Practical Guidance for Charitable Remainder Trust Planning for Residential Real Property

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INTRODUCTION

A valuable residence having a low cost basis may be a particularly attractive candidate for an inter vivos charitable remainder trust [1] if the owner wishes to move to more modest quarters and enjoy the income stream from the proceeds of sale. This is because the tax law provisions regarding the roll-over of gain upon a sale of a principal residence [2] and the $125,000 one-time exclusion for taxpayers age 55 and over [3] may afford little relief from substantial capital gains taxation, particularly if the value of the residence is very substantial — say, in the range of several million dollars. The capital gains tax may be avoided if the owner conveys the property to a charitable remainder trust, and sale is thereafter made by the trust. In addition, the property owner may receive a charitable income tax deduction (tied to present value of the charitable interest) upon the establishment of the trust.[4]

This kind of situation often occurs in geographic areas where real estate values have risen dramatically in recent years, particularly in more affluent resort areas or expanding suburban areas involving residences situated on substantial acreage eligible for subdivision. For some owners, sale may become desirable or necessary on account of a dramatic rise in real estate taxes or other carrying costs (*e.g.*, casualty insurance). Or, for reasons unrelated to the property, there may be a decrease in the owner's income stream available for maintaining the property, such as often occurs upon the owner's retirement from a professional career.

An inter vivos charitable remainder trust may be ideal for a property owner whose estate plan makes provision for a substantial charitable disposition at death. Through a charitable remainder trust arrangement, the property owner may secure an enhanced income stream from the proceeds of sale, as compared with the net proceeds of sale (after taking into account income tax consequences, including capital gains taxation) available if sale were to be made by the property owner without a charitable remainder trust arrangement. Of course, a charitable remainder trust must be coordinated with the settlor's overall estate plan to ensure that the ultimate disposition of total assets between specific charitable and noncharitable persons is consistent with the settlor's intent.[5]

Even if a property owner's estate plan does not include substantial charitable disposition, use of a charitable remainder trust may nonetheless be attractive. A common lifetime estate planning arrangement involves a combination of a charitable remainder trust coupled with an irrevocable insurance trust. This arrangement is often well suited for family situations in which parents wish to avoid, through use of a charitable remainder trust, capital gain on the sale of low basis property but also do not wish, by doing so, to reduce the level of their children's overall inheritance. Where the parents are in good health sufficient to allow the purchase of life insurance, use of an irrevocable life insurance trust (structured so as to avoid estate tax in the parents' estates) can offset the effect of the charitable remainder trust on the level of overall property ultimately passing to the children at the death of the surviving parent.[6]

The provisions of charitable remainder trusts are the subject of significant and exacting (and often complicated) tax law requirements.[7] A charitable remainder trust must take either of two basic forms — an annuity trust or a unitrust. In an annuity trust, the settlor receives regular pay-outs from the charitable remainder trust in a fixed sum, which must be at least 5% of the initial net fair market value of the trust property and remains constant in all years.[8] In a unitrust, the settlor's pay-outs are specified as a percentage of the fair market value of the property valued annually [9] so that the amount of the unitrust pay-out varies from year to year. The rate of annuity or unitrust pay-out must be irrevocably specified at the outset in the governing instrument. From the settlor's viewpoint, the pay-outs which the settlor is to receive during the trust term are not tied to the trust's actual income stream but are geared to each year's annuity or unitrust pay-outs.[10] The decision over which form of pay-out — annuity or unitrust — the settlor selects in large part depends on whether the settlor wishes for the pay-outs to be affected by future value fluctuations in the trust property.[11] Pay-outs must be made at least annually and may be specified to be as frequently as monthly.[12] Typically, the trust is structured to last for the settlor's lifetime [13] and, in the case of married persons, is specified to continue until the death of the survivor of them.[14]

Placement of a substantial residence in a charitable remainder trust, however, presents a number of technical tax concerns. Surprisingly, case law authorities and Internal Revenue Service pronouncements are

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fairly sparse in their guidance regarding the actual steps to be followed in establishing a charitable remainder trust for a residence. The balance of this article addresses various technical issues and endeavors to provide some practical guidance to the practitioner as to various aspects and problems which may be encountered.

RESIDENCE IN JOINT NAME

The Service recently issued a private ruling which, interpreted most broadly, calls into question any charitable remainder trust created by more than one grantor. In PLR 9547004, eight family members (two grandparents and six grandchildren) proposed to create a charitable remainder unitrust with cash and securities. The unitrust amount was to go first to the grandparents and, following their deaths, the grandchildren as a class. The Service noted that the trustees had the power to vary the investment of the grantors' by investing and reinvesting trust assets. The Service concluded that because the grantors would share in the profits from their joint investment, they were "associates" who pooled their assets "with an object to carry on business and divide the gains therefrom." Under the general entity classification rules of Regs. §301.7701-4, the Service therefore determined that the trust was not a "trust" for federal tax purposes, and consequently could not be a charitable remainder trust for §644 purposes. The ruling arguably implies that any charitable remainder trust with more than one donor is not a qualified trust.[15]

Read broadly, PLR 9547004 could mean that a contribution of a residence jointly owned by a husband and wife would cause a charitable remainder trust to be disqualified. Arguably, the joint contribution of a residence to the trust would indicate that the grantors were jointly seeking to divide gains from the trust investments, and were therefore "associates" in a "business." The contribution of a jointly owned residence is, of course, distinguishable from a true pooling of assets with a view toward sharing profits from new investments; and in any event, PLR 9547004 may be an overreaching by the Service.[16] Nonetheless, taxpayers who hold a residence jointly should consider carefully the ramifications of contributing the property to a charitable remainder trust, at least until the scope of PLR 9547004 can be better determined.

OCCUPANCY BY OWNER

The owner cannot occupy the property once it is transferred to the charitable remainder trust. The only type of interest the settlor may retain in a charitable remainder trust is a unitrust or an annuity interest pursuant to §664(d)(1) and (d)(2) and accompanying regulations,[17] neither of which is satisfied if the owner retains rent-free occupancy.[18] This prohibition can be a serious impediment to use of a charitable remainder trust if the owner wishes to occupy the residence until such time as a contract for sale is negotiated and closing transfer of title to a purchaser is effected.

The only Service pronouncement specifically addressing the concern is PLR 7802016, which approved placing a personal residence into charitable remainder unitrust "strictly on the condition that [the settlor] will not live on the real estate after it is transferred to the unitrust." [19] Nor may the settlor retain occupancy after transfer by entering into a lease (even at fair market value rental), because the settlor is a "disqualified person" with whom the trust would be prohibited from entering into a lease transaction pursuant to the self-dealing rules applicable to charitable remainder trusts.[20] A member of the settlor's family is likewise prohibited from leasing the property.[21]

Furnishings should likewise be removed from the property prior to transfer to the charitable remainder trust unless furnishings are included in the property transferred to the trust. However, transfer of tangible personal property is typically undesirable on account of the additional trustee responsibilities thereby imposed, and there are also certain negative tax concerns associated with holding tangible personal property in a charitable remainder trust.[22] In any event, the settlor's personal belongings (clothing, bric-a-brac and the like) should be removed prior to transfer.

MORTGAGE INDEBTEDNESS

The transfer of a residence subject to mortgage indebtedness to a charitable remainder trust gives rise to a number of issues. The issues involve the qualification of the trust under §664; recognition of gain or loss to the taxpayer and application of the private foundation excise tax rules. Because of the variety of potential problems raised by the presence of a mortgage, transfer of a mortgaged residence to a charitable remainder trust will be desirable only in fairly limited circumstances.

The transfer of property subject to mortgage indebtedness to a trust may prevent it from qualifying as a charitable remainder trust, if the settlor remains personally liable on the mortgage debt. In PLR 9015049, the Service ruled that residual recourse liability against the settlor prevented qualification of a proposed charitable remainder unitrust. The rationale was that the grantor trust rules [23] were applicable on account of the discharge of the settlor's personal liability by the trust. While that ruling concerned commercial real property, its application can be expected to extend to real property used as the settlor's residence.

An argument may be made that PLR 9015049 is incorrect because the Service's analysis does not prop-

0886-3547/96/$0+1.00

erly take into account the relationship between the settlor's personal liability and the effect of the mortgage debt in reducing the initial fair market value of the trust assets. Upon transfer to the trust, it would not be expected that the settlor would continue to pay off the mortgage debt — the mortgage debt would have initially decreased the value of the net trust property, correspondingly reducing the level of unitrust payments to the settlor and the level of charitable income tax deduction available to the settlor. Accordingly, the Service should not find it objectionable for transfer of the mortgaged real property to the trust to be accompanied by an agreement that the primary responsibility for the indebtedness is chargeable to the trust (at least to the extent of the fair market value of the residence). The resulting secondary liability in the settlor should not be sufficient to trigger application of the grantor trust rules in a charitable remainder trust setting.[24] Where (as is often the case) the fair market value of the residence exceeds the mortgage indebtedness by a level sufficient to make it remote that the settlor's secondary liability will be called on, application of the grantor trust rules would appear particularly inappropriate.[25]

Although the rationale of PLR 9015049 is questionable, a second set of problems arises under the unrelated business taxable income (UBTI) rules. The *Newhall Unitrust* [26] case recently held that any UBTI realized by a charitable remainder unitrust will subject all of the trust's income to tax.[27] Under the "debt financed" property rules of §514, presence of mortgage debt on a residence transferred to a charitable remainder trust may give rise to UBTI, including upon a sale of the residence by the trust. A limited exception to that rule under §574(c)(2)(B) applies if: (1) the trust does not assume the debt, but merely takes the property subject to the mortgage; (2) the property was held by the donor for more than five years before the gift; and (3) the mortgage was placed on the property more than five years before the transfer to the trust. If all conditions are met, income from the property — including upon a sale — is not treated as UBTI during the 10-year period following its transfer to the trust. Accordingly, the UBTI rules indicate that it would not be possible to transfer a recently purchased or recently financed residence to a charitable remainder trust. Moreover, the trust should not assume a mortgage placed on the property by the settlor, since such an assumption would cause the UBTI rules to apply. For that reason, a taxpayer cannot avoid the disqualification issue raised by PLR 9015049 by having the trust assume his personal liability.[28]

A third issue is that a transfer of mortgaged property may trigger application of the excise tax on self-dealing transactions. That issue arises because a transfer of mortgaged property to a charitable remainder trust is treated as a sale of the property to the trust if the trust assumes the mortgage or takes the property subject to the mortgage if it was placed on the property within 10 years prior to the transfer.[29] The deemed sale will constitute an act of self-dealing if the settlor is a "disqualified person" with respect to the trust, as is generally the case.[30] Regulations under §4941 provide, however, that a transaction is not self-dealing if status as a disqualified person arises from the transaction itself.[31] A transfer of encumbered property to a charitable remainder trust thus does not constitute self-dealing if the settlor becomes a disqualified person only because of the transfer to the trust. If, however, he is a disqualified person for another reason — *e.g.*, because of his status as trustee — the self-dealing rules could be triggered.

