K. CHARITABLE REMAINDER TRUSTS: THE INCOME DEFERRAL ABUSE AND OTHER ISSUES

by
Ron Shoemaker and David Jones

1. Introduction

The focus of this article is the use of charitable remainder unitrusts to defer income and the circumstances where this creates problems under the IRC 4941 self-dealing rules. Following this material is a discussion of several of the current issues relating to charitable remainder unitrusts.

Under IRC 4947(a)(2) some of the Chapter 42 restrictions, primarily IRC 4941 and IRC 4945, are applicable to split interest charitable trusts, including charitable remainder unitrusts. The Service is aware of a growing practice of using this format for purposes other than those originally intended by Congress.

In making these arrangements, a number of donors and their relatives, who are disqualified persons under IRC 4946, may have violated the self-dealing prohibition of IRC 4941. For example, in Notice 94-78, 1994-2 C.B. 555, the Service addressed the problem of the charitable remainder unitrust format being used as a vehicle to avoid tax resulting from the realization of gain on the sale of appreciated assets. An article in the FY 1996 CPE text, "Self-Dealing and Other Issues Involving Charitable Remainder Trusts" (Topic G at 159), discusses the self-dealing aspect of the problem presented in Notice 94-78.

Another recent tax scheme involves the use of the "net income with makeup" charitable remainder unitrust, the so-called "NIMCRUT." The tax deferral aspects of these trusts have been touted in a number of published tax articles.

2. Discussion of the Problem

The standard fixed charitable remainder unitrust under IRC 664(d)(2)(A) requires a minimum fixed percentage payout from the trust annually in an amount that is no less than 5 percent of the net fair market value of the trust assets which are valued no less frequently than annually. The fixed percentage payout may be greater than 5 percent. If the unitrust is unable to generate sufficient income from its investments to pay the required unitrust payout amount, the trustee must dip into trust principal for the necessary funds.

An alternative, the net income limitation under IRC 664(d)(3), allows a trust instrument to provide an annual payout that is the lesser of the amount of trust income for the year or the fixed percentage (of trust assets) payout of 5 percent or more provided for in the trust instrument. Thus, with a net income limitation, if the trust income is not sufficient to pay the fixed percentage payout amount, the trustee is authorized to pay to the noncharitable income beneficiary only the amount that is the trust's income for the year. Under IRC 664(d)(3), a trust's income is defined by state law. The advantage of this provision is that the trustee need not resort to trust principal to fulfill the trust's obligation to the income beneficiary.

The deficit in the income paid to the income beneficiary also may be made up at some future date if the unitrust has a makeup provision pursuant to IRC 664(d)(3)(B). With a makeup provision, if the trust income exceeds the fixed percentage payout amount, the excess may be paid to the income beneficiary to make up a deficiency from prior years. Trusts with both net income limitations and makeup provisions are called NIMCRUTS. The Service has seen NIMCRUTS used to defer income to the beneficiary.

When Congress described IRC 664(d)(3), it stated:

> ***Allowing a charitable remainder unitrust to distribute to the income beneficiary the lesser of the trust income or the stated payout will prevent a trust from having to invade its corpus when the income for the year is below that originally contemplated.***

General Explanation of the Tax Reform Act of 1969, 91st Cong., 1st Sess., at 85. IRC 664(d)(3) was enacted to give trustees breathing room. If, in any year, trust income dropped and the distributions to the noncharitable beneficiaries originally intended by the donor could not be met using trust income, the trustees could temporarily reduce the current payout, or could otherwise adjust the unitrust's portfolio to generate sufficient income for future years.

However, the net income and makeup provisions of IRC 664 are now being used not to gain flexibility in the normal management of the portfolio, but for a tax deferral purpose not contemplated by Congress.

To achieve a maximum deferral for a noncharitable beneficiary, a trust's assets must be manipulated in such a manner so that the net income and makeup provisions can be used to avoid payout in the early years of the trust and to realize income, including the makeup amount, only in later years when the noncharitable income beneficiary may be in a lower tax bracket. This device is called an income deferral NIMCRUT.

