



By **Conrad Teitell, Heather J. Rhoades & Margaret E. St. John**

## Termination of Charitable Remainder Trusts

“You’ve got to know when to hold ‘em, know when to fold ‘em.”

**K**enny Rogers could well have been singing about charitable remainder trusts (CRTs). Donors who create inter vivos CRTs want to: (1) provide life income for themselves (and sometimes also for a survivor); and (2) make a significant gift to charity on the CRT’s termination.

Federal tax law encourages generosity by giving itemizers an income tax charitable deduction for the value of their remainder interest. Capital gains are avoided on funding a CRT with appreciated property. Gains are taxable only to the extent that they’re deemed distributed to the life beneficiary under the 4-category taxation regime.

Almost all life beneficiaries keep their CRTs for their lifetime; they want life income. So, they hold ‘em.

But, change is inevitable (except from a vending machine). So, some CRT life beneficiaries fold ‘em and terminate their trusts early. They donate their remaining life interest to the charitable remainder organization (CRO) (the life beneficiary doesn’t need the income and wants to benefit the charity right away). Other CRTs are terminated early by dividing the trust’s assets between the life beneficiary and the CRO, based on the actuarial values of their respective interests.

How to fold ‘em, dear readers, is our topic.

### For Openers

Don’t pass “Go” before determining whether the law

permits early termination of the CRT. At common law, by unanimous consent, all the beneficiaries of an irrevocable trust could compel its termination or modification.<sup>1</sup> Several Internal Revenue Service private letter rulings allow early CRT termination. One early PLR dealt with the income beneficiaries’ assignment of their entire remaining life income interests to the CRO.<sup>2</sup> The income beneficiaries planned to petition the local court to obtain a declaratory judgment terminating the trust with the direction that the trust funds be distributed directly to the CRO.

The IRS ruled in that PLR that the assignment of the income beneficiaries’ entire income interest to the CRO and the subsequent termination of the CRT didn’t “cause the unitrust to fail retroactively as a charitable remainder trust within the meaning of section 664 of the Code.” The PLR focused on a state law that permitted assignment of the beneficiaries’ income interests.

Later PLRs dealt with early terminations of CRTs in which the trust assets were divided pro rata between the income beneficiaries and the CROs. The IRS concluded that the early terminations didn’t invalidate the trusts under Internal Revenue Code Section 664. Again, the IRS focused on a state law that allowed the assignment of an income beneficiary’s income interest.<sup>3</sup>

Most states require the consent of all the CRT’s beneficiaries to terminate the trust. Additionally, the PLRs often recite that the state attorney general approves the early termination.<sup>4</sup>

Some CRTs allow the grantor to substitute a CRO for the one named. If so, before the termination, the income beneficiary may need to prove that the named CRO hasn’t been substituted.

### Assignment to CFO

Your client might consider assigning a life income beneficiary’s entire remaining interest to a CRO.

**Why?** The income beneficiary may no longer need

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the income and want the CRO to benefit immediately. Sometimes, the CRT's value has significantly declined with the potential that continued income payments will exhaust the trust, leaving nothing for the CRO.

**The tax consequences.** When an income beneficiary assigns his entire income interest in a CRT to a CRO, the transaction is deemed a gift of a capital asset to the charity.<sup>5</sup> Itemizers are entitled to an income tax charitable deduction for the then-value of the capital asset (the income interest).

**Pointer.** All taxpayers should claim a gift tax charitable deduction.

Generally, a taxpayer can't claim a charitable deduction for a contribution of "an interest in property which consists of less than the taxpayer's entire interest in such property."<sup>6</sup> However, one PLR points out an exception under Treasury Regulations Section 1.170A-7(a)(2)(i). A deduction for a contribution of a partial interest in property is allowable when that interest consists of the taxpayer's entire interest in the property.<sup>7</sup> An income interest in a CRT falls under this exception. The IRS noted in that PLR that because the income beneficiaries donated their entire interests in the trust, they were able to claim a charitable deduction and a gift tax charitable deduction under IRC Section 2522.

**Show me the money.** Naturally, once an income beneficiary assigns his interest to the CRO, it will want all of the CRT's assets.<sup>8</sup> Enter the doctrine of merger. Generally, if a trust beneficiary is the owner of all interests in a trust (both the income and remainder interests), the trust terminates, and the beneficiary has access to the trust principal.

