire amount of the unitrust payments as if the NCRUT were a standard CRT.
17 This may allow the charitable income tax deduction of the current receipt and contributions for the net income or a remainder interest is to charity because the value of the contributed interest will be based, not on the usual payout percentage, but on the rate provided by the IRS to determine the value of a fiduciary income interest. See generally, Rev. Rul. 86-80, 1986-1 CB 302.
18 In addressing this issue, the House Rep. is accompanied the 1989 Tax Reform Act states: "The rules of present law for determining the amount of the charitable contribution deduction in the case of gifts of remainder interests to 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 distributions 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 remainder interest granted. 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." 19-4, 56th Cong., 1st Sess. 1664-f(2)101. See also. 1996-f(2)182.
20 Congress determined that the charitable remainder interest could be excluded from capital gains in these programs funded in any manner to manipulate the income stream. It 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. See Estate of Breshears, 78 B.T.C. 325 (1982), acq. rev. 89-2, 89-3 CB 217.
21 The IRS maximum annual payout requirement for private foundations and CRTs was established as part of the Tax Reorganization Act of 1995. It addresses the 5% payout requirement, discusses the Charitable Trust Act of 1997 and 1998, and addresses the charitable remainder trust, unitrust, and unitrust trust. See Rev. Rul. 1664-f(2)101, 2d (January trust), Rev. Rul. 1664-f(2)101, 2d (January trust), 1999-1 CB 222.
22 See Rev. Rul. 1664-f(2)101, 2d (January trust) for property received from a decedent and 1999-1 CB 222 for property received from a gift.
same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust. Therefore, the creation of a term and remainder interest in a trust requires dividing the uniform basis upon the sale or other disposition of one or both of such interests. Generally, the uniform basis of assets transferred to a trust is determined under Section 1015 for assets transferred by lifetime gift or under Section 1014 for assets transferred from a decedent, subject to adjustments under Section 1016.

Allocation of Uniform Basis to Term and Remainder Interests in Trust

The basis of a term interest (including a life estate or term certain interest) or a remainder interest in a trust at the time of its sale or other disposition is determined under the rules provided in Reg. 1.1014-5. Specifically, Reg. 1.1014-5(a)(5) provides that in determining the basis of a term or remainder interest, the uniform basis is apportioned or allocated to each interest as determined according to the actuarial factors found in the valuation tables contained in Reg. 20.2031-7. Therefore, the portions of the uniform basis attributable to such interests are adjusted to reflect the change in the relative values of such interests resulting from the lapse of time. The factors contained in the valuation tables provide remainder factors based on assumed Section 7520 rates and either (1) the beneficiary's age for life interests or (2) length of the term for term certain interests. The appropriate respective factor for the term and remainder interests is multiplied by the uniform basis of the underlying trust property to determine the allocable $400,000 in uniform basis apportioned to the sale of the life estate will be used twice.

Congress enacted Section 1001(e)(1) under the Tax Reform Act of 1969 to prevent this doubling of basis caused by the life tenant and the remainder beneficiary both using the uniform basis allocated to the term interest. Under this section, the portion of the uniform basis attributable to a term interest in a trust is disregarded in determining gain or loss from the sale or other disposition of such interest. In the above example, therefore, the basis otherwise allocated to the life estate sold would be zero, so that the gain, albeit capital in nature, would be equal to the amount of the entire sale proceeds, unreduced by an amount of the uniform basis of the trust assets. But for Section 1001(e)(1), the term interest holder could reduce the gain on the sale of such interest by an allocated portion of the uniform basis of the trust assets and the trust would continue to hold its assets at the full amount of the uniform basis. Additionally, the purchaser of the term interest would receive an asset that could be amortized over the remaining term instead of reducing the uniform basis in the trust's assets. Congress simply decided not to allow any part of the uniform basis to be allocated to the term interest, thereby opting to assign a zero basis to such interest upon its sale or other disposition.

