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

RICHARD L. FOX AND JONATHAN G. BLATTMACHR

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-154890-03, 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 interest" in Notice 2008-99, 2008-2 CB 1194, which stated that the "IRS and the Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets." The proposed regulations override the uniform basis rules by limiting the amount of income tax basis that may be allocated to an annuity or unitrust interest in a CRT when such interest and the charitable remainder interest are simultaneously sold to a third party. The proposed regulations accomplish this essentially by reducing the uniform tax basis otherwise attributable to the annuity or unitrust interest by the amount of undistributed ordinary income and capital gain income of the CRT that is attributable to such interest. 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).

BACKGROUND ON CRTs

A CRT is a widely-used charitable planning technique that is often a recommended vehicle for individuals with substantially appreciated capital gain property, a charitable intent,[1] and a need for a stream of income during their lifetimes.[2] 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 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, therefore, a CRT blends the philanthropic intentions of a donor with his or her financial needs or the financial needs of others.[3]

There is generally no gain recognition on the contribution of appreciated property to a CRT,[4] and because it is exempt from income tax,[5] the CRT may sell the transferred property on a tax-free basis and reinvest the proceeds in other assets. For an inter vivos CRT,[6] 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 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.[7] 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.[8]

CRATs and CRUTs

There are two basic types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT).[9] 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.[10] 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 annu-

NOTES

1 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).

2 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 Estate Planning Journal 292 (September/October 1991).

3 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.

4 The exception to this general rule of nonrecognition is when encumbered property is transferred to a CRT, whereby a bargain sale will be considered to result, thereby triggering a potential gain on the contribution. This is the case because amount of the indebtedness is treated as an amount realized by the settlor, even if the CRT does not assume or pay the indebtedness. Reg. 1.1001-2(a)(3); Ltr. Ruls. 7808016 and 7903075; Compare Ebben, 783 F.2d 906, 57 AFTR 2d 86-901 (CA-9, 1986); Ltr. Rul. 9533014. (Neither a private letter ruling nor a technical advice memorandum may be cited or used as precedent.) Transferring encumbered property to a CRT is fraught with peril because, in addition to the bargain sale issue, it raises other potential negative tax consequences, such as grantor trust status (which could cause the CRT to fail to constitute a qualified one), unrelated debt-financed income (which could cause the trust to be subject to a 100% excise tax on such income), and self-dealing (resulting in the imposition of excise tax).

5 Section 664(c)(1).

6 A testamentary CRT may be established as a trust under a donor's will, a revocable inter vivos trust, or a pour-over trust, all funded upon the donor's death.

7 Reg. 1.664-1(d)(1)(ii).

8 Theoretically, the capital gain realized by the CRT upon the sale of contributed appreciated capital gain property may never be passed out to the noncharitable beneficiary for income tax purposes. This would be the case where, subsequent to the contribution of such property, the CRT earns ordinary income each year equal to or greater than the annual annuity or unitrust payout, in which case the lower-taxed capital gain income is never passed out to the noncharitable beneficiary. Typically, however, where appreciated capital gain property is contributed to a CRT, the annuity or unitrust payouts pass out a portion of such capital gain over time, as a CRT generally doesn't earn sufficient ordinary income to cover the annuity or unitrust payouts.

9 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 Estate Planning Journal 13 (January 2006).

10 Section 664(d)(1)(A); Reg. 1.664-1(a)(1)(i).

ally.[11] 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.[12] 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. [13]

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.[14] The net income limitation has resulted in the following variations of the standard CRUT:

- Net income CRUT with make-up provision (NIMCRUT): 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.
- 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.[15]

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.[16] 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.[17]

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.[18] 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

RICHARD L. FOX is a partner in the Philadelphia office of the law firm of Dilworth Paxson LLP where he heads the Philanthropic and Nonprofit practice. Mr. Fox writes and speaks frequently on philanthropy and charitable estate and income tax planning. He is the author of the two-volume treatise *Charitable Giving: Taxation, Planning and Strategies* (Thomson Reuters/WG&L). JONATHAN G. BLATTMACHR is Director of Estate Planning for the Alaska Trust Company, an Advisor at Pioneer Wealth Partners, co-developer of Wealth Transfer Planning, a computerized system for lawyers, and author or co-author of six books and over 500 articles, several of which have appeared in this publication. Mr. Blattmachr has previously written for The Journal.

