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# Charitable Remainder Trusts: A Study of Current Problems

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# Charitable Remainder Trusts: A Study of Current Problems

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As anyone connected with the drafting or administration of charitable remainder trusts is painfully aware, an inordinately long and complex set of Treasury Regulations has been promulgated under section 664 of the Internal Revenue Code of 1954, as amended.† Moreover, in recent years the Internal Revenue Service has adopted a highly technical and rigid approach in its interpretation of the requirements of the statute and the regulations. The resulting confusion and uncertainty in this area of the law have caused many attorneys, including experts in the field, to avoid charitable remainder trusts whenever possible in creating estate plans for their clients.

This article suggests that the extremely technical interpretive approach currently pursued by the Service is unnecessary in circumstances where it is clear that the interests of charity are not materially jeopardized, and contends that both the underlying purposes of the 1969 reforms and the interests of the beneficiaries of section 664 trusts would be better served by a more realistic and flexible reading of the Code and regulations. The article begins with a synopsis of the basic requirements of the Code and the regulations relating to charitable remainder trusts, and presents an overview of the important administrative rulings recently issued by the Service. Various problems which are only now becoming apparent to those involved with the administration of a section 664 trust are then discussed, with special emphasis given to the problems of administering unfunded charitable remainder trusts during the deferral period. The article concludes with a discussion of a recent committee report by the Tax Section of the American Bar Association which considered some of the adverse tax consequences and inequities relating to the deferral period, and, in light of the present state of the case law, suggests that the statutory amendments proposed by the committee may be unnecessary.

## I. Introduction

Charitable remainder trusts have long been a preferred method for conferring an economic benefit upon both charitable and noncharitable

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†Hereinafter, all citations in the text and footnotes to sections of the Internal Revenue Code of 1954, as amended, will be by section number only, *e.g.*, section 664.

beneficiaries. Prior to the enactment of the tax reforms of 1969, the benefits accruing to the grantor from such transfers in trust were substantial. Income, estate, and gift tax deductions were allowed the grantor for the then present value of the charitable remainder interest in such a trust,[1] provided that the possibility of the trust principal being invaded for noncharitable purposes was sufficiently remote.[2] The grantor could reserve the income or a fixed amount from the trust assets to himself or a loved one, could bestow gifts on preferred charities, and could remove income subsequently earned by the transferred assets from his own gross income. The absence of any mandatory Treasury or Internal Revenue Service standards for such gifts in trust permitted the creation of a myriad variety of supplemental trust powers and clauses which ultimately resulted in abuses.[3]

Such abuses prompted growing congressional concern that what was ultimately distributed to charity did not correspond to the value of the charitable deduction initially allowed. As a result, the Tax Reform Act of 1969[4] included new charitable income, estate, and gift tax laws disallowing deductions for a charitable remainder trust unless it qualifies as a charitable remainder annuity trust ("annuity trust") or a charitable remainder unitrust ("unitrust") within the definition of section 664.[5] In contrast to the law prior to 1969, strict compliance with all of the requirements of section 664 is now necessary before the anticipated tax benefits may accrue to the grantor.

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[1]Treas. Reg. § 20.2031-7(f), T.D. 6296, 1958-2 CUM. BULL. 487-89. For example, if all trust income was required to be paid to a named individual, the value of the charitable remainder interest was determined by applying certain Internal Revenue Service tables (based on incremental earnings of 3½ percent) to the relevant payout period, i.e., a term of years or the life expectancy of the income beneficiary.

[2]Commissioner v. Estate of Louis Sternberger, 348 U.S. 187 (1954); Newton Trust Co. v. Commissioner, 160 F.2d 175 (1st Cir. 1947); Treas. Reg. §§ 1.170-1(e) (1972), 20.2055-2(b) (1974), 25.2522(a)-2(b) (1974); Rev. Rul. 143, 1959-1 CUM. BULL. 247.

[3]For example, a deduction was allowed even though the trust principal could be invaded for the benefit of the noncharitable beneficiaries or the charitable remainder interest could be defeated by a contingency, as long as such risks could be regarded as so remote as to be negligible. Ithaca Trust Co. v. United States, 279 U.S. 151 (1929); *cf.* Merchants Nat'l Bank v. Commissioner, 320 U.S. 256 (1943). Further, trust assets could be invested in speculative or high risk investments which enhanced current yield and maximized the amount distributable to the noncharitable income beneficiary while causing serious risk to the value of the remainder interest ultimately payable to charity. S. REP. No. 552, 91st Cong., 1st Sess. 86 (1969).

For an excellent discussion of the rules applicable to pre-1969 charitable remainder trusts see Taggart, *Charitable Deductions for Transfers of Remainder Interests Subject to Invasion,* 21 TAX L. REV. 535 (1966).

For a discussion of the purposes underlying the Tax Reform Act of 1969 see U.S. TREASURY DEP'T TAX REFORM STUDIES AND PROPOSALS 21, 38 (Part 1), 182-85, 190-93 (Part 2) (1969).

[4]Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of 26 U.S.C.).

[5]Sections 170(f)(2), 2055(e)(2), 2522(c)(2). Other than transfers to charitable remainder trusts, the Tax Reform Act of 1969 permits a deduction for transfers to a pooled income fund described in section 642(c)(5), for gifts of a remainder interest in a personal residence

## II. Principal Requirements of the Statute and Regulations

### *A. The Definition of Annuity Trusts and Unitrusts — Section 664(d)*

The charitable remainder trusts described in section 664 are divided into two categories, annuity trusts and unitrusts. The principal difference between the two is that in an annuity trust a "sum certain (which is not less than 5% of the initial net fair market value of all property placed in trust)" is annually distributed to the noncharitable beneficiary whereas in a unitrust a "fixed percentage (which is not less than 5% of the net fair market value of [the trust's] assets, valued annually)" is distributed to the noncharitable beneficiary.[6]

An annuity trust assures the donor that a certain dollar amount will be distributed annually to the noncharitable beneficiary, irrespective of fluctuations in the market value of the trust assets. However, the annual amount distributed under a unitrust will vary with any rise or fall in the market value of the trust assets.[7] The amount payable to the noncharitable beneficiary under a unitrust may also be defined in the trust agreement as the lesser of the fixed percentage of trust assets, described above,

or farm, or for gifts of an undivided portion of the donor's entire interest in property. Treas. Reg. §§ 1.170A-7 (1972), 20.2055-2(e)(2) (1974), 25.2522(c)-3 (1974). The limited nature of these exceptions demonstrates the pervasive changes wrought by the Tax Reform Act of 1969 in split-interest charitable gifts. A discussion of these other forms of giving, however, is beyond the scope of this article.

[6]Treas. Reg. §§ 1.664-2(a)(1), -3(a)(1) (1972). The requirement that a sum certain or a fixed percentage of no less than 5 percent be paid to the noncharitable beneficiary is arbitrary and seemingly unnecessary. The apparent genesis of this rule was congressional concern that charitable remainder trusts would be used to circumvent the minimum income distribution requirements imposed upon private foundations under section 4942, viz., that a minimum percentage of the assets held by charity or available for charitable uses be currently expended for such purposes. Because of the tax exempt status of section 664 trusts, Congress feared that by limiting the payout to the noncharitable beneficiary of such trusts, all income in excess of such amounts would be accumulated tax free. S. Rep. No. 552, 91st Cong., 1st Sess. 90 (1969). There is little similarity, however, between the policy considerations underlying the section 4942 payout requirement for amounts currently held by or available to charity and section 664 trusts which make assets available to charity only after the expiration of an intervening noncharitable interest. Moreover, a lesser payout in the case of a charitable remainder trust would increase the value of the remainder interest ultimately distributed to charity.

Although the stated reason for the 5 percent minimum was avoidance of a theoretical, but highly unlikely, abuse, it is questionable whether the rigidity and highly arbitrary nature of the present cure is necessary, especially in light of its double chilling effect on charitable giving. First, a donor may not increase his charitable contribution (with its concomitant deduction) by decreasing the percentage payout to the noncharitable interest below 5 percent. Second, instead of permitting any excess income to accumulate tax free, the 5 percent minimum distribution requirement results in current taxation of such income in the hands of the noncharitable beneficiary while depleting the total amount ultimately distributable to charity. The minimum distribution requirement, therefore, has the effect of increasing the government's income at the expense of charity.

[7]The net fair market value of the trust assets is required to be computed each year. Treas. Reg. § 1.664-3(a)(1)(i)(a). For a discussion of net fair market value see notes 72-78 and accompanying text *infra*.

or the actual income of the trust.[8] This alternative provision is only applicable to a unitrust, as an annuity trust with such a provision would be disqualified under section 664(d).[9]

Section 664(d) imposes additional requirements upon both annuity trusts and unitrusts. No invasion of the charitable remainder interest, other than for authorized payments to the noncharitable interest, is permitted in either type of trust.[10] Both types of trusts are required to provide that upon termination of all noncharitable interests, the remainder interest must be "transferred to or for the use of, [a charitable] organization described in Section 170(c)" or retained by the trust for such use.[11] The noncharitable beneficiaries of these trusts may be "one or more persons" at least one of whom is not an organization described in section 170(c), and if any beneficiary is an individual, he must be living at the time of the creation of the trust.[12] Finally, the noncharitable interest may be paid either for a fixed term not to exceed 20 years or for the life or lives of the individual noncharitable beneficiaries, but may not be paid for any combination of the two.[13]

*B. Other Rules and Requirements of the Statute and Regulations*

The other subsections of section 664 comprise a highly unusual combination of new rules — rules which have produced a lengthy and intricate body of regulations. A grantor must satisfy all of these rules in creating a charitable remainder trust or lose all tax benefits, since such rules are applicable notwithstanding other provisions of the Code.[14] Although other articles have discussed in detail the rules set forth in the regulations,[15] a few general remarks concerning some of the more important requirements applicable to both annuity trusts and unitrusts may be appropriate.