A fourth issue involves the potential recognition of gain on the transfer. A transfer of a residence subject to mortgage debt may trigger income to the settlor under the "bargain sale" rules.[32] The settlor would be treated as selling the residence to the trust for the amount of the mortgage debt. Under the bargain sale rules, the transfer is treated as in part a gift and in part a sale; a pro rata portion of the property's basis is allocated to the sale component to determine the amount of taxable gain from the transfer. As a result, the taxpayer could be subject to a tax liability in the year he transfers property to the trust.

The effect of combined application of the UBTI and self-dealing rules discussed above is to forestall charitable remainder trust planning for encumbered property, except where the debt is nonrecourse to the settlor and was incurred more than 10 years before the creation of the trust. However, a recent private letter ruling may provide an interesting potential planning opportunity. In PLR 9533014, a taxpayer planned to transfer an interest in a partnership holding encumbered property to a charitable remainder unitrust. The settlor agreed to indemnify the trust against any liabilities or obligation arising from the trust's ownership of the partnership interest. The Service ruled that the transfer of the interest to the trust would not violate §664's requirements because the settlor would remain primarily liable for partnership obligations. Moreover, the transfer did not constitute self-dealing because the trust did not assume a mortgage and because the mortgage on the partnership's property was incurred more than 10 years prior to the transfer to the trust. For similar reasons, the exception to the UBTI rules applied. The Service noted, however, that the bargain sale rules would continue to apply.

In light of PLR 9533014, taxpayers may wish to consider contributing a residence to a partnership or limited liability company.[33] Most of the consequences would appear to be the same as with a contribution of encumbered property directly, with the important exceptions that a partnership arrangement may enable the settlor to satisfy the requirements of §664 in

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the event the property is subject to recourse debt.[34] Based on PLR 9533014, it appears that an agreement to indemnify the trust against liabilities arising from the partnership would avoid the obstacles arising from assumption of a recourse liability.

On balance, however the combination of the self-dealing rules, the UBTI restrictions, the §664 qualification requirements, and the bargain sale rules generally make it unattractive to contribute encumbered property to a charitable remainder trust. If possible, the taxpayer should discharge mortgage debt before transferring the property to a charitable remainder trust. This may pose a serious problem for many property owners, not only on account of liquidity concerns, but also because mortgage discharge would significantly increase the level of net property committed to the charitable remainder trust.

COOPERATIVE APARTMENT

A special concern arises with respect to a cooperative apartment on account of the lease obligation of the property owner to pay rent to the cooperative association. A cooperative apartment typically cannot be transferred without the permission of the association's board of directors, who may question the financial ability of a charitable remainder trust to make the lease payments. If permission to transfer title is granted, it may be accompanied by a requirement that the settlor guarantee payment of the lease obligations. Such a guarantee, however, would present a risk that the Service might seek to attribute capital gain taxation to the settlor on the same basis (*i.e.*, the grantor trust rules) as asserted in PLR 9015049 with respect to mortgage indebtedness.[35] Even though the primary responsibility for the lease payments would rest with the trust, PLR 9015049 appears to indicate that the grantor trust rules may apply on account of the possibility that call for the lease obligation may be made on the settlor's guarantee.

PARTIAL INTEREST

For some substantial residences, the owner may wish to transfer a partial interest in the property to a charitable remainder trust and continue to hold a retained partial interest. This option may be attractive to an owner who wishes to use a portion of the proceeds of sale to purchase a more modest replacement residence. If the property is eligible for subdivision, then a specifically delineated part of the subdivided acreage can be transferred to the charitable remainder trust. This kind of subdivision approach may be particularly attractive if most of the value lies in the acreage surrounding the principal residence and that acreage is able to be transferred to the charitable remainder trust. Subsequent sale of the surrounding acreage by the charitable remainder trust will avoid capital gain taxation, and sale of the retained principal residence by the owner may be eligible for the $125,000 exclusion under §121 and deferral of capital gain pursuant to the exchange of principal residence provisions under §1034.

Where subdivision of the property is either legally impermissible (owing to zoning restrictions) or unattractive (because the bulk of value is in the residence), the property owner may wish to transfer an undivided partial interest in tenancy-in-common to a charitable remainder trust.[36] On account of the retained interest of the settlor, however, there is concern that the self-dealing rules under §4941 may be triggered upon a joint sale by the trust and the owner of their respective undivided interests in the property.[37] The Service has released two private letter rulings addressing this issue. In PLR 9114025, a married couple who held all interests in a limited partnership owning a shopping center proposed to transfer a portion of their partnership interests into a charitable remainder trust. The Service ruled that, upon a subsequent joint sale by the trustee and the spouses, the self-dealing rules under §4941 would not be violated and, accordingly, the charitable remainder trust arrangement was approved. More recently, PLR 9533014 determined that the self-dealing rules would not apply to a charitable remainder trust to which the settlor "plans to transfer between half and all of his partnership interest" relating to an apartment complex.

Because of the different type of asset involved in these two rulings, it may be prudent for the taxpayer to seek advance Service approval by requesting a private letter ruling for a transfer involving a partial undivided interest in a residence to a charitable remainder trust.[38] The Service has indicated that undivided co-ownership by tenancy-in-common presents self-dealing problems. Although the Service's announcements do not enunciate a clear position, it appears that the Service may object to a tenancy-in-common arrangement because of a technical provision in the Tax Reform Act of 1969 which expressly permitted continuation of certain pre-existing joint ownership arrangements.[39] However, this restrictive statutory construction is inconsistent with the Service's position on GCM 39770 (and a companion ruling in PLR 8842045), which concluded that tenancy-in-common ownership of artwork would not per se violate the self-dealing rules,[40] as well as two earlier private letter rulings sanctioning a tenancy-in-common arrangement for unimproved real property.[41]

To avoid this concern, one planning idea may be to place the residence into a limited partnership in advance of transfer to the charitable remainder trust, thereby approximating more closely the situations presented in PLRs 9533014 and 9114025. Care should be taken, however, so that the partnership arrangement is structured to withstand the partner-

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ship anti-abuse regulations.[42] In conjunction with a partnership arrangement, the settlor might create a noncharitable trust for the portion of the property which is not transferred to the charitable remainder trust. The noncharitable trust would be structured to provide a retained life income interest and a testamentary power of appointment (either general or limited) to avoid imposition of any tax resulting from its creation.[43] Presumably, the trusteeship provisions in the noncharitable trust may be structured to be identical to be the provisions in the charitable remainder trust, with control in the independent trustee in the event that the settlor is also a co-trustee.[44]

CONVEYANCE INTO TRUST

After appropriate arrangements have been made for a charitable remainder trust to proceed, the trust agreement may be executed and a deed may be prepared and recorded (with payment of any necessary transfer or recording fees) [45] to convey title to the trustee.[46] Steps routinely taken in advance of transfer of a residence into irrevocable trust should be carried out. The title should be updated by a review of the land records, although issuance of a new title insurance policy insuring title in the trustee may not be necessary. Any examination for toxic waste or other environmental hazard which a professional trustee would require should be obtained if there is any risk of the trustee becoming responsible for environmental liability with respect to the property.[47] Utilities and services should be notified and arrangements made for the trust to assume responsibility (including payment arrangements) for all such matters.[48] The settlor should also place into the trust additional monies sufficient to make the unitrust or annuity payments to the settlor and to provide for payment of expenses of the property for a reasonable period after the transfer (and, in the case of fixed expenses such as real estate taxes, the settlor may wish to make prepayment before transfer).[49] This later concern is less important in the case of a unitrust, where a subsequent contribution of monies can be made [50] (as opposed to a contrary rule with respect to an annuity trust [51]) or where an "income only" unitrust pursuant to §664(d)(3) is utilized.[52] Finally, any charitable organization named in the trust instrument should be immediately notified of its beneficial interest.[53]

CONTRACT NEGOTIATIONS AND TERMS

With a view toward minimizing any practical risk that the Service may seek to impose capital gain taxation under a prearranged sale theory, it is preferable for the independent trustee to be the lead representative in contract negotiations with potential purchasers. As in any trust situation, the trustee should regularly communicate with those having beneficial interests and seek to learn the beneficiary's preferences with respect to important matters concerning the trust administration.[54] However, it may be preferable for the trustee to stop short of seeking advance approval from the settlor for any particular contract into which the trustee proposes to enter or any advance indemnification from liability. Rather, the trustee should be satisfied that a particular sale is a prudent transaction at a reasonable price and on reasonable terms — that is, a proper exercise of the trustee's fiduciary responsibilities.[55] However, if the trustee is inclined to accept the first reasonable offer which is received, the trustee would be prudent to ascertain that the unitrust or annuity beneficiary (that is, the settlor) does not wish for the trustee to defer making sale (possibly after "testing the waters") for some period of time. Ideally, it might also be desirable for the trustee to inform any named charitable remainder organization of a proposed sale and, after adequate disclosure, seek assurance that there is no objection thereto. This practice may not be generally followed by many professional trustees, and it is not imperative, particularly if the settlor has retained a testamentary power of appointment to designate by will a different charitable beneficiary to receive the trust remainder.

Owing to fiduciary obligations, the trustee should resist contract provisions which might unduly prolong closing or a contingency which might allow a contract purchaser a substantial period of time to cancel the contract. Accordingly, the trustee should seek to eliminate from the final contract terms any financing contingency or any contingency with regard to subdivision or variance approval.[56] If the purchaser insists on a contingency, then the trustee should seek to limit the term of the contingency to a short period of time within which the purchaser may cancel the contract. Where appropriate, provision for a purchase money mortgage may be substituted for a financing contingency for a mortgage from a financial institution. The contract should specify any title defect or encumbrance subject to which the purchaser is to take title, so as not to allow any opportunity for the purchaser to cancel the contract or delay closing. As short a period of time as is reasonably practicable between contract execution and closing should be specified in the contract. Likewise, a purchase money mortgage from the purchaser payable over time should be avoided on account of the risk of the purchaser's default at some future point, which might unhappily involve participation by the charitable remainder trustee in foreclosure proceedings.

