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# Planning and Drafting CRUTs Using the New IRS Model Forms

In 2000, the IRS announced its intention to issue new model forms for charitable remainder trusts (CRTs). This was welcome news for advisors because the old forms had become outdated. Moreover, model forms often provide indications of IRS policy and interpretation as well as drafting guidance. In 2003, the IRS issued eight new model forms for charitable remainder annuity trusts (CRATs). Now, two years later, the IRS has released the new and improved model forms for charitable remainder unitrusts (CRUTs) to catch up with 15 years of statutory and regulatory changes.

The new model CRUTs and IRS commentary approach one hundred pages. Digesting them may entail a formidable commitment of time and effort. We hope this analysis will help you to use the new model CRUT forms to better serve your clients.

## EIGHT NEW MODEL CRUTS

As with the CRAT models, the new CRUT models come in eight different variations, each supported by its own revenue procedure. There are four inter vivos and four testamentary models, each group having a form for:

1. one measuring life;
2. a term of years;
3. two consecutive measuring lives; and
4. two co-beneficiaries having concurrent lifetime interests with the survivor succeeding to the entire uni trust amount.

The new revenue procedures may be downloaded at: www.irs.gov/irb/2005-34_IRB/ar01.html.

## WHEN IS THE TRUST CREATED?

A CRUT must be a valid trust under applicable state law. But it takes more than executing the trust document to create the trust. An inter vivos CRUT is created when it is funded, assuming the grantor trust rules do not apply. There are some special provisions that override the grantor trust rules; for example, the grantor can name himself/herself to receive the unitrust amount and the trust can still qualify as a CRUT [Reg. §1.664-1(a)(4); compare IRC §677].

A testamentary CRUT is deemed to be created at the testator's death for federal estate tax purposes. The new model CRUT forms deal specifically with testamentary additions to inter vivos trusts. Although the payment obligation begins at death, the forms provide that payment of the unitrust amount allocable to the testamentary addition(s) can be deferred until the trust is funded or other conditions satisfied [Reg. §1.664-1(a)(5)(i)].

The grantor trust rules can prevent a CRUT from coming into existence. These are most often a concern when the trust provides for sprinkling the unitrust amount among beneficiaries. The model CRUTs discuss the sprinkling authority of the trustee only in the two term-of-years scenarios [Rev. Proc. 2005-53; Rev. Proc. 2005-57]. The testamentary term-of-years model provides that if there is authority to allocate among members of a class, the trustee cannot be a member of the recipient class. Also, the trustee cannot use the unitrust amount to satisfy any of the trustee's own legal obligations. Furthermore, the trustee must be "independent." This test is satisfied if:

1. none of the trustees is the grantor or the grantor's spouse;
2. no more than half of the trustees are parties "related or subordinate" to the grantor, as defined in IRC §672(c).

## THE NET-INCOME LIMITATION

A straight CRUT provides for a percentage of the annual valuation of the trust assets to be paid out annually. A net-

income limitation overrides the percentage payout and limits the payout to the trust's net income if less than the percentage calculation. This limitation is often used when a CRUT holds an illiquid asset and is unable to easily make the percentage payout each year. If a CRUT has a net-income limitation, it may also include a make-up feature. A net-income with make-up unitrust (NIMCRUT) provision is included in the new revenue procedures. However, the new forms feature a net-income limitation CRUT, but without the make-up feature.

The new revenue procedures also give guidance on the "flip unitrust" whereby the net-income limitation is dropped in the year following a permissible "triggering event," and the trust thereafter becomes a straight (fixed percentage) CRUT. The new models contain language for short-period proration before and after the triggering event.

The possibility that the net-income limitation may preserve trust assets by not invading the trust principal does not affect the actuarial calculations and does not increase the charitable deduction.

### MULTIPLE GRANTORS AND ADDITIONAL CONTRIBUTIONS

In the past, the IRS has not looked with favor on multiple grantors to a CRT unless they are spouses [see, e.g., PLR 9547004, 8/9/95]. The IRS reiterates this position in the CRUT model forms, and goes even further. Additional contributions can't be made by anyone other than the grantor or the grantor's estate, thus excluding the spouse and the spouse's estate [see, e.g., Rev. Proc. 2005-52, Sec. 5.05]. Advisors should check existing wills and trusts for language that allows additional contributions to flow into an inter vivos CRUT from a party other than the grantor or his/her estate. Given the IRS position, caution may be in order when community property or jointly owned property is transferred to a CRUT established by only one of the spouses.