These rules include the requirements that: (a) no trust provision may restrict the trustee from investing trust assets in a manner "which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets";[16] (b) such trusts must "meet

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[8]Treas. Reg. § 1.664-3(a)(1)(i)(b) (1972).

[9]Treas. Reg. §§ 1.664-2(a)(1)(i), -2(a)(1)(iii) (1972). *See also* H. R. REP. No. 782, 91st Cong., 1st Sess. 296 (Conf. Rep. 1969).

[10]Treas. Reg. §§ 1.664-2(a)(4), -3(a)(4) (1972).

[11]Treas. Reg. §§ 1.664-2(a)(6), -3(a)(6) (1972).

[12]Treas. Reg. §§ 1.664-2(a)(3), -3(a)(3) (1972).

[13]Treas. Reg. §§ 1.664-2(a)(5), -3(a)(5) (1972).

[14]Section 664(a).

[15]*E.g.*, Seymour, *Charitable Remainder Trusts*, 45 N.Y. ST. B.J. 301 (1973); Sneed, *Charitable Remainder Trusts*, 1973 U. SO. CAL. TAX INST. 87; Olsen and Ledwith, *Charitable Remainder Trusts: How to Comply with Final Regulations*, 38 J. TAX 2 (1973); Teitell, *Charitable Remainder Unitrusts Under the Tax Reform Act*, 111 TRUSTS & ESTATES 859 (1972).

[16]Treas. Reg. § 1.664-1(a)(3) (1972). The meaning of the prohibition is not totally clear,

the definition of and function exclusively as a charitable remainder trust from the creation of the trust";[17] and, (c) unless already proscribed by state law, the governing trust instrument must prohibit acts which would result in the imposition of any excise tax described in sections 4941 through 4945.[18] Charitable remainder trusts are also exempt

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but it would appear to apply to express restrictions in the trust instrument which prohibit the trustee from selling certain assets, which require their retention under all or most all circumstances, or which otherwise unreasonably limit the investment policy to be pursued by the trustee. However, the language of the prohibition does not require that a minimum amount of income, *e.g.*, a minimum percentage of trust assets, be earned each year. It should be noted that such a standard based on the minimum distribution rules of section 4942 was considered by the Treasury and the Service, but was rejected because of the difficulties entailed in applying a single standard to the immense variety of factual settings in which section 664 trusts arise.

Although the regulations do not expressly forbid any particular types of investments for trust assets, in selecting an investment policy the trustee must consider state law requirements of fairness to *all* beneficiaries. For example, since the trust is tax exempt in order to protect the remainder interest from diminution, an investment in tax exempt securities will have to be justified on grounds other than their tax exempt character. In addition, because such investments clearly favor the noncharitable income beneficiary at the expense of the charitable remainderman, there is a substantial possibility that abuses in this area would cause the Service to prohibit all investments in tax exempt securities in conformity with the present restrictions applicable to pooled income funds. Section 642(c)(5)(c).

A related question is whether this regulation has established a federal rule of prudent fiduciary conduct or whether state law concepts will continue to be controlling in defining such phrases as "unwarranted restrictions" and "reasonable amount of income or gain." In Morgan v. Commissioner, 309 U.S. 78 (1940), the Court described the relationship of federal and state law as applied to taxation as follows: "State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." *Id.* at 80. Applying this standard in the present context, the better position would appear to be that state law concepts will continue to exert a substantial influence in evaluating the "prudence" of the trustee's investments. It should be noted, however, that since Commissioner v. Bosch, 387 U.S. 456 (1967), only the decisions of the highest state court will be accepted as controlling pronouncements of state law.

[17]Treas. Reg. § 1.664-1(a)(4) (1972). A trust is deemed created at the earliest time that neither the grantor nor any other person is treated as the owner of the *entire* trust under the rules applicable to grantor trusts described in subpart E, part 1 of subchapter J, but "in no event prior to the time property is first transferred to the trust." *Id.* Thus, if grantor trust powers terminate with respect to a portion of the trust, but are retained over the remaining portion, the trust will not qualify because it will not have been a section 664 trust in its entirety from the moment created. Treas. Reg. § 1.664-1(a)(6) (example 2) (1972).

An important exception to this rule applies in the case of testamentary transfers in trust. In such cases, if the obligation to pay the annuity or unitrust amount begins on the date of the settlor's death, a charitable remainder trust is deemed created on such date even though the trust is not completely funded until a reasonable period has elapsed for administration of the estate or settlement of another terminating trust. Treas. Reg. § 1.664-1(a)(5) (1972). *See also* notes 63-64 and accompanying text *infra*.

[18]Section 508(e). Section 664 charitable remainder trusts constitute split-interest trusts within the meaning of section 4947(a)(2) and consequently are subject to certain of the private foundation rules, including the section 4941 prohibitions against self-dealing and the section 4945 restrictions on taxable expenditures. However, a complete discussion of the effect of these rules on section 664 charitable trusts is beyond the scope of this article. For a discussion of the basic requirements of these rules see Rev. Rul. 395, 1972-2 CUM. BULL. 340, 343, 349; Rev. Rul. 74-368, 1974 INT. REV. BULL. No. 30, at 17. The draftsman should also consult the provisions of the applicable state law to determine the effect of legislation enacted to comply with section 508(e), if any, on the language of the trust instrument.

from federal income taxes, unless the trust has unrelated taxable business income.[19] An exclusive set of rules determines the amount and character of income to be recognized by the noncharitable beneficiary as the result of trust distributions.[20] Finally, section 664(e) provides rules for valuing the amount of the contribution deduction for a gift of a charitable remainder interest in trust, but it should be noted that other sections of the Code and not section 664 authorize the deduction.[21]

## III. Administrative Rulings

Prior to 1974, only three published rulings had been issued since the publication of final regulations.[22] However, in 1974, eight rulings affecting section 664 trusts were issued — an indication that the problems presented by the complexity of the regulations are beginning to surface.[23] A review of these recently published rulings is instructive in at least two respects. First, the issues confronted in the rulings are, for the most part,

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[19]Section 664(c). For example, a trust will have unrelated business income if it receives income-producing property subject to a mortgage or other similar lien even if the trust is not personally liable for the obligation. Such property constitutes debt-financed property and all or a portion of the income from the property will constitute unrelated business income for purposes of sections 512 and 514.

[20]Section 664(b). Taxation of distributions to noncharitable beneficiaries is not governed by the distributable net income rules generally applicable to trusts and estates, but rather by the special rules of Treas. Reg. § 1.664-1(d) (1972), which require the trustee to maintain detailed records as to the amount and character of all income received by the trust as determined at the end of each taxable year. Distributions of such amounts to noncharitable beneficiaries are deemed paid out of the following categories, first from assets includable in the current taxable year and then from prior years, in the following order: (1) as ordinary income without regard to the net operating loss deduction, since such losses are allowed both as carrybacks and unlimited carryforwards against ordinary income (*e.g.*, interest, dividends, royalties); (2) as capital gains determined on a net cumulative basis pursuant to special rules of the regulations (covering long- and short-term character) and without regard to the usual carryforward and carryback rules of section 1212; (3) as other income (*e.g.*, tax-exempt interest); and (4) as corpus. Treas. Reg. § 1.664-1(d)(2) (1972) stipulates that expenses directly attributable to an income class within a category reduce the amount of income therein, and that after such reductions, all other expenses not directly attributable to any income class are to be allocated among the classes within each category on the basis of the proportional gross income of each class. But in no event may a class of income be reduced below zero by reason of the allocation of expenses. If directly attributable expenses exceed the income of a class, the expenses are lost. Indirect expenses, however, would be reallocated to other classes of income. Finally, Treas. Reg. § 1.664-1(d)(3) (1972) requires proration of the categories of income and corpus where distributions are made by the trust to two or more beneficiaries.

[21]Treas. Reg. §§ 1.664-2(c), -2(d), -3(c), -3(d), -4 (1972).

[22]Proposed Treasury Regulations under section 664 were initially issued on August 5, 1970 (35 Fed. Reg. 12467), and reissued on September 18, 1971 (36 Fed. Reg. 18667). Final regulations were published on August 23, 1972 in Treasury Decision 7202. Treas. Dec. 7202, 1972-2 Cum. Bull. 313.

[23]As of March 1, 1975. Three of these rulings are discussed in the text accompanying notes 43-50 *infra*. The other five rulings are: Rev. Rul. 39, 1974-1 Cum. Bull. 156; Rev. Rul. 53, 1974-1 Cum. Bull. 60; Rev. Rul. 149, 1974-1 Cum. Bull. 157; Rev. Rul. 283, 1974-1 Cum. Bull. 157; and Rev. Rul. 74-368, 1974 Int. Rev. Bull. No. 30, at 17.

questions of significance, and illustrate the type of narrow, complex issue which can be presented. Second, the rulings also demonstrate that the Service has adopted a highly technical approach to interpreting questions raised under the statute and regulations, and indicate that failure to meet *all* of these requirements will result in loss of the anticipated tax benefits.

