

## Form 5227 Reporting: Charitable Split-Interest Trusts, NIIT Calculations, and More

THURSDAY, AUGUST 20, 2015, 1:00-2:50 pm Eastern

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# Preparing Form 5227

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## Introduction

There are several common mistakes that I have observed practitioners make when preparing tax returns for split-interest trusts. In almost all cases, the errors I've observed stem from a failure to read the trust agreement. Among these mistakes are:

- *Misidentifying the type of trust.* The trust agreement is the most certain source for determining which type of split-interest trust a donor created. For example, is the trust a charitable remainder trust (CRT) or a charitable lead trust (CLT). However, even within these broad classifications, it is important to further determine further details about the trust. For example, if the trust is a CRT, is it a charitable remainder *annuity* trust (CRAT), a charitable remainder *unitrust* (CRUT), a net income charitable remainder unitrust (NICRUT), a net income with make-up charitable remainder unitrust (NIMCRUT), or a flip charitable remainder unitrust (Flip-CRUT). Alternatively, if a trust is a CLT, is it a grantor trust or a non-grantor trust; is it a charitable lead annuity trust (CLAT) or a charitable lead unitrust (CLUT).
- *Incorrectly computing the amount of the required payments to income recipients.* One repeated error seen in the case of NICRUTs, NIMCRUTs, and Flip-CRUTs prior to the triggering event, is the failure to recognize that the amount due to the income recipients is the *smaller* of the *trust accounting income* or the *fixed percentage unitrust amount*. Often the amount either actually paid and reported on the Schedule K-1 to the income recipients or at least reported if not paid, is the fixed percentage unitrust amount. In many cases, if the actual amount is the fixed percentage unitrust amount, then the income recipients will have been overpaid, resulting in at least a potential act of self-dealing.

A second error is, in the case of a NICRUT, NIMCRUT, or Flip-CRUT prior to the triggering event, failing to identify any trust provisions that impact the computation of trust accounting income, particularly whether capital gains are includible in trust accounting income.

A third error is, in the case of a CLT, failing to identify that the trust agreement requires the payment of income in excess of the required annuity payment or fixed percentage unitrust payment to the charitable recipient.

*Completing unnecessary parts of the return or omitting necessary parts of the return.* In Appendix A I have provided a roadmap to completing Form 5227 that identifies which sections should be completed for the three principal types of split interest trusts, CRTs, CLTs, and pooled income funds (PIFs).

In addition to the items identified above, another common preparation error is the completion of a Form 1041, *Fiduciary Income Tax Return*, for a CRT. A Form 1041 is never required for a CRT. However, a Form 1041 is required for a CLT or a PIF.

## **What is the purpose of Form 5227?**

IRS Form 5227, *Split-Interest Trust Information Return*, meets the filing requirement for split-interest trusts found at IRC § 6034(a). The filing requirement applies to trusts described at IRC § 4947(a)(2) and includes charitable remainder trusts, charitable lead trusts, and pooled income funds. The form reports the financial activity of the trust, information about charitable deductions and distributions, and aids in the determination of whether any of the excise taxes imposed by Chapter 42 apply to the trust.

## **Who must file Form 5227?**

Form 5227 must be filed by any split-interest trust described at IRC § 4947(a)(2).<sup>1</sup> This includes:

- Charitable remainder trusts described in IRC § 664;<sup>2</sup>
- Pooled income funds (PIFs) described at IRC § 642(c)(5); and
- Charitable lead trusts (CLTs) and any other split-interest trust described at IRC § 4947(a)(2).

In general, IRC § 4947(a)(2) includes a split-interest trust that is not exempt from tax under IRC § 501(a), has unexpired non-charitable interests, and for which an income tax deduction was allowed under IRC §§ 170, 545(b)(2) (related to undistributed personal holding company income), or 642(c), an estate tax deduction was allowed under IRC §§ 2055 or 2106(a)(2), or a gift tax deduction was allowed under IRC § 2522.

A limited exception to filing Form 5227 applies to a split-interest trust created before May 27, 1969 and to which (a) all transfers of corpus occurred before May 27, 1969 or (b) for any transfer made after May 26, 1969, a deduction was not allowed under any of the code sections listed in IRC § 4947(a)(2). However, this exception is not applicable in the year in which a trust receives a transfer that qualifies for a deduction under any of the code sections listed in IRC § 4947(a)(2) or any year thereafter.

Note that prior to the passage of the Pension Protection Act of 2006 (*i.e.*, prior to 2007), a split-interest trust was also required to file Form 1041-A.

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<sup>1</sup> IRC § 6034(a). See also *2014 Instructions for Form 5227*, p. 1; available at <http://www.irs.gov/pub/irs-pdf/i5227.pdf>.

<sup>2</sup> See also Treas. Reg. § 1.6012-3(a)(6).

