Charitable Remainder Trust Pitfalls

Help your clients make significant gifts, provide life income for themselves and save taxes

Advice to Indiana Jones from the Knight of the Holy Grail: “But choose wisely for while the true Grail will bring you life, the false Grail will take it from you.”

Another knight, the Knight of the Tax Table, tells us that doing a charitable remainder trust (CRT) the right way enables your clients to make significant charitable gifts, provide life income for themselves (and others) and save taxes. Doing it the wrong way will take away income, gift and estate tax charitable deductions. And, once you encounter the ire of the Internal Revenue Service, your clients can also lose marital deductions and have to pay otherwise avoidable capital gains taxes.

Here are some common and not-so-common pitfalls. If you’re already fallen in, see “Patching Up Mucked Up Charitable Remainder Trusts,” by Conrad Teitell, Patricia Beauregard and Stefania Bartlett. For a list of items to check for before the client signs a CRT, see “Charitable Remainder Trust (CRT) Pitfallscope,” p. 27.

In Estate of Atkinson v. Commissioner, one donor’s estate lost the charitable deduction costing over $2 million in estate taxes even though her charitable remainder annuity trust (CRAT) had all the governing instrument provisions required by the Internal Revenue Code, Treasury regulations, revenue rulings and revenue procedures. And, it was a long way to certiorari. The IRS, Tax Court and a U.S. Circuit Court of Appeals denied the donor’s charitable deduction. Ultimately, the Supreme Court denied certiorari.

Choosing the Trustee

Depending on a CRT’s terms and assets, an independent trustee may be required. If so, note that:

• A CRT permitting payments to be sprinkled among the beneficiaries can’t have the donor as its trustee. If the donor is the trustee, he’ll be deemed an “owner,” and the trust will be disqualified.

• A charitable remainder unitrust (CRUT) has to be valued at least annually. An independent trustee, not the donor, must make that valuation if the trust has unmarketable assets. There are two exceptions: (1) a donor can be a trustee, but the CRUT must have an independent trustee to value unmarketable assets each year, the donor may act as the trustee, but must obtain a qualified appraisal (QA) for the valuations. (For definitions of the terms involved in this exception, see “Key Exception Terms,” p. 28.)

Take QA Requirements Seriously

At stake in a Tax Court case was the charitable deduction for the remainder interest of a CRUT funded with real estate worth multi-millions. Determining the trust’s annual value was immaterial in this case because the IRS disallowed the entire claimed charitable deduction, and the Tax Court affirmed. The donor prepared his own income tax return that reported the transfers of real estate to his CRUT. He attached a statement titled “Appraised Market Values” on which he explained the market values and signed it as “Real Estate
Broker/Appraiser.” At the Tax Court trial, he testified that he claimed a lower value on the Form 8283 because he didn’t want to risk “overvaluing the property.” The taxpayer valued the overall properties at $18,526,449.62, and an independent appraiser determined the values were $20,227,246. In fact, the properties sold while the case was ongoing for approximately $23 million. The claimed charitable deductions were approximately $4.5 million due to the applicable adjusted gross income limitation. The IRS successfully argued that the entire charitable deduction be disallowed because the appraisal wasn’t a QA. While the taxpayer argued that substantial compliance should save part of his deduction, the Tax Court held that the doctrine is inapplicable when the taxpayer fails to meet an “essential requirement” of the statute. The court acknowledged that the property was probably more valuable than the value claimed by the taxpayer, but said:

We recognize that this result is harsh—a complete denial of charitable deductions to a couple that did not overvalue, and may well have undervalued, their contributions—all reported on forms that even to the Court’s eyes seemed likely to mislead someone who didn’t read the instructions. But the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deduction, and we cannot in a single sympathetic case undermine those rules.10

Get a waiver of the spousal right of election against a CRT before creating it to prevent the possibility of a retroactive CRT disqualification if the spouse should exercise the election.
further notice, a spousal waiver of a right of election is no longer needed for CRUTs and CRATs. Thus, the IRS extended the June 28, 2005 grandfathered date indefinitely. Accordingly, the IRS will disregard a spouse’s right of election even without a waiver, but only if the surviving spouse doesn’t exercise that right. Despite the IRS’ being ambivalent on a waiver, your client shouldn’t be. Get a waiver of the spousal right of election against a CRT before creating it to prevent the possibility of a retroactive CRT disqualification if the spouse should exercise the election. The waiver of the spousal election raises ethical issues for the estate-planning attorney. If he represents both spouses, can he prepare the waiver? Is it a conflict? Should separate counsel represent each spouse?