only when the remainder interest is transferred in the form of either a CRAT or a CRUT.[19] 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[20] 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 and realization of income and gain can be postponed until a year later than the accrual 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 nondividend paying stock, which the trust sells in a year subsequent to when the required distribution is includible in the beneficiary's income, and using proceeds from that sale to pay the required distribution attributable to the prior year. Those 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)[21] or 50% of the annual net FMV of the trust assets (in the case of a CRUT),[22] 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.[23] 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.[24] Further, in response to another abusive form of accelerated CRUT that was later devised, sometimes referred to as the "son of the accelerated charitable remainder unitrust," additional regulations were added to prevent avoidance of tax when, for example, the trustee would borrow money, enter into a forward sale of the assets, or engage in some similar transaction in order to make the unitrust payment in a tax year prior to the tax year of the sale of the appreciated contributed assets.[25]

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.[26] The principle of uniform basis means that the basis of the property will be the

11 Section 664(d)(2)(A); Reg. 1.664-1(a)(1)(i).

12 Reg. 1.664-3(a)(1)(i).

13 U.S. Code Congressional and Administrative News, 91st Cong. P.L. 91-172, S. Rep't, p. A-477

14 A net income limitation may be particularly useful when the property contributed to a CRUT is not liquid and the property is unproductive or the income that it produces is substantially less than the standard unitrust payment, but it is anticipated that the property will be sold or produce significant income at some future point in time.

15 NICRUTs and NIMCRUTs are permitted under Section 664(d)(3). FLIP CRUTs are authorized under Reg. 1.664-3(a)(1)(i)(c).

16 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 amount of the unitrust payments as if the NICRUT or NIMCRUT were a standard CRUT.

17 This may also limit the charitable income tax deduction if the unitrust recipient contributes his or her net income unitrust interest to charity because the value of the contributed interest will be based, not on the unitrust payout percentage, but the rate published by the IRS to determine the value of a fiduciary income interest. See, generally, Rev. Rul. 86-60, 1986-1 CB 302.

18 In addressing this issue, the House Report accompanying the 1969 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 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." H. Rep't No. 413, 91st Cong., 1st Sess. (1969), 1969-3 CB 200, 237.

19 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. See Estate of Boeshore, 78 TC 523 (1982), *acq. in result*, 1987-2 CB 1.

20 The 5% minimum annual payout requirement for private foundations and CRTs was established as part of the Tax Reform Act of 1969. In addressing the 5% payout requirement, the Tax Court in Estate of Atkinson, 115 TC 26 (2000), *aff'd*, 309 F3d 1290, 90 AFTR2d 2002-6845 (CA-11, 2002), stated: "An expressed focus of Congress in enacting the 5-percent distribution requirement was to prevent a charitable remainder trust from being used to circumvent the current income distribution requirements imposed on private foundations. See S. Rep. 91-552 (1969), 1969-2 CB 423, 481. If there were no such requirement, a charitable remainder trust could be used to accumulate trust income tax-free, while a private foundation would remain limited in the amount of income it might accumulate." Thus, absent the 5% minimum annual payout requirement imposed on CRTs, the private foundation 5% minimum annual payout requirement could be avoided by the use of a CRT providing for only a nominal payout requirement to the noncharitable beneficiary or beneficiaries.

21 Section 664(d)(1)(A).

22 Section 664(d)(2)(A).

23 Sections 664(d)(1)(D) and (2)(D).

24 Regs. 1.664-2(a)(1)(i)(a)(1), (2), and (3) (annuity trust), Regs. 1.664-3(a)(1)(i)(g)(1), (2), and (3) (unitrust). In the preamble to these regulations, the IRS, making specific reference to the Taxpayer Relief Act of 1997, stated that "[a]lthough recent legislative changes have reduced the potential tax benefits of accelerated charitable remainder trusts, the IRS and Treasury continue to be concerned about the potential abuse of the post-year-end grace period to produce a tax-free return of appreciation in the assets contributed to a charitable remainder annuity trust or a fixed percentage charitable remainder unitrust."