### *A. Revenue Ruling 72-395 — Model Trust Forms*

Contrary to its long-standing policy of refusing to publish and give advance approval to trust forms, the Service issued model provisions for charitable remainder trusts in Revenue Ruling 72-395.[24] These provisions are merely "illustrative," however, as the ruling expressly states that no fixed language is required in order to qualify under section 664.[25] However, the model provisions will be "accepted by the Internal Revenue Service in the absence of any showing that they are not enforceable under applicable local law."[26]

Only a general discussion of the model provisions and the comments provided by Revenue Ruling 72-395 will be attempted in this article since excellent discussions of the regulations and the ruling appear elsewhere.[27] The ruling describes six mandatory provisions for annuity trusts, including: (1) creation of a proper annuity amount, (2) creation of a proper remainder interest, (3) selection of an alternative charitable beneficiary if the remainderman does not qualify under section 170(c) at the time of distribution, (4) computation of the annuity amount in short and final taxable years, (5) prohibition of additional contributions, and (6) inclusion of prohibitions governing private foundations.[28] Seven mandatory provisions are made applicable to unitrusts consisting of all of the above except (5), which is modified to permit additional contributions if the trust instrument so provides, and a mandatory provision requiring adjustments if the unitrust amount has been incorrectly determined.[29] Nine optional provisions, with comments, are also set forth for both types of trusts.[30]

The significance of this ruling stems not only from the model provisions, but also from the fact that the language of the ruling was developed contemporaneously with the drafting of the final regulations and issued one day prior to their publication. Any questions concerning the interpretation of the regulations should, therefore, be considered in

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[24] 1972-2 CUM. BULL. 340.

[25] *Id.* at 341-42.

[26] *Id.* In addition, a valid trust must be created under the applicable local law.

[27] *See* note 15 *supra*.

[28] Rev. Rul. 395, 1972-2 CUM. BULL. 340, 342-44.

[29] *Id.* at 347-49.

[30] *Id.* at 344-47, 350-52.

light of the provisions of this ruling, as courts are likely to regard it as tantamount to an extension of the regulations.[31]

Revenue Ruling 72-395 also provides that Revenue Procedure 72-3 applies to determine whether the Service will issue advance rulings concerning qualification of an instrument under section 664.[32] Under Revenue Procedure 72-3 the Service will not entertain requests concerning testamentary trusts, but will accept such requests concerning inter vivos trusts.[33]

### *B. Revenue Ruling 73-571 — Common Trust Fund Investments*

Revenue Ruling 73-571[34] permits a bank, as trustee of a unitrust, to invest the assets of the trust in a common trust fund described in section 584(a) of the Code without jeopardizing either the exempt status of the unitrust or the donor's charitable deduction. The ruling involved a common trust fund in which an aggregate of less than 2 percent of the outstanding units of participation were owned by qualified charitable remainder trusts and over 90 percent of the units were owned by inter vivos revocable noncharitable trusts. The bank, as trustee of the unitrust, had full discretion over the investment of trust assets.[35]

Normally, published rulings are issued only in cases where an important question has not been resolved by existing case law, regulations, or other rulings. It is therefore surprising that the Service felt it necessary to issue a ruling on this question, as one would have thought that the right of a bank to make such an investment was clear.

One issue which may have been implicitly decided by the ruling is whether investment by a bank trustee of unitrust assets in the bank's common trust fund, for which it also acts as trustee, constitutes a proscribed

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[31]In contrast to regulations, which are statements of general policy or interpretations for guidance of the general public, the holding of a Revenue Ruling is limited since it is addressed to a particular state of facts. Rev. Proc. 1, 1972-1 CUM. BULL. 693, 694-95. Revocation of a Revenue Ruling is normally prospective only. Revenue Ruling 72-395, however, is not addressed to a particular state of facts and cannot be so limited, since it expresses general policy and an interpretation of the statute and regulations. *See* Rogovin, *The Four R.'s: Regulations, Rulings, Reliance, and Retroactivity — A View from Within,* 8 CCH 1974 STAND. FED. TAX REP. ¶ 5980 A.0152, at 67,033.

[32]Rev. Proc. 3, 1972-1 CUM. BULL. 698.

[33]*Id.* at 700.

[34]Rev. Rul. 571, 1973-2 CUM. BULL. 213.

[35]The ruling does not discuss whether a trust instrument may properly direct the trustee to invest trust assets in investments which are clearly income producing, such as Treasury bills, bank deposits, common trust funds maintained by the bank, or other investments which have a proven earnings history. Treas. Reg. § 1.664-1(a)(3) (1972) does not clarify whether all express restrictions are prohibited or merely those which could prevent production of a reasonable amount of current income or gain. Although there is no clear answer to any of these questions, there should be little harm in permitting restrictions which allow the trustee sufficient opportunity to earn a reasonable amount of income or gain as measured by the state prudent man standards. *See* note 16 *supra.*

act of self-dealing within the meaning of section 4941.[36] Clearly, the bank is a disqualified person[37] with respect to the unitrust. The investment of trust assets in the bank's common trust fund is a service rendered for a fee, and therefore constitutes an act of self-dealing. The ruling thus appears to constitute an implicit determination that one of the exceptions to the definition of self-dealing applies. The most likely exception is that providing for the payment of compensation to a disqualified person in an amount which is not excessive for "personal services which are reasonable and necessary" to carry out the purposes of the unitrust.[38] Whether the ruling would continue to apply to investments in a common trust fund in which a substantial portion or a majority of all participation units were owned by qualified charitable remainder trusts is left unclear. The Service may contend that such a common trust fund is tantamount to a type of pooled income fund where assets are commingled for investment without meeting the requirements of section 642(c)(5) or the apparent requirement that charitable trust assets be held and invested separately from assets of other trusts.[39]

### *C. Revenue Ruling 73-610 — Investment Restrictions*

In Revenue Ruling 73-610,[40] the annuity trust permitted the grantor's spouse, who was also the sole life income beneficiary of the trust, to have the use of the grantor's antique collection for her life. The annuity trust failed to qualify under section 664 because the existence of a life estate in the antique collection restricted the trustee from investing all of the trust assets in a manner "which could result in the annual realization of a reasonable amount of income and gain from the sale or other disposition of trust assets." The facts indicated that all of the other assets of the trust were income producing, and the trustee was not subject to any restriction as to their investment.

The ruling illustrates the severe consequences if a relatively innocuous right is given to the income beneficiary in violation of the strictly interpreted regulations. The Service apparently gave no consideration to whether the antique collection would likely appreciate over the years, or whether the life estate in any practical way jeopardized the interests of charity. The lesson of the ruling, it appears, is that a life estate in any asset of a charitable remainder trust (whether income producing or not) will cause disqualification of the trust under section 664. Efforts

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[36]Section 4941(d)(1)(C).

[37]Section 4946(a)(1)(B).

[38]Section 4941(d)(2)(E).

[39]Although no such requirement is expressly stated in the statute and regulations, it may be inferred from the no additional contribution rule applicable to annuity trusts and the requirement that all unitrust assets be valued annually.

[40]1973-2 CUM. BULL. 213.

to avoid this result by including the fair rental value of the reserved life estate as a component of the annuity or unitrust amount payable will probably fail, because under normal circumstances, the trustee cannot sell an asset subject to a life estate.

In addition to the ground discussed in the ruling, the trust might also have been disqualified on the theory that the right of the noncharitable beneficiary to use a principal asset of the trust during her life constituted an act of self-dealing.[41]

### *D. Revenue Ruling 74-19 — Payout Formula*

Revenue Ruling 74-19[42] involved a trust instrument which formulated the unitrust amount payable as 6 percent of the annual net fair market value of the trust assets reduced by the portion of the trustee's fee fairly attributable to the income beneficiary's interest. In no event, however, was the amount so deducted to reduce the unitrust amount payable below 5 percent of the net fair market value of the trust assets. The ruling concluded that the unitrust failed to qualify under section 664 because the unitrust amount payable was not literally computed pursuant to a "fixed percentage" of the net fair market value of trust assets.

The Service's strict interpretation of the regulations is surprising, because the unitrust amount payable could be computed with precision and could not fall below the 5 percent minimum. Any hope that the Service would mitigate the rigidity of the regulations by a flexible administrative interpretation, especially in areas where little or no abuse is possible, should be dispelled by this ruling. Absent a change in the Service's position, a prudent draftsman must assume that any reduction or adjustment in the annuity or unitrust amount payable, for whatever reasons, risks disqualification of the trust under section 664. This position raises particular difficulties in New York[43] and other jurisdictions, where a "Warms adjustment"[44] is required by state law in every case where administration expenses of an estate or trust are claimed as deductions on the trust's income tax return. The theory underlying this adjustment is that a deduction on the trust's income tax return benefits the income beneficiaries, and therefore the principal must be reimbursed for its fair share of the deduction. Any adjustment of the annuity or unitrust amount based on such considerations, however, appears to risk disqualification of the trust under section 664. This presents a dilemma to the trustee in jurisdictions holding him liable to the remainderman for failure to make the adjustment.

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[41] *See* sections 4941(d)(1)(E) and 4947(a)(2)(A).

[42] 1974-1 CUM. BULL. 155.

[43] N.Y. EST., POWERS, & TRUSTS LAW § 11-1.2(A) (McKinney 1967).

[44] *In re* Warms' Estate, 140 N.Y.S.2d 169 (N.Y. County Sur. Ct. 1955).

