THE CATHOLIC FOUNDATION

Volcanoes and CRTs: From Powerful Production to a Fulfilling Extinction

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Volcanoes are one of the most breathtaking natural wonders on Earth. Amazing lava displays and dramatic volcanic landscapes provide a fascinating subject for scientists and unique destinations for travelers. Although volcanoes have become synonymous with force and power, that is only one phase of their exceptional "life cycle."

A volcano is "born" when the earth's tectonic plates shift to create an opening where magma flows through. Further movement of the plates lets more magma escape, and over time the build-up of crust creates the familiar structure we associate with volcanoes. During a volcano's active eruption phase the volcano continues to discharge lava and may erupt violently, spewing out molten rock and gas. After eruption, the volcano may fall dormant, releasing only small emissions. Eventually, the volcano may totally lose its magma source and become extinct. At extinction, the massive power of the volcano is spent, but the volcano's legacy of exceptionally rich soil remains to nourish flora and fauna for many centuries into the future.

While a charitable remainder trust (CRT) does not have the spectacular appeal of a volcano, it nonetheless shares other unique similarities. It is a powerful giving device that may be created when a charitably minded individual shifts assets around, freeing up funds for a significant charitable contribution. During its life, a CRT produces a regular income flow to the donor or other named beneficiaries. At the end of its life, the trust produces a meaningful charitable gift—a legacy that can nourish the charity for many years into the future.

Formation: Creating and Funding a CRT

Mt. Kilauea is the world's most active volcano.[1] As Hawaii's youngest volcano, Kilauea is in an "effusive" state, meaning it is covered by "young" lava deposits from the past 2,500 years. Lava continues to flow freely from the summit and rift zone vents (openings in the earth's surface that emit magma or gasses).[2] Although forming a charitable remainder trust is certainly not as remarkable as these dramatic lava flows, distributions from the trust can provide striking benefits to trust beneficiaries and exceptional funds to charity when the trust ends.

A charitable remainder trust (CRT) is an irrevocable trust that provides annual distributions to a non-charitable beneficiary for a specified period. The non-charitable beneficiary can be the donor or one or more individuals designated by the donor, and the payouts can last for a period of years (up to 20), for life, or for joint lives. At the conclusion of the payout period, the trust remainder interest is distributed to a qualified charity. As such, each donor's unique planning needs and proclivities influence the terms of the trust.

MEASURING TERMS FOR CHARITABLE TRUSTS:

One Life: The trust makes payments for the lifespan of one person.

Joint Lives: The trust makes payments for the lifespan of two or more people.

Term of Years: The trust makes payments for a specified time period not to exceed 20 years.

Life Plus Term: The trust makes payments for the lifespan of one or more people, and then makes payments to another set of people for a term of years not to exceed 20.

A CRT is a split-interest gift—a gift of a remainder interest to charity with a retained income interest (for the amounts the trust pays to the income beneficiary). To qualify as a split-interest trust (which generates an income tax deduction for the donor), a CRT must meet the criteria described under Section 664(d) of the Internal Revenue Code.[3] The transfer of the charitable interest qualifies for a charitable gift tax deduction in an amount equal to the present value of the remainder interest in the year the trust is created.[4]

Types of Charitable Remainder Trusts: CRATs and CRUTs

There are two types of charitable remainder trusts—the charitable remainder annuity trust (CRAT) and the charitable remainder unitrust (CRUT).[5] They both meet the definition of a CRT (namely, a split-interest gift), but the main difference lies in how the annual distribution amount is determined. A CRAT pays out a set amount (a fixed percentage of the initial value of the trust assets) while a CRUT pays out a specified percentage of the trust assets as revalued each year.[6]

> **IRS Language Guidance**
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> In 2003, the IRS issued model CRAT forms with preapproved trust language to conform to statutory and regulatory changes. This language can be found in Rev. Procs. 2003-53 through 2003-60, released in IRB 2003-31.

Funding the Trust

Since the trust is required to make distributions at least annually, an illiquid asset that does not generate income may not be a good CRAT funding choice (unless sufficient cash is also part of the gift).[7] It is also important to note that additional contributions to the CRAT are not allowed after the initial contribution.[8]

> **Planning Note:**
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> The requirement that the annuity amount be paid at least once a year includes the year the trust is created. This is a very important point to keep in mind when advising clients.