## When to File

Trusts that are required to file Form 5227 are also required to be calendar year filers.<sup>3</sup> Accordingly, the due date of Form 5227 is April 15 of each calendar year (with appropriate adjustments for years in which April 15 falls on a Saturday, Sunday, or a holiday).<sup>4</sup>

As an additional matter, note that in most cases it is permissible to pay the final installment of the annuity amount or the unitrust amount within a reasonable time after the close of the tax year.<sup>5</sup> However, the regulations provide that a “reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, ‘Split-Interest Trust Information Return,’ (including extensions) for the taxable year.”<sup>6</sup>

## Where to File

Regardless of the state of residency of the trustee, donor, or income beneficiary, Form 5227 is filed at the IRS Service Center in Ogden, UT. Use the address below that corresponds to the delivery method employed<sup>7</sup>:

U.S. Postal Service	Department of the Treasury Internal Revenue Service Center Ogden, UT 84201-0027
Private Delivery Service (or mailing from outside the United States)	Internal Revenue Service Center 1973 N. Rulon White Blvd. M/S 6054 Ogden, UT 84404

## Obtaining an Extension of Time to File

An automatic three-month extension of time to file to July 15 is available using page 1 of IRS Form 8868, *Application for Extension of Time To File an Exempt Organization Return*.<sup>8</sup> A second three-month extension to October 15 may be obtained with the IRS’s approval by completing page 2 of IRS Form 8868.<sup>9</sup>

**Trap For The Unwary!** Trusts that file Form 5227 may also be required to file Form 4720, *Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code*, or Form 8870, *Information Return for Transfers Associated With Certain Personal Benefit*

<sup>3</sup> IRC § 644.

<sup>4</sup> Treas. Reg. § 1.6012-3(a)(6). The instructions to Form 5227 explain that the references to Form 1041-B found in Treas. Reg. § 1.6012-3(a)(6) should be replaced with references to Form 5227. *2014 Instructions for Form 5227*, p. 1.

<sup>5</sup> Treas. Reg. §§ 1.664-2(a)(1)(i)(a), 1.664-3(a)(1)(i)(g), 1.664-3(a)(1)(i)(h).

<sup>6</sup> Treas. Reg. §§ 1.664-2(a)(1)(i)(c) (providing the rule for charitable remainder annuity trusts) and 1.664-3(a)(1)(i)(k) (providing the rule for charitable remainder unitrusts).

<sup>7</sup> *2014 Instructions for Form 5227*, p. 3.

<sup>8</sup> Treas. Reg. § 1.6081-9(a).

<sup>9</sup> See Treas. Reg. §§ 1.6081-9(a), 1.6081-1.

*Contracts.*<sup>10</sup> Where these ancillary forms are required, a separate Form 8868 must be completed for each one. The problem is that the need to file one or both of these forms may not become apparent until after the original due date to file Form 5227 has passed.

## **Requirement to Provide a Copy of the Trust Agreement**

In the first taxable year of a trust required to file Form 5227, a copy of the trust agreement must be attached to the return along with a signed declaration made under penalty of perjury that the attached copy “is a true and complete copy.”<sup>11</sup>

## **Accounting Method**

The general rule related to the selection of accounting method found at IRC § 446 applies to the preparation of Form 5227.<sup>12</sup> Specifically, trust income must be computed using the method of accounting the trustee regularly uses to keep the trust’s books and such method must clearly reflect income. Allowable methods include the cash basis, accrual basis, or any other method authorized by the Internal Revenue Code. Consent for a change in accounting method must be obtained using IRS Form 3115, *Application for Change in Accounting Method*.

## **Penalties for Failure to File**

IRC § 6652(c)(2)(C) imposes a penalty on trusts that fail to meet the filing requirement laid out in section 6034(a). The penalty is imposed if when the trustee<sup>13</sup>:

- Fails to file the return by the due date including extensions;
- Fails to include information required to be shown on the return; or
- Fails to show the correct information on the return.

However the penalty may be waived if the failure to comply is due to reasonable cause.<sup>14</sup>

The amount of the penalty is \$20 per day up to a maximum of \$10,000. However, in the case of a trust with gross income in excess of \$250,000, the penalty is \$100 per day up to a maximum of \$50,000. This penalty is imposed on the trust. However, if the person required to file the return knowingly fails to file the return, then the penalty is also imposed on that person and they are personally liable for the personally imposed penalty.

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<sup>10</sup> Form 4720 is required when the trust has unrelated business taxable income (UBTI) or is subject to one of the excise taxes imposed by IRC §§ 4941 (related to self-dealing), 4943 (related to excess business holdings), 4944 (related to jeopardizing investments), or 4945 (taxable expenditures). Form 8870, is required when the trust has made payments with respect to a personal benefit contract as described at IRC § 170(f)(10).

<sup>11</sup> Treas. Reg. § 1.6012-3(a)(6).

<sup>12</sup> 2014 *Instructions for Form 5227*, pp. 3.

<sup>13</sup> IRC § 6652(c)(1)(A)(i) and (ii); *see also* 2014 *Instructions for Form 5227*, pp. 3-4.

<sup>14</sup> IRC § 6652(c)(4).

In addition to the above, the IRS can make a written demand that a trustee file a delinquent return or furnish omitted or incomplete information.<sup>15</sup> Such a written demand must specify a reasonable future date for compliance with the demand. If the responsible person fails to comply with the written demand by the date specified, then a penalty of \$10 per day applies for each day after the date for compliance passes, to a maximum of \$5,000.<sup>16</sup>

**New Law:** The Achieving a Better Life Experience (ABLE) Act of 2014, signed into law on December 22, 2014, added IRC § 6652(c)(6), which now indexes for inflation the amounts described above. Amounts of \$5,000 or more will increase in \$500 increments as the cost of living adjustment is applied. Amounts less than \$5,000 will increase in \$5 increments. The change applies to returns filed after December 31, 2014.

