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Trustee's Failure to Administer Charitable Remainder Unitrust in Accordance with Governing Instrument Proves Costly

By Richard L. Fox, Esq.[*] *and Joshua D. Headley, Esq.*[**]

In two recently issued private letter rulings, PLR 201714002 and PLR 201714003, the failure of a trustee to administer a charitable remainder unitrust (CRUT) in accordance with its governing instrument caused the trust not to qualify under §664(a), leading to disastrous tax consequences.[1]

The trust was determined not to be exempt from income taxes and transfers to the trust did not qualify for a charitable deduction. And, although it failed to qualify under §664(a), the IRS ruled that the CRUT was still classified as a split-interest trust under §4947(a)(2) and, therefore, subject to the restrictive private foundation excise tax regime under Chapter 42 of the Code, including the self-dealing and taxable expenditure rules of §4941 and §4945. The fatal flaw in the administration of these trusts was that the trustee improperly included capital gain in the computation of trust income, which was not permitted under the governing trust instrument or state law. This error caused the payments to the noncharitable beneficiary to exceed the amounts otherwise permitted to be paid under the governing instrument of the CRUT.

These rulings highlight the importance of the trustee of a charitable remainder trust (CRT) to adhere to the terms of the controlling governing instrument, including, but not limited to, paying the proper amount to the noncharitable beneficiary.[2] An attorney drafting the CRT should advise the trustee regarding the proper administration of the trust and should stress that the failure to adhere to the governing instrument of the CRT may result in severe negative tax consequences, including: (i) the loss of income tax exemption under §664(a), (ii) the transfers of assets to the CRT not qualifying for a charitable deduction, and (iii) the imposition of substantial private foundation excise taxes.

CRTs GENERALLY

A CRT is a widely-used charitable planning technique that is often a recommended vehicle for individuals with substantially appreciated capital gain property, a charitable intent,[3] and a need for a stream of income during their lifetimes. The basic concept of a CRT involves a transfer of property to an irrevocable trust, the terms of which provide for the payment of an annuity or unitrust amount to the settlor (or other designated noncharitable beneficiary) for life or another predetermined period of time up to 20 years. The amount remaining in the CRT after the expiration of the annuity or unitrust payments must be transferred to one or more qualified charitable organizations or continue to be held in the trust for the benefit of such organizations. Unlike an outright gift to charity, therefore, a CRT blends the philanthropic in-

[*] Richard L. Fox is a shareholder and attorney in the Philadelphia office of Buchanan Ingersoll & Rooney PC, where he writes and speaks frequently on issues pertaining to philanthropic planning.

[**] Joshua D. Headley is an associate and attorney in the Washington, D.C. office of Buchanan Ingersoll & Rooney PC.

[1] All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

[2] Interestingly, apparently in response to the frequency of administrative errors that are committed in the administration of CRTs and other split-interest trusts, the Department of Treasury 2016–2017 Priority Guidance Plan includes ''Guidance under §§2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts.''

[3] *See* Byrle M. Abbin, *No More 'Gravy Train': 1997 Law Revisions Dramatically Affect the Economics of CRTs — Only Those With True Charitable Motivation Should Create Them*, 34 Phillip E. Heckerling Inst. on Est. Plan., Ch. 14 (2000).

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tentions of a donor with his or her financial needs or the financial needs of others.[4]

There is generally no gain recognition on the contribution of appreciated property to a CRT,[5] and because it is exempt from income tax, §664(a), the CRT may sell the transferred property on a tax-free basis and reinvest the proceeds in other assets. For an *inter vivos* CRT, a charitable income tax deduction is available for the present value of the charitable remainder interest. Therefore, in addition to providing a source of future payments to the settlor (or to one or more other or additional noncharitable beneficiaries), the CRT provides the dual benefit of an upfront charitable income tax deduction and the tax-free sale of appreciated property by the CRT. While the CRT itself is exempt from income tax under §664(c), the annual annuity or unitrust payments carry out income to the noncharitable beneficiary or beneficiaries based on specified ordering rules under a special four-tier system, generally treating the most highly taxed income of the trust as being distributed first.[6] Therefore, income realized by the CRT, although tax-free to the CRT, is ultimately taxable, albeit on a deferred basis, when it passes into the hands of a noncharitable beneficiary of the CRT.[7]

