CREATIVE PLANNING WITH CHARITABLE REMAINDER TRUSTS: YOU WILL FLIP WHEN YOU SEE THIS

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TABLE OF CONTENTS

I. Introduction.[1]

The charitable remainder trust (CRT) is a structure governed by complex statutory and regulatory rules which rewards charitable giving to an extent not existent with any other method of contributing to charity. The primary benefits afforded by a CRT are the ability to defer the recognition of taxable gain or other income while being permitted a present tax deduction for a transfer that will not be made to charity until some future date. This article summarizes the rules governing CRTs and how the rewards for their use might be maximized.

A CRT provides for specified distributions at least annually to one or more beneficiaries (at least one of which is not an organization described in IRC Sec. 170(c)) for a specified period of time. Upon the expiration of that period, the assets of the CRT must be distributed to, or held for the benefit of, one or more organizations described in IRC Sec. 170(c).[2]

A CRT must be either a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT).[3] Combinations of elements of the two types of trusts are not permitted.[4] A CRAT is obligated to pay annually a sum certain to one or more beneficiaries, at least one of which is not an organization described in IRC Sec. 170(c). The annual amount must not be less than 5% nor more than 50% of the initial fair market value of all property placed in the CRAT.[5] The amount may be expressed as a fixed dollar amount or as a fraction or percentage of that initial fair market value.[6] A CRUT is obligated to pay annually a fixed percentage of the fair market value of its assets, valued annually. The fixed percentage must be equal to at least 5% but no more than 50% of such value.[7] The distribution from either a CRAT or a CRUT for any year may be paid in a lump sum or in equal or unequal installments throughout the year.[8]

Rules specifically applicable to CRATs are discussed in Section III, *infra*. Rules specifically applicable to CRUTs are discussed in Section IV, *infra*. Rules that are applicable to both CRATs and CRUTs are discussed in the following Section II.

II. Rules Applicable to All Charitable Remainder Trusts.

A CRT continues for a period of time specified in the governing instrument. That specified period must be a term of years (not exceeding 20) or the life or lives of one or more individual beneficiaries named to receive or share in annuity or unitrust payments. Individual beneficiaries who are entitled to payments for life must be living when the CRT is established.[9] The value of the remainder interest in a CRT (determined under IRC Sec. 7520) must be at least 10% of the fair market value of the property contributed

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[1] For an excellent and detailed analysis, *see* Peebles and Katzenstein, 865-3rd Tax Management Portfolio, *Charitable Remainder Trusts*, *Charitable Gift Annuities*, and *Pooled Income Funds (Sections 664 and 642(c)(5))*.

[2] IRC Secs. 664(d)(1) and 664(d)(2).

[3] Treas. Reg. Sec. 1.664-1(a)(1)(iii)(a).

[4] Treas. Reg. Sec. 1.664-1(a)(2).

[5] IRC Sec. 664(d)(1)(A).

[6] Treas. Reg. Sec. 1.664-2(a)(1)(iii).

[7] IRC Sec. 664(d)(2)(A).

[8] Treas. Reg. Secs. 1.664-2(a)(1)(i) and 1.664-3(a)(1)(i).

[9] IRC Secs. 664(d)(1)(A) and 664(d)(2)(A).

to the CRT, valued on the date or dates of contribution.[10] The interest rate to be used in valuing the remainder interest is that which is in effect for the month of transfer or either of the preceding two months.[11]

A CRT may be established either inter vivos or at death by will or revocable trust. The remainder interest of an inter vivos CRT qualifies for an income tax deduction if payable to a charity described in IRC Sec. 170(c)[12] and a gift tax charitable deduction if payable to a charity described in IRC Sec. 2522(a).[13] The remainder interest in a CRT established at death qualifies for the estate tax charitable deduction if payable to a charity described in IRC Sec. 2055(a).[14] A CRT established at death does not generate an income tax charitable deduction.

It is important to note that while the organizations described in IRC Secs. 170(c), 2055(a) and 2522(a) are substantially the same, they are not identical. To ensure that a CRT qualifies for a gift tax deduction, the governing instrument should require that to be eligible to receive distribution upon termination of the CRT, an organization must qualify under each of IRC Secs. 170(c) and 2522(a). If it is intended that a CRT also qualify for an estate tax deduction, IRC Sec. 2055(a) should also be referenced.[15] In addition, if a donor's income tax deduction for a gift to an inter vivos CRT is not to be limited by the rules governing gifts to certain non-public charities, the governing instrument should also require qualification under IRC Sec. 170(b)(1)(A).[16]

To qualify as a CRT, a trust must be valid under applicable local law and satisfy the requirements of IRC Sec. 664 and the Regulations issued thereunder from its creation. Solely for purposes of IRC Sec. 664, a trust is considered to have been created at the earliest time that neither the grantor nor any other person is treated as the owner of the entire trust under the grantor trust rules of IRC Sec. 671, *et seq.*, but in no event prior to the time property is first transferred to the trust. For purposes of this rule, neither the grantor nor the grantor's spouse is treated as the owner of the CRT solely because either of them is named as a beneficiary to receive distributions from the CRT during its term.[17]

The IRS issued a series of revenue procedures in 2003 containing sample trust provisions for a variety of different kinds of CRATs. *See* Rev. Procs. 2003-53 through 2003-60. In 2005, the IRS issued a similar set of revenue procedures dealing with various types of CRUTs. *See* Rev. Procs. 2005-52 through 2005-59. The revenue procedures not only illustrate and discuss governing instrument requirements, they also contain examples and discussions of a variety of different types of provisions which might be included in a governing instrument. Having issued the revenue procedures, the IRS generally does not rule privately on whether a particular trust qualifies as a CRT.[18]

A. Distributions During Term of CRT. The annual distribution of annuity or unitrust amounts during the term of a CRT are required to be made to one or more named persons, at least one of which is not an organization described in IRC Sec. 170(c).[19] As used in the Internal Revenue Code, the term "person" refers to an individual, as well as a trust, estate, partnership, association, company or corporation.[20]

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[10] IRC Secs. 664(d)(1)(D) and 664(d)(2)(D).
[11] Treas. Reg. Sec. 1.664-1(a)(5)(iv)(a).
[12] IRC Sec. 170(f)(2)(A).
[13] IRC Sec. 2522(c)(2)(A).
[14] IRC Sec. 2055(e)(2)(A).
[15] Rev. Ruls. 76-307, 1976-2 C.B. 56 and 77-385, 1977-2 C.B. 331.
[16] Rev. Rul. 79-368, 1979-2 C.B. 109.
[17] Treas. Reg. Sec. 1.664-1(a)(4).
[18] *See*, e.g., Rev. Proc. 2020-3, 2020-1 I.R.B. 131 (39).
[19] IRC Secs. 664(d)(1)(A) and 664(d)(2)(A).
[20] IRC Sec. 7701(a)(1).

Thus, distributions during the term of a CRT may be made to an entity such as a corporation, partnership or limited liability company as well as an individual.

The term of a CRT may not exceed 20 years or the life of any individual named to receive all or any portion of the annuity or unitrust amount.[21] Only an individual or organization described in IRC Sec. 170(c) may receive distributions for the life of an individual. Payments may not be made to an individual for the life of another. If payments are to be made solely to an entity, such as a corporation, partnership or limited liability company, they can only be made for a period of years not exceeding 20. Payments cannot be made to A for life then to B for a term of years, because the period of payment could extend beyond both the lives of A and B and a period of 20 years. Payments to A for life and then to B for the shorter of B's life of a term of years (not to exceed 20) qualify because the period for payments cannot extend beyond the lifetimes of A and B.[22]

A CRT may provide that a portion of the annuity or unitrust amounts during its term is to be paid to an IRC Sec. 170(c) organization so long as there is at least one non-IRC Sec. 170(c) beneficiary designated to receive a portion of each payment.[23] Distribution of a portion of the annuity or unitrust amount to a Section 170(c) organization carries out income in accordance with the classification system discussed in Section II B, *infra*.[24] The trustee of the CRT can be granted the power to allocate any annuity or unitrust payment among beneficiaries so long as the power does not cause any person to be treated as the owner of any portion of the trust under the grantor trust income tax rules of IRC Secs. 671, et seq.[25] A grantor may serve as the trustee of the CRT, but cannot be given a power to allocate annuity or unitrust payments in a manner which would cause the trust to be a grantor trust under IRC Sec. 674.

Payments other than annuity or unitrust amounts may not be made during the term of a CRT to a person that is not an IRC Sec. 170(c) organization. However, the governing instrument may direct or authorize payment of other amounts to an IRC Sec. 170(c) organization during the term of the CRT.[26] Distribution of other amounts to an IRC Sec. 170(c) organization is treated as carrying out corpus and different classes of income in reverse order to the category system governing distributions to non-charitable beneficiaries described in Section II B, *infra*.[27] If such payments are discretionary with the trustee and if they may be made in kind, the adjusted basis of property distributed in kind must be fairly representative of the adjusted basis of the property of the CRT available for payment on the date of payment.[28] According to the regulations, no income tax deduction is allowable to the grantor for any portion of annuity or unitrust payment made to an IRC Sec. 170(c) organization during the term of a CRT.[29]

A CRT may not be subject to a power in another to invade, alter, amend or revoke with respect to an interest conferred upon a person other than an IRC Sec. 170(c) organization. The grantor may, however, retain the power exercisable solely by will to revoke or terminate the interest of any recipient other than an

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[21] IRC Secs. 664(d)(1)(A) and 664(d)(2)(A).
[22] Treas. Reg. Secs. 1.664-2(a)(5)(i) and 1.664-3(a)(5)(i).
[23] Treas. Reg. Secs. 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i).
[24] Treas. Reg. Sec. 1.664-1(d)(1)(ii)(a).
[25] Treas. Reg. Secs. 1.664-2(a)(3)(ii) and 1.664-3(a)(3)(ii).
[26] Treas. Reg. Secs. 1.664-2(a)(4) and 1.664-3(a)(4).
[27] Treas. Reg. Sec. 1.664-1(e)(1).
[28] Treas. Reg. Secs. 1.664-2(a)(4) and 1.664-3(a)(4).
[29] Treas. Reg. Secs. 1.664-2(d) and 1.664-3(d).

IRC Sec. 170(c) organization.[30] A donor may also retain the power to change charitable remainder beneficiaries during his or her lifetime or at death.[31]

B. Taxation on Distributions to Beneficiaries During Term of CRT. For purposes of determining the consequences of a distribution from a CRT to a beneficiary in any year, the assets of a CRT are divided into four tiers or categories. Distributions carry out income to the extent income in that category has been accumulated over the term of the CRT before the distribution in question. Distributions are deemed to carry out income from the next category when the preceding category has been exhausted. Distributions from a CRT carry out income in the following order: (i) ordinary income; (ii) capital gain; (iii) other income; and (iv) corpus.[32] Within each category, distributions are deemed to carry out income subject to the highest federal rate. Thus, all accumulated net short-term capital gain comes out before long-term capital gain. The tax rates to be utilized are the rates in effect at the time of distribution to a beneficiary and not when a particular class of income may have been accumulated in the CRT.[33] As a general rule, the priority assigned to the different categories of income results in the income subject to the highest rate of tax being drawn out first. This is not always the case. A distribution is considered to carry out qualified dividends (currently subject to tax at a maximum 20% rate) before reaching short-term capital gain (taxed as ordinary income, subject to a maximum 37% rate).