CAVEAT - SALE ACTIVITIES BY OWNER

Not every owner is willing to make conveyance to a charitable remainder trust (and move out of the

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property) before the sale process is commenced. Often an owner is not willing to make an irrevocable and definite commitment to move out of the property until after there has been a listing agreement and, through the listing activities, the owner gleans a realistic sense of the likely range of purchase price. Some owners wish to remain in occupancy of the residence until a serious purchaser appears, and then convey the property to the charitable remainder trust, with the expectation that the trustee will then successfully negotiate a sales contract with the purchaser. Although some commentary suggests that a charitable remainder trust may not be viable if the property owner has tried, and failed, to sell the property,[57] a more realistic view is that the viability of a charitable remainder trust may depend upon the manner in which the owner's own sale efforts are undertaken. Indeed, an owner may be unwilling to vacate the property during the marketing period on account of reasonable concerns that it may be more difficult for a satisfactory selling price to be obtained if the seller were a fiduciary (that is, an independent trustee) and the property unoccupied. Another concern held by some owners is that, after making transfer to the trust, all legal control over sale is vested with the trustee, who may not act in accordance with the settlor's wishes. This may be of particular concern if the settlor were to encounter, after transfer to the trust, a serious (albeit unrelated) financial setback and, as a consequence, request the property to be sold quickly at a price the trustee might consider too low.

As a general rule, the owner should try to steer clear of becoming involved in circumstances which may appear to indicate that there is any understanding that the property is to be sold.[58] Accordingly, where the owner of the property has undertaken sale activities, the risk of the Service successfully asserting a prearrangement argument is significantly greater. If the owner actually executes a sales contract and thereafter makes conveyance of title (and assignment of the contract) to a charitable remainder trust, a dangerous tax situation is presented. Short of that, however, an owner may be able to undertake sale activities and avoid imposition of capital gain taxation, as long as appropriate advance arrangements are made for a charitable remainder trust and care is taken to comply strictly with certain formalities. In this situation, the presence of an independent trustee becomes more important and, as in PLR 9114025, it may be preferable for the settlor not to serve as co-trustee. All necessary steps should be taken so that the trustee may quickly commence to act at the appropriate time. The trustee should become familiar with the property, including an examination of title and appraisals, and coordinate with the real estate broker with regard to sales price. The exact terms for the charitable remainder trust must be finalized, with a trust document reviewed and approved by the settlor and the trustee and the deed of conveyance made ready for execution. However, the settlor must not make any binding commitment to the prospective trustee which would indicate a prearrangement for the charitable remainder trust to go forward with a sale of the property. Instead, it should be documented that the settlor might decide not to go forward with a charitable remainder trust. Then, upon conveyance to the trustee, it should be documented that the settlor would not expect that the trustee enter into any particular contract for sale and that the settlor would have no objection if the trustee were not to enter into a sale transaction but instead were to lease the property.

Particular attention should be paid to the terms of any listing agreement which the owner may enter into at the outset of the owner's activities. First, the listing agreement should expressly contemplate the possibility of leasing the property, so as to evidence that the settlor had not predetermined that the property be sold. Second, the listing agreement should not impose an obligation to pay a brokerage commission under any circumstances short of actual sale upon closing. This may be a departure from the customary practice in some localities, where a brokerage commission may be earned if the broker procures an enforceable written offer from a prospective purchaser at the listing price. Third, the listing agreement should not in any way expressly contemplate that the property may be transferred into a charitable remainder trust. Fourth, the listing agreement should be structured to allow the owner to cancel at any time and without any penalty — in particular, without liability for the broker's expenses in listing the property.[59]

SALE ARRANGEMENTS

Perhaps the most difficult area involves the care which should be taken so that arrangements for the sale of the property do not give rise to an express or implied prearranged obligation undertaken by the trustee to sell the residence to avoid taxation of the capital gain to the donor.[60] Case law [61] and revenue rulings [62] have indicated that if there is a prearrangement, then the capital gain is taxed to the settlor under the grantor trust rules [63] — rather than to the charitable remainder trust. This can result in a tax disaster, not just because of the imposition of the capital gain taxation, but also because the grantor presumably has to pay the tax out of other funds and cannot be reimbursed for this tax liability out of the proceeds of sale, which have been dedicated ultimately to pass (after the grantor's death) to charity pursuant to the terms of the trust agreement.[64]

Concern has been somewhat alleviated by the recent issuance of two private letter rulings. PLR 9413020 involved an inter vivos transfer to a charitable remainder unitrust of cattle, crops, and farm

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machinery by a taxpayer engaged in a cattle ranching and farming business. Although the ruling expressly recognizes that it is likely that sale will take place shortly after transfer, PLR 9413020 states that no gain upon sale by the trust is to be recognized by the taxpayer because of the absence of any legally binding sale obligation at the time of transfer to the trust.

In PLR 9452020, the Service reached a similar conclusion. In that ruling, the grantor of a charitable remainder trust funded the trust with a large block of publicly traded stock, and indicated that, as the sole initial trustee, she anticipated selling a large portion, if not all, of the stock in order to diversify the trust's assets in accordance with a "prudent investor" standard applicable to trustees under state law.[65] The ruling held that as long as no prearranged sale contract existed whereby the trust would be legally bound to sell the stock upon the contribution, a sale by the trust would not be recharacterized as a sale of stock by the grantor, followed by a contribution of the proceeds to the trust. Accordingly, the capital gain would not be taxed to the grantor.

The rationale of these rulings should also be applicable in the context of a transfer of a residence to a charitable remainder trust — capital gain should not be recognized by the taxpayer in the absence of a legally binding sale obligation prior to transfer.[66] A private letter ruling may not be relied on as precedent by a taxpayer other than the person to whom it is directed,[67] however, so that any taxpayer contemplating a charitable remainder trust for a residence may wish to request a ruling to the same effect as these two rulings, particularly if there is, prior to the transfer to the trust, an expectation (but not a legally binding obligation) that sale is to be made to a particular buyer on certain terms and conditions.[68]

To minimize the risk that the Service may assert taxation against the settlor on the basis of prearrangement, various steps should be taken by the owner and the trustee in establishing the charitable remainder trust. The owner himself should not directly undertake any activities directed at sale, such as entering into a listing agreement or showing the property for sale to potential purchasers. The listing agreement should be entered into by the trustee of the charitable remainder trust, and should specifically contemplate leasing as well as sale of the property, making exact provision for real estate broker compensation in the event of either sale or lease.[69] In this regard, it may be desirable for the settlor, upon making conveyance of the property to the trustee, to memorialize (perhaps by a letter to the trustee) that the settlor is content to rely upon the trustee's judgment in entering into either a sale or lease in discharging the trustee's separate responsibilities — on the one hand — to make the trust principal productive of income so that unitrust or annuity pay-out to the settlor may be made and — on the other hand — to protect and conserve the trust principal ultimately to pass to charity. It may be desirable for the settlor to make an additional contribution to the charitable remainder trust of some furnishings in order for the property to be attractive for sale or lease.[70] If the owner has obtained a recent appraisal, the trustee should, in exercise of the fiduciary responsibility, closely examine that appraisal and, if not totally satisfied after examination, obtain another appraisal. Of course, if there is no recent appraisal, the trustee must obtain one.[71]

It also is important for there to be an independent trustee.[72] Ideally, this independent trustee should not be a family member or an employee of the settlor. If the settlor is also a co-trustee,[73] then the trust agreement should state that, in the event of a disagreement between the co-trustees, the decision of the independent co-trustee shall control. Although permissible,[74] a power to replace the independent co-trustee may be undesirable on account of the degree of control over trust transactions which might thereby be imputed to the settlor in the event of a challenge by the Service with respect to the capital gain treatment.[75] In some circumstances, it may be desirable for the co-trustee to obtain independent counsel, thereby reaffirming the separateness and independence of the trust's actions from the settlor's actions.[76] Provisions specifying trustee compensation under applicable state law may be set out in the governing instrument.[77]

INVESTMENT OF SALE PROCEEDS AND RELATED TAX PLANNING

Upon closing, the trustee should be prepared promptly to invest the proceeds in marketable securities. With regard to the type of investments to be selected, consideration should be given to the income tax consequences to the settlor on account of the unitrust or annuity payment to be made to the settlor. Generally speaking, the pay-out will be deemed to carry out taxable income from the trust to the settlor to the extent of the annual aggregate amount received by the settlor.[78] Ordinary income from the current year is carried out first, then any undistributed ordinary income from prior years, then capital gain income from the current year, and finally any undistributed capital gain income from prior years.[79] Only after the foregoing tiers of income are fully carried out to the settlor is tax exempt income deemed to be carried out.[80]

Generally speaking, investments which have substantial potential for appreciation and minimize ordinary income are preferable for a charitable remainder trust.[81] From the viewpoint of the ultimate charitable beneficiaries, the potential for preserving the purchasing power of the trust principal is maintained where the trust assets are invested for long-term growth.[82] Investment in tax-exempt bonds is typically not desirable, because it is unlikely that the character of the

pay-outs to the settlor will be reported as tax-exempt income on the settlor's own income tax return, at least in the near term. Even if the trust assets were to be invested entirely in tax-exempt securities, the pay-outs to the settlor would constitute capital gain from the sale of the residence. Although some settlors might prefer this approach,[83] such an investment strategy would not appear permissible under general state law principals of fiduciary investment, on account of its disadvantageous long-term impact on the ultimate charitable beneficiaries.[84] IRS pronouncements indicate that the provisions of the governing instrument may not override state law and authorize the trust to follow an investment strategy directed toward tax-exempt securities.[85]

INCOME TAX CHARITABLE DEDUCTION AND VALUATION OF CHARITABLE REMAINDER INTEREST

The settlor of a charitable remainder trust is eligible to receive a charitable deduction for income tax purposes. The amount of the deduction is based upon the present value of the charitable remainder interest.[86] The taxpayer's ability to deduct the value of the charitable remainder interest is subject to the overall limitations, or "ceilings," on the settlor's eligibility for charitable deductions on his overall charitable contributions in any one year.[87] Charitable contribution amounts in excess of those ceilings may be deducted in subsequent years (but not for more than five years) under carry-forward rules.[88]

The present value of the charitable remainder interest is determined actuarially on the basis of three essential factors.[89] First is the applicable §7520 interest rate when the trust is established [90] — the lower the interest rate is, the greater the value of the charitable remainder. The second factor is the rate of the annuity or unitrust pay-out — again, the lower the pay-out rate, the greater is the value of the charitable remainder.[91] The third factor is the settlor's age (or ages, in the case of married persons who are to receive pay-outs until the death of the survivor of them) [92] — the older the age is, the greater is the value of the charitable remainder.[93]