While a CRAT usually requires a certain amount of liquidity in its trust assets, a CRUT has much more flexibility. The CRUT comes in four varieties:

- a straight or fixed-percentage unitrust
- a net-income (without make-up) unitrust
- a net-income with make-up unitrust (NIMCRUT)
- a "flip" unitrust

These variations may permit flexibility in the annuity payout and are discussed in the next section.

Capital Gains Tax

The CRT assumes the donor's adjusted cost basis for any asset contributed to the trust and also takes the donor's holding period for the asset into account. A donor could transfer a highly appreciated asset into the trust free of capital gains tax. Since the trust is tax exempt (unless it has any unrelated business taxable income under IRC §512), the trust can sell the property and realize the gain without being subject to capital gains tax.[9]

Income Beneficiaries

Both the CRAT and the CRUT require that the trust makes distributions to the named income beneficiaries.[10] The IRC also requires that at least one of the income beneficiaries must be a person other than a charity (referred to as an organization listed in IRC §170(c)). The named individual must be alive and ascertainable at the time the trust is created, unless the trust term is for a period of years.[11]

Ring of Fire: Variations of the Same

Circling the edges of the Pacific Ocean, the 25,000-mile "Ring of Fire" is a combination of active volcanoes, deep ocean trenches, mountain trenches and "hydrothermal vents."[12] According to the National Geographic Society, the Ring of Fire is home to 90% of all earthquakes and 75% of all volcanoes and covers a wide variety of climates and terrain—Japan (Mt. Fuji), the United States (Mt. Mauna Loa in Hawaii and Mt. Saint Helens in Washington), New Zealand, South America, and even Antarctica.[13] Despite distinct differences, the underlying seismic activity ties the entire ring together geologically.

This is also true of the different types of charitable reminder unitrusts (the NICRUT, the NIMCRUT and the Flip CRUT)—though each has distinct characteristics that make it a useful tool for charitable donors, they are tied together through the underlying CRUT concept, wherein an income beneficiary receives income for a specified time and the charity then receives the remainder. While we've discussed the straight, fixed-percentage form of a CRUT, let's briefly review each of the variations.

Net Income CRUT (NICRUT)

Annually, a NICRUT pays out the lesser of:

- a fixed percentage of the trust assets for that year, or
- the net income earned by the trust for the year.[14]

This allows the trustee to make a distribution from the trust, but does not require the trustee to liquidate any of the trust corpus to make the distribution.

Net Income with Make-Up CRUT (NIMCRUT)

A NIMCRUT has a similar income limitation, but it also has a "make-up" provision that allows the trustee to make up any deficiency in the trust distributions in subsequent years.[15] If a trust does not have the income to make a distribution payment as required by the trust agreement, but in a following year the trust has sufficient income and more, the trustee may distribute additional amounts to make up for amounts that should have been distributed in a prior year.

NICRUTs and NIMCRUTs may be useful tools for donors with significant income who hold a valuable, illiquid asset that produces little income. A direct sale of the asset would cause the donor to pay capital gains taxes. However, if the donor contributes the property to a NICRUT or NIMCRUT, the unitrust could sell the property without paying capital gains taxes. The trustee could hold the asset until it could be sold on favorable terms, without worrying about being forced into an ill-timed sale just to pay the fixed-percentage unitrust amount.

"Flip" CRUT

The "flip" CRUT begins as a NICRUT or NIMCRUT, paying out the lesser of the fixed percentage or the income earned by the trust. Typically, the trust will hold an asset that does not produce income, so there is no need for the trust to make any payments. Upon the occurrence of a "triggering event," however, the trust "flips" to a straight, fixed-percentage CRUT for the remainder of its existence.[16]

The change from the NIMCRUT or NICRUT to the fixed percentage CRUT is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person.[17] This triggering event could be a retirement, marriage, divorce, birth or death. One exception to the general rule that the triggering event must be outside the control of the donor, trustee, or any other person is the sale of "unmarketable securities" in the trust (such as real estate or restricted stock), which is listed as a permissible triggering event. The trustee then invests the proceeds from the sale into income-producing assets that allow the trust to make the regular annuity payout.

The regulations also require that the flip occurs at the beginning of the taxable year that immediately follows the taxable year during which the triggering event/date occurs.[18] After the flip, any make-up provision may no longer be used.[19]

The NICRUT, NIMCRUT and "flip" CRUT are all good tools to consider if the donor has an asset that is not producing income but will eventually do so. One further consideration: using a CRUT with an income limitation would protect the trust corpus from invasion, which may result in a larger remainder distribution to the charity upon the termination of the trust.