Allocating Uniform Basis to Term Interest Permitted When Both Term and Remainder Interests Are Sold

Section 1001(e)(5) provides that Section 1001(e)(1) does not apply to a sale of other disposition that is part of a transaction in which the entire interest in property is transferred. Therefore, in the case of a sale or other disposition that is part of a transaction in which all interests in a trust are transferred, including both the term and remainder interests, under Section 1001(e)(5), the capital gain or loss of each seller of an interest is the excess of the amount realized from the sale of that interest over the seller's portion of the uniform basis apportioned to the interest transferred. In this situation, the remainder beneficiary will only be using the uniform basis apportioned to the remainder interest, therefore resulting in the basis attributable to the term interest being used only once, by the holder of the term interest. Therefore, the double basis issue that caused Congress to enact Section 1001(e)(1) does not arise in the
context of the combined sale of both the term and remainder interest.\textsuperscript{3,4}

**SALES OF TERM INTERESTS IN AND EARLY TERMINATION OF CRTs**

Because of an immediate need for cash or other possible reasons,\textsuperscript{5} a noncharitable beneficiary holding an annuity or unitrust interest (the "term interest") in a CRT may desire to sell such interest to a third-party.\textsuperscript{6} Indeed, sales of term interests in CR Ts have become increasingly common, including sales of such interests to the charitable remainder beneficiary or to an independent third-party. As an alternative to a sale of the term interest, it may be possible to terminate the CRT early,\textsuperscript{7} whereby both the term interest holder and charitable remainder beneficiary receive a distribution equal to the present value of their respective interests in the trust.\textsuperscript{8} In most cases, the charitable remainder beneficiary will be agreeable to the acceleration of its interest in the trust, although, depending on applicable state law, court and state attorney general approval may be required. In order to preserve maximum flexibility, drafters of CRTs should avoid broad spendthrift provisions that would prevent a sale of a term interest in a CRT or its early termination, and including language in the CRT specifically permitting such transactions should be considered.

**Income Tax Consequences of Sale of Term Interest in CRT**

The sale of a term interest in a CRT results in a gain equal to the entire amount of the sale proceeds and, as a consequence of the transaction for income tax purposes as a sale of the term interest under Section 1001.\textsuperscript{9,10} Accordingly, in the context of an early termination of a CRT, the IRS has ruled that although the transaction takes the form of a distribution of the present value of the respective term and charitable remainder interests, it is treated for income tax purposes as a sale of the term interest to the charitable remainder beneficiary. In Letter Rul. 200075014, for example, involving the early termination of a CRT, the IRS stated that "although the proposed transaction takes the form of a distribution of the present values of the respective interests of Grantors and Charity, in substance it is a sale of Grantees' interest to Charity, the remainder interest holder." The IRS has also consistently ruled that in the context of an early termination of a CRT, the "sale" of the term interest to the charitable remainder beneficiary is "not part of a transaction in which the entire interest in Trust is transferred to a third party."\textsuperscript{11} As a result of this treat-
ment, the IRS has ruled that the zero-basis rule of Section 1001(e)(1) is triggered upon the early termination of a CRT and, therefore, the capital gain on the “sale” of the term interest is equal to the entire amount of the proceeds received by the term holder.42 The IRS’s approach in this context, albeit consistently applied, is questionable and has been criticized,43 as under Section 664 results. The question is whether the IRS could ultimately take the position that the early termination of a CRT violates the requirement of strict adherence to Section 664, given that the trust in such event will not be administered as a CRT according to Section 664 throughout its term, but instead terminates early with a presumably large distribution made early termination ... will not be to the detriment of the charitable beneficiary.”

In the context of the early termination of a NICRUT or NIMCRUT, an interesting issue arises regarding how the net income limitation affects the valuation of the term interest. There are a number of private letter rulings addressing this issue in the

While the proposed regulations significantly limit the amount of uniform basis allocable to an annuity or unitrust interest in a CRT, the result is still better than in the context of an early termination of a CRT, where the IRS has consistently ruled that the basis of the annuity or unitrust interest is always equal to zero under Section 1001(e)(1).

it is contrary to the tax treatment generally accorded the termination of a trust, where there is no gain recognition and the beneficiaries take a carryover tax basis of the assets received under Section 1015. Absent the IRS approach, however, the noncharitable beneficiary would avoid the recognition of gain upon the contribution of appreciated assets to a CRT, the CRT could sell such assets on a tax-free basis and, upon the early termination of the CRT, the noncharitable beneficiary would not recognize gain and would obtain a “stepped-up” basis in the assets received, a result clearly not acceptable to the IRS or for public policy purposes.