TWO GENERAL TYPES OF CRTs: CRATs and CRUTs

There are two basic types of CRTs: a charitable remainder annuity trust (CRAT) and a CRUT.[8] A CRAT provides for a fixed payment of a specified dollar amount at least annually to the noncharitable beneficiary or beneficiaries. The amount of the annual payment must be equal to at least 5% but not more than 50% of the initial net fair market value (FMV) of all of the assets transferred to the trust.[9] A CRUT provides for a payment at least annually to the noncharitable beneficiary or beneficiaries of a fixed percentage of the FMV of the trust principal revalued on an annual basis. Similar to the CRAT regime, the fixed percentage for a CRUT must be equal to at least 5% but not more than 50% of the net FMV of the assets of the trust as revalued annually.[10] While the amount of the annual payment under a CRAT is determined upon the funding of the trust and remains constant throughout its term, the amount of the annual payment under a CRUT fluctuates from year to year based on the FMV of the trust assets. When the value of the trust assets appreciates, unitrust payments will increase, and when the value of the trust assets depreciates, unitrust payments will decrease.

Variations of CRUTs Based On Net-Income Limitation

While CRATs come in one basic form, CRUTs can take a variety of forms. Under the standard CRUT, the amount of the payment to the noncharitable beneficiary or beneficiaries is equal to a fixed percentage of the value of the trust assets revalued on an annual basis.[11] The payment is made even when the net fiduciary accounting income of the trust is less than the fixed percentage payout amount, in which case a portion of the payment would necessarily come from the corpus of the trust. When CRTs were first being considered in the context of the Tax Reform Act of 1969,[12] the Senate Finance Committee amended the House bill to allow distributions for both CRATs and CRUTs to be limited to the net income of the trust, under the following rationale: ''Allowing a charitable remainder trust to distribute to the income beneficiary the lesser of the trust income or the stated payout will

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[4] In *Estate of Boeshore*, 78 T.C. 523 (1982), *acq. in result*, 1987-2 C.B. 1, the court specifically noted that donors often desire to mix private objectives with philanthropy and that it is common for interests in the same property to pass for both charitable and noncharitable purposes.

[5] The exception to this general rule of nonrecognition is when encumbered property is transferred to a CRT, whereby a bargain sale will be considered to result, thereby triggering a potential gain on the contribution. This is the case because the amount of the indebtedness is treated as an amount realized by the settlor, even if the CRT does not assume or pay the indebtedness. Reg. §1.1001-2(a)(3); PLR 7808016, PLR 7903075. Transferring encumbered property to a CRT is fraught with peril because, in addition to the bargain sale issue, it raises other potential negative tax consequences, such as grantor trust status (which could cause the CRT to fail to be tax exempt), unrelated debt-financed income (which could cause the trust to be subject to a 100% excise tax on such income), and self-dealing (resulting in the imposition of excise tax).

[6] Reg. §1.664-1(d)(1)(ii).

[7] Theoretically, the capital gain realized by the CRT upon the sale of contributed appreciated capital gain property may never be passed out to the noncharitable beneficiary for income tax purposes. This would be the case where, subsequent to the contribution of such property, the CRT earns ordinary income each year equal to or greater than the annual annuity or unitrust payout, in which case the lower-taxed capital gain income is never passed out to the noncharitable beneficiary. Typically, however, where appreciated capital gain property is contributed to a CRT, the annuity or unitrust payouts pass out a portion of such capital gain over time, as a CRT generally doesn't earn sufficient ordinary income to cover the annuity or unitrust payouts.