C. Taxation of CRT (UBTI). A CRT is not subject to federal income tax.[34] A CRT is, however, subject to a 100% excise tax on any unrelated business taxable income (UBTI).[35] UBTI is defined as gross income derived from an unrelated trade or business that is regularly carried on and that is unrelated to the charitable purposes of a tax exempt organization, less deductions directly connected to that business.[36] For purposes of the UBTI rules, a trade or business is any activity which is carried on for the production of income from the sale of goods or the performance of services.[37] A CRT does not engage in its own charitable activities, and therefore can never have business income that is related to its charitable purpose. Consequently, all business income of a CRT constitutes UBTI. UBTI in a CRT typically arises from ownership of an interest in a pass-through operating entity, generally a partnership or LLC, or from unrelated debt-financed income from property subject to acquisition indebtedness under IRC Sec. 514.

The definition of UBTI is very broad, but its reach is significantly reduced by statutory exceptions. Subject to the rules on debt-financed income and controlled entities discussed below, UBTI does not include passive investment income such as dividends, interest, annuities, capital gain, royalties or rents from real estate.[38] Payments which a CRT receives from a controlled entity are included in UBTI to the extent that the payments reduce the business income of the controlled entity.[39] For purposes of this rule, control means ownership of more than 50% (by vote or value) of the entity, taking into account various constructive ownership rules.

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[30] Treas. Reg. Secs. 1.664-2(a)(4) and 1.664-3(a)(4).

[31] Rev. Rul. 76-8, 1976-1 C.B. 179. Also, see Rev. Rul. 76-7, 1976-1 C.B. 179 holding that the power to change remainder beneficiaries can be given to an individual named to receive annuity or unitrust distributions during the term of a CRT established under will.

[32] IRC Sec. 664(b).

[33] Treas. Reg. Sec. 1.664-1(d)(1)(ii)(a).

[34] IRC Sec. 664(c)(1).

[35] IRC Sec. 664(c)(2).

[36] IRC Sec. 512(a)(1).

[37] IRC Sec. 513(c).

[38] IRC Secs. 512(b)(1) and 512(b)(3)(A).

[39] IRC Sec. 512(b)(13).

Income such as rent or dividends, which normally is exempt, is considered to be a UBTI if it constitutes debt-financed income.[40] Exposure to the excise tax consequences of debt-financed property can arise not only through the CRT's own activities, but also through the activities of a flow-through entity such as a limited partnership or LLC in which the CRT has invested.[41]

Debt-financed property is any property which is held to produce income with respect to which there is an acquisition indebtedness at any time during the taxable year or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the twelve-month period ending with the date of such disposition. Acquisition indebtedness is the unpaid principal amount of indebtedness incurred before or upon the acquisition or improvement of the property which would not have been incurred but for such acquisition or improvement. Indebtedness incurred after the acquisition of property constitutes acquisition indebtedness only if it would not have been incurred but for such acquisition and the incurring of such debt was reasonably foreseeable at the time of the acquisition or improvement.[42]

If an organization acquires mortgaged property by purchase, gift, bequest or otherwise, the principal amount of the mortgage constitutes acquisition indebtedness.[43] If property subject to a mortgage is received by bequest or devise, the mortgage is not treated as acquisition indebtedness for the ten-year period following the date of the acquisition.[44] If property subject to a mortgage is received by inter vivos gift, the indebtedness does not constitute acquisition indebtedness for a period of ten years after the gift. The exception for inter vivos gifts does not apply unless the mortgage was on the property at least five years before the gift and the donor owned the property at least five years before the gift.[45] The exceptions for property subject to indebtedness which is received by an organization by bequest, devise or gift is not available if the organization agrees to pay the indebtedness secured by the mortgage or makes any payments for the equity in the property.[46]

D. Private Foundation Restrictions and Governing Instrument Requirements. Since a CRT is not exempt from tax under IRC Sec. 501(a) and all of its unexpired term (annuity or unitrust) interests are not devoted solely to charitable purposes described in IRC Sec. 170(c)(2)(B), a CRT is potentially subject to the private foundation restrictions of a number of statutes, specifically IRC Sec. 4941 (self-dealing), IRC Sec. 4943 (excess business holdings), IRC Sec. 4944 (jeopardy investments) and IRC Sec. 4945 (taxable expenditures).[47] These statutes are applicable if the CRT has amounts for which a deduction was allowed under IRC Sec. 170, 2055 or 2522. In such event, no income, gift or estate tax charitable deduction is allowable with respect to transfers made to a CRT unless the governing instrument expressly prohibits the CRT from violating any of the private foundation restrictions which are applicable.[48] The governing instrument requirements can also be satisfied by applicable state law.[49]

IRC Secs. 4943 (excess business holdings) and 4944 (jeopardy investments) apply to a CRT in two instances. The first is if any amounts during the term of a CRT are payable to an organization described in

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[40] IRC Sec. 512(b)(4).
[41] IRC Sec. 512(c).
[42] IRC Sec. 514(c)(1).
[43] IRC Sec. 514(c)(2)(A).
[44] IRC Sec. 514(c)(2)(B).
[45] *Id.*
[46] *Id.*
[47] IRC Sec. 4947(a)(2).
[48] IRC Secs. 508(d)(1) and 508(e).
[49] Treas. Reg. Sec. 1.508-3(d)(1).

IRC Sec. 170, 545(b)(2), 642(c), 2055, 2106(a)(2) or 2522 and a charitable deduction is allowed for the interest in such payments.[50] The two statutes are also applicable if the assets of a CRT are held in further trust for an IRC Sec. 170(c) organization (rather than being distributed outright). In such event, the continuing trust becomes a private foundation, and the provisions of IRC Sec. 508(e) against excess business holdings (IRC Sec. 4943) and jeopardy investments (IRC Sec. 4944) must be included in the governing instrument.[51] In such instance, the governing instrument is permitted to restrict the application of IRC Secs. 4943 and 4944 until after the termination of the CRT when the trust continues in existence for the benefit of the IRC Sec. 170(c) organization.[52]

Most CRTs do not provide for the payment to an IRC Sec. 170(c) organization during its term or for a continuing trust for an IRC Sec. 170(c) organization upon termination of the CRT. As a result, CRTs are generally only subject to the prohibitions of IRC Secs. 4941 (self-dealing) and 4945 (taxable expenditures).

1. Self-Dealing. IRC Sec. 4941 imposes penalties upon disqualified persons who engage in prohibited transactions with a CRT. In addition, the transaction must be corrected. The penalty may not be waived, even for a reasonable cause.[53] A penalty can also be imposed upon the trustee of a CRT engaging in the prohibited transaction,[54] although the trustee can avoid penalty for a reasonable cause or reliance on advice of counsel.[55]

Disqualified persons include the donor, or the donor's spouse, the donor's children, grandchildren and great grandchildren (and their spouses), and entities in which any of these individuals have specified levels of ownership or control.[56] Not included as disqualified persons are donor's siblings and their descendants.

The definition of self-dealing in IRC Sec. 4941 is very broad. Almost any interaction between a CRT and a disqualified person raises the specter of self-dealing. Acts of self-dealing include a sale, exchange or lease of property between a CRT and a disqualified person. Self-dealing exists even if the transaction is unquestionably favorable to the CRT. For example, a disqualified person's sale of property to a CRT for less than its fair market value constitutes self-dealing which is subject to the penalty[57] and which must be corrected.[58]

Statutory and regulatory exceptions for activities which are not considered to be self-dealing are actually indicative of how expansive the concept of self-dealing and its definition are intended to be. For example, payment of the annuity or unitrust amount is expressly stated not to be an act of self-dealing.[59] Although the satisfaction of an annuity or unitrust payment in kind is treated as a sale, it is not considered to be self-dealing.[60] An interest-free loan to a CRT is not self-dealing if the loan proceeds are used exclusively for purposes specified in IRC Sec. 501(c)(3). The provision of goods, services or facilities to

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[50] IRC Sec. 4947(b)(3)(B).
[51] Treas. Reg. Sec. 53.4947-2(b)(1).
[52] See the discussion of the private foundation restrictions in the 2003 and 2005 revenue procedures.
[53] IRC Sec. 4962(b).
[54] IRC Secs. 4941(a)(2) and 4941(b)(2).
[55] Treas. Reg. Secs. 53.4941(a) – 1(b)(5) and 53.4941(a) – 1(b)(6).
[56] IRC Sec. 4946(a)(1).
[57] Treas. Reg. Sec. 53.4941(d) – 2(a)(1).
[58] Treas. Reg. Sec. 53.4941(e) – 1(c)(3)(i).
[59] Treas. Reg. Sec. 53.4947 – 1(c)(2).
[60] IRC Sec. 4947(a)(2)(A).

a CRT without charge is not an act of self-dealing. A CRT may pay reasonable compensation to a disqualified person for personal services, including trustee fees and fees for investment management.[61]

2. Taxable Expenditures. IRC Sec. 4945 imposes an excise tax on any taxable expenditure. The definition of "taxable expenditure" includes any amount paid (i) to carry on propaganda or otherwise to attempt to influence legislation, (ii) to influence the outcome of any public election or carry on, directly or indirectly, any voter registration drive, (iii) as a grant to an individual for travel, study or other similar purposes (unless the foundation has obtained advance approval for its grant making process), (iv) to an organization which is not a public charity or other specified charitable entity unless the foundation exercises expenditure responsibility, and (v) for any purpose other than one specified in IRC Sec. 170(c)(2)(B).[62]

3. Excess Business Holdings/Jeopardy Investments. IRC Sec. 4943 imposes excise taxes on a private foundation's excess business holdings, which generally include more than 20% of the total voting interest in a business enterprise, with ownership by all disqualified persons being attributed to the foundation. IRC Sec. 4944 imposes excise taxes on a private foundation's so-called jeopardy investments, i.e., risky investments which jeopardize the carrying out of the foundation's exempt purposes.

E. CRT to Have No Obligation to Pay Death Tax. An individual donor might establish an inter vivos CRT reserving an annuity or unitrust interest for life, which provides for another annuity or unitrust interest in a second individual before being distributed to an IRC Sec. 170(c) organization. At the individual donor's death, all or a portion of this CRT will be includable in his or her estate,[63] and the possibility exists that federal estate tax or state death tax could be apportioned against the CRT. The payment of death taxes is not an authorized payment by a CRT.[64] In Rev. Rul. 82-128[65], the IRS held that in this factual situation a trust would not qualify as a CRT unless the governing instrument conditioned the annuity or unitrust interest of the second individual on the payment of all death taxes from sources other than the CRT, and accelerating the remainder interest in charity if this condition is not satisfied. The sample documents in the 2003 and 2005 revenue procedures giving examples of two-life CRTs provide language satisfying this requirement.