If the merger doctrine doesn't apply under governing state law, a court order may be required to terminate the trust. Some states may require the attorney general's involvement in a CRT's early termination, whether or not a court order is necessary.

**Consider the spendthrift rules.** A beneficiary under the trust's terms or as provided by state law (unless negated in the document) may not be able to dispose of his interest. Generally, a spendthrift provision is meant to protect the beneficiary's interest from creditors or to protect the beneficiary from using the trust assets to go off on a folly of his own. Thus, if a CRT has a spendthrift provision, an early termination may not be possible. However, if the CRT's donor is the income beneficiary, a

spendthrift provision won't bar him from assigning his income interest.<sup>9</sup>

**Caution.** The IRS is concerned about donors terminating trusts to circumvent the partial interest rules. If a donor creates a CRT for that reason, he'll be denied an income tax charitable deduction on an early termination. Whether he created the trust to avoid the partial interest rules is a question of fact. One major factor the IRS considers is the amount of time that's elapsed since the trust was created. Also, a representation that the donor no longer needs the income and that the charity can use the funds now can be helpful.

### Pro Rata Distribution

Another possibility is terminating a CRT by a pro rata distribution of the CRT assets (based on the then-value of the actuarial interests of the income beneficiary and the CRO).

**Why?** A CRT income beneficiary may want capital now (instead of income for life). And often, the charity would like trust assets now (equal to the current value of its remainder interest), instead of waiting until the life beneficiary shuffles off this mortal coil. The parties agree to terminate the trust now, and each receives a pro rata portion of the trust assets.

The IRS views this transaction as a sale of a capital asset by the life beneficiary.<sup>10</sup>

The uniform basis rules apply to the trust property, and the basis of trust property is generally determined under IRC Section 1014 or 1015. However, under an exception to the uniform basis rules, an income beneficiary's basis in his income interest trust is deemed to be zero.<sup>11</sup> Thus, the income beneficiary recognizes gain on the entire "proceeds of the sale."

The 4-category accounting regime under IRC Section 664(b) governs distributions to a life beneficiary. However, the IRS has ruled that property received on termination isn't a distribution of a unitrust amount and isn't governed by Section 664.<sup>12</sup> The values of the interests of the income beneficiary and the CRO are determined using the discount rate in effect under IRC Section 7520 on the date of termination—and using the methodology under Treas. Regs. Section 1.664-4 for valuing interests in CRTs.

The IRS has ruled that the "holding period for purposes of determining whether gain or loss from the



disposition of an income interest is long term or short term commences on the date the taxpayer first held such interest.<sup>13</sup> Thus, assuming a trust was created more than a year before its termination, the capital gains will be taxed favorably.

The self-dealing rules apply to CRTs.<sup>14</sup> Thus, a CRT shouldn't be terminated by dividing the assets between a life beneficiary and a private foundation (PF).<sup>15</sup>

**Always remember the IRS-was-not-born-yesterday rule.** When a CRT is terminated by dividing the trust assets between the life beneficiary and the charity, in computing the proportion to be distributed to the life beneficiary, his life expectancy under the Treasury tables is taken into account. Suppose his actuarial life expectancy is 20 years, but his actual life expectancy is only two years. Many PLRs that allow for the early termination of a CRT have one factor in common: the life beneficiary has submitted an affidavit from a physician and his own affidavit that there's no known condition that makes his life expectancy less than the normal expectancy for an individual of his age.<sup>16</sup>

### Valuation Method

In PLRs, the IRS has lowballed the amount to be transferred to the life income beneficiary of a net income with makeup charitable remainder unitrust (NIMCRUT) or net income charitable remainder unitrust NICRUT when the Section 7520 rate is lower than the CRT's percentage payout amount. And these days, that's always the case.<sup>17</sup> But, the IRS says that the NIMCRUT valuation method in the PLR is but one reasonable method. That doesn't preclude other reasonable methods.

Here's one method that seems reasonable to us:

How much would a willing buyer pay a willing seller—both having reasonable knowledge of relevant facts and neither being under compulsion to buy or sell—for a donor's life interest? Because the trust is to be terminated and assets equal to the life interest are to be distributed to the life beneficiary, it wouldn't make any difference to a willing buyer whether the trust is a NIMCRUT or a standard (fixed percentage) charitable remainder unitrust (Stan CRUT). A buyer wouldn't receive a NIMCRUT amount for the life of the income beneficiary. He would get the assets right away. Thus, for valuing the interest, it should make no difference

whether the terminated trust is a NIMCRUT, NICRUT or a Stan CRUT.