*E. Revenue Ruling 74-386 — Payout Termination*

Revenue Ruling 74-386[45] permits a qualified remainder trust to terminate the payment of the annuity or unitrust amount to *each* life beneficiary with the regular payment next preceding the date of death of such beneficiary. Prior to this ruling, several private rulings had been issued in which the Service took the position that payment of the annuity or unitrust amount could only terminate with the regular payment next preceding the termination of *all* noncharitable interests.[46] Under this published ruling, administration of charitable trusts is therefore made easier since the obligation to pro rate the amount owing to the date of each beneficiary's death is avoided.

The issuance of Revenue Ruling 74-386 constitutes a reversal of the Service's original position on what appears to be an extremely technical point, and is the first indication that a more practical and flexible construction may be given certain of the regulations. It is hoped that this approach will develop into a trend in all cases where there is little or no practical risk that the interests of charity or the basic purposes underlying the statute would be jeopardized.

*F. Revenue Ruling 74-481 — Computation of the Unitrust Payout When Additional Contributions Are Received*

Revenue Ruling 74-481[47] illustrates the computation of the unitrust amount payable where additional contributions are received by the unitrust during the taxable year.[48] Unlike the usual published ruling which reaches a conclusion in the context of stated facts, the ruling discussed the computations in general terms and may be viewed by a court as being tantamount to an extension of the regulations.[49]

No discussion of these computations will be made here, except to point out a trap which should be avoided. The Service has issued a private ruling disqualifying a trust under section 664 because the denominator of the fraction used to pro rate the amount owing to the noncharitable interest, in the case of a taxable year shortened by the death of the sole life beneficiary, was the last day of the taxable year rather than the earlier of that date or the date of the beneficiary's death. In this case, the trust

[45]1974 INT. REV. BULL. No. 32, at 11.

[46]For example, in the case of a trust with two life beneficiaries, this rule would have meant that payment could only terminate upon the death of the second life beneficiary because that was the end of the "period" referred to in Reg. § 1.664-3(a)(5) (1972). A trust provision permitting termination of such payment upon the death of the first as well as upon the death of the second life beneficiary would have caused disqualification of the trust under section 664 because the "period" had not come to an end.

[47]1974 INT. REV. BULL. No. 40, at 15.

[48]Treas. Reg. § 1.664-3(b) (1972).

[49]*See* note 31 *supra*.

failed to qualify even though the noncompliance occurred in a relatively minor matter, and actually enhanced the value of the charitable remainder interest. Moreover, it would not appear that this trap can be avoided by arguing that the taxable year ends upon the death of the income beneficiary because charitable remainder trusts do not terminate for tax purposes upon such death, but remain open for a reasonable period of time to permit settlement of the trust's affairs.[50] The position of the Service requires that the obligation to the noncharitable beneficiary end with his death, and the governing trust language must therefore anticipate the possibility that the beneficiary may die within the taxable year in which an additional contribution is received.

## IV. Current Problem Areas

The following sections discuss several current problems in drafting charitable remainder trust agreements and in administering estates and trusts having charitable remainder interests. Model forms for such trusts are not set forth, since they are the subject of Revenue Ruling 72-395 and other published articles.

### *A. Designation of the Charitable Remainderman*

*1. Requirements for qualification under section 664.* A very basic question in the drafting of charitable remainder trusts is whether the charitable remainderman must be specifically named in the trust instrument, or whether the instrument may simply designate charitable purposes or a class of charities, giving the trustee discretion to select the ultimate charitable recipients.[51] The regulations require a trust instrument to provide that an irrevocable remainder interest must be held "for the benefit of, or to be paid over to, charity,"[52] and explain that upon the expiration of the noncharitable interest, "the entire corpus of the trust is required to be irrevocably transferred, in whole or in part, to or for the use of one of more organizations described in section 170(c) or retained, in whole or in part, for such use."[53] Whether this language means that the charitable beneficiary must be specifically named and identified in the trust instrument is not clear.

One answer is suggested by analogy with comment (2) of Revenue Ruling 72-395 §§ 4.02 and 6.02, which provides that a charitable remainder may be: (1) distributed outright to, or held in further trust for, one or more charities; (2) held in further trust for "charitable purposes"; or

[50]Treas. Reg. § 1.664-3(a)(6) (1972).

[51]Only an organization described in section 170(c) may qualify as a remainderman. Treas. Reg. §§ 1.664-2(a)(6), -3(a)(6) (1972). Thus, only domestic charities may be qualified recipients.

[52]Treas. Reg. § 1.664-1(a)(1)(i) (1972).

[53]Treas. Reg. §§ 1.664-2(a)(6)(i), -3(a)(6)(i) (1972).

(3) disposed of in any combination of the foregoing.[54] The comment appears to permit a trust provision giving the trustee discretion to select the specific charitable recipients where the remainder is held in further trust for charitable purposes. There is little reason to distinguish this case from a case in which the trust is required to terminate and distribute all remaining trust assets to or for the use of one or more charitable organizations. In both cases, the trustee's discretion would be bounded by section 170(c). It is suggested, therefore, that the Service should issue a published ruling stating that a trust instrument authorizing the trustee to exercise discretion in selecting qualified charitable recipients upon termination of the trust is valid under section 664.

A related problem is that the regulations do not indicate whether a donor may reserve the right to designate, either by inter vivos instrument or by will, the charitable recipients of the remainder interest. The Service presently allows such designation only by inter vivos instrument, and will disqualify the trust if the donor retains a power to designate or alter the specific charitable recipients by will. The regulations provide, in relevant part, as follows:

> A trust is not a charitable remainder annuity trust [or unitrust] if any person has the power to alter the amount to be paid to any named person other than an organization described in § 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E of part 1 of subchapter J of Chapter 1 of Subtitle A of the Code were applicable to such trust.[55]

This language is concerned solely with a power in any person to alter the amount to be paid to a *noncharitable income beneficiary* and does not apply to a power to designate the recipient of the charitable remainder interest. Given the likelihood that both the needs of charity as well as the charitable interests of donors may change, it is reasonable to permit the donor to name the charitable remainder beneficiary either during his lifetime or upon his death without disqualification under section 664. As discussed above, the principal requirement of the statute and the regulations promulgated thereunder is satisfied because the remainder interest either passes "to, or for the use of, an organization described in Section 170(c) or is to be retained by the trust for such use."[56]

2. *Section 170(b)(1) deduction limitations.* A gift which is deemed to have been made "to" a charitable organization rather than merely "for the use of" such an organization is eligible for both the maximum percentage limitations provided for charitable contributions under section 170(b)(1)(A) and for a carryover for 5 years of any excess contribution

[54] 1972-2 CUM. BULL. 340, 343, 347. The ruling only contains examples of trust instruments in which specific charities are named.

[55] Treas. Reg. §§ 1.664-2(a)(3)(ii), -3(a)(3)(ii) (1972).

[56] Treas. Reg. §§ 1.664-2(a)(6)(i), -3(a)(6)(i) (1972).

deductions pursuant to section 170(d)(1) of the Code.[57] However, if the charitable remainder beneficiary is not specifically named in the trust instrument and the power of selection is reserved to the trustee or donor, a question arises as to whether the gift in trust is made "to" charity or merely "for the use of" charity. In *Lawrence R. James*[58] the Tax Court drew a distinction between a right to the income from trust assets, which was held to constitute a gift "for the use of" charity, and a vested right in the remainder interest of the trust (i.e., trust principal), which was characterized as a gift "to" charity.[59] *Alice Tully*[60] was cited by the court in *James* for the proposition that a gift of a remainder interest in trust creates a present right in the principal of the trust, even though the recipient charities were not expressly designated in the trust instrument but were to be selected from among the class defined by section 170(b)(1)(A).[61]

No relevant change has been made in section 170(b)(1) since the *Tully* case, although section 664 has subsequently created two new forms of charitable remainder trusts. The *Tully* and *James* cases should stand, therefore, for the proposition that a charitable remainder trust described in section 664(d) constitutes a gift "to" charity for purposes of section 170, even though the specific charitable remainderman may not be named in the trust instrument.

Since the principal of an annuity trust or unitrust may be invaded for the benefit of noncharitable interests only to the extent necessary to satisfy the annual payout requirement, the value of the remainder interest ultimately passing to charity can be measured with comparative ease.[62] In addition, as long as the transfer of property is irrevocable and the trust instrument limits the class of eligible remainder recipients strictly to organizations described in section 170(c), the underlying purpose of the 1969 reforms will be satisfied, i.e., the amount of the charitable deduction allowed will more nearly reflect the amount ultimately passing to charity. Under the authority of *Tully* and other similar cases, the question of exactly which section 170(c) organizations will ultimately receive the trust remainder is immaterial. The maximum charitable

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[57]Treas. Reg. §§ 1.170A-8(a)(2), -8(b), -10(a), -10(b) (1972).

[58]62 T.C. No. 23 (May 15, 1974).

[59]The court held in *James* that a gift in trust of $1,250 to be paid first out of income and then out of principal to organizations to be selected by the trustee for exclusively religious, charitable, or educational purposes constituted a gift "for the use of" charity because charity could only have a present right to the principal of the trust if the income of the trust was insufficient to provide for the fixed annual payment. Such a possibility was held to be so remote as to be negligible. *Id.*

[60]48 T.C. 235 (1967).

[61]Lawrence R. James, 62 T.C. No. 23 (May 15, 1974).