F. CRTs Established at Death. A CRT created under a decedent's will or revocable trust must qualify as of the decedent's date of death. This requirement is satisfied if the obligation to pay the annuity or unitrust amounts exists as of date of death, even though the governing instrument defers the actual commencement of payment until the end of the taxable year of the CRT in which complete funding of the CRT occurs. For this exception to be available, the CRT must pay (in the case of an underpayment) or must receive (in the case of an overpayment) the difference between (i) any annuity or unitrust amounts actually paid, plus interest at the IRC Sec. 7520 rate, compounded annually, and (ii) the annuity or unitrust amounts payable, plus interest at the IRC Sec. 7520 rate, compounded annually.[66] The IRS has ruled that provisions governing the procedure to be followed in deferring commencement of annuity or unitrust payments is a governing instrument requirement for a CRT created at the grantor's death.[67] The sample documents in the 2003 and 2005 revenue procedures dealing with CRTs created at death contain language satisfying this government instrument requirement.

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[61] IRC Sec. 4941(d)(2)(E); Treas. Reg. Sec. 53.4941(d) – 3(c).
[62] IRC Sec. 4945(d).
[63] Treas. Reg. Sec. 20.2036-1(c)(2)(i).
[64] IRC Sec. 664(d)(2)(B); Treas. Reg. Sec. 1.664-1(a)(6), Ex. 3.
[65] 1982-2 C.B. 71.
[66] Treas. Reg. Sec. 1.664-1(a)(5).
[67] *See* Rev. Ruls. 80-123, 1980-1 C.B. 205 and 92-57, 1992-2 C.B. 123.

G. Other Governing Instrument Requirements. There are a number of other provisions which are required in an instrument governing a CRT.

1. Incorrect Valuation. If the determination of an annuity or unitrust amount to be distributed during the term of a CRT is dependent upon a determination of the fair market value of its assets, the governing instrument must contain provisions requiring a correction in the event of an incorrect valuation. Specifically, the governing instrument must provide that within a reasonable time of the determination of the correct value, the CRT is to pay to the recipient (in the case of an undervaluation) or receive from the recipient (in the case of an overvaluation) the difference between the correct amount payable and the amount actually paid.[68] There is no requirement for interest to be paid on any under payment of over payment.

The annuity or unitrust amount from a CRT may be satisfied in cash or in kind.[69] A distribution in kind is treated as a sale or exchange by the CRT affecting the amount which is to be carried out to beneficiaries under the tier system discussed in Section II B, *supra*.[70] An incorrect valuation of assets distributed in kind could result in an error in the amount distributed. The 2003 revenue procedures state that the language dealing with incorrect valuations may be omitted if the annuity amount in a CRAT is expressed as a dollar amount rather than as a percentage of the initial fair market value of the assets placed in the CRAT. Neither the regulations nor the 2003 revenue procedures address what is to be done to correct a valuation error in satisfying an annuity payment in kind. Any steps to be taken to correct that type of valuation error appear to be left to state law.

2. Short Taxable Year. The governing instrument of a CRT must provide that for a short taxable year of the CRT, the annuity or unitrust payments are to be prorated on a daily basis based upon the actual number of days in the short year as compared to the total number of days in the full taxable year (365 or 366 in leap year).[71] As an alternative when the CRT continues for the life of an individual beneficiary, the governing instrument may provide that the annuity or unitrust payments cease with the payment immediately preceding the individual beneficiary's death.[72]

3. Qualified Appraisal or Independent Trustee. To qualify as a CRT, any required valuation of unmarketable assets must be performed or determined by an independent trustee or a qualified appraiser (as defined in Treas. Reg. Sec. 1.170A-13(c)(3)).[73] "Unmarketable assets" are assets other than cash, cash equivalents or other assets that can be readily sold or exchanged for cash or cash equivalents, e.g., real property, closely-held stock or an unregistered security for which there is no available exemption permitting public sale.[74] An independent trustee is a person who is not the grantor, a non-charitable beneficiary or a related or subordinate party under IRC Sec. 672(c) to the grantor, the grantor's spouse or a non-charitable beneficiary.[75]

4. Alternate Qualifying Charity. The governing instrument must provide that if an organization named to receive distribution upon termination of a CRT is not an IRC Sec. 170(c) organization at the time it is to receive distribution, such distribution is to be made to one or more other

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[68] Treas. Reg. Secs. 1.664-2(a)(1)(iii) and 1.664-3(a)(1)(iii).
[69] Treas. Reg. Sec. 1.664-1(d)(5).
[70] *Id.*
[71] Treas. Reg. Secs. 1.664-2(a)(1)(iv) and 1.664-3(a)(1)(v).
[72] Treas. Reg. Secs. 1.664-2(a)(5)(i) and 1.664-3(a)(5)(i).
[73] Treas. Reg. Sec. 1.664-1(a)(7)(i).
[74] Treas. Reg. Sec. 1.664-1(a)(7)(ii).
[75] Treas. Reg. Sec. 1.664-1(a)(7)(iii).

organizations or entities which is or are IRC Sec. 170(c) organizations.[76] Typically, this requirement is satisfied by granting the trustee the power to choose an alternate qualifying organization.

H. Miscellaneous. The instrument governing a CRT may not restrict the trustee from investing trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.[77] All of the sample trust forms in the 2003 and 2005 revenue procedures contain such an affirmative statement. Including an affirmative statement in a CRT would seem advisable, especially if the trustee invests heavily in a particularly type of investment, e.g., tax exempt bonds which have the effect of reducing the income tax imposed under the tier system discussed in Section II B, *supra*, on the payments to non-charitable beneficiaries during the term of the CRT.

A CRT must use a calendar year as its taxable year.[78] Although a CRT must provide that the annuity or unitrust payment must be made at least annually, the actual payment for any taxable year may be made within a reasonable time after the close of such taxable year. A reasonable time ordinarily does not extend beyond the date by which the CRT is required to file the Form 5227, *Split-Interest Trust Information Return*, including extensions.[79] A CRT is required to file a Form 5227 for any year on or before April 15 of the following year.[80] A CRT may obtain an automatic extension of up to six months by filing a Form 8868, *Application for Automatic Extension of Time to File an Exempt Organization Return*, on or before the due date of the Form 5227.[81]

The instrument governing the CRT may provide that the non-charitable term interest is to terminate prior to the time otherwise specified upon the occurrence of a qualified contingency.[82] A "qualified contingency" is defined as any provision of a trust which causes termination of the non-charitable term interest at a time which precedes the time such interest would otherwise terminate.[83] A provision terminating a CRT upon the death of an individual who is not the beneficiary of a CRT is an example of a qualified contingency.[84] A qualified contingency is ignored in valuing the remainder interest in a CRT.[85]

I. Example Illustrating Tax Consequences to a Grantor Establishing a CRT. Possible income, gift and estate tax consequences of a donor's establishment of a CRT may be illustrated by an example.

Assume that a donor ("Donor") establishes a trust which qualifies as a CRT reserving the right to receive annuity or unitrust payments for life, which then pass to another individual ("Beneficiary") for life, with ultimate disposition upon the death of the survivor of Donor and Beneficiary to an organization qualifying under each of IRC Secs. 170(c), 2055(a) and 2522(a) ("Charity").

Donor's establishment of the CRT is a gift both for income tax and gift tax purposes. The value of the interest passing to Charity qualifies for an income tax and gift tax charitable deduction.[86] At Donor's death, a portion of the CRT is included in Donor's estate for federal estate tax purposes. The portion

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[76] Treas. Reg. Secs. 1.664-2(a)(6)(iv) and 1.664-3(a)(6)(iv).
[77] Treas. Reg. Sec. 1.664-1(a)(3).
[78] IRC Sec. 644.
[79] Treas. Reg. Secs. 1.664-2(a)(1)(i)(c) and 1.664-3(a)(1)(i)(k).
[80] Treas. Reg. Sec. 1.6034-1(c).
[81] Treas. Reg. Sec. 1.6081-9.
[82] IRC Sec. 664(f)(1).
[83] IRC Sec. 664(f)(3).
[84] Ltr. Rul. 200414011.
[85] IRC Sec. 664(f)(2).
[86] IRC Secs. 170(f)(2) and 2522(c)(2)(A).

included is that portion of the CRT corpus necessary to generate sufficient income to satisfy Donor's retained annuity or unitrust interest, using an IRC Sec. 7520 interest rate and other valuation factors prescribed by regulation.[87] The actuarial value at Donor's death of Charity's remainder interest qualifies for the charitable deduction.[88]

If Donor retains the right to substitute by will another IRC Sec. 170(c) organization in the place of Charity, Donor's income tax deduction is not affected, but the gift of the remainder interest is incomplete and is not subject to gift tax.[89] At Donor's death, the reserved power to substitute causes the full value of the CRT to be included in Donor's estate.[90] The value of the remainder interest in the CRT continues to qualify for the estate tax charitable deduction.

If Beneficiary in this example is Donor's spouse, the gift to Beneficiary qualifies for the gift tax marital deduction.[91] If Beneficiary is not Donor's spouse, the value of Beneficiary's interest in the CRT is a taxable gift. At Donor's death, there is no double taxation when the CRT is included in Donor's federal gross estate. This is because inclusion of the CRT in Donor's estate causes the gift to Beneficiary to be eliminated from the tax base as an adjusted taxable gift.[92]

If Donor reserved the right to revoke Beneficiary's interest in the CRT by will, the full value of the CRT is included in Donor's estate.[93] If Donor does not revoke a non-spouse Beneficiary's interest, the actuarial value of Beneficiary's interest in the CRT at Donor's death constitutes a part of Donor's taxable estate. The value at Donor's death of Charity's interest in the CRT depends upon whether or not Donor exercises the power to revoke. If Donor exercises that power, the full value of the CRT at Donor's death qualifies for the estate tax charitable deduction. If Donor does not exercise the power, the charitable deduction is reduced by the actuarial value of Beneficiary's interest.

III. The Charitable Annuity Trust (CRAT).

A CRAT pays a fixed sum at least annually during its term irrespective of whether the assets contributed to the CRAT appreciate or depreciate in value over time. No additional contributions may be made to a CRAT after the initial contribution.[94]

A. The 5% Probability Test. As noted in Section II, *supra*, the value of the remainder interest in a CRAT must be at least 10% of the initial value of the property contributed to the CRAT. In addition to this requirement, the IRS ruled in Rev. Rul. 77-374[95] that no estate or gift tax deduction is available for a remainder interest in a CRAT payable to an individual for life if the probability that the charitable remainder beneficiary will receive nothing exceeds 5%. That probability is determined by calculating the number of years it will take for a CRAT to be exhausted, assuming that it makes the specified annuity payments while generating earnings at the applicable IRC Sec. 7520 rate. The probability that the individual will be living when the CRAT is exhausted is determined from the IRS actuarial tables (currently Table 2000CM). In a low-interest environment, only CRATs payable for the lives of older individuals satisfy the 10% interest requirement and the 5% probability test. For example, at an IRC Sec. 7520 rate of

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[87] Treas. Reg. Sec. 20.2036-1(c)(2)(i).
[88] IRC Sec. 2055(e)(2)(A).
[89] Treas. Reg. Sec. 25.2511-2(c).
[90] Treas. Reg. Secs. 20.2036-1(b)(3) and 20.2038-1(a).
[91] IRC Sec. 2523(g). It is assumed that Beneficiary is a U.S. citizen. *See* IRC Sec. 2523(i).
[92] IRC Sec. 2001(b).
[93] Treas. Reg. Secs. 20.2036-1(b)(3) and 20.2038-1(a).
[94] Treas. Reg. Sec. 1.664-2(b).
[95] 1977-2 C.B. 329, amplifying Rev. Rul. 70-452, 1970-2 C.B. 199.

