FINANCIAL STRATEGIES
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New PATH for Early Termination of Net-Income CRUTs?

When the Protecting Americans from Tax Hikes (**PATH**) Act of 2015 passed late last year, much attention from a charitable perspective was focused on making the so-called "IRA charitable rollover" permanent—giving eligible individual retirement account (**IRA**) owners the ability to make tax-free direct distributions from their accounts to charity.

But there is another provision of **PATH** with major charitable implications that could also open up significant new opportunities to beneficiaries of charitable remainder unitrusts (**CRUTs**) that include "net-income" provisions. Net-income provisions limit the amount that is paid annually to the income beneficiary to the lesser of the stated payout rate in the trust document or the actual net income of the trust. Some trusts also contain provisions for any deficits from prior years to be made up to the extent the net income in the current year is more than the stated payout rate.

§ 344 of **PATH** clears up an increasingly unsettled aspect of the law related to how, in the case of an early termination of a **CRUT** that includes net-income provisions, the value of the respective income and remainder interests are to be calculated. **PATH** states unequivocally that those values are to be based on the payout percentage stated in the trust document—the same methodology used to determine the amount of the charitable deduction upon contribution to a **CRUT**. As straightforward as this may sound, it brings a new level of clarification to what was an area previously riddled with uncertainty.

Here is why it is important: There are instances when it may be prudent and attractive to terminate a **CRUT** early. Some beneficiaries may decide that they would rather have a lump sum currently rather than smaller annual payments—particularly in times when net income is relatively low, percentage-wise. That is often the case in the current low-interest rate environment which tends to result in low annual distributions that are less percentage-wise than the payout rate stated in the unitrust document.

If the charitable remainder beneficiary agrees, the charitable remainder trust may be terminated early by dividing the current trust assets between the income beneficiary and the charitable remainder beneficiary or beneficiaries according to the present value of their respective interests. (NOTE: Any early termination is likely to require the consent of the state Attorney General and/or a court with jurisdiction over the trust.)

In other cases the income beneficiary may simply decide to relinquish his or her interest in the **CRT** and assign it to the charitable remainder beneficiary. In that case the assigning beneficiary would be entitled to a current income-tax deduction for the present value of the income interest.

There is total unanimity on the procedure for determining the value of the charitable remainder when a donor is making a gift to a **CRT**. The **IRS** provides a very specific formula for calculating the value of the respective income and remainder interests, which in turn determines the amount of the income-tax charitable deduction to which the donor is entitled.

> **EXAMPLE:** Mary W, aged 73, contributes $100,000 to a charitable remainder unitrust that will pay her 5% of its annual value each year in quarterly payments for the rest of her life. Using the prescribed IRS formula shows she can deduct $56,933, the value of the charitable remainder interest. Conversely, Mary retains a life-income interest which is deemed to be worth $43,067.

It is important to note that Mary's deduction will be $56,933 whether or not her trust contains any "net-income" provisions.

What if, rather than creating a new trust, Mary wants to terminate a unitrust with the same terms (5% stated annual payout rate with quarterly payments) that is currently worth $100,000 and has net-income provisions? How much would her income interest be worth?

That is where things had gotten murky. A reasonable answer would seem to be $43,067. However, prior to **PATH**, the **IRS** took the position in several private letter rulings that the current applicable federal discount rate determined under **IRC § 7520** should be taken into consideration in making the determination. The **IRS** advanced the position that the lesser of the **§ 7520** rate in effect at the time of the termination or the stated payout rate in the trust document should be used to determine the value of the respective interests of unitrusts with net-income provisions. Seemingly, that position would be based on the theory that since the income beneficiary could receive only what could reasonably be assumed to be the net income of the trust, the discount rate in effect at the time of the proposed termination would be a logical measure of how much that income would be.

The lower the rate used, the lower the value of the noncharitable interest will be. Using current near-record low rates would reduce the value of the income interest significantly. For example, if Mary's payout rate is deemed to be 1.8% (the discount rate in effect for May 2016 and used in the previous example), the value of her interest would be well less than half as much.