The operation of the income deferral NIMCRUT and the tax benefits that may be achieved are illustrated by the following example:

> Individual **A** is a key employee and major stockholder of closely-held corporation **M** which specializes in high technology products. **A** has substantial wealth from his ownership of **M** stock as well as a substantial salary with **M** of $500,000 per year. **A** is 55 years of age and wishes to arrange his income, retirement, and estate planning to avoid taxes to the greatest extent possible.
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> In year one, **A** executes a NIMCRUT, called **TRUST X**. **TRUST X** will pay the unitrust amount annually to **A** for his life and then to **A**'s wife for her life. The unitrust amount will be the lesser of 8 percent of the annual fair market value of the trust's assets or the income of the trust. If the trust income is greater than 8 percent in any year, the excess income will be used to make up any deficiency in the unitrust amounts for prior years. Income is defined under the governing instrument to include income from the sale of the trust's assets.
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> **Trust X** is funded with **M** stock which has a zero basis and a current fair market value in year one of $20,000,000. The **M** stock has no history of paying a dividend, and, when **TRUST X** is created, the stock is expected to appreciate significantly in value over the years.
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> Time passes. **Trust X** realizes no income from the **M** stock during the first 10 years while **A** continues to receive his substantial salary from **M** as a key employee. In year eleven, **A** retires. In year eleven the **M** stock has a fair market value of $34,000,000. By prearrangement and subject to regular consultation, **Trust X** has held the stock off the market. Beginning in year eleven and over the next five years **Trust X**, at **A's** direction, sells all of the **M** stock, 20 percent each year. Beginning in year eleven and for the next five years, **A** receives substantial income from **Trust X** under the makeup provision of IRC 664(d)(3)(B). **A** will continue to receive income from the trust in year 15 and thereafter since **Trust X** has invested a portion of the proceeds from the sale of **M** stock (the portion not distributed to **A**) in other assets.
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> Assuming that taxes can be avoided under IRC 4941, the tax benefits to **A** are obvious. As is true for donors to all charitable remainder trusts, **A** will receive a current charitable deduction. The deduction will be used to offset his substantial salary generated by his employment with **M**. In addition, **A** is able to benefit from the tax free build-

> up of the income from **Trust X** for ten years and has shifted the receipt of that income to years when he will be taxed at a lower rate.

3. NIMCRUTS and the Self-Dealing Provisions

Analytically, the self-dealing issues for both charitable remainder unitrusts used as tax shelters and for the income deferral NIMCRUTS are similar. In both cases, unitrust assets must be managed in a particular way if the desired result is to be achieved. For **Trust X**, the way is to hold the stock of **M** off the market until year eleven in order to defer tax during years one through ten. Whether this is an act of self-dealing depends on whether it can be characterized as "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation", as that phrase is used in IRC 4941(d)(1)(E).

A classic example of the use of foundation assets to benefit a disqualified person may be found in Rev. Rul. 74-600, 1974-2 C.B. 385. Rev. Rul. 74-600 states that the placing of paintings owned by a private foundation in the residence of a substantial contributor/ disqualified person constitutes an act of self-dealing.

As early as 1969, the Joint Committee on Taxation realized that self-dealing could involve something other than a transfer of the asset between the parties. The General Explanation of the Tax Reform Act of 1969 states at p. 31 that:

> A self-dealing transaction may occur even though there has been no transfer of money or property between the foundation and any disqualified person. For example, securities purchases or sales by the foundation to manipulate the prices of the securities to the advantage of the disqualified person constitute a "use by or for the benefit of a disqualified person of the income or assets of a private foundation."

This conclusion was echoed in the regulations. Reg. 53.4941(d)-2(f)(1) provides in part that "the purchase or sale of stock or other securities by a private foundation shall be an act of self-dealing if such purchase or sale is made in an attempt to manipulate the price of the stock or other securities to the advantage of a disqualified person."