.8% (May 2020), a CRAT providing for an annuity of 5% per year for an individual 62 years of age does not satisfy either the 10% remainder interest requirement or the 5% probability test. A CRAT may pass one test but not the other. For example, at an IRC Sec. 7520 rate of 1%, the percentage for the remainder interest in the CRAT for a 62 year old individual is 11.614%, satisfying the 10% requirement. However, the probability that the 62 year old individual will be alive after 23 years when the CRAT is presumed to be exhausted is 40.23%. The CRAT does not satisfy the 5% probability test of Rev. Rul. 77-374.

In Rev. Proc. 2016-42[96], the IRS established a method by which a CRAT could be terminated early and the remainder interest accelerated to avoid failing the 5% probability test of Rev. Rul. 77-374. The early termination occurs if a calculation set forth in Rev. Proc. 2016-42, which is to be performed annually based upon the current fair market value of the assets of the CRAT, indicates that the fair market value of the remainder interest has fallen below 10% of the initial value of the property contributed to the CRAT. Rev. Proc. 2016-42 contains sample language producing this result.

B. The IRC Sec. 7520 Exhaustion Test. It is uncertain to what extent, if any, the exhaustion test set forth in regulations under IRC Sec. 7520 applies to a CRAT. The IRC Sec. 7520 regulations generally apply to CRTs.[97] The IRC Sec. 7520 exhaustion test addresses the payment of an annuity over the life of an individual from a limited fund. Unlike Rev. Rul. 77-374, the IRC Sec. 7520 exhaustion test focuses on the value of the annuity interest rather than the value of the remainder interest. It is assumed that the fund generates a return equal to the applicable IRC Sec. 7520 rate. As with the approach in Rev. Rul. 77-374, calculations are performed which indicate the number of years before the fund will be exhausted. If the annuity payments are to be made for the life of an individual, it is projected that the individual has the possibility of living to the age of 110 years, the maximum age under the IRS life expectancy tables.

If it is determined that the fund will be exhausted before the individual reaches 110, the year that the fund is projected to be exhausted sets the maximum term of the annuity payments. The annuity payments are treated as being payable over the shorter of that term and the individual's life. This treatment reduces the value of the annuity payments, because it eliminates from consideration years during which the individual could continue to be living after the fund is exhausted. The purpose of the IRC Sec. 7520 exhaustion test is to eliminate from the calculated value of an annuity interest years for which it is projected that assets will not be available to make the specified annuity payments.

Under traditional valuation methodology, the sum of the present value of an annuity interest in property for a term and the present value of the remainder interest in that property is equal to the property's fair market value. A decrease in the value of the annuity interest causes a corresponding increase in the value of the remainder interest. In the case of a CRAT, that would increase the charitable deduction above what it would be without application of the IRC Sec. 7520 exhaustion test.

The IRS has not taken an official position on the application or effect of the IRC Sec. 7520 exhaustion test on the value of a remainder interest in a CRAT that continues for an individual's lifetime. Conceptually, it is difficult to see how a calculation reducing the value of the annuity interest has the effect of increasing the value of the remainder interest when the reduction is produced by the assumption that the fund out of which the annuity is payable is exhausted. An assumption that the fund is exhausted should not cause an increase in the value of the remainder interest.

The objective in valuing an annuity under the IRC 7520 exhaustion test seems reasonable. No value should be accorded to years for which it is projected that no assets will be available to make annuity

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96 2016-34 I.R.B. 269.

97 Treas. Reg. Secs. 20.7520-2(a)(1) and 25.7520-2(a)(1).

payments. The IRC needs to establish rules for valuing the remainder interest in such a case. In any event, the IRC 7520 exhaustion test should not apply to increase the charitable deduction for a remainder interest in a CRAT.

IV. The Charitable Remainder Unitrust (CRUT).

A CRUT pays at least annually during its term an amount equal to a percentage of the fair market value of its assets, valued annually. The unitrust payments vary with the underlying value of the CRUT's assets. The provisions governing a CRUT may prohibit additional contributions or permit them. If additional contributions are permitted, the value of the remainder interest in each contribution must be at least 10% of its value on the date of contribution.[98]

If an additional contribution is made to the CRUT, the governing instrument must require that for the year of contribution, the unitrust amount is to be calculated under a method which takes into account the value of the contribution and the portion of the year in which the contributed assets were held by the CRUT.[99] If an additional contribution is made to a CRUT which fails the 10% remainder interest requirement, the existing CRUT is not disqualified. Rather, the additional assets are treated as a separate non-qualifying trust.[100]

As an alternative to the unitrust amount, a governing instrument may provide for the distribution of the lesser of a percentage of fair market value or trust accounting income.[101] This kind of trust of CRUT is commonly referred to as a "net income only unitrust," or "NICRUT."

A NICRUT's "net income" is determined under IRC Sec. 643(b) and applicable regulations.[102] Under IRC Sec. 643(b), capital gain may be allocated to income pursuant to the governing instrument and applicable law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to a fiduciary by applicable local law or, if not prohibited by applicable local law, by the governing instrument.[103] In spite of this general rule, a NICRUT's gain on the sale or exchange of assets contributed to the NICRUT by the grantor must be allocated to principal at least to the extent of the fair market value of those assets on the date of their contribution to the NICRUT. Gain from the sale of assets purchased by the NICRUT must be allocated to principal at least to the extent of the NICRUT's purchase price.[104]

A variation of the standard NICRUT permits the distribution in any year of accounting income for the current year in excess of the unitrust percentage of fair market value to make up for prior years in which the net income was less than the unitrust amounts for such years.[105] This variation is commonly referred to as a "net income with make-up unitrust," or "NIMCRUT." In addition, a NIMCRUT is permitted to "flip" to a standard CRUT on a specific date or by a single event that is not discretionary with, or within the control of, the trustee of the NIMCRUT or any other persons.[106] This variation is frequently referred to as a "FLIP-NIMCRUT." Permitted triggering events include the sale of unmarketable assets[107], or the

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[98] IRC Sec. 664(d)(2)(D).
[99] Treas. Reg. Sec. 1.664-3(b).
[100] IRC Sec. 664(d)(4).
[101] IRC Sec. 664(d)(3)(A).
[102] Treas. Reg. Sec. 1.664-3(a)(1)(i)(b)(3).
[103] Treas. Reg. Sec. 1.643(b)-1.
[104] Treas. Reg. Sec. 1.664-3(a)(1)(i)(b)(3).
[105] IRC Sec. 664(d)(3)(B).
[106] Treas. Reg. Sec. 1.664-3(a)(1)(i)(c)(1).
[107] As defined in Treas. Reg. Sec. 1.664-1(a)(7)(ii).

marriage, divorce, death or birth of a child with respect to any individual.[108] The "flip" is effective in the tax year of the NIMCRUT immediately following the year in which the triggering event occurs.[109] After the flip, the NIMCRUT pays only the unitrust amount. It is no longer permitted to utilize a current year's income to make up for prior years in which the unitrust amount was not paid in full.[110]

The sample forms in the 2005 revenue procedures for unitrusts contain language for use in CRUTs, NICRUTs, NIMCRUTs and FLIP-NIMCRUTs. This language can be quite intricate when dealing with the effect of additional contributions, short taxable years, etc.

V. A CRUT Is Generally Preferable to a CRAT.

An individual who is considering the possibility of establishing a CRT might find three things appealing about doing so. The individual might be pleased about making a contribution to charity. In addition, the individual might find attractive the income tax deduction allowable for the value of the remainder interest in a CRT. Another reason for establishing a CRT is to take advantage of the CRT's tax exempt status to defer, and possibility avoid, the payment of income tax.

Frequently, a grantor transfers appreciated assets to a CRT. The contributed assets may be non-income producing. The CRT sells the contributed assets without paying tax on the gain, and reinvests the sales proceeds in assets which produce an income flow. Tax on the gain is at least postponed until the gain is drawn out to non-charitable beneficiaries by the distribution of annuity or unitrust amounts during the term of the CRT. The sales proceeds, unreduced by the payment of income tax while held by the CRT, can be reinvested. The funds which would have been used to pay income tax if the CRT had not been established produce an additional return. Over time, with compounding, this additional return can be significant.

A. Unfavorable Aspects of a CRAT. An issue with a CRAT is that the non-charitable beneficiary does not benefit from the increase in value of CRAT assets, except to the extent of being more assured that the CRAT will be able to pay all annuity amounts in full. So long as a CRAT has not been exhausted, the annuity amounts payable from a CRAT remain constant. Those payments do not change whether the CRAT's assets increase or decrease in value.

This result is beneficial if assets contributed to the CRAT decrease in value. Most individuals establishing a CRT do not do so as a means of disposing of depreciating assets. A charitably inclined individual seeking to dispose of assets anticipated to decrease in value might find it simpler to enter into a charitable gift annuity rather than establishing a CRAT.

A low interest environment, as presently exists, restricts the choices available to an individual establishing a CRAT, especially if the individual hopes to receive annuity payments for life. In applying the 10% remainder interest requirement and the 5% probability test of Rev. Rul. 77-374 discussed in Section III A, *supra*, it is assumed that a CRAT generates a return equal to the applicable IRC Sec. 7520 rate. When that rate is low, it is assumed that less is available for the charitable remainder beneficiary. It is also assumed that a CRAT will be exhausted by annuity payments sooner than would be the case if the IRC Sec. 7520 rate were higher. As illustrated by the examples in Section III A, *supra,* the 5% probability of exhaustion test is particularly difficult to pass in a low interest environment with lifetime CRAT. The problem could be alleviated if the annuity payments payable during the term of a CRAT could be reduced.

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[108] Treas. Reg. Sec. 1.664-3(a)(1)(i)(d).
[109] Treas. Reg. Sec. 1.664-3(a)(1)(i)(c)(2).
[110] Treas. Reg. Sec. 1.664-3(a)(1)(i)(c)(3).

It is, however, a statutory requirement that the annuity payment be at least be 5% of the initial fair market value of the assets contributed to the CRAT. A reduction in the annuity amount below 5% is not permitted.

It is possible to avoid the 5% probability test of Rev. Rul. 77-374 by creating a CRAT for a term of years. A term of years CRAT satisfying the 10% remainder interest requirement eliminates the need for considering the 5% probability test. This is because there is no possibility that the CRAT will extend beyond the stated term which satisfies the 10% remainder interest requirement. At an IRC Sec. 7520 rate of 1%, a 5% CRAT for a term of 19 years passes the 10% remainder interest requirement, with a remainder interest of 13.474% of the initial fair market value of the assets contributed to the CRAT. At a 1% IRC Sec. 7520 rate, a 20 year 5% CRAT fails the 10% remainder interest requirement, having a remainder interest of 9.357% of such initial fair market value.

