TAX-SMART CHARITABLE GIVING, ESPECIALLY WITH RETIREMENT ASSETS

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I. Overview

A testamentary transfer of taxable retirement assets from a retirement account to a charitable remainder trust ("CRT") means that the retirement assets will ultimately be transferred from the CRT to a charity. But there is a time lag between the time that the CRT is funded and the charity receives the assets. And that time lag can last for more than ten years. During that time period, the full value of the retirement assets, without any diminution for income taxes, can be held by the CRT to generate income for distributions. First to individuals, and then to charities.

The advantage that a CRT offers over any other type of trust that an estate planner might draft is that a CRT is exempt from the income tax. A transfer at death from a retirement plan to a CRT is a tax-free transfer of assets from one tax-exempt trust to another tax-exempt trust.

If this is the arrangement that a retirement account owner wants, then the documents must be properly drafted or else there could be significant income tax problems. First, the owner should identify the type of CRT (CRUT ? FLIPCRUT? CRAT? etc.) and should select the various options that best meet his or her objectives. For example, should the trust exist for a term of years or for a beneficiary's life? Then the retirement account beneficiary designation forms should be drafted to name the tax-exempt CRT as the beneficiary. The CRT should be legally entitled to receive the IRD contained in the retirement account. In oversimplified terms, the objective is that when the assets are ultimately distributed from the retirement account to the CRT, the Form 1099-R should correctly report the distribution as being made to a tax-exempt CRT.

Two risks that should be avoided are: (1) that income will somehow be taxed to an estate or to a taxable trust and (2) that the trust might fail to qualify as a CRT because of a drafting error or for some other reason. This paper will identify these risks and will identify steps to successfully structure a bequest of retirement assets to a CRT without triggering adverse tax consequences.

The strategies outlined in this article focus on transferring taxable income in respect of a decedent ("IRD") to a CRT. When a retirement account has little or no IRD, such as a Roth IRA, the appeal of a CRT isn't much greater than funding a conventional testamentary CRT with conventional assets, such as stocks and bonds.

II. IRAs and Qualified Retirement Plans

A. OBJECTIVES - Keep the largest amount in an IRA or QRP, so you can earn investment income on the deferred income taxes in the account. EXAMPLE:

	Principal	**10% Yield**		**5% Yield**	
Amount in IRA	$100,000	10%	$ 10,000	5%	$ 5,000
Income Tax on Distribution (40%)	40,000				
Amount Left to Invest	$ 60,000	10%	$ 6,000	5%	$ 3,000

In order to force QRP and IRA accounts to be used to provide retirement income, Congress enacted two significant penalties. First, there is a 10% penalty tax for most distributions before age 59 ½. Section 72(t). Second, there is a 50% penalty tax imposed on the account owner for not receiving the required minimum distribution ("RMD"). § 4974; Reg. § 54.4974-2. The penalty is imposed during one's lifetime after attaining the age of 72 or retiring, whichever occurs later. The 50% penalty tax also applies after the account owner's death to beneficiaries who fail to receive the post-death minimum amounts.

B. REQUIRED LIFETIME DISTRIBUTIONS AFTER AGE 72 [previously age 70 ½]
GENERAL RULES – Unless you are married to someone who is more than ten years younger than you, there is one -- and only one -- table of numbers that tells you the portion of your IRA, 403(b) plan or qualified retirement plan that must be distributed to you each year after you attain the age of 72. The only exception to this table is if (1) you are married to a person who is more than ten years younger than you and (2) she or he is the only beneficiary on the account. In that case the required amounts are even less than the amounts shown in the table. To be exact, the required amounts are based on the joint life expectancy of you and your younger spouse.
Note: There were no RMDs in the year 2020. The CARES Act eliminated RMDs for the year.

–*YEAR 2021* --UNIFORM LIFETIME DISTRIBUTION TABLE –

Age	*Payout*						
70	-0-	80	5.35%	90	8.78%	100	15.88%
71	-0-	81	5.59%	91	9.26%	101	16.95%
72	3.91%	82	5.85%	92	9.81%	102	18.19%
73	4.05%	83	6.14%	93	10.42%	103	19.24%
74	4.21%	84	6.46%	94	10.99%	104	20.41%
75	4.37%	85	6.76%	95	11.63%	105	22.23%
76	4.55%	86	7.10%	96	12.35%	106	23.81%
77	4.72%	87	7.47%	97	13.16%	107	25.65%
78	4.93%	88	7.88%	98	14.09%	108	27.03%
79	5.13%	89	8.33%	99	14.93%	109	29.42%

[Table computed from Table A-2 of Reg. § 1.401(a)(9)-9 (2002) -- (rounded up)]

TWO SIMPLE STEPS:
Step 1: Find out the value of your investments in your retirement plan account on the last day of the preceding year. For example, on New Years Day -- look at the closing stock prices for December 31.
Step 2: Multiply the value of your investments by the percentage in the table that is next to the age that you will be at the end of this year. This is the minimum amount that you must receive this year to avoid a 50% penalty.

> Example: Ann T. Emm had $100,000 in her only IRA at the beginning of the year. She will be age 80 at the end of this year. In the year 2021, she must receive at least $5,350 during the year to avoid a 50% penalty (5.35% times $100,000). If she had attained age 80 in the year 2022, she would only need to receive at least $4,950 during the year to avoid a 50% penalty (4.95% times $100,000). Please see the table below.

– *Year 2022 and later* --UNIFORM LIFETIME DISTRIBUTION TABLE –

Age	*Payout*						
70 ½	-0-%	80	4.95%	90	8.27%	100	15.63%
71	-0-%	81	5.19%	91	8.78%	101	16.95%
72	3.67%	82	5.44%	92	9.26%	102	17.86%
73	3.79%	83	5.69%	93	9.91%	103	19.24%
74	3.93%	84	5.96%	94	10.53%	104	20.41%
75	4.07%	85	6.25%	95	11.24%	105	21.74%
76	4.22%	86	6.58%	96	12.05%	106	23.26%
77	4.39%	87	6.95%	97	12.83%	107	24.39%
78	4.57%	88	7.36%	98	13.70%	108	25.65%
79	4.77%	89	7.76%	99	14.71%	109	27.03%

C. MAXIMUM YEARS FOR PAYOUTS AFTER ACCOUNT OWNER'S DEATH: TEN YEARS, FIVE YEARS, OR A REMAINING LIFE EXPECTANCY

Failure to receive the required minimum distribution ("RMD") for that year from an inherited retirement account triggers a 50% penalty on the shortfall. The maximum time period over which a decedent's account may be liquidated without such a penalty after the year of death is either:
(#1) ten years, if only "designated beneficiaries" ("DBs") (or a "look-through trust" with 100% DBs) are the beneficiaries of the account (there is no RMD until the 10th year), § *401(a)(9)(H)(i)*
(#2) the remaining life expectancy of an eligible designated beneficiary ("EDB"), based on the EBD's age at the end of the year that follows the account owner's death. An EDB is a beneficiary who is: a surviving spouse, a minor child of the decedent, disabled, chronically ill, or someone who is not more than ten years younger than the decedent (there is an RMD every year), §§ *401(a)(9)(H)(ii), (E)(ii) & B(iii)*
(#3) five years(there is no RMD until the 5th year)**,** if the account owner died before the required beginning date ("RBD") and there is even just one non-DB on the "determination date" (generally, September 30 following the year of death), §§ *401(a)(9)(B)(ii) and (H)(i)("Except in the case of...);Reg.* § 1.401(a)(9)-3 Q&A 4*;* or
(#4) the life expectancy of someone who was the account owner's age (a/k/a a **"ghost life expectancy")** if the account owner died after the RBD and there is even just one non-DB on the "determination date." There will be RMDs in each of those years. §§ *401(a)(9)(B)(i) and (H)(i); Reg.* § 1.401(a)(9)-5 Q&A 5(c)(3)

YEAR 2021 LIFE EXPECTANCY TABLE

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	82.4	20	63.0	40	43.6	60	25.2	80	10.2
1	81.6	21	62.1	41	42.7	61	24.4	81	9.7
2	80.6	22	61.1	42	41.7	62	23.5	82	9.1
3	79.7	23	60.1	43	40.7	63	22.7	83	8.6
4	78.7	24	59.1	44	39.8	64	21.8	84	8.1
5	77.7	25	58.2	45	38.8	65	21.0	85	7.6
6	76.7	26	57.2	46	37.9	66	20.2	86	7.1
7	75.8	27	56.2	47	37.0	67	19.4	87	6.7
8	74.8	28	55.3	48	36.0	68	18.6	88	6.3
9	73.8	29	54.3	49	35.1	69	17.8	89	5.9
10	72.8	30	53.3	50	34.2	70	17.0	90	5.5
11	71.8	31	52.4	51	33.3	71	16.3	91	5.2
12	70.8	32	51.4	52	32.3	72	15.5	92	4.9
13	69.9	33	50.4	53	31.4	73	14.8	93	4.6
14	68.9	34	49.4	54	30.5	74	14.1	94	4.3
15	67.9	35	48.5	55	29.6	75	13.4	95	4.1
16	66.9	36	47.5	56	28.7	76	12.7	96	3.8
17	66.0	37	46.5	57	27.9	77	12.1	97	3.6
18	65.0	38	45.6	58	27.0	78	11.4	98	3.4
19	64.0	39	44.6	59	26.1	79	10.8	99	3.1

Table A-1 of Reg. § 1.401(a)(9)-9 (“single life ”), required by Reg. § 1.401(a)(9)-5, Q&A 5(a) & 5© and Q&A 6.

LIFE EXPECTANCY TABLE - Years 2022 and later

Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	84.5	20	65.0	40	45.7	60	27.1	80	11.2
1	83.7	21	64.0	41	44.7	61	26.2	81	10.5
2	82.7	22	63.0	42	43.8	62	25.3	82	9.9
3	81.7	23	62.0	43	42.8	63	24.5	83	9.2
4	80.8	24	61.1	44	41.8	64	23.6	84	8.6
5	79.8	25	60.1	45	40.9	65	22.8	85	8.1
6	78.8	26	59.1	46	39.9	66	22.0	86	7.5
7	77.8	27	58.2	47	39.0	67	21.2	87	7.0
8	76.8	28	57.2	48	38.0	68	20.4	88	6.6
9	75.8	29	56.2	49	37.1	69	19.5	89	6.1
10	74.8	30	55.3	50	36.1	70	18.7	90	5.7
11	73.8	31	54.3	51	35.2	71	17.9	91	5.3
12	72.8	32	53.4	52	34.3	72	17.1	92	4.9
13	71.9	33	52.4	53	33.1	73	16.3	93	4.6
14	70.9	34	51.4	54	32.4	74	15.6	94	4.2
15	69.9	35	50.5	55	31.5	75	14.8	95	3.9
16	68.9	36	49.6	56	30.6	76	14.0	96	3.7
17	67.9	37	48.6	57	29.7	77	13.3	97	3.4
18	66.9	38	47.6	58	28.8	78	12.6	98	3.2
19	66.0	39	46.6	59	27.9	79	11.9	99	3.0

D. REQUIRED DISTRIBUTIONS AFTER DEATH-- Definitions

Required Beginning Date ("RBD") - The first date that a distribution must be made from an IRA, QRP or 403(b) account to the account owner in order to avoid the 50% penalty tax.[1]

> ***IRAs*:** The RBD for an IRA is April 1 following the calendar year that the IRA account owner attains age 72.[2]
>
> ***QRP or 403(b)***: The RBD for a qualified retirement plan or a tax-sheltered annuity is the *later* of (a) April 1 following the calendar year that the account owner attains age 72 or (b) April 1 following the calendar year that the employee separates from service (e.g., somebody who works past age 73).[3] Individuals who own 5% or more of a business are not eligible for this later RBD: their RBD is April 1 following the calendar year that they attain age 72.