In Rev. Proc. 2008-5,44 the IRS added to its list of areas in which it will not issue private rulings the issue of whether or not the early termination of a CRT by the commutation of the interests of the parties is properly taxed as a sale or exchange and whether or not it causes the trust to cease to be a qualified CRT.45 As such, the IRS will no longer issue rulings in this area. The possibility of the IRS considering the early termination of a CRT as causing its disqualification under Section 664 is reminiscent of Estate of Atkinson,46 in which the Tax Court emphasized that Congress required strict adherence to the requirements of Section 664 and, barring such adherence, disqualification under the noncharitable beneficiary in lieu of the contemplated annuity or unitrust payments over the term of the trust.47

Valuation Issues Involving Early Termination of CRTs

Because transactions with a CRT may be subject to the self-dealing rules of Section 4941,48 IRS rulings have indicated that when a CRT is terminated early, 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.49 Otherwise, an act of self-dealing under Section 4941 will be considered to have occurred.50 In Ltr. Rul. 200252092, for example, in the context of addressing 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 context of the early termination of a NIMCRUT.51 Given that the payout by a NIMCRUT and NICRUT is limited to net fiduciary accounting income (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 noncharitable beneficiary, because an overpayment to a noncharitable beneficiary in this context, according to the IRS, will result in an act of self-dealing. The IRS rulings provide that the appropriate calculation of the actuarial value of noncharitable interests in a NIMCRUT, taking into account the net income provisions, requires 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. These rulings have 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.52

Using this approach in the current near-record low Section 7520 rate environment has the effect of dramati-
ually reducing the value of the term interest in a NIMCRUT, thereby resulting in a much lesser distribution to the noncharitable beneficiary upon an early termination than if the net income limitation were not considered.\(^{43}\) In In re Rul. 201325921, 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 interest upon the early termination of a NIMCRUT directly contrasts with the valuation method required under applicable Treasury regulations for computing the charitable income tax deduction upon the creation of a NIMCRUT (or a MACRUT). These regulations, which are designed to ensure that the charitable deduction is not inflated, require the assumption that the NIMCRUT will distribute to the noncharitable beneficiary an amount based on the stated unitrust percentage distribution rate of the NIMCRUT, notwithstanding that the noncharitable beneficiary's actual distributions may be less (and charitable remainder beneficiary's payment more) due to the presence of the net fiduciary accounting income limitation. The IRS believes that the noncharitable beneficiaries of a NIMCRUT have a "potential right" to receive amounts in excess of net income, "a right that is dependent on the happening of events which are not so remote as to be negligible" and, therefore, for purposes of computing the charitable income tax deduction, the "charitable remainder interest must be minimized to reflect amounts that reasonably may be paid to the beneficiaries."\(^{50}\)

The IRS's valuation approach has been subject to criticism because for purposes of computing the charitable
Under the proposed regulations, therefore, the noncharitable beneficiary’s basis that is otherwise computed under the uniform basis rules must be reduced by the amount of undistributed ordinary income and capital gain income realized by the CRT attributable to the annuity or unitrust interest being sold.