One CRT requirement is that the present value of the charitable remainder interest must be at least 10% of the total value of the transfer, as measured actuarially at the time of the transfer. This rule also applies to additional contributions. The model forms note that if an additional contribution fails the 10% test, the contribution is severed and treated as a separate trust [see IRC §664(d)(4)].

### FUNDING CAN DISQUALIFY A CRUT

Both the CRUT and the CRAT revenue procedures cite a revenue ruling that states that if the grantor funds a CRT with a "problematic" asset, the trust is not qualified [Rev. Rul. 73-610, 1973-2 C.B. 213]. The CRT in the ruling was funded with antiques, and the income beneficiary had the right to use the antiques. This made it practically impossible for the trustee to sell the antiques or to realize income from them. One requirement of a CRT is that the trust document must not restrict the trustee in a manner that prevents the realization of reasonable income or gains [Reg. §1.1.664-1(a)(3)].

Both CRUTs and CRATs must adhere to certain requirements in the regulations dealing with "unmarketable assets." The regulations provide that the trust must have any necessary appraisals done by an independent trustee or adhere to the requirements for a "qualified appraisal."

### "FINANCIALLY DISABLED" BENEFICIARIES

If the unitrust amount is payable for life, the IRS generally requires the CRUT to make payments directly to the beneficiary rather than to a separate trust for the beneficiary. However, the IRS permits lifetime payments to go to a separate trust if the beneficiary is "financially disabled." The test for such "disability" is whether the beneficiary is unable to manage his or her financial affairs due to a physical or mental impairment that is expected to result in death, or that has lasted or can be expected to last for at least twelve months [Rev. Rul. 2002-20, 2002-17 IRB 794; IRC §6511(h)(2)(A)].

The new revenue procedures do not provide specific language for "financially disabled" beneficiaries, but they do refer advisors to Rev. Rul. 2002-20.

### INTERESTS FOR A TERM OF YEARS

A CRT may be set up for a term of up to 20 years. With respect to the termination of the specified term, the new model forms comment:

"Thus, for example, the unitrust period of a CRUT for a term of 20 years will end on the day preceding the twentieth anniversary of the date the trust was created." [Rev. Proc. 2005-53, Rev. Proc. 2005-57]

Some practitioners have criticized this termination of the trust on the day before the anniversary date as arbitrary nit-picking that could surprise unwary advisors.

### THE UNITRUST AMOUNT

The fixed percentage applied to the annual value of the CRUT corpus to determine the unitrust amount must be at least 5% but not more than 50%. The 50% cap was not in the statute when the old models were issued, but it is included in the new model forms.

A key decision for the draftsperson is the valuation date(s). The new model CRUTs generally provide for a valuation date that is the first day of the taxable year. This isn't necessarily January 1 since the first day of the taxable year is the date of funding in the trust's first year. The model forms discuss several possibilities, including a specific valuation date or an average of valuation dates. Once a valuation date is specified, it must be consistently used.

The new model forms provide for quarterly payments at the end of the period. However, the grantor may choose that payments be made annually, semiannually, monthly, and at the beginning of the period [Reg. §1.664-4(a)(3); see PLR 7926029, 3/27/79].

In the initial short year of a CRUT's creation, the trust cannot pay a full year's unitrust amount, but must prorate using a daily calculation. The unitrust amount must also be prorated in the year the CRUT terminates. The trustee has a reasonable period to wind down prior to making final distribution to charity, and it is possible this period will extend beyond the end of the year in which the beneficiary dies or the trust's term of years ends. The new revenue procedures refer advisors to the regulations for guidance on how to prorate.

The commentary sections of the revenue procedures note that the unitrust amount generally must be paid by year end. But each cites the regulations for circumstances in which the unitrust amount may be paid within a reasonable time after year-end [Reg. §1.664-3(a)(1)(i)(g) and (k)].

## TERMINATING THE UNITRUST AMOUNT "PREMATURELY"

Since the old model forms were issued, Congress added IRC §664(f), which permits a CRT to terminate the income interest as a result of a "qualified contingency." It is generally thought that IRC §664(f) overrides the conclusion in Situation 1 of Rev. Rul. 76-291, 1976-2 CB 284, which held that termination of the income interest as a result of the income beneficiary's remarriage violated §664. The new model forms provide alternative language if the draftsperson wants to add a "qualified contingency" that, if it comes to pass, will terminate the unitrust amount. Caution: Qualified contingency language can accelerate the passing of assets to the charity, but the present value of the remainder interest does not increase for charitable deduction purposes.