[8] The statutory framework for CRATs and CRUTs are set forth, respectively, at §664(d)(1) (annuity trust) and §664(d)(2) (unitrust). The IRS has issued model CRATs and CRUTs in series of Revenue Procedures. *See* Rosepink and Bradley, 865 T.M., *Charitable Remainder Trusts and Pooled Income Funds*, Worksheet 2.

[9] §664(d)(1)(A). Reg. §1.664-1(a)(1)(i).

[10] §664(d)(2)(A); Reg. §1.664-1(a)(1)(i).

[11] §664(d)(2)(A); Reg. §1.664-1(a)(1)(i).

[12] Pub. L. No. 91-172.

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prevent a trust from having to invade corpus when the income for a year is below that originally contemplated.''[13]

The Conference Committee, without explanation, applied this income limitation only to CRUTs. In the context of CRUTs, but not CRATs, therefore, the trust document may contain a provision limiting the distribution to the income of the trust in any year in which the net income is less than the fixed percentage payout amount otherwise required to be distributed if the trust were a standard CRUT.[14] The net income limitation has resulted in the following variations of the standard CRUT:

- Net income CRUT with make-up provision (NIMCRUT): A NIMCRUT pays a fixed percentage of the value of trust assets each year or, if less, the net income of the trust for the year, with any deficiencies due to the income limitation to be made up in later years to the extent the trust net income exceeds the amount determined using the fixed percentage payout rate.
- Net income CRUT with no make-up provision (NICRUT): A NICRUT pays a fixed percentage of the value of trust assets each year or, if less, the net income of the trust for the year. Any deficiencies due to the income limitation are not made up in later years, however, even if in later years the trust net income exceeds the amount determined using the fixed percentage payout rate.
- A NICRUT or NIMCRUT that flips to a standard CRUT (FLIP CRUT): A FLIP CRUT begins with a net income limitation, in the form of either a NICRUT or a NIMCRUT, and then, upon the occurrence of a permissible triggering event, flips to a standard unitrust[15] and, therefore, upon the flip, makes payments based on the fixed percentage payout rate without regard to the trust's net income.

For purposes of calculating the available charitable tax deduction, the calculation of the value of the remainder interest passing to charity under a NICRUT or NIMCRUT is made without regard to the fact that the annual distributions to the noncharitable beneficiary may be limited in those years in which the net income of the trust is less than the fixed percentage payout amount otherwise required to be distributed. As a result, the available charitable income tax deduction for the funding of a NICRUT or NIMCRUT is not reduced by virtue of the net income limitation, although such limitation may result in the charitable remainder beneficiary ultimately receiving more funds (and the noncharitable beneficiary ultimately receiving less funds) than when, as in the case of a standard CRUT, distributions are not subject to a net income limitation.[16]

Inclusion of Capital Gain in Trust Income of NIMCRUT

As a threshold matter, any allocation of capital gain to income in the context of a NIMCRUT must be in accordance with the rules applicable to CRTs under §664. Otherwise, an allocation of capital gain to income will result in the disqualification of the NIMCRUT. The applicable CRT regulations provide that the income of a NIMCRUT should generally be determined pursuant to the statutory and regulatory requirements of §643. Under §643(b), the term ''income'' means the amount of the income of the trust determined ''under the terms of the governing instrument and applicable state law.'' With respect to the allocation of capital gain realized by a NIMCRUT to trust income, Reg. §1.664-3(a)(1)(i)(b)(3) specifically provides as follows:

> Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state

[13] U.S. Code Congressional and Administrative News, 91st Cong, Pub. L. No. 91-172, S. Rep't, p. A-477. NICRUTs and NIMCRUTs are permitted under §664(d)(3).

[14] A net income limitation may be particularly useful when the property contributed to a CRUT is not liquid and the property is unproductive or the income that it produces is substantially less than the standard unitrust payment, but it is anticipated that the property will be sold or produce significant income in the future.