Where more than one person is liable for the penalty, then the persons liable are jointly and severally liable.<sup>17</sup>

## Public Inspection Requirement

Form 5227 and its attachments are subject to public disclosure.<sup>18</sup> However, the following items are not subject to disclosure<sup>19</sup>:

- Schedule A, including any related early termination agreement;
- Schedule(s) K-1, including any continuation pages and transmittals;
- The trust agreement (required to be submitted with the initial return);
- Any amendments to the trust agreement (required to be submitted in the year they are made);
- Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*;
- Form 8582, *Passive Activity Loss Limitations*;
- Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund*; and
- Any attachment that references a contributor or donor information.

Note that it is our understanding that where the donor's name appears in the name of the trust and where the donor serves as the trustee of the trust, this information **cannot** be redacted when the form is made available for public inspection.

The IRS has in the past included split-interest trusts, including charitable remainder trusts and charitable lead trusts, in the downloadable copy of the IRS Business Master File (BMF)

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<sup>15</sup> IRC § 6652(c)(1)(B)(i); *see also* IRC § 6652(c)(2)(C) (requiring the application of section 6652(c)(1) to split-interest trusts).

<sup>16</sup> IRC § 6652(c)(1)(B)(ii).

<sup>17</sup> IRC § 6652(c)(5)(B).

<sup>18</sup> *See* IRC § 6104(b).

<sup>19</sup> *2014 Instructions for Form 5227*, p. 1.

found at <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Business-Master-File-Extract-EO-BMF>. While the IRS has discontinued including split-interest trusts in the BMF, many third-party providers created searchable databases of nonprofit organizations using this information. A representative list of these organizations includes:

- [www.taxexemptworld.com](http://www.taxexemptworld.com)
- [www.nonprofitfacts.com](http://www.nonprofitfacts.com)
- [www.fundraise.com](http://www.fundraise.com)
- [www.charityblossom.org](http://www.charityblossom.org)

While the sites on this list do not provide a copy of Form 5227, they do provide many identifying details of a trust, including the name of the trust, the trust's taxpayer identification number, the name and address of the trustee, and the value of the trust (at least at the time the trust was last included in the BMF). At present, the IRS has not announced plans to include Form 5227 among the filed returns it publishes to providers like Guidestar and others that publish online the Form 990 of nonprofit organizations.<sup>20</sup>

### **Obtaining a Copy of a Previously Filed Form 5227**

To obtain a public inspection copy of a Form 5227 filed after 2006, submit IRS Form 4506-A, *Request for Public Inspection or Copy of Exempt or Political Organization IRS Form*.<sup>21</sup> To complete Form 4506-A, the requester must know the name, taxpayer identification number, and address of the trust. Commercial users must pay a fee of \$0.20 per page. All other users may obtain 100 pages for free, thereafter a fee of \$0.20 per page applies.

### **Four-Tier Accounting**

CRTs (and CRTs only) use a unique category and class structure to capture the taxable income of the trust for use in characterizing distribution in the hands of the income beneficiaries.<sup>22</sup> This category and class structure is often referred to as the “four-tiers” because there are four categories: (1) ordinary income; (2) capital gains; (3) other (tax-exempt) income; and (4) corpus. These categories are nominally ordered in worst to best tax rate order. This order is significant because beneficiary distributions relieve each category in order from worst tax rate to best tax rate order, commonly referred to as “WIFO”—Worst in First Out.

Within each category, items of income are further assigned to a “tax rate class” based on the highest potentially applicable tax rate in the hands of the beneficiary. For example, interest

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<sup>20</sup> See Copies of Scanned EO Returns Available, Internal Revenue Service, July 10, 2014, <http://www.irs.gov/Charities-&-Non-Profits/Copies-of-Scanned-EO>Returns-Available>.

<sup>21</sup> Available at <http://www.irs.gov/pub/irs-pdf/f4506a.pdf>. Form 5227 was not open to public inspection prior to January 1, 2007. However, prior to that date, Form 5227 filers were also required to file Form 1041-A, which at that time was also open to public inspection. A trustee may use Form 4506, *Request for Copy of Tax Return*, to obtain an unredacted copy of a Form 5227 of the trust for which the trustee serves.

<sup>22</sup> See IRC § 664(b); Treas. Reg. § 1.664-1(d)(1).

income can be taxed at an income tax rate as high as 39.6%, so interest income is assigned to a 39.6% tax rate class. Conversely, qualified dividends, a member of the ordinary income category, are maximally taxed at a lower, 20% rate and accordingly are assigned to a 20% tax rate class. Similarly, within the capital gains category or tier, four different tax rates may apply:

1. Short-term capital gains maximally taxed at 39.6%;
2. Section 1202 stock and collectibles gain maximally taxed at 28%;
3. Unrecaptured section 1250 gain maximally taxed at 25%; and
4. Other long-term capital gain maximally taxed at 20%.

With the implementation of the 3.8% surtax on net investment income in 2013, Treasury issued new regulations that provided trustees with two alternative methods for accounting for net investment income. The two methods are discussed more fully below, but for the sake of clarity here, the Section 664 Method requires that each tax rate class to which the net investment income applies be divided into two tax rate classes—one in which the net investment income tax rate is added to the income tax rate and one in which the income tax rate only is applicable. This distinction is required for two reasons:

1. Any undistributed amounts within a category/class at 12/31/2012 are not subject to the 3.8% net investment income tax;<sup>23</sup> and
2. Certain types of income that may be received by a CRT are not subject to the 3.8% net investment income tax and are, accordingly, tracked separately.