A 19 year CRAT, such as that described in the preceding paragraph, begins to look like an installment sale, i.e. a promissory note providing for equal installments over a specified period of time. In one respect, a CRAT receives less favorable tax treatment than an installment sale. If installment treatment is available for the sale of an asset, a portion of each installment payment constitutes a return of basis and is not subject to income tax.[111] Under the tier or category system discussed at Section II B, *supra,* distributions of the annuity amount carry out ordinary income first and then capital gain. No portion of any annuity payment is tax-free until all income and gain has been drawn out. No credit is given for basis until that point is reached.

B. CRAT and CRUT Compared. An example is useful in analyzing the comparative results produced by a CRAT versus a CRUT. Assume that an individual establishes a 10-year CRT with $1 million on January 1. The CRT provides for annual payments to the individual to be made on December 31 of each year for a term of 10 years. The valuation date for the CRUT is January 1. Assume that the assets of the CRT produce a return of 7% per year. Tables I, II, and III show the results if the CRT is a 5% CRAT or a 5% CRUT at assumed IRC Sec. 7520 rates of 1%, 3% and 6%.

TABLE I

1% AFR

	Annuity Trust	Unitrust
Deduction	$526,435.00 (52.644%)	$601,918.00 (60.192%)
Total to Donor	$500,000.00	$547,486.05
Total to Charity	$1,276,328.95	$1,218,994.43

[111] See IRC Sec. 643.

TABLE II

3% AFR

	Annuity Trust	Unitrust
Deduction	$573,490.00 (57.349%)	$608,026.00 (60.803%)
Total to Donor	$500,000.00	$547,486.05
Total to Charity	$1,276,328.95	$1,218,994.43

TABLE III

6% AFR

	Annuity Trust	Unitrust
Deduction	$631,995.00 (63.200%)	616,844 (61.684%)
Total to Donor	$500,000.00	$547,486.05
Total to Charity	$1,276,328.95	$1,218,994.43

Consistent with the assumption that a higher IRC Sec. 7520 rate provides more ultimately for the charitable remainder interest, the charitable deductions increase from Table I through Table III as the IRC Sec. 7520 rate increases. The CRAT and the CRUT each produce the same amounts for donor and charity in Tables I, II, and III. Irrespective of the IRC Sec. 7520 rate, a CRAT produces $500,000 for the donor and $1,276,328.95 for charity. The CRUT produces $547,486.05 for donor and $1,218,994.43 for charity. This is to be expected, because the assumed IRC Sec. 7520 interest rate relates to the calculation of the value of the remainder interest for tax purposes and has nothing to do with the actual return on investment.

Because the donor shares in any increase in the value of CRUT assets, the CRUT produces more for the donor over the 10-year term ($547,486.05) than the CRAT ($500,000.00). This will always be the result when the value of the assets of a CRUT increases over the term of the CRUT.

In Tables I and II, the donor receives more from the CRUT than the CRAT even though the charitable deduction for the CRUT is greater than for the CRAT. The donor receives more and is entitled to a greater deduction. The charitable deduction is greater because the IRC Sec. 7520 rate is less than the percentage designated as the annual distribution, and it is assumed that the value of the CRT decreases over time. With a CRUT, the amount distributable to the non-charitable beneficiary is also presumed to decrease over time, leaving more for the charity.

Table III illustrates that a CRAT produces a larger charitable deduction than a CRUT when the IRC Sec. 7520 rate exceeds the percentage designated for annual distributions. With a CRAT, it is presumed that the entire excess passes to charity. With a CRUT, the presumption is that the non-charitable beneficiary shares in the excess, reducing the amount passing to charity.

A CRUT is generally to be preferred over a CRAT. Tables I -III demonstrate that this is especially true when the applicable IRC Sec. 7520 rate is less than the percentage of annual distributions. Such is the case now, when the IRC Sec. 7520 rate is substantially below the 5% minimum annual annuity or unitrust percentage required for CRTs.

VI. Avoiding Unrelated Business Taxable Income (UBTI).

A. UBTI and Its Impact on CRTs. Over the past ten plus years two "black swan events" (the "Great Recession" and Covid-19) have resulted in significantly reduced assumptions and forecasts regarding capital market returns (the "new normal").[112] As a result, sophisticated portfolio managers have recently sought to increase overall investment returns by allocating greater portions of their managed investment portfolios into alternative investment asset classes (via alpha-seeking investments such as private equity/credit, venture capital, real estate and hard assets promising high double digit annual returns), and to reduce overall investment portfolio volatility (via non-correlating seeking investments such as hedge funds and options). In addition, in an effort to increase overall investment portfolio return expectations, and due to the historically low cost of money since the Great Recession (e.g., over the past 10 plus years the post-tax cost of borrowed money for the ultra-affluent has ranged between 1% to 2.5%), investment portfolio managers and their clients have also grown increasingly more comfortable deploying investment leverage via lines of credit secured by their marketable security investment portfolios. Unfortunately, alternative investments and investment leverage both often produce income which constitutes UBTI when allocated to a tax-exempt investor, such as a CRT. As noted in Section II C, *supra*, any form of UBTI allocated to a CRT is subject to a 100% excise tax.

One option to avoid the 100% tax is simply to avoid alternative investments and investment leverage. This strategy can result in reduced annual portfolio investment returns and increased portfolio volatility. To increase investment returns and decrease volatility, the trustee of a CRT may adopt a strategy of utilizing investments in alternative investments and implementing investment leverage without recognizing UBTI in the CRT. This strategy is more likely to be adopted by the trustee of a CRUT rather than a CRAT, because the non-charitable beneficiary of a CRUT benefits from the increased investment returns and decreased volatility along with the charitable beneficiary.

B. Avoiding Allocation of UBTI to CRTs (Without Constraining a Trustee's Investment Flexibility). The primary strategy available to eliminate the allocation of UBTI to a CRT is the formation and funding of a C corporation (a "C Corp Blocker") by the trustee of a CRT. All alternative investments and investment leverage which produce UBTI occur within the C Corp Blocker. Unlike limited partnerships and limited liability companies which are not subject to any form of entity level income tax (i.e., they are pass-through entities), C corporations are subject to an entity level tax on net profit.[113] The C Corp Blocker and not its CRT shareholder is allocated all of the income earned from alternative investments and investment leverage, thereby effectively "blocking" the CRT shareholder from receiving any UBTI. C corporations trigger a potential second level of shareholder income tax to the extent they make distributions to shareholders which constitute dividends.[114] However, dividends are excluded from

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[112] At the height of the Great Recession, Mohamed El-Erian, CEO at then bond giant Pimco, coined the term "new normal" to describe the post-financial crisis world as a place where slow growth would become the norm and extraordinary policy measures would be used to cope.

[113] The Tax Cuts and Jobs Act of 2017 reduced the top federal C corporation tax rate from 35% to 21%. Consequently, commencing in 2018, the tax cost of using domestic C Corp Blockers has been significantly reduced.

[114] Distributions to shareholders constitute taxable dividends to the extent they are paid out of accumulated or current year corporate earnings and profits. See IRC Sec. 316(a). C corporation dividends

the definition of UBTI.[115] Ironically, the often complained-about double taxation of C corporation earnings creates a tax-advantaged opportunity for CRTs to invest in alternative investments and utilize investment leverage without recognizing UBTI. C Corp Blockers have been successfully used by trustees of CRTs to avoid UBTI for close to 20 years.[116]

C. Minimizing Tax Drag Resulting From C Corp Blockers. While use of a C Corp Blocker to avoid UBTI is conceptually straight forward (i.e., converting a 100% UBTI excise tax into a 21% C corporate tax), the actual implementation and administration of such an entity in an optimized manner presents several challenges. First and perhaps most problematic is avoiding or minimizing the amount of income tax incurred by the C Corp Blocker. Although CRTs are not subject to any form of income tax, the net income or profit earned by a domestic C Corp Blocker is subject to a 21% federal tax rate, thereby resulting in a portion of the CRT's investment portfolio being inefficiently exposed to a 21% "tax drag". While any dividend distributions from a domestic C Corp Blocker to its CRT shareholder are not subject to further tax at the CRT entity level, the dividends will be carried out to the CRT's non-charitable beneficiary by annuity or unitrust distributions. This, in turn, results in a highly inefficient form of double-taxation. As a result, the trustee of a CRT must focus its investment analysis on the "post tax" return projections (which is not the case for CRT investments which do not produce UBTI) prior to committing to the use of a domestic C Corp Blocker to access investments which generate UBTI. There are at least three strategies which can eliminate or minimize the tax drag experienced by a CRT utilizing a C Corp Blocker.

1. Foreign C Corp Blocker. One strategy involves a CRT's formation and use of a foreign entity instead of a domestic C corporation. Although not created or organized under the laws of the U.S. or any state, the foreign entity is treated as a C corporation for U.S. income tax purposes.[117] The objective is to form the C Corp Blocker in a foreign jurisdiction which does not impose any corporate level income tax. Tax is imposed only on distributions to the non-charitable beneficiary. Double taxation is eliminated.[118] The administration and management of a foreign C Corp Blocker to comply with applicable foreign and domestic laws can be challenging.

2. Minimize Taxable Income. A second strategy involves using a domestic C Corp Blocker, but taking steps to minimize its taxable income. One such step simply involves maximizing the amount of various forms of deductible corporate level expenses. Note, however, that payments to a CRT from a controlled corporation which are deductible by the corporation constitute UBTI to the CRT.[119]

Another step is to reduce the quantity of non-UBTI producing assets (e.g., marketable securities) transferred by a CRT to a domestic C Corp Blocker. For example, it is not necessary for a C Corp Blocker

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are subject to a maximum 20% federal tax rate and also the 3.8% net investment income tax to the extent a shareholder has modified adjusted gross income exceeding various maximum thresholds. See IRC Sec. 1411.

[115] See the discussion at Section II C, *supra*.

[116] See, e.g., Ltr. Rul. 200252096 – no UBTI when the trustee of a CRT directly formed and funded a domestic C Corp Blocker which invested in a pass-through entity producing ongoing trade or business income; Ltr. Rul. 2002516016 – no UBTI found when the trustee of a CRT directly invested in a limited partnership which, in turn, invested in a foreign C Corp Blocker owning pass-through entities and deploying leverage; Ltr. Rul. 200315028 – no UBTI found when the four CRTs directly formed and funded a foreign C Corp Blocker which invested in pass-through entities deploying investment leverage.

[117] See IRS Form 8832.

[118] See e.g., Ltr. Ruls. 200315028, 200315032, 200315034, 200315035, 2002516016-17-18.

[119] See discussion at note 39, *supra*.

to own non-UBTI producing assets which are to serve as collateral for loans taken out by the C Corp Blocker. While any financed investment by a C Corp Blocker clearly constitutes "debt financed property" producing "acquisition indebtedness,"[120] use of assets owned by the CRT to serve as collateral for indebtedness incurred by the C Corp Blocker does cause the collateral to be subject to any acquisition indebtedness. Instead of transferring all of the required collateral directly to the C Corp Blocker, the trustee of the CRT might pledge a percentage of the CRT's underlying assets to serve as security for the C Corp Blocker's indebtedness. The amount of non-UBTI earned by the C Corp Blocker is thus reduced.