*"**Beneficiaries" versus "Designated Beneficiary" ("DB")*** - A beneficiary is any person or entity that is entitled to receive benefits from a QRP or IRA account after the account owner's death. By comparison, a *designated beneficiary* is an *individual* who is entitled to the benefits of the IRA or QRP account upon the death of the employee / participant / IRA owner (hereafter "account owner").[4] Neither a charity nor the decedent's estate will qualify as a DB since neither has a life expectancy. If certain criteria are met, a trust may be the beneficiary of an IRA or QRP and distributions will be based on the beneficiaries of that trust (a "look-through trust").

"Eligible Designated Beneficiary" ("EDB") - An EDB qualifies for an exception to the general ten liquidation rule. An EDB may receive distributions over his or her the remaining life expectancy of an eligible designated beneficiary ("EDB"), based on the EBD's age at the end of the year that follows the account owner's death. An EDB is a beneficiary who is: a surviving spouse, a minor child of the decedent (though upon attaining majority age, the ten year rule applies), disabled, chronically ill, or someone who is not more than ten years younger than the decedent.[5]

Determination Date - The minimum distributions will be computed based only on the beneficiaries who still have an interest on the determination date. That date is September 30 of the calendar year that follows the calendar year of the account owner's death.[6] Example: Sarah died on September 14, <u>2021</u>, the determination date for her IRA and QRP accounts will be September 30, <u>2022</u>.

The five year liquidation period that existed before the SECURE Act continues to apply if there is a beneficiary that is not a "designated beneficiary" on the determination date. (See the text below). Other beneficiaries will then not be eligible for a ten year liquidation time period.

There are basically three ways to eliminate some of the beneficiaries before the determination date: (1) disclaimers, (2) cash-out of a beneficiary and (3) separate accounts for different beneficiaries.[7]

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[1] ***Sub-Paragraph "H" was added by the SECURE Act, effective Jan 1, 2020***:
(H) SPECIAL RULES FOR CERTAIN DEFINED CONTRIBUTION PLANS.—In the case of a defined contribution plan, if an employee dies before the distribution of the employee's entire interest—
(i) IN *GENERAL*.—*<u>Except</u>* in the case of a beneficiary who is *<u>not</u>* a designated beneficiary, subparagraph (B)(ii)—
(I) shall be applied by substituting '10 years' for '5 years', and
(II) shall apply whether or not distributions of the employee's interests have begun in accordance with subparagraph (A).

E. REQUIRED MINIMUM DISTRIBUTIONS FROM IRAs AND QRPs AFTER THE ACCOUNT OWNER'S DEATH, BASED ON THE BENEFICIARIES AS OF THE "DETERMINATION DATE"

BENEFICIARY	DEATH BEFORE RBD	DEATH AFTER RBD
"*No designated beneficiary* ("DB")" - if there is even just one non-human beneficiary (e.g., probate estate or a charity)	Five Years *[No RMD until the 5th year*]	Remaining life expectancy of someone who was the *decedent's age* in the year of death ("ghost life expectancy") *[RMDs must be made each year]*
NON-SPOUSE DESIG. BENIF.		
General Rule if all beneficiaries are individuals ("DBs")	Ten Years *[No RMD until the 10th year*]	- Same: Ten Years - * * An argument can be made that the term can be the "ghost life expectancy," if that is more than ten years
Rollover option?	Not available to anyone but a surviving spouse.**	** - Possible to transfer decedent's account from a company plan (but not from an IRA) to an IRA payable over ten years (or life expectancy of an EDB)
Eligible Designated Beneficiary ("EDB")	Remaining life expectancy of the *EDB*,* fixed as of the year *after* death. Distributions must begin before the end of the year that follows the year of death. *[RMDs must be made each year]*	– Same Rule – * - (if the EDB is older than the deceased, use life expectancy based on the deceased's age)
Beneficiaries include both EDBs and non-EDBs	Unless separate shares are established, generally Ten Years (or Five Years). Special rules benefit accumulation trust for disabled & chronically ill.	Ten Years (or remaining life expectancy of someone who was the *decedent's age*) [unless separate shares; special rules benefit disabled & chronically ill]
SPECIAL RULES		
"Look-through"trust/ "See-through" trust	"Look through" to identity of DBs and EDBs of the trust to determine RMDs.	– Same Rule --
Remainder beneficiary	A remainder beneficiary is counted as a beneficiary of an *accumulation trust*, but not of a *conduit trust*	– Same Rule –

BENEFICIARY	**DEATH BEFORE RBD**	**DEATH AFTER RBD**
SPOUSE IS THE BENEFICIARY		
Rollover Option?	Yes, available	Yes, available
Leave in deceased's account and spouse is the sole beneficiary?		
-- General Rule	**Minimum distributions over the surviving spouse's remaining life expectancy, *gradually extended* each year as the spouse ages.**	**– Same Rule --**
-- IRAs only: elect to treat as own IRA	**Surviving spouse can elect to leave assets in deceased's IRA but treat that IRA like a rollover IRA.**	**– Same Rule --**
-- Decedent died before age 72?	**Can defer first distribution until the year that the deceased spouse would have been age 72.**	**Not applicable**
MULTIPLE DBs; ONE IS THE SPOUSE		
Both spouse and another DB are the beneficiaries	Generally ten years, unless separate shares are established.	– Same Rule --
Both spouse and a charity are beneficiaries	Five Years, unless separate accounts are established for the beneficiaries.	Remaining life expectancy of someone who was the *decedent's age*, unless separate accounts for the beneficiaries.
"Look-through" trust/ "See-through" trust	Generally ten years, since "look through" to identity of the beneficiaries. If payable to a conduit trust, then the remaining life expectancy of the spouse.	– Same Rule --
Remainder beneficiary	A remainder beneficiary is counted as a beneficiary of an *accumulation trust*, but not of a *conduit trust*	– Same Rule –

III. Qualified Charitable Distributions ("QCDs)

I. Introduction

The law that is commonly referred to as "Charitable IRA Rollover" permits a person over age 70 ½ to annually make up to $100,000 of charitable gifts directly from an Individual Retirement Account ("IRA"). The donor will benefit by not having to report the IRA distribution as taxable income, although the donor will not be able to claim a charitable income tax deduction for the gift. As will be demonstrated below, most taxpayers are better off reducing their gross taxable income compared to claiming an offsetting itemized deduction.

Many retirees have been particularly motivated to apply their charitable IRA gifts to satisfy their mandatory minimum distributions. For example, a 76 year old who would normally be required to receive a taxable distribution of just over 4% from an IRA could satisfy the requirement by contributing 3% to a charity and receive a taxable distribution of just 1%.[2]

Charitable IRA Rollover" is a permanent part of the tax code. Between 2006 and 2015, the law had been a temporary "extender" tax law that was repeatedly re-extended by tax legislation. The "Protecting Americans From Tax Hikes Act of 2015" (the PATH Act of 2015) made this and several other tax extenders a permanent tax law.

The law has no effect on charitable bequests of IRA assets, either outright to charities or to deferred giving arrangements. Such transactions qualified for favorable income tax consequences in the past and will continue to be an attractive planning strategy in the future. The Charitable IRA Rollover law only affects rules for lifetime charitable gifts from IRAs.

II. Who Wins With Charitable IRA Rollover?

A. Donors who don't itemize their deductions

Probably the biggest winners under this new law are IRA owners over age 70 ½ who do not itemize income tax deductions (i.e., they take the standard deduction). Since the charitable deduction is an itemized deduction, they normally have the worst tax consequences from the gifts they make from their IRA distributions: they had to report the entire distribution as taxable income but received no offsetting income tax deduction. In theory, they should take advantage of the charitable IRA exclusion and make <u>all</u> of their charitable gifts from their IRAs.

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[2] "Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision." *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006*," Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 266. See also IRS Notice 2007-7; 2007-5 IRB 1, Q&A 42.

B. Donors Who Pay More Tax As AGI (adjusted gross income) Increases.

1. The 3.8% net-investment income surtax. Taxpayers are subject to the health care surtax once adjusted gross income ("AGI") exceeds $200,000 ($250,000 married filing jointly). There is a 3.8% surtax on investment income (interest, dividends, rents, annuities and capital gains) and a 0.9% surtax on wages and earned income. For donors near the threshold, using QCDs to keep AGI low may protect their investment income from the 3.8% surtax.

2. Reduced Income Tax on Social Security Payments. If a social security recipient's modified AGI is over either $44,000 (married-joint) or $34,000 (single or head-of-household), 85% of the social security payments are taxable and 15% are tax-exempt. However, if modified AGI is under either $32,000 or $25,000, then <u>all</u> of the social security payments are tax-exempt. By avoiding the recognition of taxable IRA distributions an eligible social security recipient may be able to pay less tax on social security distributions. The thresholds might not apply to married individuals who live together and file separately.

3. Other Deductions That Are Phased out as AGI Increases. Other deductions that are subject to income phase-outs, and the rates of phase-out, are:

- Medicare "B" and "D" premium rates jump when income is over $87,000 ($174,000 joint)
- 7 ½% for medical expense deductions

C. Donors who live in states with a state income tax that provides no tax breaks for charitable gifts: Connecticut, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia state income tax computations do not permit itemized deductions. Consequently, Indiana, Michigan, New Jersey, Ohio, Massachusetts and West Virginia residents gets no state income tax breaks from charitable gifts. Eligible donors in these states will save taxes at their highest marginal state income tax rate (e.g., 4% or 6%) for every charitable gift that they make from their IRAs instead of from their checking accounts. Although **Illinois** residents also cannot claim charitable income tax deductions, <u>all</u> distributions from retirement plans are exempt from the income tax so they would not see any benefit on their state returns from this new law. **Michigan and New Jersey** residents also might not see benefits since they may receive threshold amounts of retirement income exempt from state income tax and only excess amounts are subject to state taxes. The thresholds are $10,000 ($20,000 married) in New Jersey and about $40,000 ($80,000 married) in Michigan.