The table below illustrates the implementation of the category/class four-tier structure after the introduction of the 3.8% net investment income tax. Note the column on the far right that specifies the tax rate class to which each income type belongs.

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<sup>23</sup> Treas. Reg. § 1.1411-3(d)(1)(iii).

CATEGORY AND CLASS STRUCTURE

Category	Income Type/Class	Excluded/NII	Tax rate (percent)
Ordinary Income .....	Interest (post-2012).....	NII .....	43.4
	Non-Qualified Dividends (post-2012).....	NII .....	43.4
	Rents (post-2012).....	NII .....	43.4
	Other Ordinary Income (post-2012).....	NII .....	43.4
	Interest (pre-2013).....	Excluded .....	39.6
	Non-Qualified Dividends (pre -2013).....	Excluded .....	39.6
	IRA Proceeds ( <b>regardless of date of receipt</b> ).....	Excluded .....	39.6
	Rents (pre-2013).....	Excluded .....	39.6
	Other Ordinary Income (pre -2013).....	Excluded .....	39.6
	Qualified Dividends (post-2012).....	NII .....	23.8
Qualified Dividends (pre-2013).....	Excluded .....	20.0	
Capital Gain .....	Short-Term Capital Gains (post-2012).....	NII .....	43.4
	Short-Term Capital Gains (pre-2013).....	Excluded .....	39.6
	Section 1202 Stock and Collectibles Gain (post-2012).....	NII .....	31.8
	Unrecaptured Section 1250 Gain (post-2012).....	NII .....	28.8
	Section 1202 Stock and Collectibles Gain (pre-2013).....	Excluded .....	28.0
	Unrecaptured Section 1250 Gain (pre-2013).....	Excluded .....	25.0
	Other Long-Term Capital Gain (post-2012).....	NII .....	23.8
	Other Long-Term Capital Gain (pre-2013).....	Excluded .....	20.0
Other Income .....	.....	.....	.....
Corpus	.....	.....	.....

*Ordinary Losses*

A current year ordinary loss within a class in the ordinary income category is first used to reduce any undistributed income from the same tax rate class. Presumably this means first that undistributed income of the same type (e.g., interest, nonqualified dividends, rent, etc.) within the tax rate class is reduced and then any remaining loss reduces other types of current and undistributed income within the same tax rate class, most likely on a pro-rata basis.<sup>24</sup> If there is any remaining loss after applying the loss to the same tax rate class, then the remaining loss is applied to reduce the current and undistributed income of the other ordinary income tax rate classes, beginning with the tax rate class with the highest tax rate and moving successively in descending tax rate order through each tax rate class.<sup>25</sup> Any remaining loss after applying the loss to all ordinary income tax rate classes is carried forward indefinitely in the tax rate class in which it originated.<sup>26</sup>

<sup>24</sup> Treas. Reg. § 1.664-1(d)(1)(iii)(a).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

### *Netting Capital Gains and Losses*

Capital losses are first netted against current and undistributed prior year capital gains of the same type in their respective tax rate classes.<sup>27</sup> Further netting occurs by taking any losses beginning with the highest tax rate class and netting those losses against any cumulative current and undistributed prior year capital gain, again beginning with the highest tax rate class.<sup>28</sup> After netting all the tax rate classes of long-term capital gain against one another, if long-term capital losses on a net cumulative basis remain, those losses are netted against any short-term capital gain.<sup>29</sup> Similarly, if a net short-term capital loss remains, that loss is netted against any available long-term capital gain, beginning with the highest tax rate class.<sup>30</sup> Finally, once all capital losses have been netted against all capital gains, the remaining balances within each tax rate class, whether gain or loss, are carried forward to the subsequent year (at least to the extent any gains are not used to characterize the current year beneficiary distribution).<sup>31</sup> A detailed explanation of the capital gain and loss netting rules can be found in the Instructions to Form 5227 under the heading “Netting Rules.”

### *Allocating Deductions*

Deductions allowed the trust in arriving at taxable income reduce the gross income of the trust in the following manner<sup>32</sup>:

1. Direct expenses attributable to a class of income are allocated to that class of income or corpus (e.g., rental expenses offset rental income);
2. Expenses attributable to a category (but not to a class of income within the category) are allocated on a pro rata basis to the classes of income within the category (after the allocation of the direct expenses described in item 1), but only to the extent of current year income;
3. Expenses of the trust that are not attributable to a category or class may be allocated in any manner; and
4. Chapter 42 excise taxes, the tax on unrelated business taxable income, non-deductible expenses, and deductions not allocable to any category of income are allocated to corpus.

### **Net Investment Income**

As an initial matter, a CRT is exempt from the net investment income tax (NIIT) imposed by section 1411.<sup>33</sup> However, the income distributed to CRT income beneficiaries is includible in their net investment income if it is distributed from a tax rate class that is subject to the NIIT.<sup>34</sup>

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<sup>27</sup> Treas. Reg. § 1.664-1(d)(1)(iv).

<sup>28</sup> *Id.*

<sup>29</sup> Treas. Reg. § 1.664-1(d)(1)(iv)(a).

<sup>30</sup> Treas. Reg. § 1.664-1(d)(1)(iv)(b).

<sup>31</sup> Treas. Reg. § 1.664-1(d)(1)(v).

<sup>32</sup> Treas. Reg. § 1.664-1(d)(2).

<sup>33</sup> Treas. Reg. § 1.1411-3(b)(1)(iii).