**Drafting pointer.** Don't draft a plain old NIMCRUT. Instead, draft the NIMCRUT with a flexible flip charitable remainder unitrust (Flip CRUT) provision. Then, if the income recipient wants to receive his share of the trust on an early termination, he pulls the trigger and voilà, on the following Jan. 1, we're dealing with a Stan CRUT. (See "Glossary," p. 60, for a description of the various CRTs.)

**Another drafting pointer.** As noted earlier, the IRS takes the position that you can't terminate a CRT and

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divide its assets between an income beneficiary and a PF remainder organization; that would be prohibited self-dealing. If a PF is the named remainder organization, keep the right in the trust instrument to substitute a public charity for the PF. Make the irrevocable substitution before terminating the trust. The public charity could be one that has a donor advised fund. That construct could give the donor advisory rights over the assets received by the public charity.

### Division (on Divorce)

*What God has joined together, let no one put asunder.* Yet, it happens. Fifty percent of all marriages end in divorce. (The other 50 percent end in death. So we ask you: Which is worse?)

When a couple splits, so can their CRTs. For example, in one case, a husband (H) and his wife (W) created a 10 percent NIMCRUT with various assets, including shares of Glutton Industries (not its real name).<sup>18</sup> Their trust called for payments to H and W jointly and then to the survivor for life, with remainder to named charities (and any additional or replacement charities).



### Glossary

Here are the definitions of some common terms in charitable planning

**Stan CRUT (standard (fixed percentage) charitable remainder unitrust)**—Pays the income beneficiary (recipient) an amount determined by multiplying a fixed percentage of the net fair market value (FMV) of the trust assets, revalued each year. On the death of a beneficiary or survivor beneficiary (or at the end of the trust term if the trust is measured by term of years—not to exceed 20 years), the charity gets the remainder. The fixed percentage can't be less than 5 percent, nor more than 50 percent, and the remainder interest must be at least 10 percent of the initial net FMV of all property placed in the trust. These percentage requirements also apply to the following types of charitable remainder trusts (CRTs).

**NIMCRUT (net income with makeup charitable remainder unitrust)**—Pays only the trust's income if the actual income is less than the stated percentage, multiplied by the trust's FMV. Deficiencies in distributions (that is, when the unitrust income is less than the stated percentage) are made up in later years if the trust income exceeds the stated percentage.

**NICRUT (net income charitable remainder unitrust)**—Pays the fixed percentage multiplied by the trust's FMV or the actual income, whichever is lower. Deficiencies aren't made up.

**Flip CRUT**—A trust set up as a NIMCRUT or NICRUT. On a qualifying triggering event specified in the trust instrument (for example, the sale of the unmarketable asset used to fund the trust) it switches (flips) to a Stan CRUT. The regulations

sometimes refer to this trust as a "combination of methods unitrust."

**Flex CRUT**—That's our name for a Flip CRUT drafted so as to give flexibility in determining when, if ever, a NIMCRUT or NICRUT will flip to a Stan CRUT. If you want a NIMCRUT or NICRUT to flip on the sale of a parcel of real estate or on a specified date or event, say so in the CRT. But, if you want maximum flexibility, specify that the trust is to flip on the sale of an unimportant unmarketable asset that's one of the assets used to fund the trust. That way, you have flexibility in determining when, if ever, a NIMCRUT or NICRUT will flip to a Stan CRUT.

**CRAT (charitable remainder annuity trust)**—Pays the income beneficiary (recipient) a fixed dollar amount (at least annually) specified in the trust instrument. On the death of the beneficiary or survivor beneficiary (or at the end of the trust term if the trust is measured by a term of years—not to exceed 20 years), the charity gets the remainder. The fixed dollar amount must be at least 5 percent but not more than 50 percent of the initial net FMV of the transferred assets, and the remainder interest must be at least 10 percent of the initial net FMV of all property placed in the trust. Additional contributions after the initial contribution may not be made to a CRAT.

**Caveat:** A CRAT must meet the "5 percent probability test" of Revenue Ruling 77-374. *But see Moor*, 43 T.C.M. 1530 (1982).

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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 H as sole trustee of the separate trust for his benefit and W as sole trustee of the separate trust for her benefit.