D. Donors who are subject to the 60% annual charitable deduction limitation. Charitable deductions cannot exceeds 60% (formerly 50%, which is scheduled to return in the year 2026) of a taxpayer's adjusted gross income ("AGI") in any year.[3] A donor who is subject to the annual deduction limitation and who uses a taxable distribution from a retirement plan

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[3] Secs. 170(b)(1)(A) and (C) and Reg. Sec. 1.170A-9(e)(11)(ii). There is a 5 year carryforward for the charitable contributions that exceed 50% of AGI. Sec. 170(b)(1)(C)(ii) and last sentence of Section 170(b)(1)(B).

account to make an additional charitable gift would generally be able to deduct only 50% of the amount in the year of the gift. The other 50% of the distribution would be subject to income tax that year. If, instead, the charitable gift is made directly from an IRA to the charity, a donor over age 70 ½ would not pay any extra income tax.

E. Wealthy Individuals Who Want to Reduce the Size of Retirement Assets in Their Estates. Whereas most inherited stock, real estate and other assets receive a step-up in tax basis, inherited retirement distributions are generally taxed as income in respect of a decedent. The combination of estate taxes and income taxes – particularly in states that have both a state estate tax and a state income tax – can produce an effective tax rate on such inherited distributions of over 80%. Some senior citizens draw down their retirement accounts to reduce the proportion of their wealth in these assets. The charitable IRA exclusion offers an opportunity to withdraw up to $100,000 for charitable gifts without triggering some of the problems that large distributions might normally cause.

F. The Heirs – They Prefer Inheriting Stock and Assets With A Stepped-Up Income Tax Basis, Rather Than Inheriting Taxable Income-In-Respect Of a Decedent

III. Who Doesn't Win With QCDs?

A. Donors Who Are About To Sell Appreciated Stock and Appreciated Real Estate. The sale of such property will trigger a <u>15% federal long-term capital gains tax</u> (or up to 23.8% for taxpayers with income over about $450,000). This tax could be avoided by instead donating the property to a charity before the sales negotiations are finalized. The issue, then, is whether the tax savings from the charitable IRA exclusion can exceed the pending 15% / 23.8% tax.

Charitable gifts of appreciated stock, mutual funds and real estate have traditionally provided donors with greater income tax benefits than gifts of most other types of assets. *In most cases, gifts of these assets will continue to provide greater tax benefits than gifts from an IRA*. On the other hand, if the donor is subject to some of the tax challenges described above – such as the 50% annual charitable income tax deduction limitation -- the donor could be better off making a gift from an IRA.

> Example: Ms. Donor has a $10,000 IRA and has stock worth $10,000 that she bought years ago for $2,000. She is 75 years old and has AGI of $200,000. If she makes a charitable gift from her IRA that qualifies for the charitable IRA exclusion, she will save a little bit of money compared to receiving a taxable IRA distribution (roughly $140, or 1.4% of the distribution, due to the phaseout of her personal exemption and the 2% loss of itemized deductions). However, she will still own her stock. If she sells the stock, she will have an $8,000 taxable gain subject to a federal 15% capital gains tax ($1,200). Consequently, even with the opportunity to make a tax-free charitable gift from her IRA, she should probably receive a taxable $10,000 distribution from her IRA and contribute her stock to produce an offsetting $10,000

charitable income tax deduction. She can use the cash from the distribution for any purpose that she chooses, including the purchase of new stock that will give her a new tax basis of $10,000.

Compare – wealthy donors in poor health have an incentive to keep appreciated stock and to instead make charitable gifts from their IRAs: "stepped-up basis." Whereas appreciated stock will receive a step-up in basis in the hands of the beneficiaries -- generally the value at the time of death -- retirement accounts receive no step-up in basis and distributions to beneficiaries are generally taxed as ordinary income. Many individuals –especially those who are so wealthy that their estates will be subject to estate tax – consciously strive to reduce the amount of retirement assets in their estates. If they plan to hold appreciated stock until death, they may prefer to make their charitable gifts from their IRAs rather than use appreciated stock.

Example: Ms. Donor has a $10,000 IRA and has stock worth $10,000 that she bought years ago for $2,000. She loves the stock and does not think it wise to sell it. She is 75 years old, in poor health and has AGI of $200,000 and would like to make a charitable gift of $10,000. She should use the IRA for her charitable gift. Upon her death the stock will receive a new tax basis – i.e., about $10,000 – and the potential capital gains tax on the $8,000 of appreciation would be eliminated. By comparison, had she donated the stock to charity and died with $10,000 in an IRA, the distribution to her beneficiaries would produce $10,000 of taxable income.

B. Donors Who Reside In States Where the State Income Tax Laws Pose Problems

For example, the **Colorado**, **Kentucky** and **New York** state income tax laws exempt the first $41,000 of retirement income and also allow a charitable income tax deduction to reduce state income taxes. Consequently, a retiree who withdraws $1,000 from an IRA and then donates $1,000 to a charity usually has a tax advantage that the withdrawal was tax-free but the gift produced tax savings. Suppose that the $1,000 charitable gift was made directly from the IRA. On the state income tax return the donor would not report any taxable income but would lose the state income tax deduction and, consequently, would pay more state income tax.

C. Donors Who Would Not Receive Any Tax Savings from the Charitable IRA Exclusion and Who Encounter Administrative Hassles Trying to Make a Charitable Gift Directly from an IRA. Millions of donors won't save any income taxes with the charitable IRA exclusion. Who are they? They are donors who itemize tax deductions (and can therefore deduct charitable gifts) with incomes under $150,000 (so they are not subject to the 2% phase-out of itemized deductions) who can't realistically make social security benefits tax-exempt and who live in states that allow charitable income tax deductions. Most of these donors have not incurred a tax cost from their charitable gifts since the charitable income tax deduction has offset the taxable income from an IRA distribution. If the IRA administrator balks at making charitable grants from an IRA or has fees for the transaction, it will be much easier to simply receive a taxable distribution from an IRA and then write a check to make a charitable gift.

III. LEGAL REQUIREMENTS

A. Overview

A person over age 70 ½ who makes an outright charitable gift from her or his IRA:

(1) will not report the distribution as taxable income,[4] and
(2) will not be entitled to claim a charitable income tax deduction for the gift.[5]

B. Seven Basic Requirements

In order to make a lifetime charitable gift from an IRA without having to report the payment as a taxable distribution, the distribution must meet the definition of a "**qualified charitable distribution" (hereafter "QCD").**[6] Unless a distribution qualifies as a QCD, any lifetime charitable gift from any sort of retirement plan account (IRA, 403(b), 401(k), profit sharing, etc.) must be reported as a taxable distribution. The donor can then claim an offsetting charitable income tax deduction.[7]

There are seven requirements for an IRA distribution to qualify as a QCD:

1. Donor must be at least age 70 ½. The distribution must be made on or after the date that the IRA owner attained age 70 ½.[8] In most cases such donors will be retirees. Donors under age 70 ½ will have to report charitable gifts from their IRAs as taxable distributions and can claim offsetting charitable income tax deductions if they itemize their deductions.

Tax Trap in The Year a Person Attains Age 70 ½: There can be a lot of confusion in the year that a person attains age 70 ½. All distributions that are made at any time during that year can be applied toward satisfying the minimum distribution requirement to avoid the 50% penalty tax for insufficient distributions. However, only the distributions that are made after attaining the age of 70 ½ qualify for the charitable exclusion. This can be a problem for someone who attains age 70 ½ late in the year, say on December 28. The law should be changed by a technical corrections act to conform the charitable IRA exclusion rules with the minimum distribution requirements. That is, all distributions should qualify for the charitable exclusion if made "within or after the calendar year that the individual for whose benefit the plan is maintained has attained age 70 ½". Tax administration would be simplified and innocent

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4 Sec. 408(d)(8)(A).
5 Sec. 408(d)(8)(E).
6 Sec. 408(d)(8)(B).
7 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 43.
8 Sec. 408(d)(8)(B)(ii).

parties would not be caught in a tax trap.

2. IRAs only. The distribution must be made from an individual retirement plan.[9] That means only an IRA -- not a qualified retirement plan or a Section 403(b) annuity. Distributions to charities from other types of retirement accounts -- such as 403(b) plans, 401(k) plans, profit sharing plans and pension plans -- will still be treated as taxable distributions to the account owners eligible for an offsetting charitable income tax deduction.

In most cases, the restriction of such favorable tax treatment to IRAs should not pose a significant problem. Many retirees have large IRA balances because they rolled over distributions from their company retirement accounts into IRAs when they retired. Donors without IRAs who would like to take advantage of the charitable IRA exclusion can establish a new IRA and then rollover some assets from their other qualified retirement plans into the new IRA.[10]

Whereas distributions from IRAs that were once part of an SEP or a SIMPLE plan qualify for the charitable exclusion, grants made from either an *ongoing* SEP IRA or an *ongoing* SIMPLE IRA do not. Small employers often establish an SEP IRA plan or a SIMPLE IRA plan as the company's only retirement plan. The employer makes contributions to each employee's IRA rather than to the usual arrangement of a single retirement trust maintained by the employer. An SEP IRA or a SIMPLE IRA is an *ongoing* arrangement if a contribution was made to it during the year. Thus , a retired individual who has an SEP IRA or a SIMPLE IRA that received employer contributions during her or his working career can make charitable distributions from that IRA if no employer contributions were deposited in the same year as the charitable gift.[11]

3. *Directly* from the IRA to the charity.[12] The check from the IRA must be issued payable to the charity. If a check is issued from the IRA payable to the IRA owner who then endorses the check to the charity, it must be reported as a taxable distribution to the IRA owner.

Does the IRA Administrator have to mail the check to the charity? Can the check be issued payable to a charity and then mailed to the IRA account owner who then forwards the check to the charity? Yes. The IRS concluded that this arrangement would be a "direct payment" to the charity.[13] This is a very good result. The NCPG survey reported that charities received about 15% of IRA gifts from donors and 83% from IRA administrators, and that when they received checks from IRA administrators, they had difficulty identifying the correct donor

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9 Sec. 408(d)(8)(B).

10 Sec. 408(d)(3). Employees who receive distributions from any type of qualified retirement account can rollover the distribution to an IRA.

11 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 36.

12 Sec. 408(d)(8)(B)(ii).

13 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 41.