The settlor's ability to utilize the charitable deduction relating to the value of the remainder interest is governed by complex rules which impose ceilings on the taxpayer's aggregate charitable deduction for the tax year. Because these rules, in general, permit a larger charitable deduction for charitable contributions to so-called "public charities" than to "private foundations," it is typically more advantageous for the identity of the charitable remainderman to be restricted to public charities.[94] In general, a taxpayer's aggregate charitable deduction for gifts to public charities is limited to 50% of the "contribution base," [95] with a further ceiling on gifts to private foundations at 30%.[96] A further limitation applies to gifts of appreciated property to public charities and lowers the ceiling to 30% of the contribution base.[97] The deduction for appreciated property given to a private foundation is limited to the taxpayer's basis, with an even lower deductibility ceiling at 20% of the contribution base.[98]

The settlor's choice of the rate of annuity or unitrust pay-out affects the value of the charitable remainder and, accordingly, the level of the charitable deduction the settlor may receive for income tax purposes. Typically, the settlor may wish to fix the pay-out rate at a relatively high rate (so as to receive greater pay-outs), but not so high so as to reduce substantially the potential income tax charitable deduction benefit to the settlor, taking into account the effect of the ceilings [99] for aggregate charitable deduction on the settlor's overall income tax situation.[100]

For married persons, an important planning concern is the potential impact on the value of the charitable remainder if the pay-out is to continue until the death of the surviving spouse. Because a continuing pay-out reduces the value of the charitable remainder, a pure tax analysis might suggest that the settlor should not name his or her spouse as a second recipient.[101] From an overall estate planning perspective, however, it may be desirable for the spouse to be a second recipient in order to provide for adequate support and maintenance after the settlor's death.[102] Accordingly, to utilize effectively the income tax charitable deduction where the spouse is a second recipient, it may be necessary to establish a lower pay-out rate. From a practical perspective, the settlor may retain the right to revoke the spouse's continuing interest (*e.g.*, taking into account possibility of divorce) and thereby cause the trust property to pass to the charitable remainderman at the settlor's death.[103]

Planning for a married couple who jointly own the residence to be transferred into a charitable remainder trust involves additional considerations. Typically, both spouses are settlors under charitable remainder trust provisions that last until the death of the survivor. Where the annuity or unitrust pay-out is to remain fully payable to the survivor for life, the overall income tax consequences should not be significantly different than if only one of the spouses were the settlor. However, one option where both spouses are settlors is to provide that, upon the death of one of the spouses, one-half of the trust property (equivalent to that spouse's one-half ownership of the residence) is to terminate in favor of the charitable remainderman, with the remaining one-half of the trust property to continue in the charitable remainder trust until the death of the survivor. Assuming that the spouses are the same (or almost the same) age, the income tax charitable deduction will be substantially the same as if only one were the settlor, and the survivor will be

0886-3547/96/$0+1.00

assured of a continuing pay-out (albeit reduced to the extent of one-half) for life. This may be advantageous for some spouses where the residence is owned solely by one spouse — transfer may be made into the joint names of both spouses, who together then make transfer into a charitable remainder trust.[104] Planning along these lines may be affected by the ill health of either spouse [105] and, if one spouse dies within the five-year carry-over period, restrictions on the survivor's eligibility for a continuing charitable deduction during the remaining carry-over years should be taken into account.[106]

One important valuation concern is potential uncertainty as to the fair market value of the residence in determining the settlor's charitable deduction. Certainly, a formal appraisal of the residence will go a long way toward establishing value, although challenge by the Service may be expected where the taxpayer claims a charitable deduction based upon a higher formal appraisal in the face of a lower sale price.[107] Uncertainty as to value is of even greater importance in the case of an annuity trust, because the amount of each year's annuity pay-out depends upon the initial value of the trust property at the establishment of the trust. Accordingly, the more conservative settlor may favor a unitrust form of pay-out, because subsequent years' payouts will be fixed by reference to the value of the trust property determined annually (and, after sale of the residence, may be determined exactly by reference to the marketable securities in which the trust property is invested on the valuation date for each year).

PLANNING WITH THE USE OF OPTIONS

Can some of the practical difficulties — that is, mortgage indebtedness and occupancy concerns — involved in charitable remainder trust planning for a personal residence be avoided through the use of options? In the past, some commentators have discussed the consequences of granting the trust an option to acquire property, presumably for an option price below the property's fair market value.[108] The trust would then list the property for sale and exercise the option shortly before it sells the property to a third party. If viable, this strategy might avoid some of the problems discussed earlier in this article. Specifically, because the trust would not own the property until it exercised the option (which might be simultaneously with closing), the problems associated with the settlor's continuing occupancy of the residence, or the transfer of encumbered property to the trust, would not arise.[109]

Application of the self-dealing rules, however, raises serious doubts about an option strategy. Because the settlor is a disqualified person with respect to the charitable remainder trust, certain transactions with the trust, including the purchase and sale of property, constitute self-dealing regardless of whether the sale took place on terms favorable to the trust.[110] As a result, the trust may not exercise the option to acquire the property directly from the settlor, as the exercise would be a purchase of property from a disqualified person, albeit at a discount to fair market value. Although a 1992 private letter ruling indicated that an option arrangement might be workable, more recent pronouncements from the Service indicate otherwise.[111] The latest Service pronouncement is PLR 9501004, which apparently sought to skirt the above issue by proposing that the trust assign the option to the prospective buyer of the residence, rather than exercising the option directly.[112] PLR 9501004 involved a taxpayer who granted for no consideration an option to purchase encumbered real property to a charitable remainder unitrust. The trust planned to assign the option to a third party (*i.e.*, the purchaser), presumably to avoid the self-dealing issue. The Service ruled that the settlor's transfer of the option would disqualify the trust as a charitable remainder trust. The Service interpreted §664 and applicable regulations to require that each contribution to a charitable remainder trust qualify for a charitable deduction.[113] The Service concluded that no current income tax deduction was available, based on an existing revenue ruling involving the transfer of options to charities.[114] In addition, the Service ruled that no tax deduction would be available. The latter conclusion was based on the Service's interpretation of local law, as the Service concluded that because the grant of the option was for no consideration, the option was not binding on the settlor and, therefore, there was no completed and no tax deduction under §2522. Without a deduction available for either income or gift tax purposes, the Service reasoned that the trust could not function in the manner intended for charitable remainder trusts and, therefore, the transfer of an option to the trust would cause it not to qualify under §664.[115] As a result, the Service ruled that the settlor would recognize gain upon the transfer of the real property to the third party purchaser under the grantor trust rules.

The Service's analysis suggests that local law involving grants of options may affect the determination whether use of an option is appropriate. Specifically, if under local law a grant of an option with no consideration imposes a binding obligation on the settlor, PLR 9501004 implies that the grant of an option may satisfy the requirements of §2522.[116] The Service apparently views the use of options in the charitable remainder trust area with a great degree of suspicion,[117] however, so that the use of an option even where local law may be favorable may be of interest only to a very brave (and aggressive) taxpayer.

0886-3547/96/$0+1.00

CONCLUSION

There are definite incentives under the tax laws for the owner of a substantially appreciated residence having significant value to use a charitable remainder trust in planning for its disposition. Unfortunately, Service pronouncements and case law provide little guidance as to certain essential elements in going forward with the mechanics of a charitable remainder trust for residential real property. Some restrictions, such as limitation on the use of mortgaged property and the prohibition against continued occupancy by the owner, are impediments for some potential settlors, and others may be dissuaded by concerns that capital gain upon sale may be attributed back to them in the event of challenge by the Service. Some relief from these limitations may be available by the cumbersome (and tax-wise aggressive) means of initially granting an option to a charitable remainder trust, although the tax consequences of this technique are uncertain. Accordingly, the Service should give consideration to fashioning its rulings so as to encourage charitable remainder trust planning when requested to rule on transactions involving transfer of residential real property.

APPENDIX *

	Single Recipient		Joint Recipient	
	A	B	C	D
Pay-out Rate	Annuity Remainder	Unitrust Remainder	Annuity Remainder	Unitrust Remainder
6%	58.27%	53.34%	48.36%	41.25%
7%	51.31%	48.63%	39.76%	35.91%
8%	44.38%	44.48%	31.15%	31.33%
9%	37.40%	40.81%	22.55%	27.41%
10%	30.45%	37.57%	13.94%	24.04%

* Illustrating the charitable deduction available for annuity trusts and unitrusts created by the grantor, age 72, for the grantor alone and for the grantor and spouse, also age 72, at a §7520 rate of 8.2%. See fn. 101, below, and accompanying test.

FOOTNOTES

The authors would like to thank John T. Sutton, Esq., for his assistance in preparing this article.

[1] *See* §664. All section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise indicated.

[2] §1034.

[3] §121.

[4] §170(f)(2)(B).

[5] For a useful discussion of other planning possibilities utilizing alternatives to a charitable remainder trust, see McCoy, "Tax Planning: Beyond The Charitable Remainder Unitrust" 132 *Tr. & Est.* No. 8, 24 (Aug. 1993.)

[6] Various life insurance policies offer coverages which may be attractive to the property owner on account of relatively low premium cost. Where the cost of the life insurance is at a low enough premium for an adequate level of coverage, the cash flow which the property owner may receive from a charitable remainder trust, after taking into account life insurance premium costs, may be more attractive to the property owner, as compared with the owner simply selling the property, paying tax on the capital gain, and investing the net after-tax proceeds. Of course, each situation is different, and comparable results depend upon investment and economic performance and actual longevity of the property owner. Generally speaking, however, where the owner is eligible for a preferred premium life insurance rate and does not outlive his or her life expectancy by any substantial measure, an overall tax saving to the family may be achieved, as long as conservatively constructed investment, economic and interest rate assumptions hold true. *See* Covey, ed., *Practical Drafting*, at 4048 (U.S. Trust 1995) (hereinafter Covey). On the other hand, where actual survivorship is significantly longer than the actuarial assumptions, or where a substantial variation from the economic, investment or interest rate assumptions occur, the overall effect on the children's inheritance instead can be disadvantageous. But even where that occurs, the income stream to the property owner nevertheless can be expected to be enhanced significantly throughout his or her life, as compared against the income stream resulting if the residence were sold directly by the owner and the proceeds reduced by substantial capital gain taxation. For illustrations, *see* Mering, "Combination of Charitable Remainder and Insurance Trusts Can Increase Wealth" 17 *Est. Plan.* 356 (Nov./Dec. 1990).

[7] Section 664 and Regs. §1.664-1 *et seq.* set forth highly technical provisions relating to charitable remainder trusts.