25 Reg. 1.643(a)-8.

26 See Regs. 1.1014-4(a)(1) (uniformity for property received from a decedent) and 1.1015-1(b) (uniformity for property received by 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.[27] 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.[28]

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.[29] Specifically, Reg. 1.1014-5(a)(3) 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 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.[30] 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 adjusted basis of each respective interest in the trust.

Allocation of Uniform Basis Not Permitted When Only the Term Interest in Trust Is Sold

Prior to the enactment of the 1969 Tax Reform Act, uniform basis could be apportioned to a term interest in a trust, so that when a life estate or other term interest in a trust was sold, the gain would be equal to the sale proceeds less the uniform basis apportioned to that interest. The result of this treatment, however, was to allow basis in the same property held by a trust to be used twice.

Example. An individual holding a life estate in a trust sells that interest to a third party for $500,000. The uniform basis of the property held by the trust is $800,000, of which $400,000 is apportioned to the life estate based on the applicable actuarial factors. As a result of using the $400,000 of the uniform basis, the gain realized on the sale of the life estate is only $100,000. The purchaser takes an amortizable basis in the life estate equal to the $500,000 purchase price and the uniform basis of the trust's assets remain at $800,000. Upon the death of the individual, the trust terminates and the remainder beneficiary's basis in the property received from the trust will still be $800,000 (or as subsequently adjusted). In this situation, the $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.[31] 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,[32] 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.[33] 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.

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.

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

Section 1001(e)(3) provides that Section 1001(e)(1) does not apply to a sale or 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)(3), 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.[34]

SALES OF TERM INTERESTS IN AND EARLY TERMINATION OF CRTs

Because of an immediate need for cash or other possible reasons,[35] 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.[36] Indeed, sales of term interests in CRTs 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,[37] 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.[38] 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 under Section 1001(e)(1), no basis may be allocated to a term interest in a CRT when that interest alone is sold. Capital gain treatment is accorded the sale because the term interest in a CRT is treated as a capital asset, as the right to income from a trust is treated as a right in the trust itself and, therefore, is a capital asset.[39]

Income Tax Consequences of Early Termination of CRT

The IRS has ruled in private letter rulings that the early termination of a CRT is treated as if the term interest is sold to the charitable remainder beneficiary and has, accordingly, recast the substance of the transaction for income tax purposes as a sale of the term interest under Section 1001.[40] 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 Ltr. Rul. 200733014, for example, involving the early termination of a CRUT, 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 Grantors' 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."[41] As a result of this treat-

The very transaction targeted by the proposed regulations was previously identified as a "transaction of interest" in Notice 2008-99.

27 Reg. 1.1014-4(a)(1).

28 Uniform basis, as adjusted under Section 1016, is referred to as "adjusted uniform basis." For purposes of this article, references to "uniform basis" should be considered as references to "adjusted uniform basis."

29 Reg. 1.1014-5 is applied to property acquired from a decedent, but the rules of this regulation are adopted in Regs. 1.1015-1(b) and -2(a)(2), which apply to property acquired by gift.

30 Reg. 20.2031-7(d)(6).

31 See also Reg. 1.1014-5(b). For purposes of the rule disregarding basis on the sale of term interests under Section 1001(e), "term interest" means a life interest in property, an interest in property for a term of years, or an income interest in a trust. Section 1001(e)(2).

32 Rev. Rul. 72-243, 1972-1 CB 233, provides that the proceeds received by the life tenant of a trust, in consideration for the transfer of the life tenant's entire interest in the trust to the holder of the remainder interest, are treated as an amount realized from the sale or exchange of a capital asset. The ruling further stated that "the life tenant's basis attributable to his life interest at the time of the sale is considered to be zero, pursuant to section 1001(e) of the Internal Revenue Code of 1954 as added by the Tax Reform Act of 1969."