10% of the time (e.g., “$1,000 from the IRA of John Smith. Which John Smith? We have several donors with that name”).[14]

4. The recipient organization must be a public charity or a private operating foundation, or possibly a conduit private foundation. The recipient organization must be described in Sec. 170(b)(1)(A).[15] This statute includes most public charities as well as private *operating* foundations. **Two exceptions: donor advised funds and supporting organizations:** Although contributions to donor advised funds and Sec. 509(a)(3) supporting organizations qualify for public charity tax deductions, they are not eligible beneficiaries for the charitable IRA exclusion. In that case, the donor must report the IRA distribution as taxable income and then claim an offsetting charitable income tax deduction.[16]

Grant-making private foundations are generally excluded, except the legislation appears to permit grants from IRAs to two types of grant-making private foundations: conduit private foundations and donor-directed funds.[17] A conduit private foundation is typically a grant-making foundation that in any given year makes an election to distribute by March 15 (oversimplified) 100% of the contributions that it received that year. A donor-directed fund allows a donor to control, not just advise, the recipient of the fund’s income. Private operating foundations, such as libraries and museums that are endowed by one family, are also eligible recipients.[18] However, payments to organizations that qualify for charitable income tax deductions but which are not eligible public charities – notably veterans organizations, certain fraternal organizations and cemetery companies – are not eligible for the charitable exclusion for IRA distribution.[19]

5. The payment would otherwise fully qualify for a full charitable income tax deduction.[20] A distribution will qualify as a QCD only if a person would normally be able to claim a charitable income tax deduction for the entire payment. This eliminates favorable tax treatment for IRA distributions that are used for auctions, raffle tickets, fund-raising dinners or any other type of *quid-pro-quo* transaction. If there is any financial benefit, then the entire

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14 NCPG survey, at *supra* n. 2.

15 Sec. 408(d)(8)(B)(i).

16 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 43.

17 Conduit private foundations are described in Sec. 170(b)(1)(A) and so therefore be eligible. Specifically, they are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(ii). Donor directed funds are described in Sec. 170(b)(1)(A)(vii) and Sec. 170(b)(1)(E)(iii).

18 Private operating foundations are described in Sec. 170(b)(1)(A)(vii) via Sec. 170(b)(1)(E)(i).

19 Charities are one of five categories of organization that are eligible to receive contributions that qualify for charitable income tax deductions: (1) governments, (2) U.S. charities, (3) veterans organizations, (4) certain fraternal organizations and (5) cemetery companies. Sec. 170(c). By comparison, only organizations described in Sec. 170(b)(1)(A) – generally public charities – are eligible for the charitable IRA exclusion.

20 Sec. 408(d)(8)(C).

distribution is taxable income and the donor must hope to get a partially offsetting charitable income tax deduction. This eliminates the possibility that an IRA distribution will qualify as a QCD if it is used to obtain a *charitable gift annuity.*

6. Distribution would otherwise be a taxable distribution, with a maximum amount of $100,000 per year.[21] By way of background, most IRA distributions are fully taxable. However, if an IRA owner made any nondeductible contributions to the IRA, then those distributions to the IRA owner are normally tax-free. A QCD only applies to the taxable portion.

The new law provides very favorable tax treatment for outright charitable gifts from IRAs that hold non-deductible contributions. Charitable distributions are deemed to come first from the taxable portion, thereby leaving the maximum amount of tax-free dollars in the IRA.[22] An example is in the footnote.[23]

If any tax-free amounts are distributed to a charity, that portion does not qualify as a QCD. Instead, the donor is deemed to have received that amount free from income tax and can claim a charitable income tax deduction for a charitable gift of that part of the payment.

7. Donor must have documentation from the charity that would qualify the gift for a full charitable income tax deduction under normal circumstances.[24]

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[21] Sec. 408(d)(8)(B) (last sentence).

[22] Sec. 408(d)(8)(D).

[23] Example: An IRA owner has a traditional IRA with a balance of $100,000, consisting of $20,000 of nondeductible contributions and $80,000 of deductible contributions and accumulated earnings. Normally, 80% of a distribution to the IRA owner would be taxable and 20% would be a tax-free return of non-deductible contributions. If however, there is a distribution to a charity that qualifies as a QCD, all of the distribution is deemed to come first from the taxable portion. Thus, if the IRA trustee makes an $80,000 distribution to a charity, the entire $80,000 is deemed to come from the taxable portion of the IRA and is a QCD. No amount is included in the IRA owner's taxable income. The $20,000 that remains in the IRA is treated as entirely nondeductible contributions.

Modified from from Example 2 of *Technical Explanation Of H.R. 4, The Pension Protection Act of 2006*, Prepared by the Staff of the Joint Committee On Taxation August 3, 2006 (JCX-38-06) on page 268.

[24] The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, *or if a deduction is not allowable because the donor did not obtain sufficient substantiation*, the exclusion is not available with respect to any part of the IRA distribution.*"* (Emphasis added). *Technical Explanation of H.r. 4, The "Pension Protection Act of*

Part of the challenge of this new law is that the donor will have to obtain the required documentation from the charity necessary to qualify the payment for the customary charitable income tax deduction.[25] That is, the charity must issue a "contemporary written acknowledgment" that describes the amount of cash contributed and that certifies that the donor did not receive any financial benefits in exchange for the gift. Failure to obtain such an acknowledgment will cause the IRA distribution to be a taxable distribution to the IRA account owner and, in the absence of the documentation necessary to justify a charitable income tax deduction, presumably might cause the person to lose an offsetting charitable income tax deduction. Many charities are "tweaking" their letters to refer to the IRA distribution, so there is less chance of confusion with other tax-deductible charitable gifts that the donor might make. For example, a letter might state "thank you for your charitable gift from your IRA of ...."

C. Technical Issues

1. How does the IRA administrator report charitable distributions to the IRS and to the IRA owner on the Form 1099-R?

For 2006 distributions, there is no special reporting responsibility for IRA administrators. Both the charitable distributions and the distributions received by the IRA owner are reported as presumably taxable distributions to the IRA owner.

2. How does the IRA owner report the charitable IRA exclusion on his or her income tax return (Form 1040)?

Since the IRA administrator does not make any distinction between charitable and non-charitable IRA distributions, the burden falls on the IRA owner to make the adjustments on his or her personal return. From a policy perceptive this is a good practice since the IRA owner is in the best position to know whether a charitable distribution in fact qualifies for the charitable IRA exclusion or not.

The IRA owner should report all of the IRA distributions on the front page on the income tax return (Form 1040 - *total distributions* on Line 15A) but should then report only the *taxable distributions* on line 15B. Source: Form 1040 instructions, page 25. Thus, the charitable IRA exclusion will be reported similarly to a traditional rollover, where a person may have received a taxable distribution from an IRA but is able to avoid taxation by rolling over the amount within 60 days to another IRA. These charitable IRA gifts will not be disclosed in any way on Schedule A, where a person claims an itemized income tax deduction for conventional

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2006," Joint Committee on Taxation, JCX-38-06 (August 3, 2006) at page 267."

[25] For any gift of $250 or more, the donor must produce a "contemporary written acknowledgment" from the charity that describes the gift and that states the value, if any, of a financial benefit that the charity provided the donor. Sec. 170(f)(8). For a contribution from an IRA, there cannot be any such benefit.

charitable gifts.

Example: Mr. Smith, age 76, is required to withdraw $4,000 from his IRA in 2007 to avoid the 50% penalty for failure to take minimum required distributions after age 70 1/2. He had the IRA trustee send a $1,000 check to his favorite charity. Mr. Smith received an acknowledgment from the charity that stated that he received no personal benefit and that the entire gift qualified for a charitable income tax deduction under the normal rules (such an acknowledgment is necessary for the charitable IRA exclusion). Mr. Smith personally withdrew an additional $3,000 from the IRA.

The IRA custodian will issue Form 1099-R and will report $4,000 of total distributions. Mr. Smith will report the $4,000 of total distributions on Line 15A of Form 1040 but will report only $3,000 of taxable distributions on Line 15B.[26] The $1,000 gift will not be disclosed or reported on Schedule A where Mr. Smith deducts the other charitable gifts that he made.

3. A person over age 70 ½ who is the beneficiary of an *inherited* IRA can take advantage of the charitable IRA exclusion.[27].

4. Can a charitable IRA distribution be used to satisfy a pledge? Yes. This is a very important development. The payment of a pledge from an IRA was a recurring reason donors cited for made a charitable gift from an IRA.[28]

a. No violation of IRA self dealing rules. Charitable IRA distributions can satisfy pledges without violating the IRA self-dealing prohibited transaction rules. "The Department of Labor, which has interpretive jurisdiction with respect to section 4975(d), has advised Treasury and the IRS that a distribution made by an IRA trustee directly to a section 170(b)(1)(A) organization (as permitted by section 408(d)(8)(B)(i)) will be treated as a receipt by the IRA owner under section 4975(d)(9), and thus would not constitute a prohibited transaction. This would be true even if the individual for whose benefit the IRA is maintained had an outstanding pledge to the receiving charitable organization."[29]

b. No income to the donor, even though normally there can be income when a third party pays off a person's personal liability. For a legally binding pledge (as opposed to a non-binding pledge), some people raise the argument that a donor might have taxable income if a legal liability is discharged by a third party, thereby making the donor richer. However, Section 108(e)(2) provides that a taxpayer does not have taxable income if there is a discharge of indebtedness and the payment would have been deductible. Since the payment of a pledge provides a charitable deduction, a donor should not have taxable income if a third party pays it.

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26 See the instructions to Form 1040 at http://www.irs.gov/pub/irs-pdf/f1040.pdf

27 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 37.

28 NCPG survey, at *supra* n. 2.

29 IRS Notice 2007-7; 2007-5 IRB 1, Q&A 44.

5. Each spouse over age 70 ½ is eligible to contribute up to $100,000 from that spouse's IRA to eligible charities, with the maximum charitable IRA exclusion on a joint return of $200,000. The distribution must come from each spouse's respective IRA. For example, a married couple would not be able to exclude $140,000 of charitable gifts from one IRA and $60,000 of charitable gifts from another since the $140,000 would exceed the annual $100,000 limit.[30] IRS Notice 2007-7; 2007-5 IRB 1, Q&A 34.

6. A charitable IRA distribution is not subject to withholding taxes. The IRA administrator may rely upon reasonable representations made by the IRA owner. A qualified charitable distribution is not subject to withholding under section 3405 because an IRA owner that requests such a distribution is deemed to have elected out of withholding under section 3405(a)(2). IRS Notice 2007-7; 2007-5 IRB 1, Q&A 40.

7. The exclusion applies to any such charitable distribution made during 2006, even those made before the law was enacted on August 17, 2006. IRS Notice 2007-7; 2007-5 IRB 1, Q&A 38. This may be advantageous to people who have "IRA checkbooks" (typically at brokerage houses) where they can write checks directly from an IRA. A person over age 70 ½ who wrote such a check to a qualifying charity early in 2006 can take advantage of the exclusion.