One point that the regulation makes quite clear is that for a stock manipulation to be considered a "use by or for the benefit of a disqualified person," it must be intentional. In the words of the regulation, it must be "made in an attempt to manipulate" the price of the stock. (Emphasis added)

Although the manipulation must be intentional, the individuals involved need not know that engaging in such manipulation may constitute self-dealing. Reg. 53.4941(a)-1(a)(1) provides that the excise tax shall be imposed on a disqualified person even though he had no knowledge at the time of the act that the act constituted self-dealing. See also G.C.M. 37731 (October 26, 1978).

Also consider the case of a private foundation which receives from an estate as a bequest three secured mortgage notes carrying a rate of interest described as excellent. The obligor under the notes is a partnership that is a disqualified person with respect to the private foundation. The loan was made at an earlier date, but is less than 10 years old. It was not contemplated that the notes would be transferred to the foundation. Reg. 53.4941(d)-2(a)(2) provides that if a private foundation assumes a mortgage that a disqualified person placed on the property within 10 years, the transfer will be considered self-dealing under 4941(d)(1)(B).

An asset manipulation intended to provide an economic benefit (the maximum tax deferral) for a NIMCRUT's income beneficiary, therefore, may be involved in self-dealing where the beneficiary is a disqualified person. In 4941 terms, it may be a use that is for the benefit of a disqualified person.

In the earlier example, **Trust X** may be involved in self-dealing, because the stock of **M** intentionally has been managed in such a way as to obtain a benefit (the maximum tax deferral) for **A**, a disqualified person. The issue then becomes whether it is the kind of benefit that is appropriate for a noncharitable beneficiary under IRC 4947(a)(2).

Charitable remainder unitrusts are unlike tax exempt private foundations in that they partially serve noncharitable interests. To rationally apply IRC 4941 to charitable remainder unitrusts, there has to be some way to draw the distinction between legitimate charitable and noncharitable interests.

For split interest trusts, that method is suggested in Reg. 53.4947-1(c)(2)(i). The regulation provides that the income beneficiaries under the terms of the trust are excepted from self-dealing with respect to unitrust distributions providing that these payments are not made from amounts for which a deduction was allowed. (Emphasis added.) This exception, found at IRC 4947(a)(2)(A), is obviously necessary to preclude the application of the self-dealing rules where a trust makes a payout to the noncharitable income beneficiary. Without such a provision, the charitable remainder trust is not possible.

It also suggests that the remainder interest must be negatively affected in order for a transaction to be characterized self-dealing.

The IRM makes the obvious point that "Payments to private beneficiaries in excess of proper unitrust or annuity amounts are subject to IRC 4941..." IRM 7752:(18)73(2). However, excessive payments made to disqualified persons are not the only form of self-dealing.

Under IRC 4941(d)(1)(B), a loan of foundation assets to a disqualified person is an act of self-dealing. Rev. Rul. 74-600, discussed earlier, illustrated this. If unitrust assets were lent to a disqualified person, the issue then becomes how it affects the remainder interest. Is it a use of the assets that ultimately affects the amount for which a deduction was allowed under Reg. 53.4947-1(c)(2)(i)?

If unitrust assets were paintings and the paintings were placed in the residence of a noncharitable beneficiary/disqualified person, the value of the remainder interest could certainly be affected if the paintings were lost or stolen. For instance, the insurance proceeds could be invested in such a way as to produce a lesser return than might have been the case had the paintings remained in the possession of the unitrust. In that circumstance, the remainderman assumes a risk so that the noncharitable beneficiary/ disqualified person may benefit.

In the unitrust format, the noncharitable beneficiary is only entitled to a stream of income. In the hypothetical, the noncharitable beneficiary/ disqualified person receives something (the use of assets in a situation where he is only entitled to an income stream) that does not fall within the self-dealing exception of Reg. 53.4947-1(c)(2)(i).

Where, in the loaned painting hypothetical, a noncharitable beneficiary/ disqualified person receives a benefit that puts the value of the remainder interest at risk, self-dealing questions arise. If the benefit is not excepted by Reg. 53.4947-1(c)(2)(i), self-dealing in fact occurs.

If both interests are served equally by a particular transaction, there would be no self-dealing. If, for example, a trustee were to sell an appreciated asset when the trustee believed the market was favorable, no self-dealing would occur because one interest would not <u>intentionally</u> be served at the expense of the other.