Divorce CRT Style

The IRS ruled favorably on the following situation, but with a caveat: A husband and wife had created a 10 percent net-income-with-makeup charitable remainder unitrust (NIMCRUT) with “various property,” including shares of Glutton Industries (not its real name). A NIMCRUT is a unitrust that pays the trust’s income if the income is less than the stated percentage multiplied by the trust’s net fair market value. The deficiencies will be paid in later years when net income exceeds the percentage. Their trust called for payments to the husband and wife jointly and then to the survivor for life, with remainder to named charities (and any additional or replacement charities). Although they shared so much—even unitrust amounts—they landed in divorce court, where the judge ordered them to petition another court to divide their NIMCRUT into two separate trusts with the husband as sole trustee of the separate trust for his benefit and the wife as sole trustee of the separate trust for her benefit. The court then ordered this division of

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Key Exception Terms

Here are four definitions to know if you want the donor to act as a trustee of the charitable remainder unitrust

Qualified appraisal. A qualified appraisal must include:
• the donor’s name and social security number;
• a description of the property;
• a brief summary of the overall condition of the property;
• the manner and date of the donor’s acquisition of the property;
• the cost or other basis;
• the name, address and employer identification number (EIN) for the donee;
• the date the donee received the property;
• a statement about whether the contribution was made by a bargain sale;
• the name, address and EIN of the qualified appraiser;
• the appraised fair market value;
• a declaration by the appraiser of his qualifications to appraise the subject property; and
• a statement by the appraiser that the fee for such appraisal isn’t a prohibited fee, and such appraiser isn’t barred from presenting an appraisal to the Internal Revenue Service.

Qualified appraiser. This is a person:
• who holds himself out to the public as an appraiser;
• qualified to appraise the subject item; and
• who’s not the donor claiming the deduction, the donee of the gift or a party to the transaction in which the donor acquired the property unless the transaction was within two months of the subject transaction, and the appraised value doesn’t exceed the purchase price.

Unmarketable assets. Any assets that aren’t cash, cash equivalents or other assets that can be readily sold or exchanged for cash or cash equivalents.

Independent trustee. A person who isn’t the grantor, a noncharitable beneficiary or related or subordinate to the grantor, the grantor’s spouse or a noncharitable beneficiary.

Endnotes
1. Treasury Regulations Section 1.170A-13(c)(4)(i).
2. Treas. Regs. Section 1.170A-13(c)(5).

— Conrad Teitell, Heather J. Rhoades & Daniel P. Fitzgerald
of the NIMCRUT's assets between the two new separate trusts: Glutton Industries stock was divided equally between the two new trusts; the remaining assets were divided unequally (the ruling is silent on the percentages) and added to the two new trusts. The ex-husband and ex-wife were named successor beneficiaries and successor trustees in each other's separate trust. They represented to the IRS that the initial trust—as modified by the court—met all the requirements of IRC Section 664 and that all the provisions of the two new separate trusts were identical to those of the initial trust (as modified by the court order). The IRS ruled that the division of the initial trust into two separate trusts won't cause the initial trust or the two new trusts to fail to qualify as CRTs under IRC Section 664.13 However, the IRS hinted that by expressing no opinion about the tax consequences under IRC Sections 61, 170, 1001 and 1041, there may be other implications. So, be careful before you put a CRT asunder.

Avoid Multiple Donors
Differentiate between the number of permissible income beneficiaries and the number of permissible donors. CRUTs and CRATs can have a number of beneficiaries, as long as the 5 percent minimum payout, 50 percent maximum payout and 10 percent minimum remainder interest (MRI) requirements are met. And, CRATs must also meet a 5 percent probability test. (More about this later.) For example, a 5 percent CRUT that benefits seven 98 year olds for life would be qualified. But, when it comes to the number of donors, you can't have more than one unless they're spouses.14

Death Tax Governing Instrument
Starting Oct. 4, 1982, to obtain income and gift tax charitable deductions for remainder interests in inter vivos unitrusts (and annuity trusts), the governing instrument must provide that a survivor beneficiary's life interest will become effective on the donor's death only if the survivor furnishes funds for payment of any federal estate taxes or state death taxes for which the trust may be liable on the donor's death.15

A donor can ensure the income and gift tax charitable deductions with a death tax governing instrument provision. And, he can ensure that the survivor beneficiary needn't pay any federal estate or state death taxes (as a condition of receiving the survivorship interest) by providing in his will (or otherwise) for the payment of any taxes attributable to the survivor's interest in the trust.