IV. CONCLUSION - An eligible IRA owner over the age of 70- ½ should attempt to make a qualified charitable distribution from an IRA if the tax savings exceed the administrative costs that the transaction might generate. For people who itemize their deductions and can claim offsetting charitable income tax deduction, it will usually be administratively easier to simply receive a check from the IRA and then make a charitable gift. However, for those individuals who do not itemize, who live in states with no charitable deduction or who otherwise benefit by keeping their AGI lower, it may be worth the effort to work with the IRA administrator to make that large charitable gift from the IRA.

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[30] IRS Notice 2007-7; 2007-5 IRB 1, Q&A 34.

IV. CRTs

A. Overview

A bequest of a retirement account to a CRT means that the retirement assets will ultimately be transferred from the CRT to a charity. But there is a time lag before the charity receives the assets. And that time lag can last for much more than just ten years. During that time period, the full value of the retirement assets, without any diminution for income taxes, can be held by the CRT to generate income for distributions. First to individuals, and then to charities.

The advantage that a CRT offers over any other type of trust that an estate planner might draft is that a CRT is exempt from the income tax. A transfer at death from a retirement plan to a CRT is a tax-free transfer of assets from one tax-exempt trust to another tax-exempt trust. The tax-exempt feature of a CRT makes it a very attractive recipient of a bequest of any source of IRD, including non-qualified deferred compensation plan assets,[8] employee stock options,[9] savings bonds,[10] unpaid wages,[11] and post-death payments under promissory notes from installment sales.[12]

B. Tax-Exempt Status of CRTs

Like a qualified retirement plan account, a CRT is exempt from the income tax.[13] No matter how much income a CRT may earn in a year, no tax is paid until a distribution is made to a taxpaying beneficiary.

The one exception is if a CRT holds an asset that generates unrelated business taxable income ("UBTI"). The CRT must pay a confiscatory 100% tax on the full amount of the UBTI.[14] The asset that is most likely to generate UBTI is a partnership interest or an LLC interest of a commercial business.[15] Debt-financed investment property can also trigger UBTI,[16] but such property would usually not be received as a distribution from a retirement plan account.

C. How Long ? Term of Years or for Life?

A CRT's term may exist for the lives of one or more individuals or for a fixed term of years (maximum 20). The requirement that there must be a minimum 10% charitable deduction (described at *infra* below in Part III.F.2) means, as a practical matter, that it is difficult to establish a CRT that lasts for the life of a beneficiary under age 27 or for the lives of multiple beneficiaries under age 38. For very young beneficiaries, a CRT for a term of years is the only option.

A CRT for a term of years will also provide the greatest assurance to people who are most interested in having distributions last for more than ten years. If a beneficiary of such a CRT dies before the term has been completed, then distributions can be made to successor beneficiaries.[17] By comparison, if a CRT is established for the life of a single beneficiary who dies within a year after the CRT was funded, then the assets in the CRT will be immediately transferred to a charity. Family members may feel that they would have been better off with a simple ten year liquidation of the inherited retirement account. Mortality risk with a CRT that will last for the life of a beneficiary can be reduced by naming multiple lifetime beneficiaries of the CRT and by using life insurance in conjunction with the funding of the CRT.

D. Choosing the Trustee and the Charity

Whereas many living grantors to CRTs also act as the trustee of the CRT, this is not possible with a testamentary CRT that will receive retirement assets. Consequently, it is important to select a competent trustee who can administer a testamentary CRT that could last for the lives of multiple CRT beneficiaries, or a for term of up to 20 years. An institutional trustee could provide greater competence and longevity compared to an individual named as trustee. At the very least, the trust instrument should name an institution that is willing to administer the CRT as a successor trustee in the event that an individual trustee resigns. Some commercial trust companies will not administer a CRT that holds less than $200,000, although some charities are willing to administer a CRT with minimum assets of $100,000.

It is also important to identify a charity that is likely to be in existence to receive the CRT's assets when the trust terminates. Since a CRT might last for as long as 50 years, it would be helpful to list stable, established charities as contingent beneficiaries in the event that the primary charity has gone out of existence.

One charitable strategy that may be appealing to many donors is to have the CRT terminate into donor advised funds that will be advised by the donor's descendants (e.g, grandchildren). This arrangement may be particularly attractive when a testamentary CRT will only last for a term of years. The CRT could terminate into donor advised funds that will make charitable grants based on the grant recommendations made by the same individuals who had received distributions during the term of the CRT (in most cases, the donor's children and grandchildren). Such an arrangement will be most effective in a family that has instilled a spirit of philanthropy and has educated descendants on effective grant-making use of donor advised funds.[18]

The same philanthropic strategy could work if the CRT liquidates into a private foundation. It is possible for a CRT to itself become a private foundation when the distributions to non-charitable beneficiaries terminate.[19]

E. Choosing the Best Type of CRT - CRATs, CRUTs, FLIPCRUTs, NIMCRUTs

1. Definitions. There are five types of CRTs:

1. *Charitable Remainder Annuity Trust* ("CRAT")[20] - A trust that pays a *fixed dollar amount* (at least 5% and no more than 50% of the value of the property contributed to the trust) each year to one or more income beneficiaries for life (or for a fixed term of years -- maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations.

2. *Charitable Remainder Unitrust* ("Standard CRUT")[21] - A trust that pays a *fixed percentage* (at least 5% and no more than 50%) of the value of the trust's assets each year (redetermined annually) to one or more income beneficiaries for life (or for a fixed term of years -- maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations.

3. *Charitable Remainder Net-Income Unitrust* ("NICRUT")[22] - A trust that pays the *lesser* of that year's net income or a fixed percentage (between 5% and 50%) of the value of the trust's assets each year (redetermined annually) to one or more income beneficiaries for life (or for a fixed term of years -- maximum 20) and then the remaining proceeds are distributed to one or more charitable organizations. A trustee may insist on a net-income limitation when a donor contributes an illiquid asset, such as real estate, that doesn't generate enough cash to make the annual required distributions of 5% or more. NICRUTs are rarely established -- donor's prefer NIMCRUTs or FLIPCRUTs.

4. *Charitable Remainder Net-Income With Make-up Unitrust* ("NIMCRUT")[23] - A NIMCRUT is a NICRUT with a "make-up" provision in the trust instrument. The trust can pay in excess of the stated payout percentage to the income beneficiary in order to make up any shortfall from a prior year when the net income limitation caused the beneficiary to receive an amount that was less than the stated payout. For example, if a NIMCRUT with a stated 5% payout only earns 3% of net income in its first year, it would only distribute 3% to the income beneficiary. If in the second year it earned 8%, it could distribute 7% to the income beneficiary: 5% for the stated percentage plus a 2% make-up amount for the reduced distribution in the first year (oversimplified).

5. *Flip Unitrust* ("FLIPCRUT")[24] - A FLIPCRUT is a unitrust that begins as a NICRUT or a NIMCRUT but converts into a standard CRUT the year after a specified date or a "triggering event" occurs. This is the most popular type of CRT for receiving illiquid assets that may take a while to sell, such as real estate or closely-held stock. The triggering event is usually defined to be the sale of the illiquid asset. When it converts to a standard CRUT, the trust will usually hold liquid investments that can easily be sold to make the required distributions.

2. Which will work best?

The principal difference between a CRAT and a CRUT is that the former requires a fixed dollar payout and the latter requires a fixed percentage payout. Estate planners usually recommend a lifetime CRUT for a young individual because of the possibility that payments may gradually increase over a long time span if the CRUT's investments increase in value. If the value of the CRUT's investments fall in any given year, then the distributions for that year will decline as well.

A CRAT might be perceived as a more desirable option if the CRT will last for a short time period, such as for a term of years or for the remaining life of an elderly beneficiary. The fixed CRAT payments will not fluctuate with the changing value of potentially volatile investments that are held by the CRAT. Such steady payments can give many people a level of comfort. But they offer no protection against inflation. Furthermore, the minimum 5% annual distribution using assumed investment returns of 2% or less means that they cannot have a projected life of more than 20 years. This doesn't offer much additional tax deferral compared to the 10-year liquidation time period for liquidating an inherited retirement account.

A FLIPCRUT might be the best choice when a retirement account holds an illiquid asset that cannot produce the required annual CRT distributions of 5 percent (or more).[25] The trust instrument can provide that the triggering event will be the sale of that asset, in which case the trust "flips" into a standard CRUT in the following year.[26] A FLIPCRUT can also serve as a retirement income vehicle. For example, the trust instrument can provide that the triggering event will be the beneficiary's 66th birthday.[27] The FLIPCRUT can invest in low-yield growth assets that produce little distributable income and then convert to higher yield assets after the trust flips.

Some estate planners have suggested using a NICRUT or a NIMCRUT that holds its assets in an LLC that distributes smaller amounts of income in earlier years and larger amounts in later years.[28]

F. CRT Requirements That Can Pose Challenges to Estate Planners

There are many technical rules that apply to CRTs. For example, the CRT beneficiary can have the power to change which charity will receive the remainder interest, and the CRT trustee should not promise to invest in tax exempt bonds. In the author's experience, the following issues are the ones that most frequently pose challenges to structuring a gift to a CRT.

1. Annual payouts between 5% and 50%

The minimum annual distributions from a CRT to its beneficiaries is 5 percent of the value of the assets.[29] A CRT cannot have a stated percentage of 3 percent or 4 percent, even though several states have adopted a 4 percent default rule under their state statutes for unitrusts and net-income trusts.

The minimum 5 percent distribution requirement has been an administrative challenge in the low interest rate environment of the past dozen years. Trustees often sell some assets in order to make the required distributions, which usually isn't a tax problem since the trust is tax-exempt. The only way to distribute less than 5 percent is if the trust instrument contains a net-income limitation (that is, the CRT is a NICRUT, a NIMCRUT or a FLIPCRUT).

2. Minimum 10% charitable deduction

a. The requirement

The value of the charity's remainder interest of a CRT must be at least 10 percent of the initial net fair market value of all property placed in the trust, computed using the Section 7520 discount rates in effect at the time of contribution.[30] Since a CRUT (unlike a CRAT) can receive several contributions over time, the 10 percent requirement must be met every time that a contribution is made to a new or pre-existing CRUT.[31] If a contribution is made to a trust that fails the 10 percent requirement, the trust will not qualify as a tax-exempt CRT.[32]

b. Impact on payout or the projected term of trust

Oversimplified, there are two ways that the present value of a charity's remainder interest in a CRT can be less than 10 percent of the value of the property that was contributed to the trust. The first is if the stated payout rate is too high (e.g., "for the next 20 years, distribute to my child 30 percent of the trust's assets each year"). The solution is to lower the CRT's payout rate, but it cannot be lowered below 5 percent. Many CRT agreements contain clauses that provide that if the rate stated in the trust instrument is too high, then the CRT's distribution percentage rate will be automatically reduced to whatever rate is necessary to satisfy the 10 percent requirement. Other agreements simply state that the distribution percentage will be whatever the maximum permitted rate is in the month that the trust is funded.[33]

The second way is if the projected term of the trust is too long. For example, if you invest $5 today and earn 3 percent interest every year for the next 100 years, then the $5 will grow to $100 in 100 years. Thus, the present value today of receiving $100 in 100 years is just 5 percent, which is less than 10 percent. The 10 percent requirement limits the projected term of a CRUT to a maximum of roughly 55 years.