33 See, e.g., Edward, 7 TC 717 (1946), *acq.* 1947-1 CB 4; Richard Hansen Land, Inc., TCM 1993-248.

34 According to the Joint Committee on Taxation, the exception is appropriate because "the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest." See General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, P.L. 91-172.

35 In a 12/31/09 letter to the IRS, in response to Notice 2008-99, 2008-2 CB 1194, discussed below, Sterling Foundation Management, LLC stated as follows: "People sell their lead interests in CRTs for a variety of reasons. Among these are divorce, business reversal, stock market losses, concern over potential future tax rate increases, death of a beneficiary, need for liquidity, family illness, desire for simplification, dislike of administrative costs, disappointment with investment performance, and the desire for increased investment flexibility."

36 The third-party purchasing the term interest could be the charitable remainder beneficiary, in which case the trust may terminate under state law by virtue of the charitable remainder beneficiary holding a 100% interest in both the term and remainder interest in the CRT. See, e.g., Ltr. Ruls. 200310024 and 200834013. If the third-party is a charity other than the charitable remainder beneficiary, the trust would then become wholly charitable, in which case the CRT would be converted to a wholly charitable trust, subject to the provisions of Section 4947(a)(1).

37 In private letter rulings involving early terminations of CRTs, the IRS has required, as a condition of issuing the ruling, a signed affidavit, under penalties of perjury, executed by the noncharitable beneficiary or his or her physician that to the best of his or her knowledge and belief, such beneficiary has no medical condition that is expected to result in a shorter longevity than that set forth in the applicable treasury regulations. See, e.g., Ltr. Ruls. 200846037, 200841041, and 200324035.

38 When a private foundation is the charitable remainder beneficiary, caution should be exercised from a Section 4941 self-dealing standpoint. If the term holder of the CRT is a "disqualified person" under Section 4946 with respect to the foundation, a sale of the term interest to the private foundation would constitute an act of self-dealing.

39 See Rev. Rul. 72-243, 1972-1 CB 233; McAllister, 157 F2d 235, 35 AFTR 91 (CA-2, 1946); Ltr. Ruls. 201325018, 201325019, 201325020, and 201325021.

40 See, e.g., Ltr. Ruls. 200403051, 200441024, 200648017, 200733014, 200739004, and 200833012.

41 See, e.g., Ltr. Rul. 200833012.

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 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. 2008-3,[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 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 to the noncharitable beneficiary in lieu of the contemplated annuity or unitrust payments over the term of the trust.[47]

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).

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 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 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[52] (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.[53]

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, thereby resulting in a much lesser distribution to the noncharitable beneficiary upon an early termination than if the net income limitation were not considered.[54] 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 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 NICRUT). 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.[55] 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"[56] 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."[57]

The IRS's valuation approach has been subject to criticism because for purposes of computing the charitable

NOTES

42 In addition to the income tax consequences, the treatment of the early termination of a CRT as a sale of a term interest to the charitable remainder beneficiary raises a self-dealing issue under Section 4941 when the remainder beneficiary is a private foundation. In Ltr. Rul. 200525014, the IRS approved the early termination of a CRT, whereby the assets of the CRT were distributed to the original donors (husband and wife) and their private foundation, which was the charitable remainder beneficiary. Among the favorable rulings issued by the IRS was that the termination would not result in an act of self-dealing under Section 4941, an issue that arises because the donors were "disqualified persons" with respect to the private foundation. In subsequently issued Ltr. Rul. 200614032, the IRS stated the following to the taxpayers: "We are revoking Private Letter Ruling 200525014, dated March 30, 2005, which addressed whether your early termination constituted an act of self-dealing under section 4941 and whether such action constituted a termination of private foundation status under section 507(a) of the Code." The ruling states that it does not constitute an adverse letter ruling, but that taxpayers may not rely on Ltr. Rul. 200525014, an obvious indication that the IRS is reconsidering its position. The question the IRS is apparently grappling with is whether the transaction should be viewed as a sale of the income interest by the noncharitable beneficiary to the charitable remainder beneficiary for purposes of Section 4941. In subsequent early CRT termination rulings in which the IRS ruled favorably on the Section 4941 issue, the IRS specifically noted that the charitable remainder beneficiary is a public charity, not a private foundation. See, e.g., Ltr. Ruls. 200816032 and 201325021.