[15] FLIP CRUTs are authorized under Reg. §1.664-3(a)(l)(i)(c).

[16] This may also limit the charitable income tax deduction if the unitrust recipient contributes his or her net income unitrust interest to charity because the value of the contributed interest will be based, not on the unitrust payout percentage, but on the rate published by the IRS to determine the value of a fiduciary income interest. *See generally* Rev. Rul. 86-60, 1986-1 C.B. 302.

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statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

Under the foregoing provision, it is permissible under §643 for a trustee of a NIMCRUT to be granted a discretionary power to allocate to trust income capital gain realized on assets purchased by the trust to the extent such an allocation would be permitted under state law. In addition, if permitted by state law, a trustee may have a discretionary power under such provision to allocate to trust income capital gain income realized with respect to such transferred assets attributable to appreciation occurring subsequent to the transfer. The two categories of capital gain income — i.e., capital gain realized on assets purchased by the trust and capital gain income on appreciation of assets transferred to the trust subsequent to the transfer — are commonly referred to as ''post-contribution capital gain.'' Of note is that Reg. §1.664-3(a)(1)(i)(b)(3) did not become final until December 30, 2003 and, according to the preamble to the regulations, the discretionary power to allocate post-contribution capital gain to trust income only to the extent permitted under state law ''is applicable to trusts created after January 2, 2004.''[17]

Even prior to the Reg. §1.664-3(a)(1)(i)(b)(3) becoming final, the IRS had privately ruled that a discretionary allocation of post-contribution capital gain to the trust income pursuant to the governing instrument of a NIMCRUT and state law was permissible for federal income tax purposes. In PLR 199907013, the IRS approved a trust provision that gave the trustee discretion to allocate to trust income some or all of post-contribution capital gain realized by the trust on the disposition of certain assets. Under the applicable state law in the ruling, capital gain income was generally required to be allocated to principal. However, state law also provided that if a trust instrument ''gives the trustee discretion in crediting a receipt or charging an expenditure to income or principal or partly to each, no inference that the trustee has improperly exercised discretion arises because the trustee has made an allocation contrary to a provision of State law.'' The IRS ruled that under the terms of the governing instrument and the applicable state law, it was permissible for the trustee to allocate capital gain income occurring after the trust held the assets to trust income. Thus, a discretionary allocation of capital gain income to trust income in this ruling was determined not to affect the qualification of the trust under §664. Therefore, the IRS stated that ''under the terms of Trust's governing instrument and applicable local law, trust income may include the appreciation in certain Trust assets that occurred since Trust held those assets.''

Application of §4947(a)(2) to CRTs

Although exempt from income taxes under §664(c)(1),[18] a CRT does not qualify under §501(c)(3) and, therefore, is not exempt from tax under §501(a). As such, a CRT cannot be classified as a private foundation under §509(a). A CRT is, however, included within the definition of a ''split-interest trust'' under §4947(a)(2) and, as such, is subject to certain Chapter 42 excise tax provisions otherwise applicable to private foundations. The private foundation excise tax provision can often prove to be quite troublesome and present certain obstacles in the context of CRTs.

Specifically, §4947(a)(2) provides that a trust that is not exempt from income tax under §501(a), not all the unexpired interests in which are devoted to one or more §170(c)(2)(B) purposes and which has amounts in trust for which a charitable contribution deduction was allowed under §170, §545(b)(2), §642(c), §2055, §2106(a)(2), or §2522, will be subject to the following private foundation provisions: (1) §507 (relating to termination of private foundation status); (2) §508(e) (relating to governing instrument requirements (to the extent applicable to split-interest trusts); (3) §4941 (relating to taxes on self-dealing); (4) §4943 (relating to excess business holdings); (5) §4944 (relating to investments, which jeopardize charitable purposes); and (6) §4954 (related to taxable expenditures).