This makes it hard (impossible?) in the low interest rate environment of 2021 to establish a CRUT that would last for the life of any individual under age 28. The problem is particularly challenging for a CRAT, where there can be a greater impact caused by the large spread between the fixed distribution amount (that must be at least 5 percent of the value of the contributed property) and the assumed investment return of the assets in the trust (in the year 2021, the Section 7520 rate was never higher than 2.4 percent). For example, in the year

2021, a CRAT could not be established to make distributions for the life of anyone under age 78![34] In fact in 2021, a person could not establish a term of years CRAT with a 20 year term – the maximum permissible term was 19 years.

Things become even more challenging when there are multiple beneficiaries. The projected life expectancy for the last-to-die of a group of individuals increases as more individuals are added to the pool. For example, if in 2021 there was only one beneficiary of a CRUT, then the 10 percent test was met with a beneficiary as young as age 28. If there were two beneficiaries who were the same age (e.g., husband and wife), then they had to be at least age 39. The comparable minimum ages for a CRAT was considerably higher: one beneficiary (age 78); two beneficiaries who were the same age (both must be at least age 80).

What can an estate planner do if the beneficiaries are so young that a CRT fails the 10 percent test? One strategy is to create multiple CRTs. For example, if a client has three children who are triplets and each is age 28, there could be three CRTs (one for each child) rather than a single CRT. Another option is to have a CRT for a term of years. A term of years CRT would permit distributions to be made over more than the 10 year time limit for liquidating an inherited retirement account, but not longer than the 20 year term limit permitted for such a CRT.

c. Multiple beneficiaries - and what about the grandchildren ?

Most CRT governing instruments provide that when there are multiple concurrent lifetime beneficiaries of the CRT and one beneficiary dies, then future distributions will be divided among the surviving beneficiaries. Thus, if a CRT distributes $3,000 monthly to three children ($1,000 per child) and one child dies, most trust instruments will provide that thereafter the $3,000 will be divided among the two surviving children ($1,500 apiece). The last surviving beneficiary would receive monthly distributions of $3,000 until death, at which point the CRT would terminate and the trust's assets would be distributed to the charitable beneficiaries.

For those individuals who want their retirement assets to benefit their grandchildren, there are a variety of options. The first is to abandon the CRT idea and leave retirement assets outright to both children and grandchildren, recognizing that the inherited retirement accounts will have to be liquidated in ten years.

The second is to establish a CRT that benefits the children for a term of years (maximum 20 years), rather than for the lives of the children. A terms of years CRT can contain per stirpes provisions that would operate in the event of an early death of one of the children. The trust will qualify as either a CRAT or a CRUT, regardless of the identity or age of the beneficiaries, since it will terminate at the end of a fixed term.[35]

Anytime there is a possible payment to a grandchild, an estate planner should consider the possible impact of the generation skipping tax[36] if the estate will be large enough to trigger a federal estate tax liability. A CRT cannot be the source of payment of estate tax liabilities,[37] and proper GST allocations or alterative tax payment arrangements should be implemented. As will be illustrated later, there can also be income tax challenges when retirement assets of an estate that is subject to the federal estate tax are used to fund a CRT.[38]

d. Term of years CRT

By naming a term of years CRT as the beneficiary of a retirement account, distributions of retirement assets (and the income that they generate) could be made to the decedent's beneficiaries for a term longer than the 10 year period that generally applies to an inherited retirement account, but not longer than the 20 year limit permitted for a term of years CRT. Upon the CRT's termination, the trust's remaining assets would be distributed to the charitable remainderman. As mentioned above, an attractive beneficiary might be donor advised funds that will be advised by the same individuals who had benefitted from the assets in the CRT over the CRT's term.[39]

There are disadvantages with a high-payout CRUT (e.g., "each year distribute 11% of the assets"). The beneficiary of a high-payout CRUT will likely receive deceasing amounts every year since the distribution rate will usually exceed the annual investment return earned by the trustee. Although the amount of each year's distribution from a CRAT would remain the same throughout the term of the CRAT, the problem for the beneficiary of a 20 year CRAT is the effect of inflation. For example, if inflation is 2% per year, then the last fixed payment at the end of a 20 year term would have the purchasing power of just 67% of the first year's payment.[40]

A maximum-payout term-of-years CRUT will usually make a final distribution to the charitable remainderman that is much less than the original contribution to the CRUT. The only way that the trust's assets could increase is if the CRUT could consistently earn more than the high stated payout percentage. For example, if the trustee can only earn the Section 7520 rate, the assets in a maximum-payout term-of-years CRUT that begins with $100,000 should fall to between just $12,000 and $16,000 by the time the trust terminates.

This can impact a trustee's decision to agree to serve as the trustee of such a CRUT. To make the administration of a high-payout CRUT economically viable, the trust would have to begin with considerably more assets than just the $100,000 or $200,000 minimum amount often cited by commercial trustees. The other option is to reduce the stated payout percentage to a rate closer to what the trustee projects could be earned on the trust's assets (but not lower than the minimum 5 percent required for a trust to qualify as a CRT). Using a 5 percent distribution rate when the CRUT can steadily earn 7 or 8 percent would permit growing payments to the beneficiary and a large distribution to the charity when the term ended

3. Avoid multiple donors to a single CRT

The Service concluded in a 1995 private letter ruling that a CRUT that would be funded by multiple contributors (two grandparents and six grandchildren) would fail to qualify as a valid CRT.[41] The Service's logic was that the joint transfers had the effect of the donors acting as associates in an association (taxable as a corporation rather than a trust) that "pooled their assets with an object to carry on business and divide the gains therefrom." The safe-harbor CRT documents released in 2005 seem to reiterate the Service's policy against multi-donor CRTs, but allowed an exception for a multi-donor CRT that was established with contributions from both a husband and a wife.[42]

4. Private foundation self-dealing rules apply to CRTs

A CRT is subject to some of the private foundation excise taxes.[43] The CRT's trust instrument should specifically state that it will not engage in transactions that violate these excise taxes.[44] The provision that comes up most often is the prohibition on self-dealing. Beneficiaries should not borrow or buy from, or lend or sell to, the CRT since that would be a violation of the self-dealing rules of Section 4941.

5. Problematic assets

a. Partnership interests

When a CRT owns a partnership or an LLC interest, it is deemed to be engaged in the underlying activities of that partnership or LLC.[45] Thus, if a partnership or an LLC is engaged in a commercial business activity, then a tax exempt organization that owns an interest in that partnership or LLC must report its share of those profits as UBTI.[46]

Only the portion of the income that is attributable to a partnership's or LLC's unrelated commercial activities is subject to UBIT. A tax-exempt organization usually will not pay any tax on its share of partnership income from passive investments, such as interest, dividends and capital gains.[47] Thus, holding a partnership interest or an LLC interest of an investment club, whose income consists entirely of interest, dividends and capital gains, should not trigger UBTI to a CRT, unless the investments were financed with debt.[48]

b. S corporation stock

A Section 401(a) retirement plan, such as an ESOP, is eligible to own S corporation stock.[49] A charity is also eligible to own S corporation stock.[50] But neither an IRA[51] nor a CRT is eligible to be a shareholder of an S Corporation. A transfer of S corporation stock to a CRT will terminate the corporation's Subchapter S tax status.[52] If a qualified plan holds S corporation stock and if that plan's assets will be transferred at death to a CRT, then the stock should be sold inside the qualified plan account and only the proceeds, rather than the S corporation stock, should be transferred to the CRT.

c. Debt-encumbered property

There are serious complications that discourage individuals from donating mortgaged property to a CRT. The donor has been relieved of a liability, perhaps triggering the private foundation self-dealing tax and perhaps causing the CRT to be reclassified as a grantor trust.[53]

G. Added Requirements for CRATs That Pose Challenges

1. Only one contribution possible

A trust fails to qualify as a CRAT unless its governing instrument states that no additional contributions may be made to the CRAT after the initial contribution.[54] This prohibition does not apply to a CRUT. Despite the prohibition, the tax regulations provide that "all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution."[55] Thus, a testamentary CRAT could probably be funded with contributions from multiple retirement accounts as well as a bequest from an estate or from a grantor trust after the death of the settlor.[56] As is explained below in Part III.I.1, there can be income tax advantages if a separate CRT will receive retirement plan assets rather than commingling retirement assets with other assets in a CRT.

2. Five percent probability that CRAT's assets will not be exhausted

The IRS takes the position that no estate tax charitable deduction is allowed for a contribution to a CRAT that will make payments over someone's lifetime unless there is less than a 5 percent chance that the corpus will be exhausted.[57] The IRS did not want to allow a charitable deduction when it was possible that the annuity payments would consume all of the assets and nothing would be paid to a charity. This 5 percent probability test does not apply to a CRUT, nor does it apply to a CRAT that is payable over a fixed term of years.

In 2016, the Service offered a solution to this low-interest rate environment. In Revenue Procedure 2016-42 the Service permitted CRATs to be formed that would fail the 5% probability test if the governing instrument contained a "qualified contingency" that the trust would terminate immediately prior to making its next payment if distributing that payment would cause the trust principal to fall below 10% of the original value of the trust, plus interest.

H. Asset protection issues

In 2014, the Supreme Court concluded in a unanimous decision that an *inherited* IRA was not afforded the protection extended to "retirement funds" under bankruptcy law.[58] This development caused many estate planners to recommend that clients name as their IRA beneficiary a trust that contained spendthrift clauses.

A typical spendthrift clause prohibits a creditor from seizing a beneficiary's interest in a trust and prohibits the beneficiary from voluntarily or involuntarily assigning his or her interest in the trust to anybody else. Often the trustee has the discretion to avoid making distributions from the trust to a beneficiary. This power might be exercised when there is a creditor who is ready to seize each and every distribution that leaves the trust payable to the beneficiary.

With the requirement that inherited IRAs must be liquidated in just ten years, naming a tax-exempt CRT as the IRA's beneficiary is becoming an attractive option compared to naming a conventional taxable trust. If a CRT has no spendthrift clause, the interest of a beneficiary can be seized by creditors. But a CRT can contain spendthrift clauses. To the extent that these clauses are effective, they could prevent a creditor from seizing the CRT beneficiary's interest and prevent the CRT beneficiary from assigning his or her interest in the CRT to somebody else.