43 In Hesch, "Early Termination of Private Trusts and Charitable Trusts: Valuation of the Interests and the Allocation of Income Tax Basis," Notre Dame Tax & Estate Planning Institute (2012), the author takes a critical view of the IRS approach to the income tax consequences of an early termination of a CRT, stating: "Because doubling up of basis is not at issue in the case of a trust termination, it is wholly outside the scope of IRC § 1001(e)(1). It is entirely the Service's baseless legal fiction that triggers taxation to the term interest holder upon termination. This theory has never been advanced regarding a private trust termination and is not supportable in the charitable remainder trust context. The plain and simple fact is that trust terminations are not income recognition events."

44 2008-1 IRB 110, section 5.10.

45 In Rev. Proc. 2008-4, 2008-1 CB 121, 110, section 6.17, the IRS similarly stated that it will not issue private letter rulings under Section 4941 or 4945 (or Section 507) pertaining to the tax consequences of the termination of CRT before the end of the trust term as defined in the trust's governing instrument in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets.

46 115 TC 26 (2000), *aff'd* 309 F.3d 1290, 90 AFTR 2d 2002-6845 (CA-11, 2002).

47 Perhaps Rev. Rul. 86-60, *supra*, note 17, involving the gift of the retained annuity interest in the CRT to charity, suggests that such a transfer does not cause the trust retroactively to be disqualified under an Atkinson case type of reasoning.

48 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.

49 See, e.g., Ltr. Ruls. 200208039, 200912036, and 201325018.

50 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).

51 Ltr. Ruls. 201325018 - 201325021, 200733014, 200725044, and 200833012. Before issuing these rulings, the IRS had issued a number of 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, 200525014.

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

53 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., 200912036.

54 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 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--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").

55 Regs. 1.664-4(a)(3) and 1.664-3(a)(1)(i)(a).

56 Note that in the context of the charitable income tax deduction, if a transfer for charitable purposes may be defeated by the performance of some act or the happening of some event, no deduction is allowable unless the possibility that such act or event will occur is "so remote as to be negligible." Reg. 1.170A-1(e).

57 Ltr. Ruls. 201325018--201325021.

deduction upon its creation, the net income limitation is simply ignored in valuing the charitable remainder interest. In a letter to the IRS dated 4//4/08, the Committee on Estate and Gift Taxation of the New York City Bar Association urged the adoption of a "consistent approach to valuation of the income interest when the NIMCRUT is created and upon early termination protects all parties" and, accordingly, asserted that the IRS should similarly ignore the net income limitation in determining payouts to noncharitable beneficiaries upon the early termination of a NIMCRUT.[58] The letter concludes that "we urge you to issue a published ruling confirming that the proper method for valuing the income interest and the remainder interest of a NIMCRUT that is being terminated early is the same method that is used to value those interests when a NIMCRUT is created." No such published ruling has ever been issued. Interestingly, the preamble to the proposed regulations states that one commentator requested guidance specifying what valuation methods the IRS will accept as a "reasonable method" on the "termination of certain types of CRTs," presumably including a NIMCRUT. The preamble states, however, that "the IRS and the Treasury Department believe that rules addressing early terminations other than those arising from a transaction described in section 1001(e)(3), and rules prescribing valuation methods, are beyond the scope of the issues intended to be addressed in these proposed regulations, and thus will not be considered as part of this guidance."

Clearly, the IRS is taking an inconsistent approach in this matter. For charitable income tax purposes, the IRS assumes that, regardless of the net income limitation, the noncharitable beneficiary of a NIMCRUT will receive the full amount of the payments based on the stated unitrust payout percentage, thereby minimizing the charitable deduction. For self-dealing purposes, however, it assumes that only the fiduciary accounting net income (based on the Section 7520 rate in the month of termination) will be paid to the noncharitable beneficiary,[59] thereby minimizing the payout to the noncharitable beneficiary.