While the valuation methods applied by the IRS upon the creation of a NIMCRUT and its early termination are indeed inconsistent, the philosophy used in applying different methods arguably is consistent, in that the methods are, respectively, aimed at preventing an inflated charitable income tax deduction upon creation and an inflated distribution to noncharitable beneficiaries upon an early termination. Query, too, whether a charitable remainder beneficiary, or the state attorney general or court having jurisdiction over the NIMCRUT, would agree that the net income limitation under a NIMCRUT should be ignored in computing the payout to a charity simply because tax regulations ignore the limitation for purposes of computing a settlor’s charitable income tax deduction. Because of their varying payout structures, different valuation methods arguably should be applied upon an early termination of a CRUT containing a net income limitation, depending on whether it is a NIMCRUT, 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 termination transactions, whereby the two parties to the sale transaction can set the price as they may ultimately agree. This transaction would not be subject to the self-dealing rules of Section 4944, as the payout does not come from the CRT or from a charity in which the noncharitable beneficiary is a disqualified person, but from a third-party, in which case the amount ultimately passing to the charitable remainder beneficiary will not be affected.

NOTICE 2008-99

The transaction targeted in the proposed regulations was first identified in Notice 2008-99, in which the IRS signaled its concern about the manipulation of the uniform basis rules to avoid tax on the gain from the sale of appreciated assets contributed to a CRT. In the transaction, a sale or other disposition of all interests in a CRT (that is, a combined sale of both the term and charitable remainder interests to a third party) subsequent to the contribution of appreciated assets to, and their reinvestment by, the CRT results in the grantor or other noncharitable beneficiary (the taxable beneficiary) receiving the value of the
1. The contribution of substantially appreciated assets to a CRT resulting in a charitable income tax deduction based on (and probably equal to or slightly greater than) 10% of the FMV of such assets attributable to the remainder interest.
2. The sale of the substantially appreciated assets by the CRT on an income-tax-free basis because of the tax-exempt status of the CRT.
3. The purchase of newly acquired assets by the CRT having a cost basis equal to their purchase price, so, at the time of purchase, the FMV of such newly acquired assets and their tax basis are the same, notwithstanding the fact that the sale of the substantially appreciated assets contributed to the CRT was not subject to tax.
4. The noncharitable beneficiary sells his or her annuity or unitrust interest and appropriate the stepped-up uniform basis of the assets purchased by the CRT to the term interest sold, so that the sale of such interest produces little or no taxable gain.

Notice 2008-99 states that the "IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale of other disposition of appreciated assets." The notice identifies these or substantially similar transactions as "transactions of interest" for purposes of § 1.6011-4(b)(4) and §§ 6111 and 6112 effective October 51, 2008. The date this notice was released to the public, thereby triggering the requirement to file Form 8886, Reportable Transaction Disclosure Statement.

NO BASIS STEP-UP UNDER PROPOSED REGULATIONS

The preamble to the proposed regulations states that it is inappropriate for a taxable beneficiary of a CRT to share in the uniform basis obtained through the reinvestment of income not subject to tax due to a CRT's tax-exempt status. The preamble also notes that while it was suggested that the IRS and the Treasury Department could create a rule requiring a zero basis for all interests in CRTs in order to prevent an inappropriate result while still allowing for an early termination of CRTs, the IRS and the Treasury Department did not adopt a rule requiring a zero basis for all interests in CRTs because they believe that the rule provided in the proposed regulations will prevent inappropriate results while treating parties to the transaction fairly. The proposed regulations provide a special rule for determining the basis of term interests in CRTs in transactions to which Section 1001(e)(5) applies, that is, when both the annuity or unitrust interest and the charitable remainder interest are simultaneously sold to a third party. Specifically, in these cases, Prop. Reg. 1.1014-5(e)(1)(ii) provides that the basis of a term interest of a noncharitable beneficiary of a CRT is the portion of the uniform
Neither the proposed regulations nor the preamble addresses basis issues in the context of the early termination of a CRT, when the ruling position of the IRS, as discussed above, has consistently been that as a result of a deemed sale of the term interest to the charitable remainder beneficiary, Section 1001(e)(1) applies to deny any allocation of the uniform basis to the term interest upon the early termination of a CRT. There would appear to be no reason, however, from a policy perspective, to differentiate between the allocation of basis to a term interest upon its sale to a third party jointly with the charitable remainder interest or upon an early termination of a CRT. Nonetheless, because the proposed regulations are limited in application to the sale or other disposition of a term interest in a CRT “to which section 1001(e)(3) applies,” and the IRS has consistently ruled that Section 1001(e)(3) does not apply to an early termination of a CRT (because the entire interest in the trust is not being transferred to a third party), the proposed regulations would not apply in determining the basis of a term interest upon the early termination of a CRT. As a result, while the IRS would treat the basis of a term interest in the context of an early termination of a CRT as being equal to zero, the proposed regulations do not require such result in the context of a combined sale of the term interest and the charitable remainder interest to a third party.