0886-3547/96/$0+1.00

The excise tax provisions relating to private foundations specified under §§4940 *et seq.* for the most part apply also to charitable remainder trusts. §4947(b). Section 664 and the related statutory provisions were enacted by the Tax Reform Act of 1969, P.L. 91-172, to correct abuses perceived by Congress by which taxpayers might achieve unwarranted tax benefits with respect to certain charitable trusts. See H.R. Rep. 91413 (1969), 1969-3 C.B. 200 at 237-238. Over the years the Service has promulgated forms for "mandatory" and "optional" provisions for inclusion in charitable remainder trusts. *See* Rev. Rul. 92-57, 1992-C.B. 123; Rev. Proc. 90-30, 1990-1 C.B. 534; Rev. Proc. 90-31, 1990-1 C.B. 537; Rev. Proc. 90-31, 1990-1 C.B. 546; Rev. Proc. 89-20, 1989-1 C.B. 841; Rev. Proc. 89-21, 1989-1 C.B. 842; Rev. Rul. 88-81, 1988-2 C.B. 127; Rev. Rul. 82-128, 1982-1 C.B. 71; Rev. Rul. 82-165, 1982-2 C.B. 117; Rev. Rul. 80-123, 1980-1 C.B. 205; and Rev. Rul. 72-395, 1972 C.B. 340. For a useful discussion of these forms, see LaPiana and McCoy, "Charitable Remainder Trust Drafting — Beyond the IRS Forms," 20 *Tax Mgmt. Ests., Gifts & Tr. J.* 188 (Sept./Oct. 1995). Rev. Rul. 79-428, 1979-2 C.B. 253, holds that a trust which does not contain a required mandatory provision will not qualify, and PLR 8421007 confirms this result notwithstanding inclusion of a saving clause in the governing instrument. A curative amendment is permissible, however, if made pursuant to form language promulgated by the Service authorizing trust amendment by the trustee. PLR 9107010.

[8] §664(d)(1) and Regs. §1.664-2.

[9] §664(d)(2) and Regs. §1.664-3. An alternative known as a "net income" charitable remainder unitrust is also permitted under §664(d)(3) and Regs. §1.664-3(a)(1)(i)(b), whereby the pay-out may be limited to the trust's annual income, with a make-up provision to pay income in excess of the unitrust's percentage amount "if the aggregate amounts paid in prior years was less than the aggregate percentage amounts." §664(d)(3)(B).The make-up provision is not required and may be omitted, PLR 9506015, but a net income unitrust may not be subsequently amended to eliminate the "net income" limitation (and thereby permit a greater pay-out based upon a higher unitrust percentage). PLRs 9506015, 9516040 and 9522021. A net income makeup unitrust (known as a "nim-crut") may be advantageous in connection with retirement planning for the settlor. *See* Covey, fn. 6, above, at 4040. Two recent rulings (PLRs 9511007 and 9511002?) have approved a variation known as a "capital gains nim-crut." *See* Covey, fn. 6, above, at 4043-45; Levin & Soled, "Near-zero CRUT Expands the Estate Planning Possibilities of Charitable Trusts," 83 *J. Tax'n* 24 (1995).

[10] Where the trust's income is below the annual pay-out requirement, the stream of funds received by the settlor is equivalent to income plus the amount of principal necessary to cover the pay-out requirement. The size of the pay-out rate must not be so large that the possibility is so remote as to be negligible for a charitable remainderman ultimately to receive any trust property. If more than a 5% probability exists that the noncharitable income beneficiary (or beneficiaries) will survive the exhaustion of the fund in which the charitable remainderman has an interest, such probability is not so remote as to be negligible. Rev. Rul. 77-374, 1977-2 C.B. 329. It is possible to compute a high pay-out to the charitable remainderman using actuarial tables published by the Treasury, and still be denied charitable deductions because this 5% test is not met. *See* Teitell, "Philanthropy and Estate Planning; Charitable Contribution Tax Strategies," C126 ALI-ABA 769, at 813-14 (1995) (hereinafter Teitell).

[11] *See* Teitell, fn. 10, above, at 798-803, and 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds,* XVI, A, for a general comparison of the annunity and unitrust alternatives.

[12] Regs. §§1.664-2(a)(1)(i) and 1.664-3(a)(1)(i)(a).

[13] Although a gift tax return must be filed under §6019, there is no gift tax consequence to the settlor in establishing a charitable remainder trust which terminates in favor of the charitable beneficiaries at the settlor's death — the settlor has not parted with dominion and control over the retained annuity or unitrust interest, Regs. §2511-2(b), and the value of the remainder interest qualifies for the charitable deduction for gift tax purposes. §2522.

[14] Where the settlor also specifies a continuing interest for his or her spouse, the spouse's interest qualifies for the marital deduction for gift tax purposes, §2523(g), although the limitations under §2523(i)(2) must be considered where the settlor's spouse is not a U.S. citizen. *See* Covey, fn. 6, above, at 4046-47, 4212. Of course, a charitable remainder trust may be established which may also make provision for a living person other than the settlor and may be created for a fixed term (not to exceed 20 years) or tied to the life of such beneficiary. §664(d)(1)(A) and (2)(A). However, such provisions involve gift and estate tax provisions which may not be attractive to the settlor. *See generally*, Teitell, fn. 10, above, at 804-12; 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds,* XIII, A and B. Such complexities may detract from the primary goals typically sought by the settlor — avoidance of substantial capital gain upon sale of the residence after its transfer to the trust, enjoyment of the pay-out stream from the trust for life, and income tax benefit for the charitable deduction attributable to the present value of charitable remainder interest.

[15] *See* Teitell, *Taxwise Giving*, Vol. XXXIV, No. 6 (Feb. 1996).

[16] *Id.*

[17] Regs. §§1.664-2 and -3.

[18] If an owner wishes to remain in the residence for life, an alternative to transferring the property to a charitable remainder trust would be to transfer a remainder interest in the property to a charity. The charity would receive the property upon the death of the owner, and the owner would be entitled to a charitable income tax deduction measured by the value of the remainder interest. *See* §170(f)(3)(B)(i). However, such a transfer would not produce an income stream for the owner, and if the owner later decided to sell the property, a sale would be complicated by the fact that the charitable remainderman would have to agree to a sale in order for fee simple to be transferred to the buyer. Under the uniform basis rules, the basis of the residence would be allocated between the owner (as the holder of the life estate) and the charitable remainderman, with the respective bases in the property being adjusted to reflect the change in relative values of each party's interest on account of the lapse in time. Regs. §1.1015-1(b). Any sale of the fee simple would generate capital gain to the owner, measured by the difference between the owner's portion of the sale price and the owner's basis as adjusted at the time of sale, while the gain of the charitable remainderman would be tax-exempt income. Regs. §1.1014-5(a)(2).

[19] *Cf.* Rev. Rul. 76-357, 1976-2 C.B. 285 (denying an estate tax deduction under §2055 where a testator devised a residence in a trust providing for his child to have life occupancy, with the trust remainder to pass to charity at the child's death).

[20] Section 4941(d)(1)(A) expressly proscribes leasing of the trust property by a charitable remainder trust to the settlor, who is a "disqualified person" under §4946(a). The level of excise tax under the self-dealing rules can be severe, with a tax in certain circumstances imposed at the rate of 200% of the amount involved. §4941(b)(1).

[21] §4946(a)(1)(D). A family member is defined to include only the settlor's spouse, ancestors, descendants, and spouses of descendants. §4946(d).

[22] PLR 9452006 approved a charitable remainder trust arrangement for a single item of appreciated tangible personal property. However, no charitable income tax deduction is allowable under §170(a)(3) (concerning transfer of a future interest in tangible personal property) for a transfer to a charitable remainder trust where the donor or a related party is the beneficiary, although a charitable gift tax deduction should be allowed. *See* Teitell, fn. 10, above, at 821-22. Notwithstanding PLR 9452006, two recent private letter rulings, imply that the denial of the charitable income tax deduction may prevent a trust from qualifying as a charitable

remainder trust. PLR 9532006 (revoking PLR 9440010) disallowed charitable remainder trust treatment for a testamentary annuity trust created where no estate tax charitable deduction was available on account of excessively low valuation of the charitable remainder interest. PLR 9501004 ruled that a trust funded with an option to acquire encumbered real property would not qualify as a charitable remainder trust and would instead be treated as a grantor trust) because transfer of the option to acquire property does not qualify for a charitable income or gift tax deduction until the option is exercised. One commentator argues that this result should not apply to tangible personal property charitable remainder trusts, since a charitable gift tax deduction would be allowed for the transfer of property to such trusts. *See* Covey, fn. 6, above, at 3966-67.

[23] §§671-678.

[24] If the trust were to default on the mortgage payments, the lender likely would foreclose on the property rather than seek payment directly from the trust or the settlor. If, however, sale at foreclosure resulted in deficiency, the lender could resort to the settlor's residual personal liability. The settlor is in effect placed in the position of guarantor of the mortgage indebtedness, which should not upset charitable remainder trust treatment. No estate or tax difficulty should be encountered by the settlor. *See* PLR 9113009, *as modified* by PLR 9409018.

[25] Potential valuation difficulty is not typically a relevant concern, as the property is likely to be sold (thereby indicating its value) to a third-party purchaser in the near term, so that valuation concerns for income tax reporting purposes may be resolved by reference to the sale price.

[26] *Newhall Unitrust v. Comr.*, 104 T.C. 236 (1995).

[27] Section 664(c) provides that charitable remainder trusts are not subject to income tax "unless such trust, for such year, has unrelated business taxable income. . . ." The implication of the statute, confirmed by the Tax Court, is that the presence of *any* UBTI causes *all* of the trust's income to be taxable. *Newhall Unitrust,* 104 T.C. at 244-46.

[28] *See* Newman & Buchanan, "Charitable Remainder Trusts Funded With Encumbered Property," 6 *Exempt Org. Tax'n* 418, 419 (Aug. 1992).

[29] §4941(d)(2)(A).

[30] The settlor of the trust will by definition be a "substantial contributor" to the trust, which generally causes the settlor to be a disqualified person. *See* §507(d)(2)(A) (a creator of a trust is a "substantial contributor"); §4946(a)(1) (substantial contributors are disqualified persons).

[31] Regs. §53.4941(d)-1(a).

[32] *See* Regs. §1.1011-2; *Guest v. Comr.*, 77 T.C. 10 (1981), *acq.* 1982-1 C.B. 1.

[33] Regs. §1.701-2. Although Example 6 (disregarding a partnership arrangement holding title to a residence) of the originally proposed regulations was deleted by Announcement 95-8, 1995-7 I.R.B. 56, the stated reason for its deletion was that the anti-abuse regulations are not to apply to gift and estate taxes. Accordingly, there is no assurance that the Service will not seek to apply the anti-abuse regulations aggressively for the purposes of the charitable income tax deduction, thereby triggering charitable remainder trust qualifications concerns.

[34] Of course, the mortgage lender must consent to the transfer of the residence to the new entity.