<sup>34</sup> *Id.*

For this reason, the accumulation of net investment income tax information is necessary for the preparation of Form 5227 for a CRT.

A CLT is not exempt from the NIIT except that any net investment income distributed in satisfaction of the annuity or unitrust amount is passed to the income beneficiary (which as a tax exempt organization is not taxed on its net investment income).<sup>35</sup> A PIF is not exempt from the NIIT except that a deduction is allowed against the PIFs net investment income for any net investment income distributed to the pool participants.<sup>36</sup> Additionally, a deduction is allowed for any long-term capital gain permanently set aside for charitable purposes under IRC § 642(c)(3).<sup>37</sup> Because CLTs and PIFs are not exempt from the NIIT, information relate to the NIIT is not reported on Form 5227, but rather is reported on Form 1041.

#### *Section 664 Method*

The default method for reporting NIIT information for CRTs is the integration of the net investment income items with the tax rate class structure described above under “Four-Tier Accounting.” The Section 664 method is especially appropriate when there are undistributed balances in tax rate classes that are not subject to the NIIT and are likely to be utilized in charactering income beneficiary distributions. An example of such a situation would be a CRT funded with the proceeds of an IRA.

#### *Simplified Method*

The optional “Simplified Method” accumulates net investment income items (after the allocation of allowable deductions) and non-net investment income items on a cumulative basis from the later of January 1, 2013 or the date the CRT is first funded into two buckets that are separate and apart from the four-tier category and class structure. Then the income beneficiary distributions are characterized by first drawing down the net investment income bucket and then, to the extent the amount of the distribution exceeds the amount in the net investment income bucket, drawing down the non-net investment income bucket.

The Simplified Method is only available for CRTs created prior to January 1, 2013 if the method was elected for the 2013 return.<sup>38</sup> The Simplified Method may be elected on an amended return so long as the year for which the election is made and all affected years, for both the CRT and its beneficiaries, are still open.<sup>39</sup>

#### *Schedule K-1 Reporting*

Information reported on the face of the Schedule K-1 is derived from the types of income contained in the category/class structure irrespective of the tax rate class or applicability of the NIIT. In other words, when the Section 664 Method is employed, interest income is reported as

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<sup>35</sup> Treas. Reg. § 1.1411-3(e)(2).

<sup>36</sup> Treas. Reg. § 1.1411-3(e)(2) and 3(e)(3)(i).

<sup>37</sup> Treas. Reg. § 1.1411-3(e)(4).

<sup>38</sup> 2014 Instructions for Form 5227, pp. 12.

<sup>39</sup> *Id.*

interest income, regardless of whether it was drawn from a tax rate class that was subject to the NIIT or not. Similarly, when the Simplified Method is employed, interest income is reported on the Schedule K-1 irrespective of whether such interest was in the net investment income bucket or not. Accordingly, these items are transferred to Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*, without regard to whether any of these amounts are not subject to NII. To remedy this, Form 8960, Line 7 allows for the recording of an adjustment to reduce the gross CRT distribution amounts reported on the face of the Schedule K-1 to a net amount that is subject to the tax. This adjustment amount is reported on Schedule K-1 in Box 14 using code H.

## **Structure of the Form**

Form 5227 consists of an identification section, seven parts, a signature block, and a Schedule A. As further described in Appendix A, some parts are required for some trust types and not for others.

## **Section-by-Section Review**

In this portion of this outline I have included selected observations regarding the completion of each section.

### ***Identification Section***

**Trust Name.** The name of the trust should be included as it appears on the Form SS-4 to obtain the taxpayer identification number. Because long trust names will have been significantly abbreviated by the IRS, you may wish to list the name as it appears on IRS correspondence you may have received (assuming such name is a fair representation of the name of the trust as it appears in the trust agreement).

**Trustee Name.** The “Name of the Trustee” is the name of the *current* trustee. If there has been a change in trustee during the year, be sure to check the appropriate box in Section E.

### **Section B Type of Entity**

Net income with make-up charitable remainder unitrusts (NIMCRUTs) and net income charitable remainder unitrusts (NICRUTs) should check box 3.

### **Section D Gross Income**

When reporting gross income, do not include capital losses.

### **Section E**

When filing an amended return, the instructions require that an attachment be included that identifies the lines and amounts being changed and provides an explanation for each change. In the case of a CRT, if the changes cause a change in amounts reportable to a beneficiary, then

each beneficiary must be provided with a revised Schedule K-1 properly marked as amended by checking the box at the top of the Schedule K-1.

## **Section G**

Be on the lookout for sources of unrelated business taxable income (UBTI). Remember that even one dollar of UBTI triggers a “Yes” response to this question. Under IRC § 664(c)(2), a trust that has UBTI is subject to a 100% excise tax on the UBTI amount.

Common sources of UBTI are energy partnerships or other similar entities that are traded on an exchange. The existence of UBTI is disclosed in Box 20, Code V of the Schedule K-1 issued by the partnership. The sum of the UBTI from all such sources is used to determine if there is UBTI (as opposed to a loss). Note that the \$1,000 specific deduction allowed under IRC § 512(b)(12) offsets the UBTI realized from partnerships and other activities before arriving at the taxable amount.

## **Part I Income and Deductions**

### **Section A Ordinary Income**

**Line 2b Qualified Dividends.** Note that, notwithstanding the fact that Form 5227 requires the reporting of qualified dividends, IRC § 6049(b)(4)(L)(i) includes **CRTs** among the list of entities for which a Form 1099-DIV or 1099-INT is not required to be issued. Accordingly, some investment firms and mutual fund companies will code a CRT as an exempt entity for purposes of Form 1099 production. American Funds is at least one such firm.