What's troubling the IRS? It's concerned that a donor will receive income and gift tax charitable deductions for the value of a charitable remainder interest based on the value of the assets transferred to a trust, but that the charitable remainderman won't eventually receive all of the trust assets. This outcome can happen if the trust principal is reduced by payment of federal estate and state death taxes imposed on a survivor beneficiary's interest.

CRAT's 5 Percent Probability Test
In addition to meeting the 10 percent MRI requirement, a CRAT must also pass a 5 percent probability test: the possibility that the charitable transfer won't become effective must be so remote as to be negligible. If there's more than a 5 percent probability that the non-charitable income beneficiary (or beneficiaries) will survive the exhaustion of the trust assets, that probability isn't so remote as to be negligible.16

Caution: It's possible to pass the 10 percent MRI requirement by a mile and nevertheless flunk the 5 percent probability test.

In Revenue Ruling 77-34, the Tax Court upheld the 5 percent probability test but did so in a way that shouldn't be relied on as a precedent.17 The court held that the test could also be satisfied as long as the trust's annual earnings can be reasonably anticipated to exceed the required annual payout to the beneficiary. The court said—by way of dicta—that in any event, the 5 percent used by the IRS was too low. The Tax Court also said, by way of dicta, that Treasury tables may be disregarded if the tables' application is shown to be unreasonable or inappropriate.

Don't rely on this Tax Court Memorandum decision. Be sure to pass both the 10 percent MRI requirement and the 5 percent probability test.

Caution: If the trust fails the 5 percent probability test, it isn't a CRAT for any purpose.18
Latest development. The IRS in its most recent to-do list (Priority Guidance Plan for the period July 1, 2015 to June 30, 2016) has added “Guidance on qualified contingencies of charitable remainder annuity trusts under IRC §664.” We understand that this means that the IRS will be reviewing the 5 percent probability test of Rev. Rul. 77-374 and could provide a different method for determining whether a CRAT is likely to run dry. Remember, items have been on IRS’ Priority Guidance Plans for years. So, don’t hang by your thumbs waiting for a new rule.

Ten Percent MRI Requirement
Donors who create CRTs and charitable gift annuities (CGAs) are allowed charitable deductions (income, gift and estate) for the value of the charity’s interest computed using Treasury tables. The tables’ interest assumption is pegged to the federal midterm interest rate, based on the average market yield of U.S. obligations. Each month, Treasury announces an applicable federal rate (AFR). The interest rate for computing charitable remainder gifts and CGAs—a figure we call the charitable midterm federal rate (CMFR)—is 120 percent of the annually compounded AFR for midterm obligations, rounded off to the nearest 0.2 percent.

For gifts that have no charitable component—for example, giving a child a remainder interest in a house—the donor uses the AFR for the month of the transfer. However, donors whose gifts are partially charitable—for example, CRTs, CGAs—can use the CMFR for the month of the gift or can elect to use the CMFR from either of the two previous months in computing the value of the charitable contribution. The two month “look back” can actually give a donor four months to choose from because the IRS publishes the CMFR ahead of time—generally on the 21st day of the previous month. So if it’s beneficial, he can wait and make his gift in the following month.

With a low CMFR, it’s easy for CRATs to flunk the 10 percent MRI requirement. Ditto for the 5 percent probability test governing CRATs. It’s also easy for CGAs to flunk the requirement that the gift portion be more than 10 percent. Although CRUTs are affected by swings in the CMFR, for reasons known to the actuaries, the effect is much less significant.

A recent case dealt with this situation. An elderly donor created two NIMCRUTs, paying himself income for life. One son was the survivor beneficiary of one of the trusts; another son was the survivor beneficiary of the second trust. At the donor’s death, both trusts failed the 10 percent MRI requirement. The Tax Court agreed with the IRS that the estate had to use the tables just described and rejected the estate’s contention that the remainder could be valued on the basis of the trust being a NIMCRUT and not a standard charitable remainder unitrust (Stan CRUT). A Stan CRUT is a standard fixed percentage CRUT. The estate maintained that method would pass the 10 percent MRI requirement. Apparently, the CRT flunked the 10 percent MRI requirement when it was created during the donor’s lifetime.

Flunking the various requirements described means loss of income, gift and estate tax charitable deductions—and the CRTs not being qualified. And if a spouse is involved, the marital deduction will also be lost. For CGAs, if the gift portion doesn’t exceed 10 percent, the charities will be taxed under IRC Section 514(c)(5) and 501(m). Not a good thing.