[35] One possible method to avoid this concern (if acceptable to the association's board of directors) is for the guarantee to be made by another family member who may be in a position to do so, which would not appear to be proscribed by the self-dealing rules under §4941(d). Section 672(c), which generally provides that a grantor is treated as holding any power or interest held by the grantor's spouse, may require that the guarantor be someone other than the settlor's spouse. Such a guarantee may result in a gift to the settlor, however, in an amount equal to the economic benefit of the guarantee. PLR 9113009.

[36] By way of comparison, §170 (f)(3)(B)(ii) expressly permits a charitable income tax deduction with respect to a transfer of an undivided portion of the taxpayer's entire interest in property.

[37] The availability of capital gain exclusion or deferral under §121 or §1034 for sale of the owner's retained partial interest in the residence is uncertain. No IRS pronouncement or case law authority addressing this issue can be found.

[38] PLRs 9533014 and 9114025 involved investment ownership in a limited partnership, where transfers of partial interests among separate owners are routine, as compared with personal residence ownership, where holdings of separate undivided interests (other than joinfly by husband and wife) are less commonplace. Little comfort may be placed in authority permitting transfer of a partial remainder interest in a residence to a charitable organization pursuant to §170(f)(2)(A), as to which §4947 does not extend application of the self-dealing rules. *See* Rev. Rul. 87-37, 1987-1 C.B. 295 (a charitable deduction is allowable for a gift to charity of a legal remainder interest in the donor's personal residence where the charity's interest is in tenancy-in-common with an individual).

[39] Tax Reform Act of 1969, P.L. 91-172, *See* Regs. §53.4941(d)-4(e).The taxpayers in PLR 9114025 had at first owned the property in tenancy-in-common which was converted to parmership ownership after the Service initially took the position that mere joint ownership of the real property would trigger the self-dealing rules. Blattmachr, "Something Pretty Scary. . . ," 26 *U. Miami Inst. on Est. Plan.* 10-1, at 10-11 (1992).

[40] However, the Service's position indicated that the right of the settlor/co-owner to posession of the artwork is to be curtailed. *See* Blattmachr, fn. 39, above.

[41] PLRs 8038049 and 7751033. *See also* Regs. §53.4941(d)-2(f)(2) (incidental or tenuous benefit through use by a disqualified person permitted. For a critique of the Service's position in this area, see Newman & Buchanan, fn. 28, above, at 420-21. A joint sale by a disqualified person and a charitable remainder trust should not be considered to be between them, §4941(d)(1)(A), and would not appear to fall within any of the other self-dealing categories.

[42] *See* fn. 33, above.

[43] If it is intended that the noncharitable trust may, after sale of the partial interest owned by it, acquire a residence to be used rent-free by the settlor, express authorization to do so should be included in the enumerated fiduciary powers granted under the trust instrument.

[44] Although there may be concern as to the status of the noncharitable trust as a "disqualified person" with respect to the charitable remainder trust under §4946(a)(1)(G), the fact that the disqualified person is an entity over which the settlor does not exercise control may be sufficient as a practical matter to divert scrutiny by the Service. §4941(d)(1)(E).

[45] No substantial costs are incurred for gratuitous transfers in most states. *See, e.g.,* New York Tax L. §1401; Fla. Stat. §201.02 (Florida recording tax does not apply to gifts (*Culbreath v. Reid,* 65 So.2d. 556 (1953)).

[46] Where the owner is married, it may be necessary in some states for the deed also to be executed by the owner's spouse. *See e.g.,* Fla. Const. Art. 10, §41(c) and Fla. Stat. §689.111, relating to homestead restrictions on transfer.

[47] *See City of Phoenix v. Garbage Services Co.,* 816 F. Supp. 564 (D. Ariz. 1993); *see also U.S. v. Bums,* 1988 WL 242553, at 2 (D.N.H. 1988) (not reported in F. Supp.).

[48] Presumably, arrangements should be made for employment of household staff to be shifted from the settlor to the trust. A change should also be made for casualty insurance, which may produce an increase in premium (owing to the fact that the property is no longer to be occupied by the settlor), especially for properties in states (such as California and Florida) which have recently experienced high insurance loss claims occasioned by natural disasters. *See generally* Appleman & Appleman, *Insurance Law and Practice,* §§2581, 2831-39.

[49] A portion of these monies equivalent to the actuarial value of the charitable remainder is eligible for charitable deduction treatment for income tax purposes, thereby providing some tax benefit with respect to expenses (including, if not prepaid, real estate taxes which may not be deductible on account of the

0886-3547/96/$0+1.00

alternative minimum tax) otherwise not eligible for income tax deduction.

[50] Regs. §1.664-3(b).

[51] Regs. §1.664-2(b). Borrowing by the trust after its creation may be an alternative to the grantor placing additional monies into the trust, although it may not be viable to secure feasible lending arrangements which comply with the self-dealing rules under §4941 and the grantor trust rules under §671 *et seq.* PLR 7724055 indicates that any permissible borrowing may result in unrelated business taxable income consequences under §512. *See generally* Englebrecht, Hume & Lefever, "How Charitable Trusts Can Avoid Unrelated Business Income," 20 *Est. Plan.* 226, 230-31 (1993).

[52] *See Restatement (Third) of Trusts* §170 (1990).

[53] *See Restatement (Second) of Trusts* §36 (1957). Notification should be given regardless whether the settlor may have retained a testamentary power of appointment to designate other charitable organizations to receive the remainder interest. As discussed in the following text, notification of the beneficiary in the event of a sale may not be required.

[54] *See Restatement (Third) of Trusts* §170 (1990).

[55] Only rarely would advance local court approval of a proposed sale transaction be appropriate. Subsequent approval may be obtained from the beneficial interests, presumably by nonjudicial receipt and release agreement, after the sale is completed and an appropriate period of post-closing trust administration elapses, during which any post-closing expense matters (such as any real estate tax adjustments or escrowed item) are concluded and a record established with respect to investment of the proceeds of sale. *See Restatement (Third) of Trusts* §190 (1990).

[56] *See Restatement (Second) of Trusts* §174 (1957).

[57] Leahy, "Charity Bank," 7 *Registered Representative,* No. 8, 71, at 74 (Aug. 1993).

[58] Rogers, Blattmachr and Rivlin, "Charitable Trusts Can Avoid Loss of Benefits," 18 *Est. Plan.* 292, 295 (1991).

[59] Presumably, the owner should give written cancellation notice to the real estate broker upon transfer to the trustee of the charitable remainder trust, and shortly thereafter the trustee should enter into a listing agreement on substantially similar terms at the same time as the trustee enters into a contract for sale of the residence. Under these cirmmstances, the broker should not be entitled to recoup his earlier marketing expenses. Even if legally entitled to reimbursement, the broker might elect to forego reimbursement, which could be harmful to the settlor's tax position if a prearranged sale argument were subsequently to be asserted by the Service. As a practical matter, the owner may find that many prospective real estate brokers may insist on expense reimbursement in the event of early listing cancellation, although a savvy broker may be flexible enough to waive this requirement after appropriate explanation that tax considerations with respect to the property involve some complexity.

[60] *See* 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds,* XVI; Kirkwood, "Income Tax Planning For Property Transfers to Charitable Trusts and Foundations," 66 *Fla. Bar J.* 34, at 35 (Mar. 1992).

[61] *Blake v. Comr.,* 697 F. 2d 473 (2d Cir. 1982); *Palmer v. Comr.,* 62 T.C. 684 (1974), *affd,* 523 F.2d 1308 (8th Cir. 1975), *acq.* 1978-1 C.B. 2.

[62] Rev. Rul. 78-197, 1978-1 C.B. 83; Rev. Rul. 60-370, 1960-2 C.B. 203. *See also* PLR 9114025, which expressly assumes, as a condition of a favorable ruling that the "taxpayers have not entered into any arrangement or understanding with respect to the sale of any portion of the shopping center or interests in the limited parmership they propose to create," although the ruling recognizes that the applicable state law relating to diversification of trust assets is likely to cause the trustee to sell all or a portion of the partnership interests. The Service indicated in a private ruling that it will not challenge a contribution to a trust followed by a sale so long as the donee trust is not legally bound, or can be compelled by the donor, to sell the contributed property. *See* PLR 9452026, citing *Palmer,* fn. 61, above.

[63] §§671-678.

[64] This concern cannot be handled by inclusion of a provision in the governing instrument requiring return of the property to the settlor in the event the trust fails to qualify as a charitable remainder trust, because Rev. Rul. 76-309, 1976-2 C.B. 196, holds that such a provision itself disqualifies the trust.

[65] For general standards of "prudent investment," see *Restatement (Third) of Trusts* §227 (1990) and Uniform Prudent Investor Act §§1-9 (1994). Diversification concerns were also recognized in PLR 9114025 as discussed in fns. 38-39, above, and the accompanying text.

[66] PLR 9413020 also ruled that no unrelated business income tax under §512 is triggered at the trust level because the prospective sale considered in that ruling is not part of business regularly carried on.

[67] §6110(j)(3).

[68] This is probably not viable for most situations on account of the time required to seek and obtain a private letter ruling. Also, the Service will "not ordinarily" rule on whether a trust qualifies as a charitable remainder trust under §664. *See* §4.01(39) of Rev. Proc. 96-3, 1996-1 I.R.B. 82. "Not ordinarily" connotes that the taxpayer must demonstrate unique and compelling reasons to justify the issuance of a ruling, and some taxpayers may not wish to attract any special Service attention by seeking a private letter ruling.

[69] Under the self-dealing rules, no member of the settlor's family (as defined in §4946(d)) may act as listing agent or broker because of the proscription under §4941(d)(1)(C) and (D) regarding furnishing of services by and compensation paid to a disqualified person.

[70] Even though the settlor may wish to leave furnishings in the residence on an informal basis (and remove them upon execution of a sales contract), there is no assurance that such an arrangement is permissible. Moreover, such an arrangement could constitute self-dealing, as the grantor receives the benefit of a place to store such items as well as showcase them for a potential sale. *See* §4941(d)(1)(C) (relating to furnishing of facilities between a private foundation and a disqualified person) and §4941(d)(1)(E) (relating to transfer to, or use by or for the benefit of, a disqualified person of the assets of a private foundation). *Cf.* PLRs 9011053 and 8824001.

[71] The appraisal presumably is to be made available to the settlor for use in connection the computation of the charitable deduction for income tax purposes for the preparation of the settlor's income tax return for the year in which the charitable remainder trust is established.

[72] Rev. Rul. 77-285, 1977-2 C.B. 213.

[73] Where the settlor serves as co-trustee, it is imperative that no powers which would subject the trust to the grantor trust rules under §671 *et seq.* be retained by the settlor. Where the settlor's spouse serves as co-trustee, this same concern applies under §672(e), which would attribute any power held by the settlor's spouse to the settlor.