The court then ordered a division of the CRT'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 and added to the two new trusts. H and W were named successor beneficiaries and successor trustees in each other's separate trust.

H and W 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 any of the trusts to fail to qualify as CRTs under Section 664.<sup>19</sup>

In another PLR, H and W created a 15 percent NIMCRUT, paying them equally for their joint lives and then all to the survivor with the remainder to charity.<sup>20</sup> The spouses were co-trustees. They were divorcing and proposed to divide the trust assets equally and transfer them to two separate NIMCRUTs, with each spouse as the sole beneficiary and trustee of his or her individual

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trust. Accumulated make-up amounts and any make-up deficiencies would also be equally divided. Each spouse would be the successor beneficiary of the other's trust. Both trusts would terminate on the survivor's death.

The IRS ruled that dividing the trust into two separate trusts won't cause: (1) any of the trusts to fail to qualify as CRTs under Section 664; and (2) the original trust, the two new trusts or the trustees to realize income or gain under either IRC Section 61 or Section 1001. Further, the equitable allocation between the two new trusts of the aggregate accumulated make-up deficiency amounts won't cause forfeiture of those amounts or cause any of the trusts or the trustees to realize income or gain.

Another PLR dealt with splitting a CRT on a divorce.<sup>21</sup> H and W created a CRT, funding it with community property. The trust was to pay H and W, and the survivor of them, for life, with the remainder to several charities. H and W served as co-trustees, and they didn't have any individual control over the CRT or its assets.

As part of their divorce settlement, H and W proposed to equally divide the CRT into two separate trusts—H CRT and W CRT. Each will be the sole trustee and

income beneficiary of his or her trust, and neither will retain a survivorship interest in the other's trust. Before the split up of the marriage and the CRT, each spouse had a survivorship interest in the entire trust after the first spouse to die's death.

The parties anticipated the side effects and asked for an IRS ruling on other issues. The IRS ruled that dividing the CRT into two separate trusts wouldn't disqualify either trust under Section 664. H and W wouldn't be subject to income tax because the CRT's division is a transfer of property incident to a divorce; thus, it's a non-recognition event under IRC Section 1041. The division would also be a nontaxable property transfer incident to a divorce for gift tax purposes because it's deemed to be a transfer made for a full and adequate consideration "in money or money's worth" under IRC Section 2516.

### **Surrender of survivorship rights—deductible?**

Remember, H and W gave up their survivorship rights. Actuaries can value those rights. It seems to us that an income tax charitable deduction should be allowable. This issue wasn't raised in the PLR request.

### **Sale to Third Party**

Another possible (but highly not recommended) way to terminate a CRT early could be for both the income beneficiary and the CRO to sell their respective interests to an unrelated third party. The technique purports to allow the income beneficiary to step up the basis of his income interest and eliminate or reduce capital gain on the CRT's early termination.

The income beneficiary and CRO claim to have disposed of their interests in the trust in a transaction described in IRC Section 1001(e)(3). Thus, they maintain that the zero basis rule of Section 1001(e) is inapplicable.

The donor maintains that in calculating his gain on the sale of his life interest, the uniform basis is derived from the basis of the new assets rather than the basis of the original appreciated assets used to fund the CRT. This claim allows the donor to have a stepped-up basis without having to recognize gain.

**Notice 2008-99.** The IRS issued Notice 2008-99, deeming this type of transaction as a "transaction of interest..."<sup>22</sup> The IRS was concerned that this transaction has the potential for abuse and tax evasion by allowing the taxpayer to achieve both a stepped-up basis and little or no capital gains. The Notice required anyone entering



into this type of transaction to disclose the transaction to the IRS or face penalties.

Earlier this year, the IRS and the Treasury issued proposed regulations as a follow up to Notice 2008-99. The transactions described in Notice 2008-99 must continue to be disclosed.<sup>23</sup> Simplifying pages of the proposed regulations, the life income beneficiary on a sale to a third party must reduce his basis to zero. However, if he reported gains on the sale of the original assets under the 4-category distribution regime, he doesn't have to reduce the basis by the amount of that gain.

**The IRS' warning:** Participants who entered into these transactions at any time may already be in hot water:

Independent of their classification as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in this notice already may be subject to the requirements of §§6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have gathered enough information to make an informed decision as to whether this transaction is a tax avoidance type of transaction, the IRS and Treasury Department may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction.