Using the Past to Understand the Future: A CRUT Case

In 79 A.D., Mt. Vesuvius erupted, abruptly burying the city of Pompeii in a thick layer of volcanic ash. Modern anthropologists and scientists are able to study a "well-preserved snapshot of life in a Roman city,"[20] as well as the volcano's impact on nearby civilization—research that may help us handle future eruptions. In similar fashion, financial professionals may clarify future choices by researching well-preserved statutes, regulations and guidance. When those are not sufficiently clear, case law may provide interpretation. Sometimes, the court itself must look back to a statute's history to understand the present case.

In the 2015 case of Estate of Arthur E. Schaefer, Deceased, Kathleen J. Wells, Executor, v. Commissioner of Internal Revenue, the U.S. Tax Court addressed the issue of valuing the charitable remainder interest in a NIMCRUT. The Court looked at the language of IRC §664(e) and specifically considered whether the regulations expressly address how to account for NIMCRUT distributions when valuing the remainder interest.[21]

Arthur Schaefer created two charitable remainder unitrusts. During life, he was the income beneficiary of both trusts. Upon his death, each of his two sons became the income beneficiary of one of the trusts. Both CRUTs included a make-up provision, making them NIMCRUTS. As such, the trust payments equaled the lesser of (1) the net trust income for the year or (2) the percentage of the net fair market value of the trust assets as stated in the trust (11% for one trust and 10% for the other).

When Arthur Schaefer died, the estate reduced the amounts reported on the estate tax return by the amounts it deemed to be charitable, but did not claim a charitable contribution deduction for any portion of the trust assets. The IRS audited the estate tax return and sent the estate a notice of deficiency for the amount of the reduction in transfers. The IRS argued that the remainder interests of the trusts did not meet the requirement that the value of the charitable remainder interest be at least 10% of the net fair market value of the property on the date of contribution, and the estate had not shown any other basis upon which the charitable remainder interests in the trusts should be discounted.[22] As a result of this failure, the estate was not allowed a charitable contribution deduction for the values in the remainder trusts.[23]

In the Tax Court, the estate argued that "in valuing the remainder interest, the distributions are calculated by using the section 7520 rate to determine the trust's expected income, so long as the section 7520 rate is above 5% of the net fair market value of the assets."[24] The IRS countered that the remainder interest is valued "using a distribution rate equal to the fixed percentage in the trust instrument." The Tax Court asked the parties to present analysis valuing the charitable remainder interest at a 5% distribution rate.[25]

However, the Tax Court found issues with each of these approaches:

- The IRS position potentially undervalues the charitable remainder interest by assuming that each distribution will be at the maximum distribution percentage, even though the trust may not distribute that amount due to a lack of trust income.
- The estate's position potentially overvalues the charitable remainder interest, since the trust may produce income that leads to distributions larger than the 5%. The Court noted that while the estate position would provide a value "closer to what the charitable beneficiary would ultimately receive," this approach had "no basis" in federal tax statutes.

At that point, the Court stated: "Nevertheless, our task is not to look to the varying results and choose the best answer. Instead, we interpret the statute to the best of our ability, looking beyond it if necessary." Looking at IRC §664(e) on the Valuation for Purposes of a Charitable Contribution, the Tax Court found the statute language ambiguous.[26] Although 664(e) applies to both CRAT and CRUT, it does not use the distribution terms applicable to the CRAT (a "sum certain") or the CRUT (a "fixed percentage").

This lack of clarity led the Court to review legislative history from both the House and the Senate, noting a clear statement of legislative intent. A Senate report on an amendment to §664(e) made clear that "where there is a net income provision, the distribution amount or rate set forth in the trust instrument is to be used for valuation purposes, even though distributions may be limited by net income."[27]

Turning to the IRS regulations and guidance, the Tax Court found that while the Treasury regulations on this issue were not completely clear, the administrative guidance was consistent with the legislative history.[28] The Court noted that both Revenue Ruling 72-395 and Revenue Procedure 2005-54 point to the fixed percentage unitrust amount as the basis for computation of the charitable deduction.[29] While noting that it was not bound by these revenue rulings or procedures, the Tax Court found the prior guidance provided by the IRS to be persuasive:[30]