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 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.[60] Because the IRS will no longer issue private letter rulings on early terminations of CRTs, obtaining a ruling on another possible valuation method is, however, no longer possible.

Of course, the valuation issue raised on the early termination of a NIMCRUT can be avoided by the noncharitable beneficiary selling the term interest to an unrelated third-party,[61] rather than participating in an early termination transaction, 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 4941, 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 noncharitable beneficiary's trust interest while claiming to recognize little or no taxable gain. Specifically, upon the contribution of the appreciated assets to the CRT, the settlor claims an upfront income tax deduction under Section 170 for the portion of the FMV of the assets contributed to the CRT that is attributable to the charitable remainder interest. When the CRT sells or liquidates the contributed assets, the noncharitable beneficiary does not recognize gain, and the CRT is exempt from income tax on such gain under Section 664(c). The CRT then reinvests the proceeds in other assets, often marketable securities, which then have an income tax basis equal to their cost. The noncharitable beneficiary and charity subsequently sell all of their respective interests in the CRT to a third party. The noncharitable beneficiary takes the position that the entire interest in the CRT has been sold as described in Section 1001(e)(3) and, therefore, Section 1001(e)(1) does not apply to the transaction. As a result, the noncharitable beneficiary computes gain on the sale of the noncharitable beneficiary's term interest in the CRT by taking into account the portion of the uniform basis allocable to the term interest and that the uniform basis is derived from the basis of the new assets acquired by the CRT rather than the settlor's basis in the assets contributed to the CRT. The results sought by the noncharitable beneficiary in this transaction are summarized as follows:

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 apportions 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 or other disposition of appreciated assets." The notice identifies these or substantially similar transactions as "transactions of interest for purposes of § 1.6011-4(b)(6) and §§ 6111 and 6112 effective October 31, 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.[62] 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)(3) 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(c)(1)(ii) provides that the basis of a term interest of a noncharitable beneficiary of a CRT is the portion of the uniform

NOTES

58 www.pgdc.com/pgdc/ny-city-bar-calls-guidance-valuing-income-interests-when-terminating-crts-early.

59 This assumes that the Section 7520 rate is less than the stated unitrust payout rate in the month of termination.

60 One potentially complicating factor arises because, in some states, the sale by a trust of an asset that had been underproductive of income may result in part of the proceeds being allocated to fiduciary accounting income and could be considerable. Compare this with Estate of de St. Aubin, TCM 1998-323, discussing the then version of the New York underproductive property rule. See also Reg. 1.643(b)-1 (as revised by TD 9102, 12/30/03) providing that "an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation." Any pre-contribution gain with respect to property contributed to a NIMCRUT (or NICRUT), however, may not be allocated to trust income. Reg 1.664-3(a)(1)(i)(b)(3). In addition, if the Section 7520 rate is extremely low (e.g., a mere 1% as it was for August 2012), it would seem to be conservative to assume that it would increase over a reasonable period.

61 One company that facilitates sales of term interests in CRTs is Sterling Foundation Management, LLC, whose website (www.sterlingfoundations.com) states that "Sterling Foundation Management is the nation's leading facilitator of sales of income interests in CRTs. We've been active in the market since 2003 and have reviewed thousands of CRTs for clients and their advisors. Based on our experience, we can very often arrange a sale which is worth more to the seller--after all taxes and fees--than keeping the CRT." The website continues, "Whether or not an income interest can be sold depends on the terms of the trust, but experience shows that most interests are salable. At no cost or obligation to you, we'll confidentially review your CRT to determine if your income interest is salable and, if so, at what price." In a 1/31/09 letter to the IRS, in response to Notice 2008-99, discussed below, Sterling Foundation Management stated that "the more a market exists for CRT lead interests, the less disincentive there is for a donor's creation of a CRT in the first place. In other words, a market for CRT lead interests, everything else being equal, will lead to more CRTs being created, and, therefore, to more charitable donations from people who otherwise would give less or not at all."