[62]For a more complete discussion of this point see notes 93-105 and accompanying text *infra*.

deduction permitted under section 170(b)(1)(A) should therefore be available to the settlor of an otherwise qualified charitable remainder annuity trust or unitrust irrespective of powers in the donor or trustee to designate the specific charitable recipients.

*B. Problems Arising from Deferral of the Annuity or Unitrust Amount Payable*

A testamentary charitable remainder trust is deemed created at the date of the settlor's death, even though the trust is not actually funded until after a reasonable period for administration of an estate or settlement of a terminating trust, provided that the obligation to pay the annuity or unitrust amount begins as of the date of death.[63] In such circumstances, actual payment of the annuity or unitrust amount may be deferred (if permitted by state law and the trust instrument) until the end of the taxable year of the trust in which complete funding occurs.[64] Problems have arisen, however, in determining whether deferral will also be permitted for certain types of inter vivos remainder trusts, and in computing the deferred annuity or unitrust amount payable to the noncharitable income beneficiary.

*1. When is deferral permitted?* As previously noted, where complete funding of an otherwise qualified testamentary trust is dependent upon pourover contributions from an estate or a terminating trust, payment of the annuity or unitrust amount may be deferred during a reasonable period for administration of the estate or settlement of the prior trust.[65] However, the regulations do not expressly indicate whether the right to defer payment of the annuity or unitrust amount is available in situations other than those involving testamentary trusts. Reg. § 1.664-1(a)(5) is entitled "Rules applicable to testamentary transfers," but nothing in the text of the regulation or in the accompanying examples of situations in which deferral is permitted suggests that a restrictive application of the deferral rules was intended.

In the usual case involving an inter vivos remainder trust which is either irrevocable or is to become irrevocable on the death of the grantor, the trust is fully funded during the grantor's lifetime[66] and is not dependent upon pourover contributions from an estate or another trust. In such cases it is clear that deferral of the annuity or unitrust amount payable is neither necessary nor permissible. The regulations are not clear, however, as to whether deferral may be available in cases involving: (1) a revocable, nominally funded inter vivos charitable remainder trust which, pursuant to its terms, becomes irrevocable on the death of the

[63]Treas. Reg. § 1.664-1(a)(5)(i) (1972).

[64]*Id.*

[65]Treas. Reg. § 1.664-1(a)(5)(i) (1972).

[66]*See generally* Treas. Reg. § 1.664-1(a)(6) (*example* 1) (1972).

grantor and which is dependent for complete funding upon a pourover from an estate or a terminating trust; or (2) an irrevocable, funded inter vivos unitrust which is to receive a pourover from an estate or a terminating trust.

*a. The revocable, nominally funded inter vivos trust.* Whenever complete funding of a revocable, inter vivos charitable remainder trust, which is to become irrevocable on the death of the grantor, is dependent upon a pourover contribution from an estate or another terminating trust, deferral of the annuity or unitrust amount payable should be allowed during a reasonable period for administration of the estate or settlement of the prior trust. The crucial factor in the application of the deferral rules of Reg. § 1.664-1(a)(5)(i) appears to be the dependency of the trust on a pourover contribution. While revocable inter vivos trusts of this type may be nominally funded during the life of the grantor, as a factual matter, they are totally dependent upon a pourover before complete funding can occur. Thus, despite the absence of express language in the regulations which would permit this result, allowing deferral in such cases should be fully justified because the significance of the trust and its role in the estate plan parallels that of a testamentary trust which is dependent upon a pourover for complete funding, and for which deferral is clearly allowed.

*b. The irrevocable, funded inter vivos unitrust.* The problem presented in the case of an irrevocable, funded inter vivos unitrust, which is entitled to receive additional contributions from the grantor's estate or from another trust terminating on the grantor's death, lies in determining when the contribution is deemed to have been made for purposes of computing the unitrust amount payable to the noncharitable beneficiary. Is the contribution made as of the date of the grantor's death or as of the date when the final distribution from the estate or terminating trust has been made? The regulations clearly provide that all property passing to a unitrust by reason of the grantor's death is considered one contribution,[67] and since the unitrust becomes entitled to receive this contribution from the date of the grantor's death, the Service could insist that the contribution was made on that date. Accordingly, the trustee could be required to make a reasonable estimate of the then present value of the contribution and to reflect that amount in his determination of the annual amount payable for each year prior to the actual receipt of such contribution. If, on the other hand, the contribution is deemed made in the year in which the full amount of property passing to the unitrust by reason of the death of the grantor has actually been received, no annual amount attributable to the additional contribution would be required to be paid to the noncharitable beneficiary until such year — a result

[67]Treas. Reg. § 1.664-3(b) (1972).

clearly unfair to such beneficiary. A practical solution would be to assume that the additional contribution was made as of the date of the grantor's death, but permit deferral of the amount payable until the full amount of the contribution has actually been received by the trust. While this result is not expressly provided by the regulations, it appears to be consistent with the requirements of Reg. § 1.664-1(a)(5)(i) which limit deferral to those cases in which actual receipt of the funds passing to the trust by reason of the settlor's death is delayed for a reasonable period for administration of the estate or settlement of a terminating trust.

2. *What constitutes "complete funding"?* Once it is concluded that payment of the annuity or unitrust amount may be deferred, the trustee of a charitable remainder trust must still determine the length of the period during which deferral is permissible. The regulations provide that payment may be deferred until the end of the taxable year in which "complete funding" of the trust occurs,[68] but fail to specify whether "complete funding" means actual or constructive receipt of all property passing to the trust by reason of the grantor's death. This distinction becomes significant in those cases in which an estate or inter vivos trust is deemed terminated for tax purposes before all pourover amounts designated for the charitable remainder trust have been distributed. The Service might take the position that in such circumstances the charitable remainder trust is in constructive receipt of all pourover amounts as of the date of termination. Accordingly, since payment of the annuity or unitrust amount may not be deferred after "complete funding" of the trust, the trustee of the charitable remainder trust could be required to cause the executor or trustee of the terminated estate or trust to pay the annuity or unitrust amount to the noncharitable income beneficiary within a reasonable period following termination.[69] However, this situation is likely to arise only in the unusual circumstances where the Service deems an estate or trust terminated for tax purposes because of the lapse of an unreasonable period for administration or settlement.[70] It would therefore seem appropriate to permit the charitable remainder trust to remain qualified, even though the annuity or unitrust amount is not paid within a reasonable period following such termination, as long as the trustee has acted reasonably in pursuing his rights under state law against the fiduciary of the terminated estate or trust.

A related problem which may occur more frequently arises in the case

[68]Treas. Reg. § 1.664-1(a)(5)(i) (1972).

[69]A trust must pay any deferred amount within a reasonable period of time after the complete funding of the trust. Treas. Reg. § 1.664-1(a)(5)(i) (1972). A reasonable period of time for payment of the unitrust amount following the end of the taxable year extends to the date upon which the trustee is required to file Form 1041-B (including extensions) for such year. Treas. Reg. § 1.664-3(a)(1)(i)(a) (1972).

[70]Treas. Reg. § 1.641(b)-3(b) (1956).

of a terminated estate or trust which either comes into possession of unforeseen assets or which, after paying all debts and liabilities, finds that it has excess assets distributable to the charitable remainder trust. Presumably, the charitable remainder trust was completely funded upon the "final" distribution from the terminated estate or trust. This unexpected receipt of additional assets raises a question concerning the obligation of the trustee to the noncharitable income beneficiary with respect to payment of the annual amount due in prior years. A practical solution to this problem would be to treat the newly found assets as increasing the value of the general trust assets as of the date of actual receipt. The administrative convenience of this approach should be particularly appealing to the trustee, since the payout to the noncharitable income beneficiary would be increased only in the year in which such assets were actually received.

The prospect of receiving additional assets presents particularly knotty theoretical questions in the case of an annuity trust, since no additional contributions are permitted to be received by such trust. However, the answer may be that all property passing to the trust by reason of the death of the grantor is treated as one contribution — a rule which should encompass the receipt of additional assets under the above circumstances.[71]

3. *Net fair market value*. Before discussing the actual computation of the deferred amount payable to the noncharitable beneficiary, it is desirable to examine the definition of the term "net fair market value." In general, the sum certain to be paid under an annuity trust must be stated as a fraction or a percentage (which is not less than 5 percent) of the "initial net fair market value," as finally determined for federal tax purposes, of the property passing in trust.[72] The unitrust amount payable must be computed pursuant to a fixed percentage (which is not less than 5 percent of the "net fair market value of the trust assets determined annually."[73] However, neither section 664, nor the regulations thereunder, define the term "net fair market value," and it is not used in any other section of the Code.[74] Instead, the regulations merely provide that, in determining the net fair market value of the trust property, all assets and liabilities of the trust are to be taken into account regardless of whether particular items would be included in determining the income of the trust.[75]

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[71]Treas. Reg. § 1.664-2(b) (1972).

[72]Treas. Reg. §§ 1.664-2(a)(1)(ii), -2(a)(1)(iii), -2(a)(2)(i) (1972).

[73]Treas. Reg. § 1.664-3(a)(1)(i)(a) (1972).

[74]It does, however, appear in Treas. Reg. §§ 1.334-1(c)(4)(viii) (1955), and 1.334-2 (1955) (relating to the basis of property received by shareholders in a corporate liquidation under section 333), where the term is defined as the fair market value of an asset less any specific mortgage or pledge to which the asset is subject.

[75]Treas. Reg. § 1.664-3(a)(1)(iv) (1972).