### **Section D Deductions**

**Line 18 Taxes.** State taxes, such as income taxes or property taxes may be deducted on Line 18. However, specifically in the case of a CRT, federal income taxes and excise taxes due under Chapter 42 are not deductible, rather these items are allocated to corpus. In the case of a PIF or CLT, any tax that is deductible in arriving at taxable income is reported on Line 18.

**Line 23 Charitable Deduction.** While a CRT is not permitted a charitable contribution deduction, PIFs and non-grantor CLTs may be allowed a charitable contribution deduction under IRC § 642(c). This includes the specific deduction allowed to PIFs under IRC § 642(c)(3) for long-term capital gains that are permanently set aside for charitable purposes. Any allowed charitable deduction for these types of split-interest trusts is reported on Line 23.

### **Section E – Deductions Allocable to Income Categories (CRTs Only)**

Only complete Section E if the trust is a CRT. To complete Section E, apply the deduction allocation rules found at Treas. Reg. § 1.664-1(d)(2).

## **Part II Schedule of Distributable Income (CRTs Only)**

The Schedule of Distributable Income is the first place on the return that the distinction between income subject to the Section 1411 3.8% net investment income (NII) tax and income not subject to the surtax (Excluded Income) is identified.

**Line 27 Undistributed income from prior years.** The amounts reported on Line 27 come from Schedule A on the prior year return.

**Line 28 Current tax year net income (before distributions).** Income from Part I (net of the expenses allocated in Part I, Section E), must be placed in the proper class (NII or Excluded Income) within the Ordinary Income, Capital Gain, and Nontaxable Income categories. Note that per the instructions, apply the netting rules found at Treas. Reg. §§ 1.664-1(d)(1)(iii) and (iv) before completing Line 28. Further note that when utilizing the **Simplified Net Investment Income Calculation Election**, all income or loss from Part I is reported in the Excluded Income column.

## **Part III-A Distributions of Principal for Charitable Purposes**

**Line 31 Principal distributed during the current tax year for charitable purposes.** Amounts reported on Line 31 include distributions of principal from a CRT to the charitable remainder beneficiary made during the term of the trust. Also included are the remainder interest of a CRT or PIF distributed to the charitable remainder beneficiary upon the expiration of the income interest in the CRT or pooled fund interest (in the case of a PIF). Finally, any amounts distributed from a CLT in excess of the deduction allowed under IRC § 642(c), should be reported on Line 31.

## **Part III-B Accumulated Income Set Aside and Income Distributions for Charitable Purposes**

**Line 33b.** The amount shown on Line 23 in Part I is transferred to Line 33b. This includes the specific deduction allowed to PIFs under IRC § 642(c)(3) for long-term capital gains that are permanently set aside for charitable purposes.

## **Part IV Balance Sheet**

Of special note when completing the balance sheet is the completion of column (c) FMV. Column (c) is required to be completed in the case of a charitable remainder unitrust (including a NIMCRUT, NICRUT, or Flip-CRUT). It may optionally be completed in the case of a charitable lead unitrust (CLUT). Column (c) should not be completed for a charitable remainder annuity trust (CRAT), charitable lead annuity trust (CLAT), or PIF.

## **Part V-A Charitable Remainder Annuity Trust Information**

This section captures the value of the property transferred to the trust and the annual annuity amount. Note that for short tax years, the amount reported on Line 61b must be prorated to reflect the short year.

## **Part V-B Charitable Remainder Unitrust Information**

This section captures information about charitable remainder unitrusts, including the payout rate and the unitrust amount. For NICRUTs, NIMCRUTs, and Flip-CRUTs, the trust accounting income must be reported. For trusts with a make-up provision, the deficiency amount is also tracked.

## **Part VI-A Statements Regarding Activities**

IRC § 508(e) requires that a private foundation contain provisions that subject the foundation to the excise taxes found at IRC §§ 4941 (self-dealing), 4942 (failure to make timely distributions of the minimum investment return), 4943 (excess business holdings), 4944 (jeopardizing investments), and 4945 (taxable expenditures). Rev. Rul. 75-38 contains a list of states that have enacted statutes that effectively amend the governing instruments of certain private foundations and charitable trusts to comply with IRC § 508. States not found in Rev. Rul. 75-38 may have enacted appropriate statutes after the ruling was released.

## **Part VI-B Statements Regarding Activities for Which Form 4720 May Be Required**

IRC § 4947(a)(2) imposes the private foundation excise taxes of IRC §§ 4941 (self-dealing), 4942 (failure to make timely distributions of the minimum investment return), 4943 (excess business holdings), 4944 (jeopardizing investments), and 4945 (taxable expenditures) to charitable split-interest trust unless an exception applies. In Part VI-B, the trustee self-reports compliance with or a violation of one or more of these rules. Note that when signing the return, the trustee is attesting, under penalties of perjury, that the return is true, correct, and complete.

Of particular note in this section is question 76, “Does section 4947(b)(3)(A) or (B) apply?” Section 4947(b)(3)(A) describes a CLT, the charitable income interest of which was not more than 60% of the aggregate fair market value of the property transferred to the trust. Section 4947(b)(3)(B) describes a CRT. Where either of these sections apply, the trust is not required to comply with sections 4943 (excess business holdings) or 4944 (jeopardizing investments). Accordingly, where section 4947(b)(3)(A) or (B) applies, then questions 77 and 78 may be marked “N/A”.