Reg. 20.2031-7 that is used in determining the uniform basis attributable to such interest.63 The proposed regulations apply in all situations involving the combined sale of a term interest and charitable remainder interest in a CRT,64 whether or not there was a perceived intent to manipulate the uniform basis rules, substantially appreciated assets were contributed, or there was a prearranged plan to ultimately dispose of both interests prior to the creation of the trust.

The following are examples of the application of the proposed regulations:

Example 1. Grantor creates CRUT on Date 1 in which Grantor retains a unitrust interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual tax-payer subject to income tax. CRUT meets the requirements of Section 664 and is exempt from income tax. Grantor’s basis in the shares of X stock used to fund CRUT is $10x. On Date 2, CRUT sells the X stock for $100x. The $90x of gain is exempt from income tax under Section 644(a)(1). On Date 3, CRUT uses the $100x proceeds from its sale of the X stock to purchase Y stock. On Date 4, CRUT sells the Y stock for $110x. The $10x of gain on the sale of the Y stock is exempt from income tax under Section 644(a)(1). On Date 5, CRUT uses the $110x proceeds from its sale of Y stock to buy Z stock. On Date 5, CRUT’s basis in its assets is $110x and CRUT’s total undistributed net capital gains are $100x.

Later, when the fair market value of CRUT’s assets is $150x and CRUT has no undistributed net ordinary income, Grantor and Charity sell all of their interests in CRUT to a third person. Grantor receives $100x for the retained unitrust interest, and Charity receives $50x for its interest. Because the entire interest in CRUT is transferred to the third person, Section 1001(e)(5) prevents Section 1001(e)(1) from applying to the transaction. Therefore, Grantor’s gain on the sale of the unitrust interest in CRUT is determined under Section 1101(a), which provides that Grantor’s gain on the sale of that interest is the excess of the amount realized, $100x, over Grantor’s adjusted basis in the interest. Grantor’s adjusted basis in the unitrust interest in CRUT is that portion of CRUT’s uniform basis that is assignable to Grantor’s interest under Reg. 1.1014-5, which is Grantor’s ac-

64 The proposed regulations are limited in application to only CRTs under Section 664. Prop. Reg. 1.1014-5(c).
65 These examples are derived from Prop. Reg. 1.1014-5(c), Example 7 and 8.
66 When, pursuant to a prearranged plan between a donor and a charity involving interrelated transactions, some benefit (including a tax benefit) will be bestowed on the donor that would not otherwise have resulted but for the charity’s participation, only the end result of the transactions will be considered in determining the available charitable contribution deduction. Thus, where various steps to a transaction between a donor and a charity are “so mutually interdependent that legal relations created by one would have been fruitless without the completion of the series,” the various steps of the plan are to be regarded as making up one transaction for the purposes of determining the tax effects.” See O’Neil, 50 AFTR2d 62-5227 (DC Cir. 1970). Burr Oaks Corp. 365 F2d 24 (18 AFTR2d 501B (CA7: 1966). This concept is generally known as the “step transaction doctrine,” in which several transactions are merely stages in carrying out one preconceived purpose. In that case, the object sought and obtained must govern, and the integrated steps used in effecting the desired result may not be treated separately for tax purposes. The transaction will typically be treated according to its substance, rather than its form. See, e.g., Blake, TCM 1981-757, aff’d 692 F2d 473 (1st Cir. 1982).
67 In such a case, the charitable income tax deduction could be disallowed if the taxpayer did not obtain a contemporaneous written acknowledgment from the charity required under Section 170(f)(8) for contributions of $500 or more. This is in contrast to a contribution to CRT, for which Section 170(h)(8) does not apply. Reg. 170(h)(8)(2003).
tuarial share of the uniform basis. In this case, CRUT's uniform basis in its sole asset, the Z stock, is $110x.