In the absence of proof to the contrary, a trust is presumed to have amounts in trust for which a deduction was allowed under §170, §545(b)(2), §556(b)(2), §642(c), §2055, §2106(a)(2), or §2522 if a deduction would have been allowable under one of these sections.[19] During the term of the trust where annuity or unitrust payments are being made to noncharitable beneficiaries, a CRT qualifying under §664 is subject to §4947(a)(2). Under special rules provided under §4947(b)(3), the excess business holdings rules of §4943 and the jeopardy investment rules of §4944 do not apply to a trust otherwise described in §4947(a)(2) if a deduction was allowed under §170, §545(b)(2),

[17] *See also* Reg. §1.664-3(a)(1)(i)(b)(3) (last sentence).

[18] Note, however, that under §664(c)(2)(A), a CRT is subject to a 100% excise tax on any unrelated business taxable income as defined under §512.

[19] Reg. §53.4947-1(a). *See also*, *e.g.,* PLR 200009058 (''The Trust is presumed (in the absence of proof to the contrary) to have amounts in trust for which a deduction was allowed if a deduction would have been allowable under those sections.''); IRM 7.26.15.2.3(1) (''If a charitable deduction was allowable, it will be presumed to have been taken and allowed in the absence of proof to the contrary.'').

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§642(c), §2055, §2106(a)(2), or §2522 for amounts payable under the terms of such trust to every remainder beneficiary but not to any income beneficiary. As a result, §4943 and §4944 do not apply CRT qualifying under §664 where such a deduction was allowed.

Formalities in the Administration of CRTs in Accordance With Governing Instrument

Where a CRT otherwise meets all of the requirements of §664, the failure to comply with the formalities in connection with the administration of the trust in accordance with its governing instrument may result in disqualification of the trust under §664, causing potentially disastrous results. The leading case in this area is the *Estate of Atkinson v. Commissioner*,[20] where the settlor of a CRAT, at age 95, funded a CRT with stock worth approximately $4 million. The trust provided for annuity payments of $200,000 to be paid to her for life. Notwithstanding the terms of the CRAT, the annuity payments were never, in fact, made to the settlor. The settlor's estate claimed a $3.9 million estate tax charitable deduction,[21] which the IRS disallowed on the basis of the trust not complying with the terms of the trust from the date of its creation. In affirming the decision of the Tax Court, the Eleventh Circuit Court of Appeals stated:

> The documents that establish the Atkinson annuity trust track the CRAT requirements to the letter. However, the Atkinson annuity trust failed to comply with the CRAT rules throughout its existence. Yearly annuity payments to Atkinson were not made during her lifetime. Accordingly, since the CRAT regulations were not scrupulously followed through the life of the trust, a charitable deduction is not appropriate.

In response to the taxpayer's argument that the failure to pay annuity payments amounts to nothing more than a ''foot fault'' or a minor mistake, the court stated that ''[i]t is not sufficient to establish a trust under the CRAT rules, then completely ignore the rules during the trust's administration, thereby defeating the policy interests advanced by Congress in enacting the rules. . . .'' The court emphasized that Congress required strict adherence to the requirements of §664 and, barring such adherence, a complete denial of a charitable deduction was warranted. Notwithstanding that the failure to pay the annuity payments in *Atkinson* in no way injured the charitable remainder beneficiary (in fact, it would have benefitted the charity), the court disallowed the entire estate tax charitable deduction claimed by the estate. Thus, even where there is no harm to the charitable remainder beneficiary, all of the technical requirements and formalities of a CRT must be followed.

Discussion of PLR 201714002 and PLR 201714003

Facts

In PLR 201714002 and PLR 201714003, the taxpayer had assets consisting primarily of low basis, non-dividend paying stocks. The taxpayer was advised by his financial planner, as well as his lawyer, who was recommended by the financial planner, to transfer his low basis capital assets to a CRUT in order to avoid the imposition of capital gain taxes on the subsequent sale of those assets by the trust. The taxpayer was also advised that this arrangement would allow the trust to sell the stock in the future without incurring capital gains taxes, and that trust would serve both as an estate planning vehicle and a charitable giving vehicle. In addition, the taxpayer claimed charitable income tax deductions under §170 upon funding the trust and for the second and third year of the trust, when additional transfers were made to the trust by the taxpayer.