On the other hand, a CRT trustee is subject to very rigid requirements that distributions must be made each year pursuant to the instructions in the trust instrument. Once a distribution leaves a trust, it can be seized by a creditor. When there is just one beneficiary of a CRT, there is not the flexibility that a trustee could have with a conventional trust to withhold distributions to the beneficiary. Failure to make the required distributions can disqualify the CRT.[59]

Finally, there is concern that the spendthrift clauses might not be effective. In 2014, a bankruptcy court held that the broad spendthrift clause contained in a mother's trust did not prevent creditors from seizing a share of the trust's assets when one of the mother's four children filed a petition in bankruptcy.[60]

I. Four-tier system for income distributions to beneficiaries

1. Overview

Instead of the usual pass-through rules that apply to distributions from conventional trusts, distributions from charitable remainder trusts are subject to a "four tier" system. The distribution regime is commonly referred to as WIFO ("worst-in, first-out"). The income that is subject to the highest tax rates will be distributed from the trust before income that qualifies for lower tax rates can be distributed. Thus, all of the ordinary income from both the current year and from all prior years must be fully distributed from the first tier before a single dollar of capital gain income is distributed from the second tier, and so on.

The four-tier system provides that distributions from a charitable remainder trust shall have the following characteristics to the income beneficiary:[61]

(1) First, as amounts of income (other than capital gains) to the extent of such income for that year and undistributed income of the trust for all prior years;

(2) Second, as a capital gain to the extent of the capital gain for the year and the undistributed capital gain of the trust for all prior years;

(3) Third, as other income (such as tax-exempt municipal bond interest) to the extent of such income for the year and such undistributed income of the trust for all prior years; and

(4) Fourth, as a distribution of trust corpus.

Within each tier, there are layers of income. For example, the tax rate on the long-term capital gain from selling a collectible asset (e.g., a painting) can be as high as 28% but the long-term capital gain tax rate on the gain from selling a share of corporate stock is no more than 20%. Hence, following the WIFO principle, all current and prior-year collectible gains must be distributed in full from a CRT before a single dollar of 15%/20% long-term capital gain can be distributed. Most investment income in the first and second tiers can be potentially subject to the 3.8% surtax on net investment income,[62] but distributions from qualified retirement plans and IRAs are *not* subject to the 3.8% surtax.[63]

A CRT that was established after 2012 and that holds inherited retirement assets will report distributions to the beneficiary as coming from income from the following sources in the following sequence (income marked with an asterisk ("*") is exempt from the 3.8% surtax) :[64]

Tier 1 - **<u>Ordinary income</u>**	**Tier 2 -** **<u>Capital Gains</u>**	**Tier 3 -** **<u>Tax-exempt income</u>**	**Tier 4 -** **<u>Corpus</u>**
1. Taxable interest	1. Short-term capital gain (Ordinary income tax rate)	1. Current year's tax-exempt interest and other tax-exempt income*	1. Section 691(c) income tax deduction for IRD deposited into a CRT (per PLR 199901023 - see *infra* Part III.I.4)*
2. Net rents	2. Collectible gain (max 28% rate)	2. Accumulated tax-exempt interest and other tax-exempt income from prior years*	2. Capital contributions to the trust*
3. Annuity and royalty income	3. Building 1250 recapture gain (max 25% rate)	*(* no 3.8% surtax on tax-exempt income)*	*(* no 3.8% surtax on distributions of tax-exempt corpus)*
4. Dividends (non-qualified)	4. Other long-term capital gain (15% or 20% rate)		
5. Retirement income* *(* no 3.8% surtax on IRA/QRP distribution)*	5. NUA capital gain* (15%/20% tax, and *also exempt from 3.8% surtax)*		
6. Dividends (qualified-15%/20% tax rate)			

2. Implications for IRD

If a CRT is funded only with assets received from an IRA or QRP, then the CRT beneficiary likely won't receive dividends or long-term capital gains that would be taxed at the advantageously lower rates of 15% or 20% for at least 15 or 20 years. The entire amount of taxable IRD from the retirement account will be classified as first-tier income rather than fourth-tier corpus.[65] Even if all of the CRT's assets were invested in stocks and municipal bonds, it could take 15 or 20 years for a CRT with a 5 percent payout (5% times 20 = 100%) to completely distribute the IRD that was deposited into the CRT and thereby permit some lower-taxed qualified dividend income or long-term capital gain income to be distributed. Consequently, investing in lower-yielding tax-exempt bonds makes little sense for a CRT that was funded with retirement assets.

The four tier system also affects the decision of whether to add *non*-retirement assets to such a CRT. Rather than commingle IRD with a deposit of non-IRD assets (stocks, bonds, mutual funds, etc.) in a single CRT, it may be advisable to have a separate CRT for the IRD assets, particularly when there is a very large retirement accumulation of several hundred thousand dollars. The large amount of first-tier IRD will prevent the distribution of dividend or capital gain income generated from the investment of the non-IRD assets that were deposited in the trust. If, instead, there are two CRTs, a person can receive from one CRT the retirement income IRD (taxed as ordinary income but exempt from the 3.8% health care surtax) and have the chance of receiving dividends and long-term capital gains, taxed at rates as low as 15%, from the other CRT. The threshold issue is whether the potential income tax savings to the beneficiary will outweigh the cost of administering two CRTs.

As a service to upper-income beneficiaries who could be subject to the 3.8% surtax, the trustees of both CRTs and conventional trusts should point out in very strong terms that the IRD from retirement distributions is exempt from the surtax. Unless that is done, many upper-income beneficiaries will likely mistakenly pay the 3.8% surtax on CRT distributions of retirement income that is actually exempt from the surtax.

3. Long-term capital gain treatment for NUA

When employer stock is received as a lump sum distribution from a Section 401 qualified retirement plan, the net-unrealized appreciation ("NUA") can qualify for long-term capital gain treatment when the stock is sold. Unlike other capital gains, the NUA gain is exempt from the 3.8% surtax.[66]

4. Challenges when federal estate tax was paid

a. Overview

What happens to the Section 691(c) deduction when a retirement account is part of an estate that paid the federal estate tax? As an oversimplified example, if the sole contribution to a testamentary CRT was $1,000,000 from an IRA that was subject to the 40% federal estate tax, PLR 199901023 would classify $600,000 as first-tier ordinary income and the $400,000 (which would normally qualify for the Section 691(c) income tax deduction for the federal estate tax that was paid) as fourth-tier corpus.[67] The only way that any of the $400,000 could be distributed to a beneficiary of the CRT would be if the $1,000,000 CRT shrank to less than $400,000 of assets.

b. Tax planning implications

If the Service sticks to this approach, then in most cases it is better to abandon the IRA-to-CRT strategy for wealthy individuals whose estates will be subject to the federal estate tax.

Instead, a wealthy individual would be better advised to leave some or all of the pre-tax retirement assets outright to charities at death. The combination of federal estate and income taxes (plus in some states the estate and income taxes of the state) can consume as much as 80% of the IRD. Many people will prefer to leave 100% of the assets to a charitable purpose that they have selected rather than leave 80% to the governments in taxes. If there is a large amount of IRD, there may be sufficient assets to justify the cost of establishing a private foundation. By comparison, donor advised funds can provide philanthropic involvement by descendants at a much lower cost, while still avoiding both estate and income taxes.

For those with no charitable intent, it may be better to leave the retirement assets outright to beneficiaries rather than have the assets transferred to a CRT. An outright bequest to beneficiaries will permit them to claim the Section 691(c) income tax deduction to offset the taxable income from the IRD. Thus, a $100 distribution received from an inherited retirement account will only produce $60 of taxable income (oversimplified). By comparison, leaving the retirement assets to a CRT effectively strips away that income tax deduction by placing the deduction in the fourth tier. The $100 distribution received from the CRT will produce $100 of taxable income.

J. Charitable lead trusts are not tax-exempt

Another type of split-interest charitable trust is a charitable lead trust ("CLT).[68] Donors are usually attracted to such trusts because, in addition to charitable grants, they can provide estate and gift tax benefits. Unlike a CRT, a CLT is *not* exempt from the income tax. Either the trust (for a "non-grantor CLT")[69] or the donor (for a "grantor CLT")[70] will be subject to income tax on the trust's income. Hence, a CLT is a lousy beneficiary of IRD. The income tax burden will significantly shrink the CLT's assets and will reduce whatever other benefits that a CLT could provide.

CONCLUSION

Naming a charitable remainder trust as the beneficiary of a retirement plan is a way that a charitably inclined individual can use the pre-tax assets in a retirement account to benefit both charity and family. The circumstances that are most likely to provide the best income tax consequences for the family are (a) an anticipated long-term CRT (e.g., 30 years or more) and (b) anticipated high income tax rates imposed on income in respect of decedent.

ENDNOTES

1. § 4974; Reg. § 54.4974-2, Q&A 1 and 2; § 401(a)(9)(C)(i).

2. § 408(a)(6); Reg. § 1.408-8 Q&A 3.

3. § 401(a)(9)©; Reg. § 1.401(a)(9)-2, Q&A 2.

4. § 401(a)(9)(E)(i); Reg. § 1.401(a)(9)-4, Q&A 1.

5. § 401(a)(9)(E)(ii)

6. Reg. § 1.401(a)(9)-4, Q&A 4.

7. If a beneficiary's interest is eliminated between the time that the account owner died and the determination date – for example by a cash out or a disclaimer -- then that beneficiary will not impact the required minimum distributions. PLR 200740018 (July 12, 2007).

8. See Private Letter Rulings 200002011 (Sept. 30, 1999) and 200012076 (Dec. 29, 1999) (outright charitable bequests of nonqualified deferred compensation amounts).

9. *Id.*, also addressed the income tax aspects of charitable bequests of employee stock options.

10. There is no taxable income to an estate when savings bonds are transferred to a charity upon the owner's death. Private Letter Ruling 9845026 (August 11, 1998). If the charity is a private foundation, then it will be liable for the 1%/2% excise tax on the interest income. Rev. Rul. 80-118, 1980-1 C.B. 254.

11. Reg. § 1.691-2(b). Damages recovered by heirs for a decedent's back pay is IRD. *Carr Est. v. Commissioner*, 37 T.C. 1173 (1962).

12. Such payments are IRD. § 453B(c); Reg. § 1.691(a)-5. See also Rev. Rul. 78-32, 1978-1 C.B. 198 where the IRS concluded that if a sale is completed after the seller's death, then payments are income in respect of a decedent if most of the terms of the sale had been agreed to before death.

13. A CRT is tax-exempt under Section 664(c)(1), whereas charities and qualified plans are tax-exempt under Section 501(a).

14. Section 664(c)(2); Reg. § 1.664-1(c).

15. Section 512(c); Reg. § 1.512(c)-1. See also *Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner*, 724 F.2d 519 (6th Cir. 1983) (retirement plan's 90% ownership interest in limited partnership that distributed fasteners was taxable, even though the plan physically did no work).