Another method of providing collateral for loans to the C Corp Blocker without transferring non-UBTI assets to the C Corp Blocker is for the non-charitable beneficiary to pledge future annuity or unitrust distributions as collateral. For this method to be implemented, the instrument governing a CRT cannot contain a spendthrift clause precluding the assignment or anticipation of such future distributions.

3. Alternative Investment Management LLC (AIM LLC). There is a third strategy useful only to NIMCRUTs to reduce the tax drag resulting from the use of a domestic C Corp Blocker. This strategy involves the formation by a NIMCRUT of a separate limited liability company, which might be referred to as an alternative investment management LLC ("AIM LLC"). The AIM LLC is structured to be a pass-through entity for federal income tax purposes. All of the NIMCRUT's capital to be allocated to alternative investments or investment leverage might first be contributed to the AIM LLC. The AIM LLC, in turn, might allocate a percentage of its capital directly into a domestic C Corp Blocker, which invests solely in alternative investments which generate UBTI or in investments issuing investment leverage.[121] The AIM LLC might then invest the rest of its capital not allocated to the domestic C Corp Blocker directly into so-called "blocker feeder funds." These are funds which contain their own blockers which trap UBTI. In addition, funds held by the AIM LLC may be invested intentionally (e.g., low volatility liquid investment portfolio) to be used as collateral for credit utilized by the C Corp Blocker. See Section VI C 2, *supra*.

The primary purpose of inserting an AIM LLC below a NIMCRUT and above a domestic C Corp Blocker is to defer the recognition of income on dividends distributed out of the domestic C Corp Blocker. Dividends are often distributed out of a C Corp Blocker to avoid the Personal Holding Company Tax or Accumulated Earnings Tax.[122] Dividends received by the AIM LLC constitute taxable income at the LLC entity level, but do not constitute fiduciary accounting income or an asset of the NIMCRUT as an upstream member of the AIM LLC unless and until the AIM LLC distributes the dividend out to the trustee of the NIMCRUT.[123]

For the AIM LLC to be effective in deferring the receipt of dividends by the NIMCRUT, it must be recognized as an entity separate and apart from the NIMCRUT. If the LLC is wholly-owned by the NIMCRUT, the IRS is likely to assert that its existence should be disregarded for all purposes, just as it is as a disregarded entity for income tax purposes. Specifically, the IRS might assert that any dividends received by the wholly-owned AIM LLC should be considered as income of the NIMCRUT to be distributed immediately to the non-charitable beneficiary rather than being retained in the AIM LLC within the NIMCRUT.

The existence of a non-tax related purpose for the AIM LLC clearly makes it more likely that its existence apart from the NIMCRUT will be recognized. For example, the AIM LLC might serve as a

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[120] See discussion at note 42, *supra*.
[121] See, e.g., Ltr. Rul. 2002516016.
[122] See Section VI D, *infra*.
[123] See IRC 643(b). See also Ltr. Rul. 19952035.

vehicle for like-minded co-investors to pool their resources to qualify for investment minimums or to maintain diversification.

The IRS has indicated that it will ordinarily not issue a private ruling on the qualification of a trust as a NIMCRUT if a grantor, trustee, beneficiary or a person related or subordinate to a grantor, trustee or beneficiary controls the timing of the trust's receipt of income from an entity or through the purchase of a deferred annuity contract "to take advantage of the difference between trust income under IRC Sec. 643(b) and income for federal income tax purposes for the benefit of the unitrust recipient".[124] The use of an AIM LLC not controlled by any of these parties should eliminate any question regarding the effectiveness of the AIM LLC to defer distribution of dividends received from a C Corp Blocker to a NIMCRUT.

D. Avoiding Personal Holding Company Tax and Accumulated Earnings Tax. There are two forms of tax which are intended to prevent the use of C corporations from sheltering accumulated earnings: the Personal Holding Company Tax ("PHC Tax") imposed under IRC Sec. 541 and the Accumulated Earnings Tax imposed under IRC Sec. 531 ("AE Tax"). Both the PHC Tax and AE Tax potentially operate as additional forms of tax drag on the use of domestic C Corp Blockers.

The PHC Tax" is a separate 20% entity level tax on a domestic C Corp Blocker's undistributed personal holding company income ("PHC Income"). In general, the PHC Tax applies to a domestic C Corp Blocker if (i) it has 5 or fewer individual shareholders who own greater than 50% of the C Corp Blocker (the "Ownership Test"), and (ii) 60% or more of its adjusted gross income constitutes PHC Income (the "Income Test").[125] PHC Income includes dividends, interest, rents, royalties, and other forms of passive income.[126] A domestic C Corp Blocker failing both the Ownership Test and Income Test may still completely avoid the PHC Tax by distributing out 100% of its PHC Income as dividends to its shareholders.[127]

To be deductible in any taxable year, dividends must be paid no later than the 15th day of the fourth month following the close of such taxable year.[128] Actually paying dividends may, as a practical matter, be difficult due to lack of liquidity and delay in obtaining the information necessary to calculate the amount of PHC Income. The PHC Tax can be avoided through the use of a consent dividend by which the shareholder(s) of the C Corp Blocker consent in writing to the artificial receipt and recognition of a deemed dividend distribution in an amount required to zero out the PHC Tax.[129]

The AE Tax operates similarly to the PHC Tax in that it also subjects a 20% tax on the accumulated earnings of C corporations.[130] However, the two forms of tax are mutually exclusive, since the AE Tax does not apply to any corporation which meets the definition of a personal holding company.[131] The AC Tax is likely to be a consideration only in the rare instance when the C Corp Blocker is engaged in an active business.

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124 Rev. Proc. 2020-3, Sec. 4 (40), 2020-1 I.R.B. 134. In spite of this general no-ruling position, the IRS has ruled favorably on the qualification of NIMCRUTs in which such control over a NIMCRUT's receipt of income existed. See Ltr. Ruls. 9825001 and 200043047.

125 IRC Sec. 542(a).

126 IRC Sec. 543(a).

127 IRC Sec. 561.

128 IRC Sec. 563(b).

129 Treas. Reg. Sec. 1.565-1(a).

130 IRC Sec. 531.

131 IRC Sec. 532(b)(1).

The AE Tax is broader than the PHC Tax in that its application is not limited by an Ownership Test. The AE Tax is avoided, however, by a showing that accumulated earnings and profits are necessary to provide for a C corporation's reasonable business needs.

E. Avoiding Private Foundation Self-Dealing Rules When Forming Multi-Shareholder C Corp Blockers. Most C Corp Blockers are wholly-owned by a CRT. In some cases however, the desire to gain access to investments with high investment minimums limited to high net worth investors satisfying "accredited investor" or "qualified investor" status may result in a need to form a multi-shareholder C Corp Blocker. A multi-shareholder C Corp Blocker provides the significant non-tax benefit of pooling capital resources and interests among investors who or which alone would not invest in such high minimum investments due to prudent investment asset allocation considerations (e.g., the investment minimum exceeds 10% of the investor's underlying investment portfolio), or an inability to satisfy investor status requirements. If the private foundation restrictions apply to a CRT[132] and if a co-investing shareholder constitutes a "disqualified person" under the private foundation rules, questions arise regarding possible self-dealing under IRC Sec. 4941(d). Numerous private letter rulings have held that co-investing through the formation of an investment entity and the subsequent withdrawal from or termination of such an investment entity does not constitute a "sale or exchange" under IRC Sec. 4941(d)(i)(A), and thus does not constitute an act of self-dealing.[133] The formation of a C Corp Blocker involving the simultaneous contribution of funds by a CRT and disqualified persons should not itself constitute an act of self-dealing, since the C Corp Blocker's status as a disqualified person only arises as the result of its formation. This exception is known as the "first bite exception" to the self-dealing rules. A transaction does not constitute self-dealing if a party becomes a disqualified person solely as a result of the transaction.[134] The following provisions, which are drawn from the private rulings, might be included in a shareholder agreement governing a multi-shareholder C Corp Blocker as a safeguard in avoiding a prohibited self-dealing violation:

- The C Corp Blocker is prohibited from charging any investment/management fees;
- A CRT shareholder is only charged the actual marginal increase in expenses attributable to the CRT's participation (i.e., all cost savings in fees are retained by the CRT shareholder);
- A CRT shareholder has mandatory right to withdraw from the C Corp Blocker on a given date of each month at full fair market value (i.e., without valuation discounts transferring value to disqualified persons);
- A CRT shareholder is granted the right to receive distribution in-kind in satisfaction of withdrawals/redemptions;
- Any indemnity is limited to a "non-compensatory" indemnity;[135] and
- A broad self-dealing prohibition (including a required reversal of any act deemed to be self-dealing by the IRS).

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[132] See Section VII, *infra*.

[133] See, e.g., Ltr. Ruls. 9448047, 9533041, 200018062, 200318069, 200420029, 200043047 (involving 15 CRTs which formed a family investment LLC), and 200551025.

[134] Treas. Reg. Sec. 53.4941(d)-1(a).

[135] See Treas. Reg. Sec. 53.4941(d)-3(c)

VII. Avoiding Private Foundation Restrictions.

As discussed in Section II D, *supra*, the restrictions on self-dealing (IRC Sec. 4941) and taxable expenditures (IRC Sec. 4945) apply to CRTs if a charitable deduction has been allowed under any of the statutes enumerated in IRC Sec. 4947(a)(2). The restrictions on self-dealing can be particularly onerous when a CRT's assets include private investments in which disqualified persons might be participating. Three recent private letter rulings addressed the possibility of avoiding the charitable deductions listed in IRC. Sec. 4947(a)(2), making the private foundation restrictions inapplicable to the CRTs in those rulings.

A. Letter Rulings Holding IRC 4847(a)(2) Inapplicable. Ltr. Ruls. 201713002 and 201713003 involved two CRUTs established by the same grantor. Under the terms of the CRUT in Ltr. Rul. 201713002, the grantor was to receive unitrust payments for life. At the grantor's death, the unitrust payments were to continue for another individual. The CRUT was to continue for the individual beneficiaries' lifetimes or a period of 20 years, whichever was longer. In Ltr. Rul. 201713003, unitrust payments were to be made to the grantor for a period of 20 years. In both Rulings, it was represented that the grantor had not claimed a deduction under IRC Sec. 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2) or 2055 with respect to the CRUTs. The IRS ruled that the CRUTs were not subject to IRC Sec. 4947(a)(2) because no deduction had been "allowed" under any of the specified statutes, even though a deduction may have been "allowable." The IRS noted the statement in Treas. Reg. Sec. 53.4947-1(a) that a CRT is presumed (in absence of evidence to the contrary) to have amounts for which a deduction was allowed under one of the enumerated statutes. The IRS stated that the burden was on the grantor to keep records to show, through the life of the CRUTs, that no deduction was ever taken.