Under the governing instrument of the CRUT, the taxpayer was named a co-trustee and the initial noncharitable beneficiary of the unitrust payments. The term of the CRUT was 20 years and, if the taxpayer died during the term of the trust, a successor noncharitable beneficiary, who was the other co-trustee, was to receive the unitrust payments for the remainder of the term and become the sole trustee. If the successor noncharitable beneficiary did not survive the 20-year term, then such beneficiary's spouse was to become the sole trustee and successor noncharitable beneficiary for the remaining term.

According to the rulings, the attorney advised the taxpayer that there would be no gift taxes due upon the creation of trust because there would be no completed gift to the successor recipient at that time. To achieve this result, the taxpayer was supposed to retain the right to change the successor recipient. However, when the attorney drafted the trust agreement, he failed to reserve the taxpayer's right to change the successor recipients. As a result, the interests of the successor recipients vested at the time the trust agreement was executed, and the gift to the successor recipients became complete causing gift tax to be due and owing. However, when gift tax returns were pre-

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[20] 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002).

[21] Because the settlor was the designated noncharitable beneficiary of the annuity payments, the corpus of the trust was required to be included in her gross estate under §2036. In such a case, however, an estate tax charitable deduction is allowable for the value of the remainder interest passing to a qualified charity.

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pared by the taxpayer's accountant for the year the trust was created and funded, the accountant relied on the advice given by the attorney that no gift was made as result of the property transfers to the trust.

The trust governing instrument provided that the definition of trust income for purposes of determining the payouts to the noncharitable beneficiary was ''defined in §643(b) of the Internal Revenue Code of 1986 and regulations thereunder.'' Apparently, there was no language contained in the trust governing document either requiring or granting the discretion to the trustee to allocate any post-contribution capital gain to trust income and, under the applicable state law, capital gain income was otherwise required to be allocated to principal, not trust income.

According to the rulings, the taxpayer's financial planner and attorney ''allegedly made a number of misleading and legally erroneous representations regarding the operation of [the] Trust,'' including promising the taxpayer that he would receive a guaranteed fixed percentage annual return on the net fair market value of trust assets. Relying upon the advice and representations made by the financial planner and attorney, the taxpayer executed the trust agreement.

Apparently, unbeknownst to the taxpayer, and perhaps the drafting attorney as well, the trust was, in fact, drafted as a NIMCRUT, whereby the trust was required to pay a unitrust amount each year equal to the lesser of a fixed percentage of the value of the trust or the trust income, with any deficiencies resulting from the income limitation to be made up in later years to the extent the trust income exceeds the amount determined using the fixed percentage payout rate. The fixed percentage was not stated in the rulings, but had to be at least equal to the 5% minimum required payout.

At the recommendation of the financial planner, the trust assets were invested by the trustees in annuities and insurance products that the planner was licensed to sell. These types of investments were apparently incapable of producing trust income sufficient to pay the fixed percentage payout rate under the trust, which would have caused the payouts to be limited to trust income, not the greater fixed percentage payout amount that the financial planner and attorney represented would be paid.

Based upon the advice of the financial planner and attorney, contrary to the governing instrument and applicable state law and in an effort to bring the trust income up to the fixed percentage payout amount, the trustee augmented the trust income by including capital gain income of the trust in the calculation of trust income. This augmented amount was paid to the taxpayer during the term of the trust for each year that he was alive, including the year the trust was created and funded. By improperly allocating capital gain income to trust income for purposes of determining the payouts to the noncharitable beneficiary, the trustee erroneously determined the amount to be distributed to the taxpayer by improperly including capital gain income in the calculation of trust income. Therefore, from its creation, the trust was not administered according to the terms of its governing instrument, resulting in distributions having been made to the taxpayer during his lifetime that exceeded the amounts that were legally permissible.