The CRT regulations specifically permit the grantor to terminate the unitrust amount by will [Reg. §1.664-2(a)(3)(ii), (4)]. Despite the general prohibition against invading or altering the trust, "the grantor may retain the power exercisable only by will to revoke or terminate the interest of any (noncharitable) recipient" [Reg. §1.664-2(a)(4)]. The testamentary right to revoke may avoid a taxable gift if the grantor is the initial lifetime beneficiary, and the revocation power applies to a successor interest that arises after the grantor's death [Rev. Rul. 79-243, 1979-2 CB 343, Rev. Rul. 74-149, 1974-1 CB 157]. Nevertheless, there may be a concern that a testamentary right to revoke could disqualify the trust when the beneficiary has begun accepting payments. Pending clarification from the IRS, some caution may be appropriate before including the testamentary right to revoke in circumstances where it might cut off a lifetime interest.

Reserving a testamentary right to revoke results in inclusion of CRT assets in the grantor's estate under IRC §2038. Of course, the CRT is included in the grantor's estate anyway if, as is common, the grantor retains an income interest [IRC §2036].

## DESIGNATING THE CHARITABLE REMAINDERMAN

The revenue procedures for inter vivos CRUTs provide additional language to limit the remainderman to a public charity. Limiting the charity to one described in IRC §§170(c) (income tax), 2055(a) (estate tax) and 2522(a) (gift tax) results in a qualified trust, but this definition would be broad enough to encompass private foundations as well. The trust document should refer to IRC §170(b)(1)(A) in the usual case where the donor's intention is that trust assets pass to a public charity.

Note: The old model forms could trap the unwary because the model language, if not modified, resulted in an income tax charitable deduction limited to the more restrictive rules for gifts to private foundations.

The trust document should provide a method for choosing an alternate charity if any designated charity is not qualified at the time of a distribution. The trust may restrict the class of charities to qualified (public) charities, but grant a trustee or other person the power to designate the actual charitable remainderman.

## LAST WORD

The IRS has a policy not to rule on the qualified status of charitable remainder trusts because it provides model forms to follow in drafting such trusts [Rev. Proc. 2005-3, 2005-1 IRB 118]. With the release of the eight new Revenue Procedures, the model CRUT forms are again worthy of practitioner reliance.

# New Tax Developments

## IRS Reconsiders Its Requirement that the Grantor of a Charitable Remainder Trust Obtain a Spousal Waiver

In March 2005, the IRS issued Rev. Proc. 2005-24, 2005-16 I.R.B to address a potential problem for inter-vivos charitable remainder trusts (CRT) created when the spouse of the deceased grantor chooses to take an elective share against a will. Under some state laws, the CRT assets are included as part of the decedent's augmented estate subject to the spousal election. Because the corpus of the trust could be invaded to satisfy that elective share, the trust fails under IRC §664. In response, the IRS set forth the requirement that all CRTs created after a certain time should include a written waiver signed by the grantor's spouse to disclaim any statutory right to include the trust assets in the augmented estate for the elective share.

However, the publication of Rev. Proc. 2005-24 led to sharp negative response from commentators and a call to either withdraw the requirement or change the safe harbor to something more reasonable in practice. In Notice 2006-15 published on February 3, 2006, the IRS has suspended the requirement that all CRTs created after June 28, 2005 contain a signed written waiver to state that a spouse disclaims the assets placed in a CRT when electing against the will and taking a spousal share in the estate. "The purpose of this notice is to extend the June 28, 2005, grandfather date in Rev. Proc. 2005-24, 2005-16, I.R.B. 909, until further guidance is issued by the Internal Revenue Service." Thus, the IRS has decided to disregard its own waiver requirement for all CRTs, even those created after June 28, 2005, but only if the spouse does not actually exercise the right of election. Notice 2006-15; 2006-8 IRB 1

## Early Termination of CRUT Would Not Result in Self-Dealing

The grantors had set up a CRUT, named their private foundation as the remainderman, and funded it with closely held stock. Grantors had the right to change and to add charitable remaindermen, and to specify the percentages each of the remaindermen would receive. The stock has been sold. The grantors now propose to terminate the CRUT, and to distribute the income and remainder interests on a proportionate basis, based on their remaining joint life expectancy under IRS actuarial tables.

As part of the CRUT termination, the grantors propose to release their power to change the remainderman, and to irrevocably designate the private foundation as the remainder beneficiary. Applicable state law allows early termination if all beneficiaries consent. The termination must be approved in a state court proceeding, with the consent of the state attorney general.

The IRS ruled privately that the proposed early termination would not result in self-dealing under IRC §4941. Indeed, the IRS noted that the private foundation might receive more under the early termination than if the CRUT ran its full term, because of the release of the grantors' power to change and add remaindermen.

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