Note that the initial prototype CRT agreements issued in 1989 and 1990 included language that applied sections 4943 and 4944 to a CRT drafted using those forms, even though this was not required by the language of 4947(b)(3)(B). It is an open question whether a trust whose agreement specifically states that sections 4943 and 4944 will apply must respond in the negative to question 76 and thus answer questions 77 and 78.

## **Part VII Questionnaire for Charitable Lead Trusts, Pooled Income Funds, and Charitable Remainder Trusts**

### **Section A – All Trusts**

**Line 82.** Line 82 requires that a trust disclose the reason that the return is not a final return when all of the income interests in the trust expired in a previous year. For CRTs, the general rule is that the assets of the trust must be “transferred, in whole or in part, to or for the use of one or more organizations described in section 170(c) or retained, in whole or in part, for such use” allowing for “a reasonable time after the [termination of the income interest] to complete the settlement of the trust.”<sup>40</sup>

### **Section B – Charitable Lead Trusts**

A CLT’s governing instrument may permit income in excess of the annuity amount or unitrust amount to be paid to the charitable lead beneficiary.<sup>41</sup> Both the existence of this provision and the amount of any excess income required to be distributed are disclosed in this section.

### **Section D – Charitable Remainder Trusts**

**Line 91.** Line 91 is used when, after the conclusion of a tax year, a trustee makes an in-kind distribution of property it owned at the end of that tax year to satisfy the unitrust amount related to that tax year. When this is the case, the trustee should elect to treat any income generated by the in-kind distribution as occurring on the last day of the taxable year in which the unitrust amount is due.<sup>42</sup> Without this election the trust may be deemed<sup>43</sup>:

- (1) To have engaged in an act of self-dealing (within the meaning of section 4941);
- (2) To have unrelated debt-financed income (within the meaning of section 514);
- (3) To have received an additional contribution; or
- (4) To have failed to function exclusively as a charitable remainder trust (within the meaning of §1.664-1(a)(4)).

### **Other Matters**

#### ***Substantiating charitable contributions.***

The charitable contribution substantiation requirement of IRC § 170(f)(8) does not apply to transfers to a CRT or CLT.<sup>44</sup> This substantiation requirement does apply to a PIF, including the requirement that the donee organization issue a contemporaneous written acknowledgment of the gift that “indicate[s] whether any goods or services (in addition to an income interest in the

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<sup>40</sup> Treas. Reg. § 1.664-3(a)(6).

<sup>41</sup> Treas. Reg. §§ 20.2055-2(e)(2)(vi)(d) and (vii)(d); 25.2522(c)-3(c)(2)(vi)(d) and (vii)(d).

<sup>42</sup> Treas. Reg. § 1.664-3(a)(1)(i)(g)(1).

<sup>43</sup> Treas. Reg. § 1.664-3(a)(1)(i)(g).

<sup>44</sup> Treas. Reg. § 1.107A-13(f)(13).

fund) were provided in exchange for the transfer.”<sup>45</sup> However, the contemporaneous written acknowledgment is not required to include a “good faith estimate of the income interest.”<sup>46</sup>

In proposed regulations the IRS has indicated that the requirement of IRC § 170(f)(17) that the donor maintain a bank record of a cash, check, or other monetary gift or a written notice from the donee organization showing the name of the donee organization, date of the gift, and the amount of the contribution does not apply to transfers to a CRT or CLT.<sup>47</sup> This rule does, however, apply to a transfer to a PIF.<sup>48</sup>

In addition to the foregoing, a donor must attach a statement to the return on which he or she claims a deduction for the remainder interest in a CRT showing the computation of the present value of the remainder interest.<sup>49</sup> Prudence dictates that a similar statement should be attached to a return claiming a deduction for the present value of an income interest in a CLT or a remainder interest in a PIF. Further, if the donor makes the election to use the section 7520 rate for one of the two months preceding the month in which the transfer in trust occurs, a statement making the election should be attached to the donor’s individual income tax return.<sup>50</sup>

Regardless of the type of trust, if the property transferred in trust is noncash property, then the qualified appraisal rules of Treas. Reg. § 1.170A-13(c) apply to the transfer. Further the donor will need to complete Form 8283, *Noncash Contributions*, to substantiate their income tax deduction for the gift.

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<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> Prop. Reg. § 1.170A-15(g).

<sup>48</sup> *Id.*

<sup>49</sup> Treas. Reg. § 1.664-2(d) (as to a charitable remainder annuity trust) and § 1.664-4(c) (as to a charitable remainder unitrust).

<sup>50</sup> See IRC § 7520(a); Treas. Reg. § 1.7520-2(b).