While private letter rulings apply only to the party seeking the ruling and cannot be cited as precedent, these rulings have created a chilling effect on trust beneficiaries and charities moving forward with early terminations. From the income beneficiary's standpoint, valuing the income interest based on the current discount rate has created far less than appealing results—either in terms of the net lump sum he or she would receive if the trust funds are proportionately divided or the amount of the charitable deduction available if the interest is contributed to charity.

LEGACY IRA Bill Would Expand IRA Charitable Rollover

Provisions in the Protecting Americans from Tax Hikes (PATH) adopted late in 2015 made permanent rules allowing qualifying direct distributions to charity for outright gifts from individual retirement accounts of qualifying IRA owners aged 70½ without those distributions being included in the taxable income of the account owner. Now a bill has been filed in the U.S. House of Representatives (H.R. 5171) which would create the opportunity for IRA owners aged 65 or older to make direct transfers from those accounts to qualifying charities in exchange for life-income gifts for the donor, the donor's spouse, or the donor and the donor's spouse.

Only donors aged 70½ or older will be able to make outright contributions, and only $100,000 of the proposed $400,000 annual limit could be allocated to outright gifts—consistent with the age and dollar restrictions under existing law. Any additional contributions, up to the $400,000 overall limit, would have to be for life-income gifts. In addition, distributions will continue to count toward the required minimum distribution (RMD) obligation of account owners subject to RMD rules.

IRA owners and their advisors will want to track the progress of H.R. 5171. Please check with our office to learn more about the status of this important legislation.

PATH now states unequivocally that the value of the remainder interest in cases of early terminations is to be calculated exactly as it is for contributions to a **CRUT**, regardless of whether or not the trust contains net-income provisions. Beneficiaries sometimes determine that they no longer need the income they are getting from a charitable remainder trust. If the **CRUT** from which they get the distributions contains net-income provisions, they are much more likely to consider assigning that interest to charity knowing their income interest will be valued much higher than by the method advanced in **IRS** private letter rulings. Similarly, they are likely to be more open to an early termination that would generate a larger lump sum distribution to them while freeing up the present value of the remainder interest for use by charity.

Letter Ruling Allows CRT to Invest in Shares of Charity's Endowment

In a recent private letter ruling the IRS has approved the investment of assets of a charitable remainder unitrust in units of the endowment of a college that is the remainder beneficiary of the trust (**PLR 201613015**). The charitable remainder unitrust sought a ruling that exchanging assets of the trust for units of the college's endowment would not generate unrelated business-taxable income for the trust.

Under the proposed plan the remainder beneficiary college would become the trustee of the unitrust and subsequently exchange assets of the unitrust for units of the college's endowment. As noted in the ruling, the college uses a "unit" concept as a financial record-keeping device for various college funds—with each fund allocated a certain number of units of the endowment. The college itself is recognized as a tax-exempt organization described in **§ 501(c)(3)** and **170 (b)(1)(A)(ii)** of the Internal Revenue Code.

The unitrust will be assigned units of the endowment in proportion to the total value of the unitrust's assets exchanged to the total value of the endowment at the time of such exchange. The contract governing the exchange will expressly provide, among other things, that the unitrust has no ownership interest in the underlying assets of the endowment, that the unitrust will have no power to control investments of the endowment, and that the college is neither a partner nor an agent of the unitrust.

In light of these facts the IRS determined that the acquisition of the units in the endowment constitutes merely an investment of the unitrust, the nature of which will not give rise to unrelated business-taxable income for the unitrust. The amount distributed in respect of each unit of the endowment is determined by the spending policy of the college. As such, according to the ruling, the amount distributed will constitute ordinary income to the unitrust and will not take on the character of the income of the underlying assets. This will affect the nature of income ultimately distributed to the income beneficiary of the unitrust.

The agreement also provides that the unitrust may choose to reinvest part of the periodic payments received in additional units of the endowment or redeem units based on its own needs for funds to make distributions to the income beneficiary.