16. §§ 512(b)(4) and 514; Treas. Reg. § 1.514(b)-1(a). The tax problems associated with debt-encumbered investment property are described further at *infra* Part III.F.5.

17. Rev. Rul. 74-39, 1974-1 C.B. 156.

18. The education process can begin during the donor's lifetime. The donor can establish donor advised funds for the children and grandchildren and educate them on philanthropy. Many organizations require a minimum of only $10,000 to establish a donor advised fund. The parent/grandparent can lead by example and identify the charitable interests that were most important to him or to her. The children and grandchildren in such a situation will likely do a better job with the resources in the donor advised fund than others who learn about donor advised funds for the very first time upon the termination of a CRT.

19. Treas. Reg. § 1.664-2(c)(6)(ii). As a practical matter, the CRT would need to have considerable assets to justify the costs of administering a private foundation.

20. I.R.C. § 664(d)(1); Treas. Reg. § 1.664-2.

21. I.R.C. § 664(d)(2); Treas. Reg. § 1.664-3.

22. I.R.C. § 664(d)(3)(A); Treas. Reg. § 1.664-3(b).

23. I.R.C. § 664(d)(3)(B); Treas. Reg. § 1.664-3(b).

24. Treas. Reg. § 1.664-3©.

25. See, for example, Michael Jones and Michelle Ward, "Alternative Investments in IRAs", *Trusts and Estates Magazine* (June, 2 Treas. Reg. § 1.664-3(c). The legal standard for the conversion is that it must be "triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons." Treas. Reg. § 1.664-3(a)(1)(i)(c)(1). The sale of an illiquid asset, such as real estate, might be considered to be within the discretionary control of the trustee. However, the regulations provide a safe harbor that "a triggering event based on the sale of unmarketable assets ... or the marriage, divorce, death, or birth of a child with respect to any individual will not be considered discretionary with, or within the control of, the trustees or any other persons." Treas. Reg. § 1.664-3(a)(1)(i)(d).

26. *Id.*

27. *Id.* ("a specific date").

28. Jonathan G. Blattmachr, Matthew D. Blattmachr, and Richard L. Fox, *Using a Charitable Remainder trust as the Recipient of Qualified Plan and IRA Interests*, 47 Estate Planning Journal #5 (May 2020).

29. I.R.C. §§ 664(d)(1)(A) (CRAT) and 664(d)(2)(A) (CRUT)

30. I.R.C. §§ 664(d)(1)(D) (CRAT) and 664(d)(2)(D) (CRUT). The test is applied on the date that the property is placed into the trust rather than on the date that the trust was created. Reg. § 1.664-2(c).

31. § 664(d)(2)(D). If an existing CRUT receives a new contribution that fails the 10% test, there is no affect on the existing assets of the trust but for federal tax purposes the new contribution will be treated as a transfer to a separate trust that is not a CRT. § 664(d)(4).

32. *Id.*

33. Rather than state the specific payout percentage in the trust instrument, it is possible to draft a formula clause in the trust instrument so that the exact payout rate will be determined at the time that the trust is funded. This is especially helpful for a testamentary CRT. The § 7520 rates could change so much between the time that a trust instrument is drafted and the time that a CRT is actually funded after the settlor's death that the fixed percentage that was stated in the trust agreement could be too high for the trust to pass the 10 percent charitable value test. Something akin to: *The Trustee shall pay, in each taxable year of the unitrust, a unitrust amount equal to the "payout percentage" multiplied by the net fair market value of the trust assets, as finally determined for federal tax purposes, valued as of the first day of each taxable year of the unitrust. The "payout percentage" shall be the highest rate allowable for this trust to qualify as a charitable remainder trust under § 664 of the Internal Revenue Code of 1986, as amended.* Thus, for example, if a 65 year old used this language in a testamentary CRUT for the benefit of a 33 year old child, the payout percentage would be 5.78% if the 65 year old died immediately but would be 7.66% if he or she died 10 years later and the child was then 43 years old. This computation was made assuming a 2.2% § 7520 rate (a common rate between 2012 and 2019) would also be in effect 10 years later. Is that likely to occur?

34. By comparison, the CRUT computations assume the payout computation will be based on a gradually shrinking pool of assets in the CRUT each year, so a higher stated payout is permitted.

35. See *supra* Part III.E.2.b for a range of possible distribution percentages that vary with the term of a CRAT or a CRUT.

36. I.R.C. §§ 2601 through 2652.

37. I.R.C. §§ 664(d)(1)(B) and 664(d)(2)(B).

38. See *infra* Part III.H.4.

39. See *supra* Part III.D.

40. Computed as: 1/(1.02 ^ 20^{th} power) = 67.3%.

41. PLR 9547004 (Aug. 9, 1995).

42. "*Identity of donor*. For purposes of qualification under this revenue procedure, the donor may be *an individual* <u>or</u> *a husband and wife*. Appropriate adjustments should be made to the introductory paragraph if a husband and wife are the donors." (emphasis added by author). Rev. Proc. 2005-54, 2005-2 C.B. 353 , Section 5.01(5) (annotations).

43. A CRT is subject to the excise taxes on "self-dealing" and "taxable expenditures," but is usually exempt from the excise taxes on excess business holdings and jeopardy investments. I.R.C. §§ 4947(a)(2) and (b)(3).

44. Treas. Reg. § 1.664-1(b), citing I.R.C. § 508(e).

45. "The activities of an LLC *treated as a partnership* for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of I.R.C. § 501(c)(3)." Rev. Rul 98-15, 1998-1 C.B. 718. This would not be the case, however, if the LLC elected to be treated as a corporation taxed under Subchapter C.

46. § 512(c); Reg. § 1.512(c)-1. See also *Service Bolt & Nut Co. Profit Sharing Trust v. Commissioner*, 724 F.2d 519 (6th Cir. 1983) (retirement plan's 90% ownership interest in limited partnership that distributed fasteners was taxable, even though the plan physically did no work).

47. Reg. § 1.512(c)-1; See also S. Rep. No. 1402, 85th CONG., 2d SESS. 2 (1958), reprinted at 1958-1 C.B. 656, 657. Interest, dividends, and capital gains are generally excluded from UBTI. §§ 512(b)(1), (3) and (5) and Reg. § 1.512 The exception would be if the investment income was generated by debt-financed property, described *infra* , at Part III.F.5.c.

48. Debt-financed income of a partnership passes through to a tax-exempt partner. § 514(c)(9)(B)(vi). See *infra* Part III.F.5.c for debt-financed UBTI.

49. § 1361(c)(6).

50. *Id.*

51. An IRA is generally not eligible to be a shareholder of an S corporation. See the last sentence of Treas. Reg. § 1.1361-1(h)(1)(vii) and *Taproot Administrative Services v. Commissioner*, 133 T.C. 202 (2009).

52. The IRS rejected creative arguments that a CRT could perhaps qualify as an S corporation shareholder. Rev. Rul. 92-48, 1992-1 C.B. 301; Private Letter Ruling 8922014 (June 2, 1989) (a CRT cannot be a QSST); § 1361(e)(1)(B)(iii) (a CRT cannot be an ESBT). There have been several mistaken transfers of S corporation stock to CRTs and the Service has forgiven the transgressions as "inadvertent terminations" provided that the transactions were undone. Private Letter Rulings 200819009 through 200818013(Jan. 11, 2008); 200704026 and 200703023 (Oct. 16, 2006) and PLR 199908046 (Nov. 19, 1998). Even if a CRT could be a shareholder, any S corporation income that was classified as UBTI would cause the CRT to incur a 100% tax liability because a CRT is subject to a 100% tax rate on UBTI. § 664(c)(2).

53. Reg. § 1.664-1(a)(6); Private Letter Rulings 9533014 (May 15, 1995) and 9015049 (Jan. 16, 1990) (when a CRT makes payments on a mortgage for which the donor remains liable, the CRT could be a "grantor trust" and thereby fail to qualify as a CRT - see Reg. § 1.677(a)-1(d)).

54. Treas. Reg. § 1.664-2(b).

55. *Id.*

56. In a private letter ruling the IRS concluded that a testamentary CRAT could receive contributions from both the settlor's estate and the settlor's inter vivos trust without violating the "additional contributions rule "because all properties passing to the charitable remainder annuity trust by reason of the death of the settlor are considered one contribution." Private Letter Ruling 8121108 (Feb. 27, 1981).

57. Revenue Ruling 77-374, 1977-2 C.B. 329.

58. *Clark v. Rameker*, 573 U.S. (2014).

59. When a trustee failed to make any required distributions to the life beneficiary, the Tax Court and the 11th Circuit Court of Appeals held that the trust failed from its inception to qualify as a CRT. *Estate of Atkinson*, 309 F.3d 1290 (11th Cir. 2002).

60. *In re Castellano*, 2014 WL 3881338 (Bk.N.D.Ill., Aug. 6, 2014).

61. § 664(b); Treas. Reg. § 1.664-1(d)(1)(I) (general rules) and 1.1411- 3(d) (the 3.8% net investment income tax – rules for CRT distributions).

62. § 1411(a)(1) imposes a surtax of 3.8 percent on the *lesser* of (A) an individual's net investment income or (B) the amount by which the individual's modified adjusted gross income exceeds the threshold amount of $250,000 (married joint returns; $125,000 if file separately) or $200,000 for all other returns (single or head of household).

63. § 1411(c)(5), Treas. Reg. § 1.1411- 8.

64. Modified from example contained in Treas. Reg. § 1.1411- 3(d)(2)(ii), Example 1. A CRT's accumulated income from before the year 2013 is exempt from the 3.8% surtax on net investment income, but most investment income after 2012 is subject to the surtax. Treas. Reg. § 1.1411-3(d). To simplify things, this table ignores pre-2013 income.

65. Private Letter Ruling 199901023 (Oct. 8, 1998).

66. Treas. Reg. § 1.1411-8(b)(4)(ii).

67. Actually, no more than $360,000 of federal estate tax would qualify for the § 691(c) deduction, since the estate would be able to claim at least a 10% charitable estate tax deduction on the federal estate tax return. For simplicity, though, the example uses $400,000 to make it is easier for the reader to follow the numerical illustration.

68. A charitable lead trust is the inverse of a CRT: the trust pays amounts to a charity for a period of years and then the remainder interest is distributed to non-charitable beneficiaries, typically family members related to the original donor. The charity's income interest must be either a guaranteed annuity of fixed payments (a charitable lead annuity trust, or

"CLAT") or annual distributions of a percentage of the fair market value of the trust's property, revalued annually (a charitable lead unitrust, or "CLUT"). I.R.C. § 170(f)(2)(B)(income tax); I.R.C. § 2055(e)(2)(estate tax); I.R.C. § 2522(c)(2)(B)(gift tax).

69. I.R.C. § 642(c)(1). Such a trust may be able to claim offsetting charitable deductions for distributions that are required to be made to charities.

70. I.R.C. § 671.