Clearly, the maximization of the noncharitable beneficiary/disqualified person's tax deferral is not a benefit excepted from the self-dealing rules under

Reg. 53.4947-1(c)(2)(1). The question becomes how holding an asset off the market adversely affects a charitable remainder interest for which a deduction is allowed. Returning to the example at the beginning of the article, suppose that the **M** stock, which funded **Trust X**, did not rise in value as fast as the general market. Suppose that, as is often the case, the products that **M** produced were not technology leaders as was originally thought, but played only a secondary role. By withholding from the market a stock that pays no current dividend, the trustees of **Trust X** were not taking advantage of market conditions that would have benefitted the charitable remaindermen of **Trust X**.

In the end, it does not matter whether a charitable remainderman gains or loses as the result of any particular transaction. The rules of IRC 4941 apply to whatever a transaction produces. As Reg. 53.4941(d)-1(a) puts it: "For purposes of this section [defining self-dealing] it is immaterial whether the transaction results in a benefit or a detriment to the private foundation."

In a general sense, preventing the manipulation of the assets of a charitable remainder trust was precisely the purpose of Congress in enacting the rules relating to split interest charitable remainder trusts as a part of the Tax Reform Act of 1969. <u>The General Explanation of the Tax Reform Act of 1969</u>, supra., at page 84, explained that the fixed percentage payout requirements imposed on charitable remainder trusts "... remove the flexibility of the prior provisions whereby it was possible to favor the income beneficiary over the remainder beneficiary by means of manipulating the trust's investments." The application of IRC 4941 to the split interest remainder trusts gave the Service the tools to address the problem of manipulation by deferral of income.

4. <u>Application to Other Situations</u>

Another issue before the National Office involves a NIMCRUT holding limited partnership interests in a partnership. The facts involve a husband and wife who transferred shares of stock to a newly formed limited family partnership. They each received in exchange therefor, a .5 percent general partnership and a 49.5 percent limited partnership interest. Both husband and wife donated their limited partnership interests to the NIMCRUT.

The stock will then be sold to purchase diversified investment assets. Both husband and wife retained the .5 percent general partnership interest and use their authority as general partners to manage the partnership investments and make distributions. They do not foresee making any income distributions from the partnership to the NIMCRUT until many years in the future after the husband has retired from his current position which pays a significant salary.

Accordingly, the NIMCRUT will receive no income distributions from the partnership for many years and until after the husband's retirement.

The creators of the NIMCRUT are disqualified persons by virtue of being substantial contributors to the trust. IRC 4946(a)(2) and 507(d)(2). In addition, the partnership, as an entity, would also be a disqualified person by virtue of the application of the constructive ownership rules. The income interest of the husband and wife in the NIMCRUT results in the application of the attribution rules.

Treating the partnership as a disqualified person probably makes little difference in the final analysis in asserting that the decision not to distribute income to the NIMCRUT may constitute an act of self-dealing. Clearly, its purpose is to maximize the income deferral.

The missing element, using the preceding analysis, may be the absence of risk to the remainder interest. In a situation such as this, there is no risk that the remainderman assumes if the trustee chooses to accumulate the income inside of the partnership. Quite to the contrary, the value of the remainder interest should increase with the accumulation.

If, on the other hand, one takes the position that self-dealing involves <u>any</u> impact that this transaction has on the remainder interest whether positive or negative, then this transaction involves self-dealing.

5. <u>Charitable Remainder Trusts - Other Issues</u>

As of March 1, 1996, there were over 61,000 charitable remainder trusts on file with the Service under IRC 4947(a)(2). There are a number of issues that have surfaced recently related to such trusts; these issues have no common element or central theme other than the characteristic of involving organizations as charitable remainder trusts. These issues are discussed briefly in the following material.

A. <u>The Settlor's Charitable Pledge</u>

The charitable pledge issue is a self-dealing issue not strictly limited to organizations that are only IRC 4947(a)(2) trusts. However, the issue has been addressed recently in the context of charitable remainder trusts as well as typical private foundations.