[74] Rev. Rul. 77-285, 1977-2 C.B. 213.

[75] The regulations provide that the grantor trust rules *will* apply if the settlor retains an unrestricted power to remove an independent trustee and substitute any person, including himself, as trustee, with the exception that the settlor may be empowered to remove an independent trustee on the condition that the settlor substitute another independent trustee. Regs. §1.674(d)-2(a). The cautions approach is to avoid use of a power in the settlor (or the settlor's spouse) to remove an independent trustee in a charitable remainder trust. *Cf.* Hiscock & Russell, "Power to Replace a Trustee Can Produce Adverse Tax Results," 18 *Est. Plan.* 276, 282 (1991), suggesting a trustee replacement provision to allow replacement of an independent trustee on a periodic basis after passage of a fixed number of years) in connection with estate tax planning. For estate and gift tax purposes, the Service has recently ruled that a grantor's reservation of an unqualified power to remove a trustee and appoint a new trustee (other than the grantor) is not tantamount to a reservation by the grantor of the trustee's discretionary powers of distribution. Rev. Rul. 95-58, I.R.B. 1995-36 (revoking Rev. Rul. 79-353 and Rev. Rul. 81-51 and

citing *Wall Est. v. Comr.*, 101 T.C. 3000 (1993) and *Vak Est. v. Comr.*, 973 F.2d 1049 (8th Cir. 1992), *rev'g* T.C. Memo 1991-503). As a practical matter, it may be sufficient in many situations for the governing instrument to set out a procedure for trustee resignation and appointment of a successor.

[76] Absent unusual circumstances, there should not be any impediment to the same attorney representing both the settlor and the trustee, as long as concerns regarding informed consent necessary for dual representation consistent with Rule 1.7 of the Model Rules of Professional Conduct are satisfied. *See ACTEC Commentaries on the Model Rules of Professional Conduct* at 85-91 (American College of Trusts and Estates Counsel 1995).

[77] PLRs 7828006 and 7807096 have ruled that trustee compensation may not be payable out of the unitrust or annuity payments, with the result that the impact of trustee compensation is borne by the ultimate charitable beneficiaries. *See* 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds*, IV, I. The settlor acting as co-trustee may receive trustee compensation ordinarily payable pursuant to applicable state law. *See* PLRs 8035078 and 8033026.

[78] §664(b).

[79] §664(b)(1) and (2).

[80] §664(b)(3).

[81] Covey, fn. 6, above, at p. 4040.

[82] *See generally* Halbach, "Trust Investment Law in the Third Restatement," 27 *Real Prop. Prob. & Tr. J.* 407, 441-45 (1992); Hirsch, "Inflation and the Law of Trusts," 18 *Real Prop. Prob. & Tr. J.* 601, 625-26 (1983).

[83] For some taxpayers with high levels of taxable income, the wider differential in maximum income tax rates between capital gain income (28%) and ordinary income (39.6%) under current income tax rates may make investment in tax-exempt bonds a more attractive strategy — the pay-out to the settlor may be taxed at a lower capital gains tax rate, as contrasted with the applicable tax rate if the trust principal were instead invested in taxable securities from which ordinary income was carried out to the settlor (and taxable at higher income tax rates). This strategy may be particularly attractive in the case of an annuity trust, where potential appreciation of the trust principal is of less concern to the settlor than in the case of a unitrust. *See* Teitell, *Deferred Giving: Philanthropy and Taxation* ¶5.14 (1995).

[84] *See Restatement (Third) of Trusts* (1990); Uniform Prudent Investor Act §3 (1994). Two state court cases, both in Pennsylvania, have specifically considered whether a charitable remainder trust may be properly funded with tax-exempt securities. *McCahan Trust*, 8 Fiduc. Rep.2d 188 (Orphan's Court, Chester Co., Pa. 1988); *Feinstein Est.*, 6 Fiduc. Rep.2d 195 (Orphan's Court, Phil., Pa. 1986). Both cases were brought by the Attorney General of the State of Pennsylvania, and in one of those cases (*McCahan Trust*) the Attorney General prevailed.

[85] Regs. §1.664-1(a)(3) provides that a charitable remainder trust may not include a provision that restricts the trustee from investing assets in a manner which could result in the annual realization of a reasonable amount of income or gain. PLR 8439091 ruled that an inter vivos charitable remainder trust may be funded with tax-exempt obligations as long as there is no express or implied agreement that the trustee must invest or reinvest in such bonds. However, PLR 7802037 ruled that a requirement that the trustee invest only in tax-exempt securities during the lifetime of the grantor/beneficiary disqualified the trust under the charitable remainder trust rules. In addition, if appreciated assets transferred to a charitable remainder trust are sold and converted into tax-exempt securities pursuant to a prearranged plan, the settlor will be deemed to have sold the assets himself and transferred the proceeds to the trust; the gain from the sale will be imputed to the settlor. Rev. Rul. 60-370, 1960-2 C.B. 203. *See also* Teitell, *Deferred Giving: Philanthropy and Taxation* ¶5.14 (1995). By way of analogue, a pooled income fund is expressly prohibited by the statute from holding tax-exempt securities under §642(c)(5)(c).

[86] §170(f)(2)(B). Section 170(f)(8), entitled "Substantiation requirement for certain contributions," was enacted by the Revenue Reconciliation Act of 1993, P.L. 103-66, §13172(a) and disallows a charitable deduction in the absence of contemporaneous written acknowledgment by the donee. Prop. Regs. §1.170A-13(f)(13) exempts transfers to charitable remainder trusts from the substantiation requirements of §170(f)(8).

[87] *See* fns. 94-98, below, and accompanying text. The donation of appreciated property is not an item of tax preference for purposes of the alternative minimum tax (AMT), although certain gifts made before 1993 may have been subject to the AMT. Carryovers of excess pre-1993 charitable deductions may continue to be subject to the AMT. *See* H.R. Rep. No. 103-213, 559 (1993) (conference committee report to Omnibus Budget Reconciliation Act of 1993).

[88] §170(b)(1)(B).

[89] Pubs. 1457 and 1458 contain valuation tables for charitable remainder annuity trusts and unitrusts, respectively. *See also* Regs. §1.664-4(e)(6). The necessary actuarial calculations may be quickly done through the use of an available computer software program, such as BNA Estate Tax Planner.

[90] The applicable interest rate is set monthly under §7520 based upon U.S. Treasury obligation interest rates. For the purposes of valuing the charitable remainder, the settlor may elect to use the Service's interest rate for the month in which the trust is created or either of the two preceding months. §7520(a).

[91] Similarly, the less frequent the unitrust pay-outs, the greater is the value of the charitable remainder. 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds*, XI, B, 2.

[92] An individual's nearest birthday determines his or her age for actuarial purposes. *See* Regs. §§20.2031-7(d)(5) and 25.2512-5(d)(2)(v).

[93] Actuarial tables are to be disregarded if an individual, at the time of transfer, is afflicted with an incurable illness or other deteriorating physical condition such that the individual is considered "terminally ill" (*i.e.*, there is at least a 50% probability that the individual will die within one year) under Regs. §§1.7520-3(b)(3) and 20.7520-(3)b)(3). *See* Rev. Rul. 96-3, 1996-2 I.R.B. 14, revoking Rev. Rul. 80-80, 1980-1, C.B. 194 and Rev. Rul. 66-307, 1966-2 C.B. 429, which stated the former standard for departing from the tables in cases where death was imminent.

[94] The term "50% public charities" includes: (1) exempt organizations that are not private foundations by reason of being described in §509(a)(1), (2), (3) or (4); (2) private operating foundations defined in §4942(j)(3); (3) conduit foundations described in §170(1)(1)(E)(ii); and (4) private foundations having pooled assets in a fund defined in §170(b)(1)(E)(iii). §170(b)(1)(A).

[95] §170(b)(1)(A) specifies the 50% limitation, and §170(b)(1)(F) defines the taxpayer's "contributions base" to be adjusted gross income computed without regard to any net operating loss carryback. In order for the 50% limitation to be available, the regulations require that the trust property be distributed to (and not held in continuing trust for) one or more public charities upon the termination of the noncharitable interest. Regs. §1.170A-8(a)(2). It is often desirable for the settlor to retain a testamentary power of appointment to change the identity of the charitable reamindermen, and the 50% limitation is available as long as the permissible charitable appointees are restricted to public charities. *See* 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds*, XII, C.

[96] Regs. §170(b)(1)(B).

[97] §170(b)(1)(C)(i). The taxpayer may elect instead for the 50% limitation to apply to appreciated property, although its valuation is computed with reference only to its basis where such an election is made. §170(b)(1)(C)(iii). See 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds*, XII, A, 3 for a discussion of situations in which such elections may be advisable. Effective December 31, 1992, the alternative minimum tax under §55 *et seq.* no longer applies with respect

0886-3547/96/$0+1.00

to the charitable deduction for appreciated property. Revenue Reconciliation Act of 1993, P.L. 103-66, §13171(a)(d).

[98] §170(b)(1)(D). There may be significant nontax reasons for contributing property to a private foundation. See McCoy, "Family Foundations — A User's Guide (Non-Tax Edition)," 28 *U. Miami Inst. on Est. Plan.* Chap. 12 (1994). Some taxpayers may be satisfied that their nontax objectives (*e.g.*, control) may be achieved by utilizing a community foundation (*i.e.*, a public charity) rather than creating a private foundation. *See* Blattmachr, "Tax and NonTax Advantages of a Community Foundation," 132 *Tr. & Est.*, at 30, 32-33 (Aug. 1993). Use of a private foundation generally will result in less favorable income tax treatment because of a smaller aggregate charitable deduction to the settlor (taking into account the five-year carry-forward period under §170(d)) than where there are designated public charity remaindermen. An exception would be a settlor who has made substantial other contributions to public charities to such an extent that the settlor's aggregate charitable deductions allowable under §170(b)(1)(A) will not be decreased by the use of a private foundation as the charitable remainderman and the resulting limitations under §170(b)(1)(B).

[99] §170(b).