The regulations also provide that the trustee shall have full discretion in selecting the taxable year of the trust, the valuation date or dates, and the valuation methods to be used in making the computation. However, once made, the trustee's election is irrevocable and must be consistently followed in subsequent years.[76] Thus, the trustee should carefully consider his options of utilizing different methods and dates in valuing separate categories of trust property and in computing the net fair market value on the basis of the average or mean of such values. Moreover, in the absence of specific section 664 rules or methods for valuing different categories of trust property, the trustee may appropriately refer to the rules and methods for valuing assets for estate tax purposes contained in section 2031, or to the section 4942 rules concerning the valuation of assets for determining the annual amount of qualifying distributions which must be made by private foundations.[77]

Special valuation problems are presented by accrued liabilities, such as funeral expenses, trustee's commissions, and attorney's fees. Even though the trust's accounts are kept on the cash method of accounting, such liabilities should be deductible from the gross fair market value of trust assets if ascertainable with reasonable certainty, i.e., if all events have occurred which fix the liability, even though the amount must be estimated and cannot be fixed with exactness.[78]

For example, annual trustee commissions should constitute an accrued liability in each taxable year even though they are not paid until the trustee's final accounting has been approved. Commissions based upon the final value of the estate or trust assets, on the other hand, should constitute an accrued liability only in the final taxable year. Attorney's fees present a more difficult question because they represent services rendered over the entire period, but may not be approved for payment in full until the entire legal account has been settled. A practical resolution of this problem would be to assume that if a bill has been received by the trustee requesting partial payment (i.e., creating an account) for legal services rendered, an accrued liability would be created. In the absence of such a bill, however, it may be difficult for the trustee to make an estimate of the portion of the legal expense incurred in any specific taxable year. In such cases, the legal fee should be taken as an accrued expense in the final taxable year of the estate or terminating trust, which would normally be the year in which complete funding of the remainder trust occurs.

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[76] *Id.*

[77] For example, securities which are traded in the public markets are valued for purposes of Treas. Reg. § 20.2031-2(b) (1958) as the mean of the highest and lowest quoted selling prices on the valuation date. No specific rule is laid down under Treas. Reg. § 53.4942(a)-2(c)(4)(i) (1973), however, except the statement that a computer pricing system accepted by the Commissioner for federal estate tax purposes may be used.

[78] Treas. Reg. §§ 1.461-1(a)(2) (1947), 20.2053-1(b)(3) (1958).

*4. Corrective payments arising from a final determination of net fair market value.* The net fair market value of the trust property is likely to be incorrectly determined from time to time. In order to qualify under section 664, the trust instrument must, therefore, provide for corrective payments by the trustee in the case of an underpayment, and for similar payments by the beneficiary in case of an overpayment.[79] Such corrective payments must be distributed within a reasonable period of time after the *final determination* of net fair market value,[80] and are included in the taxable year in which paid, credited, or required to be distributed, even though made with respect to a prior year.[81] The regulations do not indicate who is to make such final determination, but it seems clearly intended that such determination is either to be made by the Commissioner or adjudicated in court.

In the case of an annuity trust, proper determination of net fair market value should not prove particularly troublesome, since in the usual case, the value of the assets transferred to the trust will be finally determined upon the audit of the income or estate tax return filed by the grantor or his estate. In contrast, the problem of accurately determining net fair market value should arise persistently in the case of a unitrust, because the trustee's determination will generally not be subject to current review by the Service unless the issue is raised and determined during an audit of the income beneficiary's tax return. Moreover, even though the beneficiaries acquiesce in the trustee's valuation of the assets, both the trustee and the beneficiaries will remain contingently liable for any adjustment in such value by the Service until such time as the Service is legally bound not to raise the issue. Until that happens, either through the running of the statute or the execution of a closing agreement, there has been no final determination within the meaning of the regulations. This aspect of charitable remainder trusts creates a risk of liability both to the trustee and to the beneficiaries not usually found in the circumstances presented by other forms of trusts and estates.

*5. Determination of the annuity or unitrust amount payable during the deferral period.* The method for determining the aggregate annuity or unitrust amount payable at the end of the deferral period may differ in the case of an annuity trust as opposed to a unitrust. With respect to an annuity trust, the amount payable is the difference between (a) the amounts actually distributed to the noncharitable income beneficiary during the deferral period, plus compound interest computed at 6 percent a year, and (b) the annuity amount payable, plus compound interest at 6 percent a year.[82] The annuity amount payable in (b) must either be

[79]Treas. Reg. §§ 1.664-2(a)(1) (iii) (1972), -3(a)(1)(iii) (1972).

[80]*Id.*

[81]Treas. Reg. § 1.664-1(d)(4)(ii) (1972).

[82]Treas. Reg. §§ 1.664-1(a)(5)(i) (1972).

a stated dollar amount, or a fraction or percentage of the *initial* net fair market value of the property irrevocably passing in trust as finally determined for federal tax purposes.[83] The valuation may be made, at the election of the executor, either as of the date of the settlor's death or on the alternative valuation date of 6 months following the settlor's death.[84]

The general computation method described above may also be used in the case of a unitrust. However, as previously indicated, the unitrust amount payable is a fixed percentage of the net fair market value of the trust assets, as determined annually[85] using the valuation dates and methods initially selected by the trustee. Thus, computation of the unitrust amount payable is more complex, because a separate valuation must be made *for each year of the deferral period.*

In addition to the general computation discussed above, the regulations also provide an alternative formula for computing the deferred amount payable under a unitrust.[86] Since use of the alternative formula is not discretionary with the trustee, but rather must be incorporated in the governing unitrust instrument (either explicitly or by reference), the draftsman must be aware of the differences between the alternative formula and the general computation.

For example, the date for valuing trust assets in the general computation may be selected by the trustee (usually the first day of the taxable year), and if 3 years elapse before the unitrust is completely funded, separate computations based on the valuation date selected by the trustee are required for each of the 3 years. The valuation date of the alternative formula, on the other hand, is the *earlier* of the date of death of the last noncharitable income beneficiary, or the last day of the taxable year in which complete funding of the trust occurs. Significant differences will result, therefore, if there has been a substantial increase or decrease in the value of trust property during the deferral period. Moreover, even if the value of the trust assets were identical for both computations, the alternative formula would yield a lower payout to the noncharitable beneficiary for two reasons: (1) the formula assumes that a valuation of the assets at the end of the deferral period includes the actual income earned during the period, and that the addition of 6 percent interest is therefore unnecessary; and (2) the tables referred to in the formula compute the 6 percent interest as owing from the end of the taxable year rather than from the date on which payment is required under the trust instrument, *e.g.*, equal monthly payments. The draftsman must carefully evaluate the nature of the assets transferred to the trust, the inter-

[83]For a discussion of what may constitute a final determination see text accompanying note 80 *supra*.

[84]Treas. Reg. § 1.664-2(c) (1972).

[85]Treas. Reg. § 1.664-3(a)(1)(i)(a) (1972).

[86]Treas. Reg. § 1.664-1(a)(5)(ii) (1972).

ests of the income beneficiary, and the administrative convenience afforded the trustee in making the required computations before deciding whether to include the alternate formula in the trust instrument.

The language of the alternate formula presents some ambiguity when applied to a trust which has been only partially funded on the death of the last income beneficiary. The formula computes the unitrust amount payable on the earlier of the date of death of the last income beneficiary or the date on which the trust is completely funded, and provides that on such date the value "*of the property held in trust which is attributable to property passing to the trust at the death of the decedent*" is to be measured.[87] It is unclear whether this language refers to the full amount of property ultimately to pass to the trust by reason of the death of the settlor, or only to such portion of that property as is actually held in trust on the death of the last income beneficiary. Since a trust which is unfunded or only partially funded on the date of death of the income beneficiary would not actually hold in trust the full amount of the assets ultimately to be distributed to it when completely funded, the language "of the property held in trust" should be construed to mean the value of all property which is required to pass to the trust by reason of the death of the grantor, whether or not such property is actually held in trust on the date of death of the last noncharitable beneficiary.

### *C. Tax Consequences of an Estate's Accumulation or Distribution of Amounts Payable to a Charitable Remainder Trust*

The remaining sections of this article explore some of the differing tax consequences to the grantor's estate, the charitable remainder beneficiary, and the noncharitable income beneficiary flowing from the estate's accumulation or distribution of "trust" income prior to complete funding of the trust.

*1. Current distribution by the estate to the noncharitable beneficiary of the charitable remainder trust.* If the estate distributes amounts directly to the noncharitable beneficiary during the administration period, the estate is allowed a distribution deduction pursuant to section 661 (a). Upon receipt of such distributions, the beneficiary will recognize income for federal income tax purposes as provided under the familiar distributable net income ("DNI") rules of sections 661 and 662, rather than under the special characterization rules of section 664.[88] It is possible, therefore, for the estate to withhold all distributions to the income beneficiary until a year in which little or no taxable income has been realized by the estate, *e.g.*, a short taxable year caused by termination of the estate. The

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[87] *Id.*

[88] Section 662(a), (b); Treas. Reg. § 1.664-1(a)(5)(iii) (1972).

amounts distributed to the beneficiary under such circumstances would be subject to little, if any, tax.[89]

2. *ABA committee proposal concerning the section 642(c) deduction for accumulations of income payable to the charitable remainder trust.* If an estate accumulates income for eventual distribution to a charitable remainder trust, a question arises as to whether the estate is entitled to a section 642(c) charitable deduction (set aside deduction) for income permanently set aside for a qualified section 664 trust. This question is the subject of a 1974 report by a committee of the Tax Section of the American Bar Association.[90] The committee proposed adding a new paragraph "(3)" to section 642(c) which would expressly allow a deduction for any amount of the estate's distributable net income, reduced by tax exempt income, which, pursuant to the terms of the will, was permanently set aside during the taxable year for distribution to a qualified section 664 trust. The committee also proposed the addition of a new subsection "(f)" to section 664 which, in the year of distribution, would attribute to the trust an amount of gross income equal to the amount of the section 642(c) deduction allowed to the estate.