PLR 8128072 (April 16, 1981) ruled that a distribution from a private foundation to fulfill the obligation of a disqualified person to pay a legally enforceable charitable pledge constitutes an act of self-dealing under IRC 4941(d)(1)(E). The private foundation was created by corporations which intended to use the private foundation as a conduit to distribute the contributions made by such corporations to and through the private foundation to satisfy certain legally enforceable charitable pledges to exempt organizations which were previously incurred by the creating corporations. The Service ruled that such actions were acts of self-dealing under the authority provided by Reg. 53.4941(d)-2(f)(1).

However, the Service seemed to reach a contrary result in PLR 9233053 (May 22, 1992), where it ruled that the creation of a charitable remainder trust in satisfaction of a previously incurred charitable pledge did not result in an act of self-dealing. In the ruling, the charity that had previously received the pledge received the remainder interest under the charitable remainder trust in the place of the charitable pledge that had reached maturity prior to such exchange. In a letter dated December 14, 1995, the Service advised the subject trust that it could no longer rely on PLR 9233053. That letter has not yet been numbered for publication.

Another charitable pledge case (PLR 9540042 (July 6, 1995)) is also being revisited. PLR 9610032 (December 13, 1995) also advised the subject trust that it could no longer rely on PLR 9540042. PLR 9540042 involved a charitable trust under IRC 4947(a)(1) which was created to distribute funds to charities in order to fulfill the charitable pledges of the corporate creator of the trust and the pledges of related corporate entities.

The authority for the Service position regarding the charitable pledges is found in Reg. 53.4941(d)-2(f)(1). It provides that if a private foundation makes a grant or other payment which satisfies a legal obligation of a disqualified person, that payment or grant will normally constitute an act of self-dealing. There is an exception for certain pledges made on or before April 16, 1973.

On a slightly different topic, G.C.M. 38103 (September 21, 1979) and G.C.M. 39644 (June 26, 1987) discuss permissible substitutions of existing charitable pledges with new charitable pledges or with charitable transfers <u>prior</u> to the maturity date of the original charitable pledge. The key element to the pledge issue discussed in the G.C.M.s is that the terms of the pledge are revised with the consent of the charity prior to the date that the pledge was to mature. Further, such revision of the pledge is made without any economic disadvantage to the charity.

B. Reformation of Charitable Remainder Trust

In PLR 9522021 (March 1, 1995), the Service ruled that reformation of the terms of an existing charitable remainder unitrust would constitute an act of self-dealing. The creator and income beneficiary received an income right for a period that was the greater of his life or a set period of years. The trust document was drafted to include a net income limitation that limits the income to the lesser of trust income or the fixed percentage of the value of trust assets under IRC 664(d)(3)(A). The grantor wished to petition to reform the trust instrument to delete the net income limitation provision. The Service concluded that such reformation by the creator of the trust, a disqualified person, would constitute an act of self-dealing under IRC 4941(d)(1)(E). The Service held that the reforming of the trust in the manner proposed would remove interests in the trust that were previously dedicated to charity and transfer them to the benefit of the disqualified person (income beneficiary).

This issue continues to be debated in estate planning circles. Critics argue that the ability to "flip" (change format from a NIMCRUT to a standard CRUT) is a necessity given modern portfolio management theory. Variations of the "flip" trusts need to be closely scrutinized to make sure they comply with self-dealing rules.

C. Installment Redemption

The Service ruled in PLR 9347035 (August 31, 1993) that the redemption of stock held by a charitable remainder trust by a corporation which was a disqualified person with respect to the trust did not constitute an act of self-dealing, but rather fell under the IRC 4941(d)(2)(F) exception to self-dealing for any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization or reorganization. The unusual aspect of the ruling was that the redemption was made on the installment basis so that the charitable trust received the installment note of the corporation. Thus, in effect, the note constituted a loan from the trust to the corporation, a disqualified person. The loan constitutes an act of self-dealing under IRC 4941(d)(1)(B). PLR 9347035 is being revoked. For a further discussion of this topic, see the material in the FY 1995 CPE article, Private Foundations in the Mid-1990s with an Emphasis on IRC 4941 and IRC 4945 at 263.