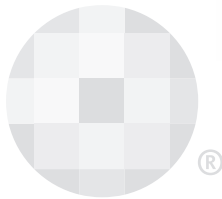


Estate & Succession Planning Corner

By Lawrence I. Richman

Selling Interests in a Charitable Remainder Trust Identified as a Transaction of Interest



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During these times of severe economic contraction, liquidity is particularly important to individuals. A charitable remainder trust (CRT) that provides for a steady income stream may have made sense based on projected returns for other assets; however, in today's economic environment those projected returns may not exist causing individuals to (1) rethink the continued viability of their CRTs and (2) seek the sale of their CRT income interest.

The recent issuance of Notice 2008-99¹ significantly impacts one of the planning approaches usually considered when disposing of an income interest in a CRT. Notice 2008-99 identifies as a transaction of interest for purposes of Reg. §1.6011-4 (b)(6) and Code Secs. 6111 and 6112 the sale of CRT interests to third parties. Identifying the transaction as such means that "The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion, but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction."²

Notwithstanding the recent issuance of the Notice, transactions involving the disposition or liquification of an income interest in a CRT have a relatively long history of IRS approval. Generally, in such cases, the income interest is disposed of either by the commutation of the CRT or by a sale to third parties.

Commutations of the income interest in a CRT occur when all of the beneficiaries of the CRT agree to terminate the CRT. Because CRTs are established under state law, they must respect state law formalities allowing for dissolution including notifying the state Attorney General where necessary as a party in interest. A commutation terminates the CRT by providing



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the holders of the income interest and the charitable remainder beneficiaries with an amount equal to the present value of the income and remainder interests calculated in the manner described in Reg. §1.664-2(c) using the valuation factor for the month of commutation provided under Code Sec. 7520.³

In various private letter rulings, the IRS has ruled that the commutation does not constitute an act of self dealing (if the remainder beneficiary is not the donor's private foundation)⁴ and is not a taxable expenditure under Code Sec. 4945.⁵ For these purposes, the type of CRT does not appear to be significant because IRS approval of the commutation of income and remainder interests has been granted not only for annuity trusts (CRATs), but also for unitrusts (CRUTs)⁶ and net income with makeup charitable remainder unitrusts (NIMCRUTs).⁷ Notwithstanding the number of private letter rulings on the subject, the IRS in Rev. Proc. 2008-3⁸ included CRTs that terminate prematurely "in a transaction in which the (recipients) receive their actuarial shares of the value of the trust" to its no-ruling list.

The IRS position regarding the income tax effects of a commutation is relatively clear: namely (1) that there is no charitable deduction to the income holder as a result of the transaction and (2) that the income holder recognizes capital gain equal to the value of the income interest with no offsetting reduction for any basis, because under Code Sec. 1001(e)(1) the income holder has no basis given that what is being sold through the commutation is a term interest. The fact that the commutation transaction is a taxable transaction should limit its perception as tax abusive.

The transaction addressed in Notice 2008-99 is one in which the holders of the term interest and the remainder interests in a CRT sell their respective interests to a third party at fair market value. The CRT terminates by merger because the third-party purchaser acquires both the term and remainder interests. The most significant tax difference between the third-party sale and the commutation is the different way in which the basis of the term holder's interest is treated. Unlike in the commutation situation where Code Sec. 1001(e)(1) provides that the term holder's basis is disregarded (in other words, zero), in the third-party sale situation the term holder's basis is

not disregarded due to the express statutory language of the exception in Code Sec. 1001(e)(3), which instead causes basis to be determined pursuant to the uniform basis rules as explained in the Regulations under Code Sec. 1014. Those rules require that two or more persons who acquire interests in the same property must use the same basis determined at the time they receive their interests.⁹

In Notice 2008-99, the IRS presented a factual situation that highlighted the potential for abuse on account of the uniform basis rules. The facts posited the creation of a CRT to which the Grantor who was the term holder contributed appreciated assets. The CRT then sold the appreciated assets at no current income tax cost and reinvested the proceeds in new assets such as a money market fund or a diversified portfolio of marketable securities. Significantly, the

CRT's basis in the new assets was the price the CRT paid for those new assets. The term holder and charitable remainderman, in a transaction falling within the exception to the no basis rule provided in Code Sec. 1001(e)(3), then sold their entire interests in the

CRT to an unrelated third party for an amount equal to the fair market value of the assets of the CRT. The CRT then terminated and the assets of the CRT, including the new assets, were distributed to the third-party purchaser.

The tax avoidance issue highlighted by the IRS occurs—

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When Grantor and Charity sell their respective interests in Trust to X, Grantor and Charity take the position that they have sold the entire interest in Trust within the meaning of Section 1001(e)(3). Because the entire interest in Trust is sold, Grantor claims that Section 1001(e)(1), which disregards basis in the case of a sale of a term interest, does not apply to the transaction. Grantor also takes the position that, under Section 1001(a) and related provisions, the gain in the sale of Grantor's term interest is computed by taking into account the portion of uniform basis allocable to Grantor's term interest under [Regulation] Section 1.1014-5 and [Regulation] Section 1.1015-1(b), and that this uniform basis is derived from the basis of the New Assets rather

than the basis of the Appreciated Assets... A result of the claimed tax treatment of the transaction is that the gain on the sale of the Appreciated Assets is never taxed, even though the Grantor receives the Grantor's share of the appreciated fair market value of those assets.¹⁰

Notice 2008-99 makes clear that the IRS is neither concerned with the creation of a CRT nor with the funding, sale or reinvestment of the trust estate of the CRT. Rather "the IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets." Accordingly, persons, which include the term holder, the charity participant and any material adviser who has participated in such a transaction must make the required disclosures on Form 8886, Reportable Transaction Disclosure Statement.

Responding to the fact that third-party sales of interests in a CRT are usually not tax-motivated transactions, but rather ones prompted by a multitude of non-tax reasons such as liquidity needs, divorce, death or a desire for simplification, the American Council on Gift Annuities in a submission to the IRS dated January 12, 2009, argued for the adoption of a new basis rule: one which would be greater than the zero basis rule that applies in the commutation situation, but less than the uniform basis rule that applies to a third-party sale. Termed the adjusted uniform basis rule, it provides that the term holder's basis is the holder's pro rata share of the CRT's basis reduced by the term holder's pro rata share of any undistributed amounts then in the capital gains category of Reg. §1.664-1.

Given the serious economic reasons supporting many early terminations of CRTs, the IRS needs to adopt a fair resolution to the potentially abusive transaction described in Notice 2008-99.

ENDNOTES

¹ Notice 2008-99, IRB 2008-47, October 31, 2008.

² *Id.*

³ See LTR 200127023 (Apr. 4, 2001) involving the termination of a term of years CRT and LTR 200208039 (Nov. 29, 2001) for the

termination of a lifetime CRT.

⁴ LTRs 200616035 (Jan. 25, 2006) and 200739004 (Jun. 21, 2007).

⁵ LTR 200441024 (Jun. 10, 2004).

⁶ LTR 200827009 (Apr. 3, 2008).

⁷ LTR 200733014s (Apr. 26, 2007).

⁸ Rev. Proc. 2008-3, IRB 2008-1, 110 at 4.01(40).

⁹ Reg. §§1.1014-4, 1.1014-5 and 1.1001-1(g)(3).

¹⁰ Notice 2008-99, IRB 2008-47, 1194, October 31, 2008.

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