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# Early Termination of Charitable Remainder Trusts: Tax Consequences And Planning Opportunities

Drafting Provisions That Allow Termination; Navigating Methods  
of Termination, State Law Considerations and Tax Complexities

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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# Early Termination of Charitable Remainder Trusts: Tax Consequences and Planning Opportunities

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# CRTs in general

- CRAT (fixed annuity) vs. CRUT (annuity varies with trust assets)
- Testamentary vs. inter vivos CRTs
- CRUT variations: NICRUT, NIMCRUT, FlipCRUT
- Income beneficiaries
  - Single beneficiary (usually the donor) for life or term of years
  - Two lives (usually donor and donor's spouse)
  - Entity as donor/beneficiary
- Remainder beneficiary
  - May be private foundation or public charity (including donor-advised fund)
  - Donor may retain power to choose remainder beneficiary or modify named remainder beneficiary
- Tax Goals
  - Immediate income tax deduction for remainder value
  - Avoidance of capital gain upon sale of appreciated asset
  - Ongoing deferral of investment income and gains

# Reasons to consider early termination

- Immediate cash flow needs of income beneficiary
- Value has declined and administration is costly relative to the current size and benefit of the trust
- Income beneficiary no longer needs the income interest and can utilize an additional income tax deduction
- Income beneficiary wishes to support immediate charitable program
  - New building or expansion, endowment, naming rights
- Free assets from investment restrictions
  - UBTI (active business interests, debt-financed investments)
  - Self-Dealing

# Forms of early termination

- Assignment termination (gift): income beneficiary assigns interest to remainder beneficiary
- Actuarial split: income beneficiary and remainder beneficiary divide trust assets or income beneficiary sells interest to remainder beneficiary (“cashing in” of income interest)
- Third party sale: income beneficiary and remainder beneficiary sell interests to third party

# State law issues

- Confirm transferability of trust interests
  - Review spendthrift clause, if one exists
  - Consider state spendthrift statutes (e.g. NY EPTL 7-1.5(a))
  - Exceptions may apply for CRTs with donor as sole income beneficiary
- Confirm assignment or sale of the income interest will cause the trust to terminate/accelerate
  - Common law merger doctrine may apply if all interests are deemed held by the remainder beneficiary upon termination
  - Court proceeding or other method may be necessary if state law is unclear
- Structure of beneficial interests is important
  - Donor may need to irrevocably designate remainder beneficiary (see PLR 200140027)
  - Donor may need to revoke or release future interests (see PLRs 9550026, 200912036)
- Attorney general may need to approve of the early termination or approve transaction on a final accounting

# IRS's general position

- Early terminations are acceptable if done correctly
- No “recapture” of initial deduction
- Authority is almost exclusively set forth in long history of over 20 PLRs
- Almost all PLRs recite the threshold requirement that the early termination be valid under state law
- The IRS will no longer issue PLRs regarding tax issues relating to actuarial splits (Rev Proc. 2008-4; Rev. Proc. 2015-3)
- Recent regulations address income tax issues relating to certain third-party sales (Reg. 1.1014-5)
- Attorney general involvement may be helpful, but is not required if state law does not so provide (see PLRs 200616035, 200725044)

# Tax issues: assignment terminations

- Income tax charitable deduction
  - Assignment is deemed gift of a capital asset (Rev. Rul. 72-243)
  - Basis of an income interest is zero (Section 1001(e)(1)); FMV deduction available only if held for longer than a year and assignment is to public charity or operating foundation (Section 170(e)(1)(B)(ii))
  - Partial interest rules should not apply as long as income interest is donor's entire interest and was not created to circumvent partial interest rules (see 1.170A-7(a)(2)(i); Rev. Rul. 86-60; PLR 200140027)
  - Substantiation requirements apply (e.g. qualified appraisal rules)
- Gift tax charitable deduction
  - Should be available for one-life trusts
  - Needs careful consideration in two-life trusts (see, e.g., PLR 9550026)