As noted in the ruling, much of the appeal of this plan would be for the charitable remainder entity, in its capacity as trustee, to be able to achieve greater economies of scale in the management of the unitrust's assets, a higher and more stable investment return, and a greater diversification of investment. While the ruling is not a precedent on which parties other than those seeking the ruling may rely, it may be a source of encouragement for other donors and charities who may want to enter into a similar kind of arrangement to realize similar benefits.

Briefly …

Suggested Gift Annuity Rates Unchanged. At its board meeting in conjunction with its 32nd Conference on gift planning, the American Council on Gift Annuities voted to make no changes to the suggested maximum gift annuity rates currently in effect. The vote was pursuant to a recommendation of **ACGA's** Rates Committee.

The Rates Committee noted that the expected net return calculated by applying **ACGA's** assumptions about asset allocation, expenses, and life expectancy had not changed enough from the expected net return under which the current rates were calculated to justify changes in rates. In recommending rates, **ACGA** assumes gift annuity reserves will be invested 55% in 10-year Treasury bills, 40% in equities—with an expected 8% return—and 5% in 90-day Treasury securities. The current return on the 10-year Treasuries has been less than 2% for some time, and the rate on the 5-year is virtually zero.

Based on those assumptions and a 1% expense expectation, the current net return would be very close to the 3.25% return on which current rates are based. **ACGA** generally will not recommend a change in rates unless the assumptions produce a net return that varies from the net return assumed in current rates by more than 50 basis points.

IRS Backs Off Requiring Charities to Collect and Submit Additional Information. The Treasury Department has decided not to pursue new requirements for charities to collect personal data about donors and submit it to the IRS to substantiate charitable gifts. The idea was introduced in Proposed Regulations (REG-138344-13) that were unveiled in September 2015.

Those regulations were intended to create an exception to the requirement of providing a contemporaneous written acknowledgement of gifts of $250 or more under **IRC § 170(f)(8)(D)** and would have required charities who chose this optional method to submit the names, addresses, and tax identification numbers of donors, along with other personal information. Even though the proposed regulations created a procedure that was optional, it drew a host of objections based largely on concerns about security of taxpayer information and increased burden on charities. In January the proposed regulations were withdrawn.

Foundation Allowed to Split Three Ways. A private foundation has been allowed to split into three foundations with no negative tax ramifications for any of the entities, according to a recent Private Letter Ruling (**PLR 201609001**).

The original foundation is governed by a nine-person board consisting of five children and four grandchildren of the founder. Over time, the directors have developed different visions of how the foundation should operate and of the charities it should support. Accordingly, the foundation seeks approval to create two new foundations, each of which would receive 20% of the current assets of the foundation. The original foundation would continue and would retain 60% of the current assets.

Among the many rulings requested by the foundation, the IRS found that the transfer would not terminate the status of the original foundation and would not cause the new foundations to be treated as newly created organizations. In addition, the transfer of assets to the two new entities will be deemed to be in furtherance of the foundation's exempt purposes and will not give rise to any gross investment income. The transactions will not constitute acts of self-dealing and will not be considered to be jeopardizing investments or taxable expenditures.

Very important, the ruling determined that the foundation may count assets transferred to the new entities toward satisfaction of its minimum distribution requirements under **IRC § 4942** to the extent the new private foundations make qualifying distributions described in **IRC § 4942(g)(3)**. The foundation will, in that regard, need to exercise expenditure responsibility with respect to the two new entities.

Financial Strategies *is intended for a select group of attorneys, accountants, trust officers, insurance advisors, investment counselors, and financial planners. It is designed to keep these planners up to date on developments in estate planning as they relate to testamentary and lifetime plans in support of qualified charities.*

The Diabetes Research Institute Foundation supports the Diabetes Research Institute at the University of Miami Miller School of Medicine, an international center whose mission is to develop and rapidly apply the most promising research to treat and cure those now living with diabetes.

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