## Appendix A

### Form 5227 Preparation Roadmap

Return Section	Charitable Remainder Trust	Charitable Lead Trust	Pooled Income Fund
Identification Section	Complete all portions	Complete all portions <i>except</i> Box G	Complete all portions <i>except</i> Box G
Part I	Complete all sections (A through E)	Complete only sections A through D	Complete only sections A through D
Part II	Complete	Not applicable, do not complete	Not applicable, do not complete.
Part III-A	Complete (but only if a payment from principal was made to a charitable organization)	Complete (but only to the extent principal was used to satisfy the charitable lead interest payment)	Complete (but only if a remainder interest was paid to the charitable sponsor upon the expiration of the related income interest or an income interest was commuted resulting in a distribution of principal to the charitable sponsor)
Part III-B	Do not complete	Complete (whether a grantor or non-grantor trust)	Complete
Part IV	For CRATs, complete columns (a) and (b). For all versions of CRUTs complete all columns	Complete columns (a) and (b) A charitable lead <b><u>unitrust</u></b> may optionally complete column (c). A charitable lead <b><u>annuity</u></b> trust should <b><u>not</u></b> complete column (c).	Complete columns (a) and (b) <b><u>only</u></b>
Part V-A	Complete	Not applicable; do not complete	Not applicable; do not complete
Part V-B	Complete	Not applicable; do not complete	Not applicable; do not complete
Part VI-A	Complete	Complete	Complete
Part VI-B	Complete	Complete	Complete
Part VII	Complete Section A and Section D	Complete Section A and Section B	Complete Section A and Section C
Schedule A, Part I-A	Complete	Not applicable; do not complete	Not applicable; do not complete
Schedule A, Part I-B	Complete (but only if electing to use the Simplified Net Investment Income Calculation)	Not applicable; do not complete	Not applicable; do not complete
Schedule A, Part II-A	Complete	Not applicable; do not complete	Not applicable; do not complete
Schedule A, Part II-B	Not applicable; do not complete	Complete	Complete

<b>Return Section</b>	<b>Charitable Remainder Trust</b>	<b>Charitable Lead Trust</b>	<b>Pooled Income Fund</b>
Schedule A, Part III	Complete	Complete	Not applicable; do not complete

**Appendix B  
Sample Declaration**

**Trust Name**  
**Taxpayer Identification Number**  
**Tax Year Ended**

I declare under penalties of perjury that this is a true and complete copy of the trust instrument of the above named trust.

\_\_\_\_\_  
Trustee Signature

\_\_\_\_\_  
Date

Client Name  
 Four-Tier Analysis  
 Tax Year \_\_\_\_\_

Prepared By: \_\_\_\_\_

Date: \_\_\_\_\_

**Federal Regular Income Tax - Four-Tier Detail**

	Carryforward Balance from Prior Year	Additions	Indirect Expense		Subtotal	Distributions	End of Year Balance
			Allocations	Allocated Losses			
<b>Ordinary Income</b>							
<b>43.4% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Interest Income					0.00		0.00
US Government Interest					0.00		0.00
Non-qualified Dividend Income					0.00		0.00
Rents					0.00		0.00
<b>Total 43.4% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>39.6% Tax Rate Class (NOT Subject to Net Investment Income Tax)</b>							
Interest Income					0.00		0.00
US Government Interest					0.00		0.00
Non-qualified Dividend Income					0.00		0.00
Rents					0.00		0.00
<b>Total 39.6% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>23.8% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Qualified Dividend Income					0.00		0.00
<b>Total 23.8% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>20.0% Tax Rate Class (NOT Subject to Net Investment Income Tax)</b>							
Qualified Dividend Income					0.00		0.00
<b>Total 20.0% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Total Ordinary Income</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Capital Gain</b>							
<b>43.4% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Short-Term Capital Gain					0.00		0.00
<b>Total 43.4% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>39.6% Tax Rate Class (NOT Subject to Net Investment Income Tax)</b>							
Short-Term Capital Gain					0.00		0.00
<b>Total 39.6% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>31.8% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Collectibles Gain					0.00		0.00
Sec. 1202 Stock Gain					0.00		0.00
<b>Total 31.8% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>28.8% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Unrecaptured Sec. 1250 Gain					0.00		0.00
<b>Total 28.8% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>28.0% Tax Rate Class (NOT Subject to Net Investment Income Tax)</b>							
Collectibles Gain					0.00		0.00
Sec. 1202 Stock Gain					0.00		0.00
<b>Total 28.0% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>25.0% Tax Rate Class (Not Subject to Net Investment Income Tax)</b>							
Unrecaptured Sec. 1250 Gain					0.00		0.00
<b>Total 25.0% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>23.8% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Other Long-Term Capital Gain					0.00		0.00
<b>Total 23.8% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>20.0% Tax Rate Class (NOT Subject to Net Investment Income Tax)</b>							
Other Long-Term Capital Gain					0.00		0.00
<b>Total 20.0% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Total Capital Gain</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Other Income (Tax-Free)</b>							
<b>0.0% Tax Rate Class (Subject to Net Investment Income Tax)</b>							
Municipal Bond Interest					0.00		0.00
<b>Total 0.0% Tax Rate Class</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Total Other Income (Tax-Free)</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>Corpus</b>					<b>0.00</b>		<b>0.00</b>
<b>Total</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>

**Client Name**  
**Four-Tier Analysis**  
**Tax Year** \_\_\_\_\_

Prepared By: \_\_\_\_\_

Date: \_\_\_\_\_

**Net Investment Income Tax Summary**

Ordinary Income Includible in NII	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Capital Gains Includible in NII	0.00	0.00	0.00	0.00	0.00	0.00	0.00
<b>Total Includible in NII</b>	<b>0.00</b>						
Ordinary Income NOT Includible in NII	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Capital Gains NOT Includible in NII	0.00	0.00	0.00	0.00	0.00	0.00	0.00
<b>Total NOT Includible in NII</b>	<b>0.00</b>						
<b>Total</b>	<b>0.00</b>						