# Tax issues: actuarial splits

- Gain recognition by income beneficiary
  - Actuarial split is treated as sale by income beneficiary to remainder beneficiary (see PLR 200733014, 201323018)
  - Basis of an income interest is zero; gain will be recognized on entire sale (compare to taxation of CRT income to beneficiary)
  - Holding period may be important
- Self-dealing (Section 4941)
  - Will generally disallow this transaction if private foundation named as remainder beneficiary if life beneficiary is disqualified person (see PLR 200616035, superseding PLRs 200525014, 200614032)
- Life beneficiary should establish an ordinary life expectancy by physician affidavits (see, e.g., PLRs 200733014, 201325018)

# Tax issues: third-party sales

- Type of early termination most scrutinized by the IRS
- Gain recognition by income beneficiary
  - Third-party sales were a transaction of interest under Notice 2008-99, because of concern over manipulation of uniform basis rules to obtain a step-up in basis without realizing capital gain
  - Reg. 1.1014-5 (finalized August 31, 2015) confirms that basis is determined using special rule, generally the income beneficiary's pro rata share of the CRT's basis, less a pro rata share of undistributed net ordinary income and undistributed net capital gains
- Self-dealing (Section 4941)
  - CRT with private foundation as remainder beneficiary cannot sell its interest to a disqualified person

# Valuing beneficial interests

- 664 regulations (same principles that apply to creation of CRTs) should generally apply
- “Capital Gain” NIMCRUT (growth treated as trust accounting income under state law)
- Alternative Calculation Methods
  - Lower of (i) CRT stated percentage or (ii) 7520 rate is used for the income payout percentage
    - IRS rulings provide that this is “one reasonable method” (PLRs 200725044, 200733014, 200809044, 200816032/3, 201325018)
    - Assumes payout to income beneficiary would have been limited to 7520 rate
    - Gives low value to income interest under current 7520 rates
  - Stated percentage used for the income payout percentage
    - Consistency with methodology used in computing initial charitable deduction
    - Utilized in earlier rulings (PLR 200208039 –8% stated rate used, notwithstanding actual earnings of 3%)
    - Assumption that distributions would ultimately equal the stated percentage
    - Estate of Schaefer, 145 TC 4 (7/28/15) – estate tax valuation
  - Willing buyer – willing seller test (most popular with charitable planning experts)\*
    - Market rate is utilized to present value the income interest
    - Assumes general market performance of assets
    - Consider actual asset performance and/or percentage distributions made over term
  - Actual life expectancy may be relevant (PLR 200208039, PLR 200552015, PLR 201325018)

\*Hesch, et al, “Converting Ordinary Income into Capital Gains Using the Early Termination of Private Trusts and Charitable Remainder Trusts,” NYU School of Professional Studies - 73<sup>rd</sup> Institute on Federal Taxation (October 23, 2014)

\*\*Teitell, et. al., “Termination of Charitable Remainder Trusts,” Trusts and Estates, October 2014, p. 57.

# Miscellaneous issues

- Consider final annuity/unitrust payment and how it should be paid
- For assignment terminations and actuarial splits, consider selling assets prior to termination to avoid decrease in value
- Consider allocation of final expenses payable by the trust (legal and accounting fees)

# Lessons for drafting

- Avoid spendthrift clauses that would prevent early termination of the CRT
- Consider FlipCRUTs instead of NICRUTs or NIMCRUTs to avoid unfavorable valuation of the income interest upon early termination
- If using NIMCRUT, consider establishing in jurisdiction where capital gains may be treated as trust accounting income
- Provide for flexibility to irrevocably change the remainder beneficiary, especially if a private foundation is being named
- Consider the necessity of multiple income beneficiaries, who may complicate the unwinding of the CRT at a later time

# Final tips

- CRTs come in different shapes and sizes- think broadly about potential issues that may arise upon early termination
- Notify the charitable beneficiary and required government agencies before developing the termination plan
- Tread carefully with new ideas: the IRS has carefully considered certain CRT transactions “transactions of interest”
- Ethics of charitable planning where no charitable intent
- Charitable remainder trusts always work best for donors who are charitable
- Alternatives to Termination
  - Divorce – division into two separate plans (PLR 200035014, PLR 200221042)
  - Sale of unitrust interest to investor groups