The proposed amendment to section 642(c) is premised upon a conclusion by the members of the committee that a set aside deduction would not otherwise be available to the estate, because the possibility that the principal of a section 664 trust might be invaded to meet the annual payout requirement to the noncharitable beneficiary cannot be regarded as remote. The amendment was limited to the set aside deduction presumably on the assumption that amounts of income actually paid to a section 664 trust would qualify for a section 661(a) distribution deduction if the charitable deduction under section 642(c) were not available.[91]

The committee was quite properly concerned that, if the estate were not allowed a set aside deduction under present law, the burden of the tax would fall entirely upon the charitable remainderman in the case of an annuity trust, and substantially upon such remainderman in the case of a unitrust.[92] On the other hand, if the trust realized such income directly, no tax burden would exist to the remainderman, and the noncharitable beneficiary would be taxed on the income distributed to him by the trust pursuant to the characterization rules of Reg. § 1.664-1(d)(1). The effect of the proposed amendments, therefore, would be to shift the

[89]The right of an estate to distribute amounts to a person who is a beneficiary of the trust and not directly of the estate is presumably based upon the desirability of avoiding unnecessary income commissions.

[90]Tax Section Recommendation No. 1974-4, Committee on Income of Estates and Trusts, 27 TAX LAW 834 (1974).

[91]Mott v. United States, 462 F.2d 512 (Ct. Cl. 1972) (which denied a distribution deduction for income distributed to a charity which failed to meet the requirements of section 642(c)). *But see* Rev. Rul. 667, 1968-2 CUM. BULL. 289.

[92]The committee discussed an example involving an estate consisting of $500,000 of 8

burden of the income tax away from the charitable remainderman by allowing a set aside deduction to the estate, while preserving the character of the income of the estate so that the noncharitable beneficiary would be taxed on such income when ultimately distributed to him. The amendments would thus insure parallel tax consequences to all beneficiaries, whether the income was earned directly by the trust or earned and accumulated by the estate for future distribution to the trust.

The amendments would not, however, eliminate the possibility of differing tax consequences to the noncharitable beneficiary if the estate made distributions directly to such beneficiary during the deferral period. As previously discussed, the usual DNI rules apply to estate distributions on a year-by-year basis, whereas the special characterization rules of Reg. § 1.664-1(d)(1) apply to trust distributions on a total experience or throw-back basis. When planning distributions during the deferral period, the fiduciaries of estates and trusts should therefore give special consideration to the tax consequences resulting to the noncharitable beneficiary if the distributions are made by the estate rather than by the trust.

*3. Remainder interest measurable for section 642(c) purposes despite the possibility that principal will be invaded.* Unfortunately, the remedial legislation suggested by the ABA committee will not cure the problems faced by existing estates during the taxable years prior to the enactment of such legislation. Under current law, the central issue in determining whether a set aside deduction is available to an estate is whether the possibility of invading the principal of the recipient charitable remainder trust for the benefit of a noncharitable interest can be considered so remote as to be negligible. Thus, under existing law, the charitable deduction is disallowed if there exists a sufficient likelihood that the charitable remainder interest could be defeated or limited upon the action of a trustee or upon the occurrence of events beyond the remainderman's power to control. As previously noted, the ABA committee report concluded that because there was a substantial possibility that the annuity or unitrust amount payable would exceed the trust's annual income and that principal would have to be invaded to make up the difference, no set aside deduction would be available to an estate for transfers to a section 664 trust. The report did not discuss the fact, however, that in a section 664 trust, the extent to which principal may be invaded is strictly limited by the statute and the regulations.

percent corporate bonds and $300,000 of income in respect of a decedent. A residuary annuity trust requires the payment of 5 percent of the initial value of the trust to the noncharitable beneficiary, i.e., $40,000. If the estate accumulates the bond interest each year, an income tax will be paid by the estate on $340,000 which will reduce the amount distributable to the trust when completely funded although the trust will still be required to pay the $40,000 for each year of deferral undiminished by taxes paid by the estate. The estate would have to pay tax on only $300,000 a year if it made current distributions to the noncharitable beneficiary.

Although brief mention was made of the *Ithaca Trust Company*[93] and *Merchants National Bank of Boston*[94] cases, the only authority discussed by the ABA committee in support of its conclusions and recommendations was Revenue Ruling 66-367.[95] In Revenue Ruling 66-367, a charitable deduction was allowed even though the trust instrument permitted invasion of the trust corpus when necessary to support the income beneficiary in the manner to which she had become accustomed. The ruling indicated that the income of the trust was more than sufficient to support the beneficiary in her accustomed manner. After considering such factors as the beneficiary's life expectancy, her past standard of living, and the projected trust income, the ruling held that the possibility that trust principal would be invaded was so remote as to be negligible.

In *Ithaca,* facts similar to those in the above ruling were presented. The Supreme Court sustained the challenged charitable deduction on the grounds that the standard for invading trust principal was fixed, readily ascertainable, and capable of being stated in definite money terms. In *Merchants National Bank,* however, the Court denied the deduction because the power to invade was not limited to the beneficiary's accustomed life style, but included the beneficiary's happiness — a standard viewed by the Court as too uncertain and speculative to permit accurate measurement of the extent of future diversions from corpus.

Since the value of the charitable remainder interest in both annuity trusts and unitrusts is capable of being measured with precision, section 664 trusts are substantially different from the trusts described in the foregoing authorities and from almost every case or ruling decided under prior law. In the case of a section 664 trust, there is no necessity to compare the beneficiary's estimated needs with his other income and assets, or to project the amount of trust earnings. Rather, by using the Service's actuarial tables, a donor can readily ascertain the present value of the portion of his transfer in trust allowable as a charitable deduction for income, estate, or gift tax purposes. If the deduction can be measured, and is allowable to donors under sections 170, 2055, and 2522, it seems anomalous not to allow the estate a corresponding set aside deduction under section 642(c). The ABA committee, however, did not consider this inconsistency, even though the rules for deduction should be the same. The committee also failed to consider several authorities involving trusts more closely resembling those described in section 664 — authorities which would suggest that under current law, a section 642(c) set aside deduction should be available to an estate for all amounts ultimately payable to such trusts.

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[93]Ithaca Trust Co. v. United States, 279 U.S. 151 (1929), *rev'g* 64 Ct. Cl. 686 (1928).

[94]Merchants Nat'l Bank v. Commissioner, 320 U.S. 256 (1943), *aff'g* 132 F.2d 483 (1st Cir. 1942).

[95]1966-2 CUM. BULL. 241.

Revenue Ruling 54-285,[96] for example, involving facts similar to *Ithaca* and Revenue Ruling 66-367, is significant because of the language used to describe the circumstances in which a deduction is allowed.

> In view of the foregoing it is held that a charitable deduction for estate tax purposes may be allowed on account of bequests or gifts of remainder interests to charity in cases where the will or instrument authorized invasion of corpus for the comfortable maintenance and support of life beneficiaries if (1) there is an ascertainable standard covering comfort and support which may be either expressed or implied, and (2) the probability of invasion is remote *or the extent of the invasion is calculable in accordance with some ascertainable standard.*[97]

Section 664 trusts do not permit invasion of the trust based on any standard other than the fixed amount payable to the noncharitable beneficiary. The extent of any invasion is, therefore, much easier to calculate than in the *Ithaca* type trusts for which deductions were allowed.

*Estate of S. Schildkraut*[98] constitutes persuasive authority that a charitable deduction should be permitted for any transfer in trust where the charitable interest is presently ascertainable, and where there is assurance that charity will actually receive such interest. In *Schildkraut,* the settlor's will created a $300,000 testamentary trust and directed the trustees to pay his widow $12,000 a year out of income or, if income was insufficient, out of principal. The trustees were also directed to pay all federal and state income taxes owed by the widow as the result of the trust distribution, as well as all property taxes on her Florida real estate as long as she owned such property. Upon the widow's death, the principal and accumulated income, if any, vested in a qualifying charitable foundation.

Reversing the decision of the Tax Court, the Second Circuit permitted an estate tax charitable deduction for the commuted value of the charitable remainder interest. In arriving at this result, the court used the tax rates as of the settlor's death as a standard for determining the value of the power to invade the trust assets for payment of the widow's tax liabilities. Moreover, in the absence of any evidence that the widow's actual life expectancy would be materially different, the court approved the use of an actuarial computation of her life expectancy. The key assumption made in assessing the probability of invasion, however, was a 3½ percent income rate — the rate utilized by the Service in determining the present value of money to be received in the future.[99] Noting

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[96] 1954-2 CUM. BULL. 302.

[97] *Id.* at 303 (emphasis added).

[98] Estate of Sol Schildkraut v. Commissioner, 368 F.2d 40 (2nd Cir. 1966), *cert. denied* 386 U.S. 959 (1967).