**Who are participants?** The Notice says that:

Under §1.6011-4(c)(3)(i)(E), each recipient of the term interest and Trust are participants in this transaction for each year in which their respective tax returns reflect tax consequences or a tax strategy described in this notice. Charity is not a participant if it sold or otherwise disposed of its interest in Trust on or prior to October 31, 2008. For interests sold or otherwise disposed of after October 31, 2008, under §1.6011-4(c)(3)(i)(E), Charity is a participant for the first year for which Charity's tax return reflects or is required to reflect the sale or other disposition of Charity's

interest in Trust. In general, Charity is required to report the sale or other disposition of its interest in Trust on its return for the year of the sale or other disposition. See §6033 and §1.6033-2(a)(ii). Therefore, in general, Charity will be a participant for the year in which charity sells or otherwise disposes of its interest in Trust.<sup>24</sup>

**Penalties.** The book will be thrown at those who are required to disclose but don't. The Notice continues:

Persons required to disclose these transactions under §1.6011-4 who fail to do so may be subject to the penalty under §6707A. Persons required to disclose these transactions under §6111 who fail to do so may be subject to the penalty under §6707(a). Persons required to maintain lists of advisees under §6112 who fail to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under §6708(a). In addition, the IRS may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A.

Donors, lawyers and other advisors may be "material advisors" required to file a disclosure statement.

### Parthian Shot

When terminating a CRT early—or indeed in any other type of transaction—don't just look straight ahead. Always consider what's going on in the wings. Otherwise you can be blindsided. For example, "Oops, we didn't consider whether there would be a problem if the remainder organization is a PF or that the income beneficiary would get a greatly reduced amount because his CRT is a NIMCRUT."

At our firm, we try to always keep in mind this fable by Ambroce Bierce:

An Associate Justice of the Supreme Court was beside a river bank when a Traveler approached and said, "I wish to cross. Will it be lawful to use this boat?" "It will," was the reply; "it is my boat." The Traveler thanked him and, pushing the boat



into the water, embarked and rowed away. But the boat sank and he was drowned. "Heartless man!" said an Indignant Spectator. "Why did you not tell him that your boat had a hole in it?" "The matter of the boat's condition," said the great jurist, "was not brought before me."<sup>25</sup>



## Endnotes

1. *Restatement (Third) of Trusts* Section 65 (2003).
2. Private Letter Ruling 7949035 (Sept. 5, 1979). PLRs aren't authority except for the recipients.
3. PLR 200208039 (Feb. 22, 2002); PLR 200304025 (Jan. 24, 2003).
4. PLR 200127023 (July 6, 2001); PLR 200208039 (Feb. 22, 2002).
5. Revenue Ruling 72-243 (1972); PLR 7949035 (Sept. 5, 1979); PLR 200127023 (July 6, 2001).
6. 26 U.S.C.A. Section 170(f)(3)(A).
7. PLR 7949035 (Sept. 5, 1979).
8. PLR 8311063 (Dec. 14, 1982); PLR 9550026 (Dec. 15, 1995); PLR 200140027 (Oct. 5, 2001).
9. *Restatement (Third) of Trusts* Section 58 (2003).
10. Rev. Rul. 72-243, 1972-1 C.B. 233 (1972); *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *cert denied*, 330 U.S. 826 (1947).
11. 26 U.S.C.A. Section 1001(e)(1).
12. PLR 200127023 (July 6, 2001).
13. *Ibid.*
14. 26 U.S.C.A. Section 4947(a)(2); 26 U.S.C.A. Section 4941.
15. PLR 200525014 (June 24, 2005) and PLR 200614032 (April 7, 2006).
16. PLR 200208039 (Feb. 22, 2002); PLR 200552015 (Dec. 30, 2005); PLR 200543061 (Oct. 28, 2005); PLR 201325018 (June 21, 2013).
17. See PLR 201325018 (March 27, 2013) for the IRS' complicated reasoning.
18. PLR 200045038 (Nov. 9, 2000).
19. *Ibid.*
20. PLR 200035014 (Sept. 1, 2000).
21. PLR 200221042 (May 24, 2002).
22. Notice 2008-99, 2008-47 I.R.B. 1194.
23. "Basis in Interests in Tax-Exempt Trusts," 79 FR 3142-01.
24. Notice 2008-99; for the rules on the time for disclosure, see Treasury Regulations Sections 1.6011-4(e) and 301.6111-3(e).

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