[100] For useful empirical analysis of the various income tax planning considerations, *see* Adams, Deby & Breber, "Lowering your Capital Gains Tax: the Charitable Remainder Trust," 134 *Tr. & Est.* No. 7, 20 (July 1995); Bergen, "Charitable Remainder Trusts: Giving Money to Charity Doesn't Mean Sacrificing Current Income," *J. of Accountancy*, at 64 (May 1993), Robbins, "Charitable Remainder Trusts Should Flourish With Increase in Tax Rates," 24 *Tax Advisor* 505 (1993). A separate consideration is the impact upon the settlor's estate plan where the settlor may be concerned that the settlor may die in the near term, leaving lower than anticipated accumulated funds from pay-outs in the settlor's estate. PLR 8749052 indicates that the governing instrument may designate that the pay-outs are to continue for a minimum number of years (despite the earlier death of the settlor) payable to the settlor's estate. This kind of variation is not usually attractive, because it reduces the value of the charitable remainder and would subject continuing pay-outs to the settlor's estate to estate tax. A better approach to cover the settlor's concern may be for the settlor to purchase term life insurance. *See* Rogers, Blattmachr & Rivlin, "Charitable Trusts Can Avoid Loss of Benefits," 18 *Est. Plan.* 292, 296 (1991).

[101] See Appendix, which is a comparison of unitrust and annuity pay-out rates under a §7520 interest rate of 8.2% for July 1996 pursuant to Rev. Rul. 96-34, 1996-27 I.R.B. Columns A and B set out percentage values where a single individual who is 72 years of age is the sole pay-out recipient for life, and Columns C and D set out percentage values where married persons who are both 72 years of age are to be joint pay-out recipients until the death of the survivor. The range of pay-out rates is between 6% and 10%, payable quarterly at the end of each quarter.

As can be seen from the Appendix where the pay-out is set at a rate above the applicable §7520 interest rate, a larger charitable deduction results where a unitrust rate of pay-out rather than the same annuity rate is selected, and vice-versa when the pay-out is set at a rate below the applicable §7520 interest rate. *See* Covey, fn. 6, above, at 4049.

[102] Marital deduction treatment for estate and gift tax purposes is available under §§2056(a) and 2523(a), but is subject to restrictions where the settlor's spouse is not a U.S. citizen. §§2056(d) and 2523(i). At the settlor's death, the inclusion of trust property in the settlor's gross estate will result in a step-up in basis for all or part of the property, eliminating the capital gain character of pay-outs to the surviving spouse. *See* Covey, fn. 6, above, at 4045 (citing Rev. Rul. 76-273, 1976-2 C.B. 268, and Rev. Rul. 82-105, 1982-1 C.B. 133).

[103] The grantor trust rules will not be triggered, under §674(b)(3) where the settlor retains the power by will to revoke the spouse's continuing interest. *See* Regs. §§1.664-2(a)(4) and 1.664-3(a)(4). No gift tax marital deduction concern arises on account of §2523(g). Where the settlor and the settlor's spouse are to be joint pay-out recipients during their lives, the trust may provide for the spouse's interest to terminate upon divorce, as §664(f) permits the spouse's interests to be terminated upon the occurrence of a "qualified contingency" (defined as any trust provision which provides that, upon the happening of a contingency, the payments from a charitable remainder trust will terminate not later than they would otherwise terminate under the trust). A divorce should be a "qualified contingency." *See* Covey, fn. 6, above, at 4046 (citing PLR 9322031). If any person has the power to alter the amount to be paid from a trust to any noncharitable beneficiary and such power would cause such person to be treated as the owner of all or a portion of the trust under the grantor trust rules, then such trust will not qualify as a charitable remainder trust. Regs. §§1.664-2(a)(3)(ii) and 1.664-3(a)(3)(ii). Accordingly, the settlor may not retain the power to alter pay-out shares between the settlor and the settlor's spouse. *See* 435 T.M., *Charitable Remainder Trusts and Pooled Income Funds*, V, D, 2. Although the power to alter pay-out shares may be granted to an independent trustee, §674(d), it may be uncertain whether such an arrangement qualifies for the gift tax marital deduction available under §2523(g).

[104] It may be appropriate for some interval of time to pass between the transfer between the spouses is made and before the transfer to the charitable remainder trust in order to ensure that the title rearrangement is respected for tax purposes. *Cf.* Wood, "Is the Step-Transaction Doctrine Still a Threat for Taxpayers?," 72 *J. Tax'n* 296 (May 1990), discussing income tax case law respecting step transaction concerns. In the case of an alien spouse, consideration should be given to the limitations on the estate and gift tax marital deduction under §§2056(d) and 2523(i), with respect to any transfer of any property interest to the spouse (*i.e.*, either an undivided interest in the residence transferred prior to creation of the trust or, if the spouse is not a settlor, an annuity or unitrust interest made payable to the spouse). PLR 9244012 ruled that an alien spouse's unitrust interest may qualify for qualified domestic trust treatment under §2056A.

[105] Presumably, trust provisions should be structured so that a spouse in ill health is not to receive any pay-out interest, because the valuation tables will apply (unless the spouse is terminally ill under Regs. §1.7520-3(b)(3), fn. 93, above), and cause lower valuation for the charitable remainder based upon actuarial (*i.e.*, longer) life expectancy.

[106] Despite the filing of joint income tax returns, the deceased spouse's unused excess charitable contribution will be lost in the year following the death of that spouse. Regs. §1.170A-10(d)(4). Accordingly, a spouse contemplating transfer of property to a charitable remainder trust who is in ill health and has a shorter actual life expectancy than the other spouse should consider transferring the property outright to the other spouse, who then makes the transfer to a charitable remainder trust. An alternative approach would be to place the property in joint names and then both jointly create the charitable remainder trust. Under this approach, if one spouse dies, the other spouse will still be able to carry over the portion of the charitable deduction attributable to his or her interest in the property. *See* Teitell, *Portable Planned Giving Manual* ¶1.18[C] (1992). Where a spouse is gravely ill, a primary tax benefit available through a charitable remainder trust — avoidance of capital gain — may be of no particular advantage on account of the step-up in basis upon that spouse's death, under §1014(a), assuming the residence was not retitled into his or her name within one year of death, which cause loss of the step-up under §1014(e).

[107] Charitable deductions would have to be reported on both the grantor's income and gift tax returns. In addition, the trust must file Forms 1041-A and 5227. §6034. Although a high value may produce a greater income tax charitable deduction benefit in the near term, it would also produce a greater capital gain which may potentially be carried out and taxable to the settlor through later years' pay-outs. §664(d)(2).

[108] *See, e.g.*, Teitell, "Funding Charitable Remainder Trusts with Innovative Assets," 132 *Tr. & Est.* No. 1, 53 (Jan. 1993).

[109] See fns. 17-34, above, and accompanying text for a discussion of the occupancy and encumbrance issues..

[110] *See* §4941(d)(1)(A) (the sale or exchange of property between a private foundation and a disqualified person is an act of self-dealing for tax purposes); Regs. §53.4941(d)-1(a) (in determining whether a transaction is an act of self-dealing "it is immaterial whether the transaction results in a benefit or a detriment" to the charitable remainder trust.).

[111] In PLR 9240017, the taxpayer proposed to grant an option to a charitable remainder unitrust at a discount to the property's fair market value. The Service ruled, in keeping with Rev. Rul. 82-197, 1982-2 C.B. 72, that the grant of the option did not entitle the taxpayer to a charitable deduction. He would receive a deduction only when the trust (or a transferee charity) exercised the option, equal to the difference between the fair market value of the property at the time of the exercise and the amount paid for it, if the trust qualified as a charitable remainder trust when it exercised the option. PLR 9240017 was revoked by PLR 9417005 because the Service was "reconsidering" the issues in the rulings.

[112] Once a prospective purchaser acquired the option, he or she would have the right to acquire the residence from the settlor for the amount provided in the option agreement. As a result, the buyer would presumably be willing to pay the charitable remainder trust an amount equal to the excess of the residence's fair market value at the time of the sale over the exercise price of the option. Insofar as that transaction is more complicated and somewhat less secure to the buyer (because the buyer's right to acquire the residence is limited to the rights provided for in the option agreement), such a strategy would be unacceptable to some purchasers without regard to tax-related concerns.

[113] Deductions for payments to charitable remainder trusts are available under §§170 (income tax), 2055 (estate tax), 2106 (nonresident estate law), and 2522 (girl tax). In the case of an inter vivos transfer to a trust, the only relevant provisions are §§170 and 2522.

[114] Rev. Rul. 82-197, fn. 111, above.

[115] The Service reached a similar conclusion in PLR 9532006, which did not involve an option. There, no charitable estate tax deduction was available upon a transfer of property to a testamentary charitable remainder trust because, based on applicable interest rates and actuarial tables, the present value of the charitable remainder interest was zero. The Service concluded that the absence of a deduction prevented the trust from qualifying under §664.

[116] In some cases, statutory provisions require that a written offer may be irrevocable for a stated duration, notwithstanding lack of consideration. 17A *Amer. Jur.* 2d §119. *See* N.Y. Gen. Obl. L. §5-1109.

[117] In PLR 9501104, the Service stated that by transferring an option (rather than the property itself) to a charitable remainder trust, "the donor is attempting to avoid the requirements that would be applicable to a direct transfer of the property." The unfavorable ruling in PLR 9501104 may indicate an inclination by the Service to scrutinize closely charitable remainder trust ruling requests and disallow arrangements involving questionable issues. This concern may be reflected in PLR 9532006 (a ruling not involving an option), in which the Service disapproved qualification of a testamentary charitable remainder trust because no estate tax charitable deduction was allowable to the decedent's estate. On the other hand, PLR 9533014 (concerning transfer of a partial interest in a commercial real estate parmership) does approve charitable remainder trust treatment, albeit under strict application of the labyrinth of relevant restrictions imposed by the tax laws. These three recent rulings should be read against the broader backdrop of Notice 94-78, 1994-2 C.B. 555, in which the Service announced that it will recast (through application of "appropriate legal doctrine") certain transactions it calls "accelerated charitable remainder trusts," in which a settlor transfers appreciated assets to a short-term charitable remainder unitrust with a high percentage unitrust amount. Notice 94-78 specifically addressed a short (two-year) unitrust with a high (80%) unitrust pay-out under an arrangement which purported to avoid most of the income tax on the underlying capital gain and allow the settlor to convert appreciated assets to cash, but without any substantial benefit to charity. Notice 94-78 warns that if a "mechanical application of regulations" to a transaction yields a result inconsistent with the purposes of a charitable remainder trust, such a transaction will not be respected. Unfortunately, this statement suggests that the Service may be less receptive to creative legal approaches involving charitable remainder trust planning for a personal residence where no abusive tax consequences are sought. The Service's disqualification of a multiple-grantor trust in PLR 9547004, discussed above, may be another aspect of a broad reconsideration of charitable remainder trusts. Practitioners should be mindful of the practical problems associated with use of charitable remainder trust for a personal residence, particularly in the context of comparing its potential use with other lifetime gifting techniques, such as a personal residence (which is statutorily sanctioned by §2702(a)(3)(A)(ii) and involves comparatively less administrative difficulties, taking into account the regulatory requirements contained in Regs. §25.2702-5).

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