[99] Treas. Reg. § 20.2031-7(f) (1958). The court also referred to the 3½ percent discount rate utilized by the triers of fact in the second circuit in personal injury cases to compute the

that the case did not involve a degree of "uncertainty appreciably greater than the general uncertainty that attends human affairs,"[100] the court asserted that the many assumptions made in valuing the charitable interest were both reasonable and frequently made in other areas of the law.

Since no qualifying section 664 trust may contain a power, no matter how limited, to invade principal for any purpose other than to satisfy the required annuity or unitrust amount payable, valuation of a section 664 trust is a much simpler task than was presented in *Schildkraut*. To illustrate, had the trust in *Schildkraut* been a qualified section 664 trust, the court could have computed the life expectancy of the widow actuarially and would not have had to make any of the other assumptions. Moreover, the Service could not challenge the estimated income payout rate because, as previously mentioned, such rate is derived from tables issued by the Service for valuing the noncharitable and charitable remainder interests.[101] In short, a section 664 trust presents a much stronger case for permitting a charitable deduction than the facts presented in *Schildkraut*.

Subsequent cases have been favorably influenced by the test adopted in *Schildkraut*, i.e., if the value of the charitable remainder interest is presently ascertainable and there is assurance that charity will receive such interest, a deduction will be allowed.[102] In *Estate of Judge*,[103] the court discussed this test and commented as follows:

> It should be noted that the *Schildkraut* case asserts that this test instead of the "so remote as to be negligible" test is applicable in these circumstances. This court believes that the test enumerated in *Schildkraut* in effect states the underlying purpose of the remoteness test and is not inconsistent therewith.[104]

It is noteworthy that the government's position in *Estate of Judge* was that no deduction was available because it was certain that some invasion of the corpus would occur. Presumably, this position prompted the members of the ABA committee to conclude that legislative amend-

present value of money earned in the future. *See generally*, Conte v. Flota Mercante del Estado, 277 F.2d 664, 670 (2d Cir. 1960); Alexander v. Nash-Kelvinator Corp., 271 F.2d 524, 527 (2d Cir. 1959). *See also* T.D. 7077, 1970-2 CUM. BULL. 183; Treas. Reg. §§ 20.2031-10(f) (1970), 1.642(c)-6(d)(3) (1971) (concerning pooled income funds), 1.664-4(a)(5) (1972) (concerning unitrusts).

[100] 368 F.2d at 49 (quoting from Ithaca Trust Co., 279 U.S. at 154).

[101] *See* note 99 *supra*.

[102] In William T. Grant, 48 T.C. 606 (1967), (a case which did not cite *Schildkraut*), the Tax Court considered a provision requiring stock dividends having a value of 5 percent or less to be paid to the income beneficiary and whether a more than negligible possibility existed that a diversion might occur. Although the value of the original shares will decrease upon the issuance of stock dividends, the court concluded that the remainder interest can be computed with reasonable certainty.

[103] Estate of Margaret D. Judge, 371 F. Supp. 716 (M.D. Pa. 1974).

[104] *Id.* at 722 n.4.

ments were necessary. However, the government's position was expressly rejected by the court in *Judge*.

> The remoteness test is utilized in order to determine the likelihood that the charity will take and the value of what it will receive. *Newton Trust Co. v. Commissioner,* 1947, 160 F.2d at 178-79. Therefore, if it were factually shown that the possibility of invasion of the corpus beyond a certain amount was so remote as to be negligible and the value of the charitable bequest was then determinable, the remoteness test would be met and a charitable deduction allowable. If it is proven that, beyond a certain amount of the corpus the possibility of invasion of the remaining portion is so remote as to be negligible, the purpose of the remoteness test of assuring that the amount of the charitable deduction is no greater than the amount which the charity does in fact eventually receive will have been satisfied.[105]

Unfortunately, the taxpayer in *Judge* lost the deduction because the trust instrument contained a power to invade corpus to pay all medical, hospital, and nursing bills incurred by the life beneficiary. Even though evidence was submitted as to the amounts actually distributed from the trust for such purposes during the years 1967 through 1971, the court concluded that on the basis of the evidence presented, the maximum amount which would be utilized for such expenses could not be calculated with reasonable certainty.

4. *Tax consequences to the noncharitable beneficiary of the payment of the annuity or unitrust amount after the deferral period.* The regulations require the noncharitable income beneficiary to take into his own income the full annuity or unitrust amount in the year in which such amount is paid, credited, or required to be distributed.[106] Thus, a deferral in the payment of such amounts results in a bunching of the beneficiary's income in the taxable year in which the accumulated payments are made.[107]

As previously discussed, the general computation of the amount payable for the deferral period includes 6 percent interest. However, since the obligation to pay the amount attributable to this interest is imposed by the federal tax law and not state law, it is not clear whether this amount constitutes interest income to the beneficiary within the meaning of section 61(a)(4) or is to be taxed to the beneficiary pursuant to the normal characterization rules of section 664. If the 6 percent amount is treated as interest income, the reservoir of taxable income of the trust subject to the characterization rules would be unchanged, and the potential tax liability of the beneficiary would be increased.

The regulations under section 61 include as taxable interest any inter-

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[105] *Id.* at 721.

[106] Treas. Reg. § 1.664-1(d)(4)(ii) (1972).

[107] *See* note 17 *supra*.

est paid under state law with respect to overdue legacies.[108] Interest normally accrues in such cases if a legacy remains unpaid after the expiration of a specified period of time, *e.g.*, 6 months. However, since few similarities exist between a legacy of a stated amount and the obligation to pay the annuity or unitrust amount, a reasonable interpretation of the regulations would exclude the so-called deferred interest amount from section 61(a)(4), and treat it merely as a device for determining the total amount payable. Under this approach, such amount would be taxed to the noncharitable income beneficiary pursuant to the characterization rules of section 664. This view is supported by the absence of any interest figure in the alternative computation formula provided for unitrusts. Taxation of the deferred amount payable should not be dependent upon the method utilized in computing such amounts.

*5. Measurement of the section 642(c) and section 661(a) deductions.* Even if the section 642(c) deduction is available to an estate for amounts paid or permanently set aside for distribution to a section 664 trust, questions remain concerning the effect of the deduction upon the trust and the proper measurement of the deduction allowed to the estate.

Although a charitable remainder trust pays no tax on income earned by it or attributed to it as the result of an estate distribution, the trustee is required to determine the tax character of all trust income and assets for purposes of taxing future distributions to the noncharitable beneficiary. In the case of a distribution from an estate which qualifies for the section 642(c) deduction, however, this task is complicated by the fact that such distributions are not attributed with any income character under the familiar DNI rules of section 662. In such cases, it only comports with common sense to treat distributions having no income character as an item of trust corpus.[109] On the other hand, to the extent a distribution from an estate does not qualify under section 642(c) and is therefore subject to the distribution deduction rules of section 661(a), the trust should be attributed with the receipt of various categories of income as determined pursuant to the DNI rules of section 662(b). Such income would pass out to the noncharitable beneficiary in future distributions from the trust according to the characterization rules of Reg. § 1.664-1(d)(1)(i) previously referred to.[110]

A related question concerns the proper method for determining the amount of the section 642(c) deduction allowable to the estate. A logical

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[108]Treas. Reg. § 1.61-7(a) (1957).

[109]*But see* Treas. Reg. § 53.4940-1(d)(2) (1972) which, for purposes of the 4 percent tax on net investment income of private foundations, provides that distributions from trusts to private foundations do not carry over income except with respect to distributions from split interest trusts described in section 4947(a)(2) created after 1969 (which would include section 664 trusts). The enforceability of the regulation has not as yet been tested.

[110]*See* note 17 *supra*.

approach to the problem would be to compute the deduction on the same basis as for income, estate, and gift taxes. The rules for the various deductions should be identical and should not vary merely because section 642(c) and not section 170 or section 2055 is involved. Reg. §§ 1.664-2(c) and 1.664-4 provide general rules for determining the present value of the remainder interest of annuity trusts and unitrusts respectively. Thus, where distributions to the trust are made by the estate, the amount attributable to the remainder interest would be deducted under section 642(c), and the rest of the distribution would be deducted in accordance with the distribution rules of section 661(a). Amounts permanently set aside for charity by the estate would be subject to the same apportionment. It should be noted, however, that the estate would be subject to tax on the amount of income apportioned to the noncharitable interest. Moreover, the ultimate burden of such tax would be borne by the charitable remainder interest and the unfairness recognized by the ABA committee would exist. To avoid this result, the executor would be required to distribute such amounts either to the beneficiary or to the trust.

Apportioning amounts otherwise qualifying under section 642(c) between the noncharitable and charitable interests and only allowing a deduction for the latter is a logical extension of the *Schildkraut* approach. Under prior law, however, the usual approach was to determine whether the possibility of invasion was remote and to deny or allow the deduction for the full amount without apportionment. In light of the present state of the law, there does not appear to be sufficient authority to sustain a deduction under this approach for the full amount of estate income designated for a section 664 trust. In contrast, the approach of sections 170, 2055, and 2522 is to divide every dollar passing to a section 664 trust between the noncharitable and charitable interests. The charitable deduction under section 642(c) should be valued on the same basis.

## Conclusion

We have only begun to perceive the problems and complexities presented by the new forms of charitable remainder trusts described in section 664. While hope exists that the new statute and regulations will permit the development of a well-recognized, clearly defined method for dividing gifts between loved ones and charity, many fear that the present complexities in this area of the law will adversely affect charitable gift giving. Under these circumstances, the lawyer's responsibility to his client and to the public is most formidable.