Following the third year of the term of the trust, the taxpayer died and the successor noncharitable beneficiary became the sole trustee and sole unitrust recipient. After presumably being advised (by someone other than the financial planner and attorney involved in the trust's creation) about the trust's compliance failures, the trustee petitioned the local court to either reform or terminate the trust.[22] In response to the petition, and despite objections by the State Attorney General, the court issued a declaration and order determining that trust was void *ab initio*. The court's order in this regard was contingent on the trust receiving from the IRS a favorable ruling that provides that such declaration would not result in additional federal income tax consequences. The court order further provided that, in the event the trust does not receive a favorable ruling from the IRS, the trustee was required to file a statement to that effect with court, and upon such filing the trust will be declared to be terminated and, after payment of all amounts due and owing the IRS and State Department of Revenue from the assets of trust, the remaining assets in the trust will be distributed to its unitrust recipient, with no funds going to the charitable remainder beneficiary. The successor noncharitable beneficiary died after the date the court order was issued, and his surviving spouse then became the sole trustee and unitrust recipient.

IRS Rulings Made in PLR 201714002 and PLR 201714003

The IRS ruled that, based on *Atkinson*, the trust failed to operate exclusively as a CRT from its creation and throughout its entire existence by virtue of failing to operate in accordance with its terms by making distributions in excess of the annual trust income to the noncharitable beneficiary of the trust. Therefore, from the date of its creation, the trust was determined not to be a CRT for purposes of §664.

The IRS ruled that the court's order to treat the trust as void *ab initio* provided, however, that the IRS confirmed the lack of any additional federal tax conse-

[22] This was done after a number of failed petitions by the successor beneficiary for the trust to be reformed, to which the State Attorney General and the charitable remainder beneficiary objected.

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quences, ''would be equivalent to a rescission.'' In this regard, the IRS noted that in §3.02(8) of Rev. Proc. 2016-3,[23] the IRS announced that the question of whether a completed transaction may be rescinded for federal income tax purposes is an area in which rulings will not be issued. Based on Rev. Proc. 2016-3, and citing Rev. Rul. 80-58 as additional support,[24] the IRS concluded that it was unable to provide a favorable ruling that the local court's declaration that the trust was void *ab initio* would have no federal tax consequences. Without a favorable ruling on this issue, the IRS stated, ''it appears that Court's order would default to Trust termination. In that event, the question becomes whether there are federal tax consequences for such termination.'' As such, the IRS could only determine the tax consequences of the trust's termination, whereby the remaining trust funds (after payment of taxes due) would be distributed to the unitrust recipient, with no funds to be distributed to the charitable remainder beneficiary.

In making this determination, the IRS stated that while the trust failed to operate exclusively as a CRT and thus maintain its tax exemption under §664, it was nevertheless subject to the split-interest trust rules under §4947(a)(2) because (1) the trust was not exempt from tax under §501(a), (2) not all of the unexpired interests in the trust were devoted to charitable purposes, and (3) the trust had amounts in trust for which a charitable deduction was allowed under §170. Even though the charitable deduction taken under §170 was technically not allowable because the trust failed to qualify under §664, the IRS stated that because charitable deductions were claimed by the taxpayer under §170 and were not challenged by the IRS, these deductions were ''allowed'' for purposes of §170, under the reasoning of *Virginian Hotel Corp. v. Helvering*.[25] In that case, the Supreme Court held that ''allowed'' meant that the taxpayer had taken the deduction and the IRS had not challenged it. Noting that there was ''no machinery for formal allowances of deductions from gross income,'' the Supreme Court held that a deduction being claimed and going unchallenged by the IRS is the only way in which a deduction could be ''allowed.''