Prop. Reg. 1.1014-5(c)(1)(ii) applies to the transaction, however. Therefore, Grantor's actuarial share of the CRUT's uniform basis determined by applying the factors set forth in the tables contained in Reg. 20.2051-7 is reduced by an amount determined by applying the same factors to the sum of CRUT's $0 of undistributed net ordinary income and its $100x of undistributed net capital gains. If by applying the Reg. 20.2051-7 factors, the unitrust interest in CRUT equals 66.66%, the $110x basis in Z stock allocable to such unitrust interest would equal $73.5x. Such $73.5x basis would then be reduced by 66.66% of the $100x of the undistributed net capital gains, or $66.66x. As a result, the basis of the unitrust interest would be reduced from $73.5x to $6.67x and Grantor would realize a gain equal to $100x minus $6.67x, or $93.33x. Without the application of the proposed regulations, the gain would have been equal to $100x minus $73.5x, or $26.5x.

Example 2. Grantor creates a CRAT on Date 1 in which Grantor retains an annuity interest and irrevocably transfers the remainder interest to Charity. Grantor is an individual taxpayer subject to income tax. CRAT meets the requirements of Section 664 and is exempt from income tax. Grantor funds CRAT with shares of X stock having a basis of $50x. On Date 2, CRAT sells the X stock for $150x. The $100x of gain is exempt from income tax under Section 664(c)(1). On Date 3, CRAT distributes $10x to Grantor, and uses the remaining $140x of net proceeds from its sale of the X stock to purchase Y stock. The trust experiences no other taxable income through the close of the year in which Date 3 fall. Grantor treats the $10x distribution as capital gain, so that CRAT's remaining undistributed net capital gains amount is $90x. On Date 4, when the FMV of CRAT's assets, which consist entirely of the Y stock, is still $140x, which also has a basis of $140x, Grantor and Charity sell all of their interests in CRAT to a third person. Grantor receives $112x for the annuity interest, and Charity receives $28x for its remainder interest. Because the entire interest in CRAT is transferred to the third person, Section 1001(e)(5) prevents Section 1001(e)(1) from applying to the transaction. Therefore, Grantor's gain on the sale of the annuity interest in CRAT is determined under Section 1001(a), which provides that Grantor's gain on the sale of that interest is the excess of the amount realized, $112x, over Grantor's adjusted basis in that interest.

Grantor's adjusted basis in the annuity interest in CRAT is that portion of CRAT's adjusted uniform basis allocable to Grantor's interest under Prop. Reg. 1.1014-5, which is Grantor's actuarial share of the adjusted uniform basis. In this case, CRAT's adjusted uniform basis in its sole asset, the Y stock, is $140x. However, Prop. Reg. 1.1014-5(c)(1)(ii) applies to the transaction. Therefore, Grantor's actuarial share of CRAT's adjusted uniform basis determined by applying the factors set forth in the tables contained in Reg. 20.2051-7 is reduced by an amount determined by applying the same factors to the sum of CRAT's $0 of undistributed net ordinary income and its $90x of undistributed net capital gains, or $90x. As a result, the basis of the unitrust interest would be reduced from $140x to $73.5x. Without the application of the proposed regulations, the gain would have been equal to $100x minus $73.5x, or $26.5x.

Conclusion
By providing a special rule applicable to the combined sale of the term and charitable remainder interest in a CRT, the proposed regulations thwart a planning technique aimed at taking advantage of the uniform basis rules that would otherwise provide a tax-free step-up in the tax basis of the term interest in the CRT. While the proposed regulations significantly limit the amount of uniform basis allocable to a term interest in a CRT, the result is still better than in the context of an early termination of a CRT, where the IRS has consistently ruled that the basis of the term interest is always equal to zero under Section 1001(e)(1).