Ltr. Rul. 201831009 involved a QTIP marital deduction trust established for a decedent's surviving spouse under the decedent's revocable trust. The spouse was entitled to all net income from the QTIP trust, plus principal encroachments for care, support, health and maintenance. At the spouse's death, the assets of the QTIP trust would be included in the spouse's federal gross estate under IRC Sec. 2044. When the QTIP trust terminates upon the spouse's death, its assets were to be distributed to charity.

The IRS ruled in Ltr. Rul. 201831009 that during the spouse's lifetime, the QTIP trust was not a split-interest trust to which IRC Sec. 4947(a)(2) applied. The IRS held that IRC Sec. 4947(a)(2) was inapplicable during the spouse's lifetime for the reason that no charitable deduction was allowed or allowable prior to the spouse's death. The IRS also held that after the spouse's death, the QTIP trust would not be considered to be a non-exempt charitable trust under IRC Sec. 4947(a)(1) for a reasonable time which permitted the trustees to perform the ordinary duties of administration necessary to settle the trust and effect distribution.

B. Gift and Estate Tax Charitable Deductions Are Mandatory. It is unclear in Ltr. Ruls. 201713002 and 201713003 how no gift tax deduction was allowed with respect to the two CRUTs. A statutory requirements for a CRT is that the value of the remainder interest payable to charity must be at least 10% of the value contributed to the CRT. The CRUTs in Ltr. Ruls. 201713002 and 201713003 named a specific organization as remainder beneficiary. That organization is described in the two Rulings as being exempt from tax under IRC Sec. 501(c)(3), which is virtually identical to IRC 170(c). The Rulings do not indicate whether the named organization in Ltr. Ruls. 201713002 and 201713003 also qualified for the charitable deduction under IRC Secs. 2055(a) and 2522(a), but it seems probable that it did.

The gift and estate tax charitable deductions appear to be mandatory and not optional. The language in the beginning of IRC Sec. 2055(a) governing the estate tax charitable deduction is virtually identical to that of IRC Sec. 2056(a) governing the estate tax marital deduction. In Rev. Rul. 59-123,[136] the IRS held

[136] 1959-1 C.B.248

that allowance of the estate tax marital deduction was mandatory and could not be waived.[137] If the language of the IRC Sec. 2056(a) precludes waiver of the estate tax marital deduction, the virtually identical language in IRC Sec. 2055(a) should also preclude waiver of the estate tax charitable deduction. The enactment of IRC Secs. 2056(b)(7) and 2523(f) has changed this rule with respect to QTIP, which is elective. There has been no such change to IRC Secs. 2055 or 2522 authorizing any kind of elective charitable deduction.

The language of IRC Sec. 2522(a) dealing with the gift tax charitable deduction and IRC Sec. 2523(a) dealing with the gift tax marital deduction similarly appears to be mandatory rather than elective. IRC. Sec. 170(a) contains similar language which appears to mandate an income tax deduction for charitable contributions. In the case of the income tax charitable deduction, however, a taxpayer can avoid claiming the deduction by failing to follow IRS requirements for substantiating the deduction or by electing not to itemize.

C. Omit Reference to IRC Secs. 2055(a) and 2522(a). Rather than attempting to waive the gift and estate tax charitable deductions, a grantor establishing a CRT might disqualify transfers to the CRT for a gift or estate tax charitable deduction by directing distribution at the termination of the CRT to an IRC. Sect. 170(c) organization selected by the trustee, without requiring that the organization also qualify under IRC. Secs. 2055(a) and 2522(a). Rev. Rul. 76-307, cited at note 15, *supra*, indicates that eliminating reference to IRC Secs. 2055(a) and 2522(a) in this fashion precludes a CRT from qualifying for the gift or estate tax charitable deduction.

In Rev. Rul. 76-307, the governing instrument named a specific charity to receive distribution upon termination of a CRT. The named charity qualified under both IRC Secs. 170(c) and 2522(a). The governing instrument further provided that if the named charity did not qualify for distribution, an alternative distribution was to be made to another organization selected by the trustee which qualified under IRC Sec. 170(c). The provisions for alternate distribution did not mention IRC Sec. 2522(a). The IRS nevertheless allowed the gift tax charitable deduction after concluding that the possibility of distribution to a charity which did not qualify under IRC Sec. 2522(a) was so remote as to be negligible. The necessary inference is that the deduction would not have been allowed in Rev. Rul. 76-307 if the governing instrument had not initially named an organization which, in fact, qualified under IRC Sec. 2522(a).

D. CRT Established by an IDIT. Another option to avoid a gift or estate tax charitable deduction with respect to a CRT is to have the CRT established by an entity which is not subject to gift or estate tax. Specifically, the CRT might be established by an irrevocable trust which is excluded from the estates of its grantor and all of its beneficiaries.

A grantor may establish a so-called intentionally defective irrevocable trust (an "IDIT") and effect a sale of assets which qualify for valuation discounts to the IDIT in exchange for the IDIT's promissory note. Although the assets of the IDIT are excluded from the grantor's federal gross estate, the grantor continues to be taxed on the IDIT's income under the grantor trust rules of IRC Sec. 671 et seq. The IDIT is a person permitted to establish and be a beneficiary of a CRT.[138] The IDIT might contain provisions which specifically authorize it to establish a CRT in which it reserves the right to receive annuity or unitrust payments for a term of years, not exceeding 20.

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[137] See also Rev. Rul. 79-398, 1979-2 C .B. 338 holding that the use of the unified credit is mandatory, and Rev. Rul. 73-47, 1973-1 C. B. 397 holding that the use of the IRC. Sec. 2013 credit is mandatory.

[138] See discussion at notes 19 and 20, *supra*.

Because the IDIT is a grantor trust for income tax purposes, the grantor could claim an income tax deduction for the value of the remainder interest in the CRT passing to charity upon the expiration of the 20 year term. As noted above, the grantor can decline to claim the deduction by failing to follow the requirements for establishing the deduction or by electing not to itemize deductions. The income tax deduction can be avoided. IRC Sec. 4947(a)(2) will not apply to the CRT if its establishment does not constitute a gift by the grantor or any beneficiary of the IDIT, and so long as the IDIT is not included in the estate of its grantor or any of its beneficiaries.

E. Avoiding a Gift and Estate Tax Inclusion. The grantor is not a beneficiary of an IDIT. A grantor can serve as a trustee of an IDIT without causing its assets to be included in the grantor's federal gross estate. If limited by a fixed and ascertainable standard, the grantor's power as trustee to allocate distributions among beneficiaries does not cause the IDIT to be included in the grantor's estate under IRC Sec. 2036(a)(2) or 2038(a).[139] If the grantor is to act as a trustee of the IDIT, the grantor should not as trustee be permitted to participate in the decision to establish the CRT. Such a power would cause the IDIT to be included in the grantor's federal gross estate under either or both of IRC. Secs. 2036(a)(2) and 2038(a). Any power the grantor possesses over the identity or succession of other trustees should be limited so as not to cause the powers held by the other trustees to be imputed to the grantor.[140] With the limitations described in this paragraph, the IDIT's establishment of a CRT should be without gift or estate tax consequences to the grantor.

The IDIT is includable in a beneficiary's estate only if the beneficiary possesses a general power of appointment over its assets. Assuming the provisions governing the IDIT were drafted to avoid IRC. Sec. 2041, it is difficult to see how the exercise of a power expressly granted by the governing instrument authorizing an independent trustee to establish a CRT has any gift or estate tax impact upon a beneficiary.

The question is closer if a beneficiary is a trustee who participates in the decision to establish the CRT. That situation might be analogized to a beneficiary of a trust who possesses an inter vivos limited power to appoint trust assets to others. In such an instance, the beneficiary's exercise of the power can have gift tax consequences to the beneficiary even though the trust itself is not includable in the beneficiary's federal gross estate.

A beneficiary may possess an inter vivos limited power of appointment over a trust from which the beneficiary is to receive all net income for life. If the trust is not includable in the beneficiary's federal gross estate, the beneficiary's exercise of the power does not constitute a gift of trust principal. The beneficiary does, however, make a gift of the income interest in the appointed assets.[141]

A beneficiary may be eligible to receive distributions of income and principal from a trust for the beneficiary's health, support or maintenance, or in the absolute discretion of an independent trustee. If the beneficiary also has an inter vivos power to appoint the assets of the trust to others, it appears to be the IRS's position that the beneficiary's exercise of such a power also constitutes a gift. In such a case, ascertaining the amount of the gift depends upon being able to determine what the beneficiary gives up by exercising the power.[142] That determination involves a great deal of speculation, especially when the trust

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[139] *Estate of Budd v. Commissioner*, 49 T.C.M. 468 (1968); *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967) *acq.* 1973-2 C.B. 3; *U.S. v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of Kasch v. Commissioner*, 30 T.C. 102 (1958), *acq*. 1958-2 C.B. 6; *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); Rev. Rul. 73-143, 1973-1 C.B. 407.

[140] See Rev. Rul. 95-58, 1995-2 C.B.191.

[141] Treas. Reg. Sec. 25.2514-1(b)(2); *Estate of Regester v. Commissioner*, 83 T.C.1 (1984).

[142] Ltr. Ruls. 8535020 and 9451049.

has an independent trustee not governed by an ascertainable standard. Even with an ascertainable standard, a beneficiary's exercise of the power likely has no gift tax consequences to the beneficiary unless it can be demonstrated that the beneficiary will receive less from the trust in the future as a result of such exercise.

The IRS's analysis in Ltr. Rul. 201831009 is to be contrasted with that in Ltr. Ruls. 201713002 and 201713003. In both of the 2017 Rulings, the IRS emphasized the necessity of maintaining records to prove that no charitable deduction is claimed with respect to the CRUTs. The IRS stated that in the absence of proof, it would be assumed that a charitable deduction was, in fact, allowed. In Ltr. Rul. 201831009, there was no discussion of recordkeeping. The IRS held that IRC. Sec. 4947(a)(2) was not applicable solely by examining the governing instrument. Under the assumption that the directives of the decedent's revocable trust in Ltr. Rul. 201831009 would be followed, the IRS determined that IRC. Sec. 4947(a)(2) did not apply as a matter of law.

In January of this year, the IRS announced that it would no longer issue private rulings on the applicability of IRC. Sec. 4947(a)(2) when it is represented that a CRT does not have any amounts for which a charitable deduction was allowed under the sections listed in that statute.[143] In informal discussions, IRS personnel involved with the decision to place the application of IRC. Sec. 4947(a)(ii) on the no-ruling list indicated that the question of adequate recordkeeping was a consideration in the ultimate decision. It is clearly preferable to follow the example set by Ltr. Rul. 201831009 and create a situation in which IRC. Sec. 4947(a)(2) can be determined to be inapplicable as a matter of law. Giving the trustee of a CRT the power to select charitable beneficiaries qualifying under IRC. Sec. 170(c), without requiring qualification under IRC. Sec. 2055(a) or 2522(a), should produce that result. The same should also be true with including an express power in an irrevocable trust which authorizes an independent trustee to establish and fund a CRT.