As a result of the trust being subject to §4947(a)(2), the IRS ruled that the proposed distribution of trust assets to the noncharitable beneficiary upon the termination of the trust, ''without regard to the interest of the charitable remainder beneficiary,'' would result in excise taxes under §4941 (self-dealing) and §4945 (taxable expenditure), which would require correction,[26] in effect, making any such distribution prohibitive. The IRS stated that the trust ''may avoid these chapter 42 [private foundation] taxes by voluntarily terminating its private foundation status under §507(a)(1) prior to distribution of assets pursuant to the court order, under the procedures set forth in §1.507-1(b).'' Such a voluntary termination, however, as noted in the rulings, triggers a ''termination tax'' under §507(c), which could be equal to the entire net value of the remaining assets.[27] Therefore, a voluntary termination of the trust's private foundation status prior to the proposed distribution to the noncharitable beneficiary would not have been a workable solution to the noncharitable beneficiary seeking a distribution from the trust.

The IRS further noted in the rulings that if a distribution was made to the noncharitable beneficiary in accordance with the court order prior to the trust voluntarily terminating its private foundation status, such a distribution ''may also be regarded as a willful and flagrant act giving rise to liability for tax under chapter 42 (as voluntarily, consciously, and knowingly in violation of chapter 42 and grossly contrary to the purpose of a split-interest trust . . .),'' thereby justifying the involuntary termination of the trust's status as a private foundation, which also triggers the termination tax under §507(c).

Finally, the IRS ruled that the trust must file income tax returns and pay any income tax owed, plus interest and penalties, as a trust subject to taxation under Title 1, Subchapter J of the Code for any tax years that may remain open under §6501(a) from the date of trust's establishment. And because the trust did not qualify as a CRT under §664 and no distributions, in any event, were proposed to go to charity, the entire value of the trust would have been included in the tax-

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[23] 2016-1 I.R.B. 126, 133.

[24] In Rev. Rul. 80-58, 1980-1 C.B. 181, which did not involve a trust, the IRS stated that the legal concept of rescission refers to the abrogation, cancelling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. However, the annual accounting concept requires that one must look at the transaction on an annual basis at the end of the tax year. That is, each taxable year is a separate unit for tax accounting purposes. Therefore, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

[25] 319 U.S. 523 (1943).

[26] Generally, ''correction'' means undoing a transaction to the extent possible which, in these rulings, would have required that the distributions to the noncharitable beneficiary be repaid to the trust.

[27] Section 507(c) imposes on a organization voluntarily terminating its private foundation status a tax equal to the lower of: (1) ''the amount which the private foundation substantiates by adequate records or other corroborating evidence as the aggregate tax benefit resulting from the section 501(c)(3) status of such foundation,'' or (2) ''the value of the net assets of such foundation.''

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payer's gross estate, with no offsetting estate tax charitable deduction under §2055.

Given the rulings by the IRS, it is a virtual certainty that no distribution was ever made by the trust to the noncharitable beneficiary pursuant to the local court order. Instead, it was likely ''back to the drawing board'' for this trust, whereby the trustee would have likely sought a court order for the termination of the trust by distributing all of the assets to the charitable remainder beneficiary or, possibly, a proportionate distribution of trust assets to the unitrust recipient and the charitable remainder beneficiary.[28]

CONCLUSION

Recently issued PLR 201714002 and PLR 201714003 reinforce how importance it is for the trustee administering a CRT to ensure adherence to the terms of the controlling governing instrument and that the failure to do so can lead to potentially disastrous tax consequences. It is equally important for taxpayers to retain advisors who are knowledgeable, experienced, and reputable, given that the financial planner and attorney in these rulings committed major mistakes and made improper representations, and gave advice that ultimately resulted in a flawed CRT and a host of tax problems.

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[28] *See* Richard L. Fox and Jonathan G. Blattmachr, *New Valuation Rules for NICRUT/NIMCRUT Early Termination*, 43 Est. Plan. J. 3 (July 2016).

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