IRC Section 7520 says you can use either of the two preceding months for computing any income, estate or gift tax charitable deduction. It doesn’t say you can use either of those two months for determining whether the 10 percent MRI requirement is met. Yet, IRC Section 664(d)(1)(D) and IRC Section 664(d)(2)(D) say the values for meeting the 10 percent MRI requirement shall be “determined under section 7520,” and those IRC sections don’t carve out the “either-of-the-two-preceding months” election. IRC Section 664(d)(2)(D) provides:

... with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust. [emphasis added.]

A splendid argument can be made that for purposes...
of meeting the 10 percent MRI requirement, the remainder can be valued using the CMFR for either of the two preceding months or the month of the transfer. But, do you want to have to make that argument to the IRS or to a court? So, before using the two month look back, make sure that the 10 percent tests are met for the month of transfer.

Accomplishing a Client’s Goals
Would you say that a lawyer who knowingly drafts a testamentary CRT that might fail the 10 percent MRI requirement is a good or a bad lawyer? And, suppose the governing instrument also provides that if the trust doesn’t satisfy any MRI requirement, it shouldn’t be amended to comply?

The answer depends on the client’s wishes. Leona Helmsley had a brilliant lawyer. She wanted the trusts for her grandkids to be created and not amended even if they weren’t qualified. The estate tax charitable deduction was secondary. We always want our clients to accomplish their objectives and save taxes and other costs. But, don’t let tax and other savings wag your client’s goals.

The testamentary CRT in Leona Helmsley’s will provided:

I direct that even if the value of the charitable remainder interest is less than the minimum amount which is required for a trust to qualify as a charitable remainder trust (such minimum is currently ten percent), I nevertheless direct that the unitrust amount of five percent not be changed, even if it means the trust would therefore not qualify as a charitable remainder trust.20

We suggest that the draftsman of this type of provision write a letter to the client—and have it signed by him—before the will is executed explaining the consequences. Writing this letter should assure the client’s wishes and discourage another lawyer seeking reformation of the CRT based on scrivener’s error. And, the drafting lawyer won’t have to worry about his malpractice coverage.

P.S. As it turned out, Leona’s CRTs passed the 10 percent MRI with flying colors.

But, the grandsons can blow their CRTs if they disobey Grandma Leona’s requirements:

Notwithstanding any provision of this Will to the contrary, my grandchildren DAVID PANZIRER and WALTER PANZIRER shall not be entitled to any distributions from any trust established for such beneficiary’s benefit under this Will unless such beneficiary visits the grave of my late son, JAY PANZIRER, at least once each calendar year, preferably on the anniversary of my said son’s death (March 31, 1982) (except that this provision shall not apply during any period that the beneficiary is unable to comply therewith by reason of physical or mental disability as determined by my Trustees in their sole and absolute discretion). If DAVID or WALTER fails to visit the grave during any calendar year, . . . his interest in the separate trust established for . . . his benefit shall be terminated at the end of such calendar year and the principal of such trust, together with all accrued and undistributed net income, shall be disposed of as if such beneficiary had then died.21

Does this provision disqualify the CRUTs? No, it’s a qualified contingency—authorized by IRC Section 664(f). Simply put, a qualified contingency is one that provides on the happening of the contingency the payments to the beneficiary will terminate not later than the payments would otherwise terminate.

Qualified contingency planning pointer. For CRTs, “[I]f an individual receives an amount for life, it must be solely for his life.”22 Suppose a son wants to create a CRT to pay the income to his mother for the period of the son’s life. The regulations disqualify this trust.

Here’s the end run to accomplish the son’s objective: “Pay the CRUT (or CRAT) amount to my mother for her life; however this trust shall terminate upon my death if I predecease her.” That momma, is a qualified contingency! (The income tax charitable deduction will, however, be based on the son’s life, not momma’s.)

Trust Must Operate as CRAT
Consider Melvin Atkinson’s case. About two years before her death at age 97, she funded a 5 percent CRAT with almost $4 million to make annuity payments to her for life. On her death, the annuity amount was to be paid equally to four secondary beneficiaries with an eventual remainder to charities. The CRAT didn’t make any payments to the donor during her lifetime, missing seven quarterly payments totaling just under $350,000.
Late Payments

Atkinson could spell trouble for CRTs with only minor infractions. The estate tax deduction in Atkinson was lost because the trust failed to operate as a CRAT. It didn’t make the required payments to the first beneficiary. It didn’t miss just one quarterly payment, but seven of them. But, suppose payments are being made and then only one of them—for a good reason or through carelessness—is just a little bit late. It’s not a big leap for the IRS (and a court) to say that a late payment is just as bad as a payment that isn’t made at all.