62 REG-154890-03, 1/17/14. Although it might seem that the Treasury and IRS could not issue a regulation that is contrary to an explicit provision of the Code (that is, Section 1001(e)(3)), Section 643(a)(7) expressly states, "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part, including regulations to prevent avoidance of such purposes" and Section 664, which contains the provisions for CRTs, is contained in the same part of the Code that Section 643 is--that is, part I of subchapter J of Chapter 1 of subtitle A of the Code.

PRACTICE NOTES

PRACTICE NOTES

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

basis assignable to that interest, reduced by the portion of the sum of the following amounts assignable to that interest: (1) the amount of undistributed net ordinary income described in Section 664(b)(1) and (2) the amount of undistributed net capital gain described in Section 664(b)(2).

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. The amount of the undistributed ordinary income and capital gain attributable to the annuity or unitrust interest is determined by applying the same factor under 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:[65]

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 taxpayer 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 664(c)(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 664(c)(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)(3) 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 1001(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-

NOTES

63 Prop. Reg. 1.1014-5(c)(1)(ii).

64 The proposed regulations are limited in application to only CRTs under Section 664. Prop. Reg. 1.1014-5(c)(2).

65 These examples are derived from Prop. Reg. 1.1014-5(d), Examples 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'Neill, 50 AFTR2d 82-5227 (DC Cal., 1974) ; Burr Oaks Corp., 365 F2d 24, 18 AFTR2d 5018 (CA-7, 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 1981-579, *aff'd*, 697 F2d 473, 51 AFTR2d 83-445 (CA-2, 1982), in which the donor transferred appreciated stock to a charity, the charity sold the stock, and the charity then used the proceeds to buy the donor's yacht. The transaction was recast as: (1) a sale of stock by the taxpayer (treating the sale of the stock by the charity as being made on the donor's behalf) and (2) a donation of the yacht by the taxpayer to the charity at its FMV.

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 $250 or more. This is in contrast to a contribution to a CRT, for which Section 170(f)(8) does not apply. Reg. 1.170A-13(f)(13).

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. 20.2031-7 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. 20.2031-7 factors, the unitrust interest in CRUT equals 66.66%, the $110x basis in Z stock allocable to such unitrust interest would equal $73.33x. Such $73.33x 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 $73.33x 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 $73.33x, or $26.67x.

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)(3) 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 assignable to Grantor's interest under 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. 20.2031-7 is reduced by an amount determined by applying the same factors to the sum of CRAT's $0x of undistributed net ordinary income and its $90x of undistributed net capital gains. If by applying the Reg. 20.2031-7 factors, the annuity interest in the CRAT was equal to 80%, then the $140X basis in Z stock allocable to such unitrust interest would be equal to $112x. Such $112x basis would then be reduced by 80% of the $90x of the undistributed net capital gains, or $72x. As a result, the basis of the unitrust interest would be reduced from $112x to $40x and the Grantor would realize a gain equal to $112 minus $40x, or $72x. Without the application of the proposed regulations, the gain would have been equal to $112x minus $112x, or $0, resulting in no gain realized on the sale of the annuity trust interest.

Effective date of proposed regulations.

The proposed regulations apply to sales and other dispositions of interests in CRTs occurring on or after 1/16/14, except for sales or dispositions occurring pursuant to a binding commitment entered into before that date. The IRS has cautioned in the preamble to the proposed regulations that the inapplicability of the proposed regulations due its effective date does not preclude the IRS from applying other legal arguments to contest the claimed tax treatment of the transaction. Although not identified in the preamble, one potential attack could be based on the step-transaction doctrine, particularly when the transfer of appreciated assets to a CRT is relatively shortly followed by a prearranged sale of the term and remainder interests, whereby the IRS simply ignores the existence of the CRT and attributes the sale of assets and related tax consequences to the grantor.[66] In such a situation, the only tax consequence resulting from the charity's participation in the transaction is that the transfer of any assets to the charity is treated as a direct charitable contribution from the settlor to the charity.[67] All other tax consequences would be determined as if the CRT was never created, thereby causing the grantor to recognize capital gain on the sale of any appreciated assets by the CRT. Taxpayers who engaged in this type of transaction after Notice 2008-99 was issued on 12/31/08 did so at their own risk.

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).