VIII. Comparison of Results Produced by Different types of CRUTs.

Table IV is a comparative analysis of different types of CRUTs under assumed facts. Each of Trusts 1 – 5 is established on January 1 of a given year with $10 million and has a term of 20 years. The unitrust percentage is 11%. The valuation date is January 1 of each year and the unitrust payment for any year is due on December 31 of that year. The IRC Sec.7520 rate is 2%.[144]

Trusts 1 – 4 are established by an individual grantor. Trust 1 is a standard CRUT. Trust 2 is a standard NIMCRUT. Trust 3 is a FLIP-NIMCRUT making use of an AIM LLC. It flips in year 15. Trust 4 is a FLIP-NIMCRUT making use of a C Corp Blocker which is owned by an AIM LLC. It also flips in year 15. Trust 5 is identical to Trust 4, except that it is established by an IDIT which has been established by an individual who is its owner under the grantor trust income tax rules.

Trust 3, 4 and 5 each establish an AIM LLC. The AIM LLC owned by each of Trust 4 and 5 forms a C Corp Blocker with 50% of its assets. All assets of the C Corp Blocker are invested in alternative investments generating UBTI. Those assets appreciate at rate of 13% per annum and generate interest at a rate of 1% per annum. The C Corp Blocker's income is subject to a tax of 21%.

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[143] Rev. Proc. 2020-3, 2020-1 I. R. B. 131, Secs. .01(125) and 4.01(62).

[144] At an assumed 2% IRC Sec. 7520 rate, an 11% unitrust percentage produces a remainder interest equal to 10.207% of the assets contributed to the CRUT. At an assumed IRC Sec. 7520 rate of 0.6%, a unitrust percentage of 10.919% produces a remainder interest equal to 10.049%. At an assumed IRC Sec. 7520 rate of 5%, a unitrust payment of 10.919% produces a remainder of 11.124%. The 2% IRC Sec. 7520 rate assumed in Table IV is representative of results produced by a wide range of possible IRC Sec. 7520 rates.

The remaining 50% of the assets held by the AIM LLC in each of Trust 4 and 5 not contributed to the C Corp Blocker is invested in marketable securities which do not generate UBTI. These investments appreciate at a rate of 8% per annum and generate interest at a rate of 1% per annum.

The assets originally contributed to each of Trusts 1 – 5 have an income tax basis of $5 million. These assets are sold at the end of year 5.

Dividends from either of the C Corp Blockers are accumulated in the AIM LLC which owns such Blocker and are paid to Trust 4 or Trust 5 in years 10-15, 1/5th in year 10, 1/4th in year 11, etc. All distributions by an AIM LLC to any of Trusts 3 – 5 are accounting income. Investments in an AIM LLC appreciate at 8% per annum and generate interest at a rate of 1% per annum.

A C Corp Blocker remains invested through year 10. After the C Corp Blocker is dissolved and its assets are distributed to an AIM LLC, those assets are invested in marketable securities which appreciate at a rate of 8% per annum and generate interest at a rate of 1% per annum.

The non-charitable recipient of payments from any of Trusts 1 – 4 invests the after-tax amounts which such recipient receives in assets producing an 8% rate of appreciation and interest at a rate of 1% per annum. The non-charitable recipient sells appreciated investments at a rate of 25% per year (the "Capital Gain Churn Rate"). The non-charitable recipient pays a federal income tax on dividends and capital gains at 23.8%, the 20% standard rate plus the 3.8% Medicare tax. Interest is assumed to be taxed at a rate of 40.8%, the maximum federal income tax rate of 37% plus the 3.8% Medicare tax. The IDIT receiving distributions from Trust 5 pays no income tax, as all tax on its income is paid by its grantor. The individual in each of Trusts 1 – 5 dies in year 20. An estate tax is paid at a rate of 40% on the net value held by Trusts 1 – 4 as of the grantor's date of death. The assets of Trust 5 are not included in its federal gross estate of the IDIT's grantor.

An observation to be made about Table IV is that all of Trusts 1 – 5 are CRUTs and not CRATs. At an IRC Sec. 7520 rate of 2%, an 11% CRAT for 20 years does not satisfy the 10% remainder interest requirement. The maximum term for an 11% CRAT at a 2% IRC Sec. 7520 rate is 9 years, resulting in a remainder interest of 10.216%. CRATs simply do not present the planning possibilities that exist with CRUTs.

The difference in the amounts shown held by the non-charitable beneficiaries and charitable beneficiaries of Trusts 1 – 3 at the end of the 20-year term deserves comment. One of the supposed benefits of the NIMCRUT is the ability to postpone distribution to the non-charitable beneficiary and invest funds which would be used to pay income taxes if distributed. Deferral of the payment of taxes is generally to be recommended, but the results of Trusts 1 – 3 show that this is not a universal rule. By virtue of being NIMCRUTs, Trusts 2 – 5 are limited to the 1% of earned income as the amount which can be distributed to the non-charitable beneficiary during the first 5 years. The accumulated deficit, i.e., the amount which may be made up for distribution to the non-charitable beneficiary in future years, increases substantially during the 5-year period. During that period, Trust 1 is making distribution of the 11% unitrust amount to its non-charitable beneficiary. In addition, for each year during the 20-year term, each of Trusts 1 – 3 have a total return of 9%, while the unitrust percentage is 11%. In no year does either Trust 2 or Trust 3 produce a return equal to that percentage.

Trust 1 pays its 11% unitrust amount every year irrespective of its income. The benefits of tax deferral and tax-free accumulation are not sufficient to overcome the advantage Trust 1 has in not being limited to annual distributions of income. Any trust assets not distributed to the non-charitable beneficiary ultimately pass to charity. This explains why the amount held by charity in the case of Trust 2 ($10,000,000) is substantially greater than the amount held by charity in the case of Trust 1 ($6,676,080). This result is ameliorated somewhat in the case of Trust 3 because of the flip in year 15. For the last five years, the non-charitable beneficiary of Trust 3 receives distribution of the 11% unitrust amount irrespective of the income earned by Trust 3.

This situation changes with Trust 4, which pursues a more aggressive investment strategy because of the existence of the C Corp Blocker. The total return on the value of the assets of the C Corp Blocker is 14% per annum. In Trust 4, this additional return produces more for both the non-charitable beneficiary and the charitable beneficiary than is produced by any of Trusts 1 – 3.

The results produced by Trust 5 illustrate the power of the individual grantor's continued payment of taxes on the income earned by an IDIT, combined with the avoidance of estate tax. The payments of income tax reduce the value of the grantor's estate for federal estate tax purposes while maintaining the value of the IDIT. In spite of the benefit the grantor's payment of those taxes confers upon the beneficiaries of the IDIT, the IRS held in Rev. Rul. 2004-64[145] that such payment is not a transfer subject to gift tax. A cost of producing this result is the inability to claim a $1 million gift tax charitable deduction upon the establishment of Trust 5 which would have been allowable if the grantor of the IDIT and not the IDIT itself had formed the NIMCRUT. With the results produced by Trust 5, this seems a small price to pay. Note that because of the IDIT's grantor trust status, the grantor can claim an income tax charitable deduction for the remainder interest in Trust 5.

IX. Conclusion.

A CRUT (as opposed to a CRAT) permits the benefits of tax deferral and positive investment returns to be shared by the charitable and non-charitable beneficiaries. This can especially be true in the case of a NIMCRUT (with or without FLIP provisions), which can be utilized to provide for the accumulation of investment returns in a tax-free environment over extended periods of time.

Maximizing the total wealth transferred to non-charitable and charitable beneficiaries requires a sophisticated, strategic and innovative wealth structuring approach. That approach should integrate the assets to be contributed (e.g., marketable or non-marketable, low or high basis, secured or unsecured) with the terms of the underlying CRUT document (e.g., duration of CRUT, distribution percentage, type of charitable beneficiary, NIMCRUT with our without a FLIP provisions), and optimization of the risk-reward profile of a CRUT's resulting managed investment portfolio. With a carefully considered structure and coordination of that structure with the investment strategy to be followed, a CRUT can produce rewards for both its charitable and non-charitable beneficiaries. A CRUT established by an IDIT can be particularly rewarding.

[145] 2004-2 C.B. 7.

TABLE IV

Strategic Charitable Planning Scenario Analysis

Key Assumptions

Contributed Asset

Marketable Securities	yes
Non-Marketable (Private Equity)	no
Fair Market Value	$10,000,000
Contribution Value	$10,000,000
Basis	$5,000,000

CRUT/NIMCRUT Terms

Stated Percentage Payout (Optimized)	11%
Term of Years	20
7520 Rate	2%
Charitable Income Tax Deduction	$1,000,000

Miscellaneous Assumptions

Contributed Asset is Sold at End of Year 5
AIM LLC Planning Distributions Occur Years 10-15
C Corp Blocker Remains Invested Through Year 10
C Corp Blocker Planning Utilizes Investment Portfolio A
CRUT-NIMCRUT-AIM LLC Planning Utilizes Investment Portfolio B

CRUT Investment Portfolio (A)

C-Corp Blocker (Alt. Investments)	***50% Allocation***
Annual Capital Appreciation	13%
Annual Yield	1%
Tax Drug – Flat Tax	21%
Marketable Securities	***50% Allocation***
Annual Capital Appreciation	8%
Annual Yield	1%
Tax Drag - Flat Tax	0^
Cap Gain Churn Rate	***n/a***
Cap Gain/Dividend Tax Rate	***n/a***
Other Tax Rate	***n/a***

CRUT Investment Portfolio (B)

C-Corp Blocker (Alt. Investments)	***0% Allocation***
Annual Capital Appreciation	13%
Annual Yield	1%
Tax Drag - Flat Tax	
Marketable Securities	***100% Allocation***
Annual Capital Appreciation	8%
Annual Yield	1%
Tax Drag - Flat Tax	0%
Cap Gain Churn Rate	***n/a***
Cap Gain/Dividend Tax Rate	***n/a***
Other Tax Rate	***n/a***

Non-Charitable Bene Investment Portfolio (C)

C-Corp Blocker (Alt. Investments)	***0% Allocation***
Annual Capital Appreciation	13%
Annual Yield	1%
Tax Drag - Flat Tax	
Marketable Securities	***100% Allocation***
Annual Capital Appreciation	8%
Annual Yield	1%
Tax Drag - Flat Tax	0%
Cap Gain Churn Rate	***25%***
Cap Gain/Dividend Tax Rate	***23.8%***
Other Tax Rate	***40.8%***

Strategic Charitable Scenarios

CRUT Structure		**Non-Charitable Bene's Ending Portfolio Value**	**Estate Tax**	**Ending Value Transfer to Charity**	**Total Wealth Transferred**
Standard CRUT	**- Trust 1**	$33,238,481	($13,295,393)	$6,676,080	$26,619,169
Standard NIMCRUT	**- Trust 2**	$32,180,501	($12,872,200)	$10,000,000	$29,308,300
NIMCRUT with AIM LLC & Flip in Year 15	**- Trust 3**	$33,950,550	($13,580,220)	$9,039,208	$29,409,538
NIMRUT with AIM LLC & C Corp Blocker & Flip in Year 15	**- Trust 4**	$39,940,756	($15,976,302)	$8,993,090	$32,957,543
NIMCRUT with AIM LLC & C Corp Blocker & Flip in Year 15 with IDIT as Grantor	**- Trust 5**	$55,387,160	$0	$8,993,090	$64,380,699