Treasury regulations say that a CRUT or CRAT that makes late payments will be deemed “to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution . . . [and] have failed to function exclusively as a charitable remainder trust . . . .”24

Lesson. It’s important that the lawyer spell out in writing to the trustee the valuation rules, the

The CRAT’s governing instrument required that the secondary beneficiaries pay their share of any death taxes on their life interests as a condition of receiving their annuities. The trustee informed them of their rights to annuities and the condition.

Only one beneficiary—May Birchfield, the housekeeper—elected to take her share. She told the trustee that Melvine had said that May wouldn’t be liable for her share of death taxes and that she had a notarized document from Melvine to that effect. “After increasingly hostile exchanges” (the Tax Court’s characterization), the trustee decided that it would be in the CRAT’s best interest to settle May’s claim. So, it set aside the amounts that would be due for her annuity payments. On getting a probate judge’s order, the trustee paid her $667,000. Then four additional payments were made to May. But, she paid no federal estate or state death taxes on the amounts she received.

The donor’s estate had insufficient assets to pay the estate taxes attributable to May’s interest, estate administration expenses and donor’s debts. So, the CRAT had to pay the shortfall.

The IRS disallowed the estate tax charitable deduction. Although the CRAT was properly drawn, it didn’t function as a remainder annuity trust: (1) the trust didn’t pay the required annuity amounts to the donor during her life; and (2) the trustee ostensibly agreed to pay money towards the tax liability on the funds distributed to May under the settlement.

The Tax Court upheld the $2,654,976 tax deficiency that the IRS imposed. The CRAT failed to function exclusively as a CRT from its creation. Thus, it was invalid and got no estate tax charitable deduction for the remainder interest. The court reasoned that a CRAT must make fixed annuity payments to a named non-charity beneficiary each year. Though the terms of the annuity trust met the letter of the statutory requirement providing for distributions equal to 5 percent annually, the trust didn’t operate in accordance with those terms.

The U.S. Court of Appeals for the Eleventh Circuit affirmed the Tax Court, and in a footnote said this about a beneficiary’s non-payment of death tax:

. . . since we decide that the trust was not a CRAT because of its failure to pay Atkinson a lifetime annuity, we do not reach the issue of whether the trust additionally failed due to its exposure to estate tax liability.23

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importance of making payments on time and the federal (and any state) tax returns that must be filed. In Atkinson, it wasn’t the donor’s fault that her trustee didn’t make seven quarterly payments. As a result, the charitable remainder organizations (CROs) suffered by the loss of the estate tax charitable deduction and the costly legal fees for litigation in the Tax Court, a U.S. Circuit Court of Appeals and the unsuccessful petition to the Supreme Court for certiorari. The taxes and the legal fees came out of the CRAT and thus reduced the charities’ remainder interests.

Flexibility for Known Unknowns
Former Secretary of Defense, Donald Rumsfeld said:

There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know that there are some things we do not know. But there are also unknown unknowns—the ones we don’t know we don’t know.25

We’ve told you about many—but not all—of the known pitfalls.

In planning CRTs, build in flexibility for known unknowns. Right now, the donor wants his private foundation to be the CRO. But, it’s unknown whether he may later want to terminate the trust and divide the assets with the charity. However, it’s a prohibited act of self-dealing if a private foundation is the CRO.26 You can provide for this known unknown by giving the donor the right to change the CRO to a public charity. And, that public charity can be a donor advised fund that gives the donor and family a voice in how the CRO’s share of the CRT’s assets will be used. The donor and family can only give advice. But, it’s rare for legitimate recommended distributions not to be made.

As another example, right now the donor wants a NIMCRUT. But later, it may be to his advantage to have a Stan CRUT. So, make the CRT a flip CRUT. When funding the trust, add an unmarketable asset of minor value. Provide that on the sale of that asset, the trust becomes a Stan CRUT on the following Jan. 1. You’ve kept an option open: stand pat or flip.

Endnotes
4. Treasury Regulations Section 1.664-3(a)(2)(i)-(ii).
5. Revenue Ruling 77-73.
8. Treas. Regs. Section 1.130-3(a).
10. Ibid.
15. Rev. Rul. 82-128.
21. Ibid.
23. Atkinson, supra note 3 at p. 1293.
25. Donald Rumsfeld, United States Secretary of Defense, Department of Defense News Briefing (Feb. 12, 2002).

Serenity