Particularly in the light of the legislative history previously discussed, we find the Commissioner's guidance to be persuasive. Both pieces of guidance are thoroughly reasoned, providing examples and explanations based on the applicable provisions. Additionally, the guidance has withstood the test of time. Rev. Rul. 72-395, supra, has been in effect for over four decades without any change to the provision before us. Further, Rev. Proc. 2005-54, supra, reaffirmed that reasoning when it was published some 30 years later. The Commissioner's position also has remained consistent and has been the subject of little litigation.[31]

As a result, the Tax Court found that "the value of the remainder interest of a NIMCRUT must be calculated using the greater of 5% or the fixed percentage stated in the trust instrument."[32] The Schaefer estate was directed to use the annual distribution amount of 11% and 10% (as stated in the trust instrument for each respective trust) when valuing the remainder interests.

While creativity can be rewarding and may present bold new opportunities, for charitable deduction valuation issues with the NIMCRUT, looking back to this "historical" IRS guidance is good practice, and may lead to more successful NIMCRUT planning in the future.

Activity and Eruptions: Trust Distributions and the Activities of the CRT

Rising above the city of Catania in Sicily, Mt. Etna is one the most active volcanoes in Europe, with consistent eruptions since 2001. Although Mt. Etna's continuing lava flow provides a challenge to residents who live on or near the mountain, the volcano also brings income to residents, since Mt. Etna is a tourist destination and the rich volcanic soil is excellent for farming.[33]

CRTs also provide income through a stream of distributions that consistently flow from the trust to the named income beneficiary. But while lava is nearly impossible to control, the donor has significant control of the manner in which trust income is distributed.

Trust Distributions

The donor sets the payout rate for the CRT, but must follow the requirements found in the Internal Revenue Code. The payout rate must be at least 5% (but not more than 50%) of the initial value of the assets transferred to the trust, and the calculation for the proposed CRT at the given rate must provide at least a 10% remainder to charity.[34]

CRAT Payouts

The payout of a CRAT is fixed at the time the trust is created and never varies—not even if the trust fluctuates in value.[35] The payout may be an annuity percentage or some other amount that is fixed in the trust.

Prior to August 8, 2016, for a CRAT to qualify for the applicable tax deductions, the CRAT had to pass the 5% probability test (probability-of-exhaustion test).[36] This test required that the annuity amount could not be so large that there was a greater-than-5% probability that the corpus would be exhausted before the (last) noncharitable beneficiary dies, the trust terminates, and the charity receives its remainder. With the low interest rates over the last several years having a significant impact on the use of CRATs, the IRS issued Revenue Procedure 2016-42 (effective on August 8, 2016) with specific language that allows the CRAT to satisfy the probability-of-exhaustion test.[37]

CRUT Payouts

The payout rate of a CRUT typically varies from year to year, since it is a percentage of the trust assets as revalued every year.[38] Also, a net-income CRUT payout may vary depending on the income the trust has earned, with the payout being the lesser of the net income earned or a percentage of the trust assets.[39] In the case of a net-income CRUT with a make-up provision, the trustee can pay a percentage of the trust assets as valued for the year, plus any amount of trust income in excess of the percentage to the extent that the trust experienced income deficits in prior years.[40]

Income Taxation

A CRT payout is taxed as income according to a four-tier system that accounts for the nature of the income itself:

1. Ordinary income
2. Capital gain income[41]
3. Other income (i.e., tax-exempt interest)
4. Tax-free return of trust principal[42]

Distributions are made according to a "worst-in, first-out" system for each respective tier. The highest-taxed income in the top tier—ordinary income—is distributed first. If there is both ordinary interest income and qualified dividend income, the ordinary interest income is distributed first. After all ordinary income has been distributed, capital gain is distributed. Within the capital gain tier, net short-term capital gain is distributed before net long-term capital gain.

Ongoing Administration

A CRT has ongoing administrative issues that the trustee must oversee:[43]

- Providing regular investment management of the trust assets
- Filing the trust's tax returns and making an accounting of trust income
- Tracking the make-up amount (in the case of net income make-up unitrusts) when the trust income is less than the payout rate
- Reporting and distributing income—perhaps the most important duty, especially to the beneficiaries

Dormancy and Extinction: The End of the CRT and the Fulfillment of the Charitable Purpose

When a volcanic eruption empties the magma chamber and surface rocks collapse into the empty chamber, the result is a crater—or caldera—where the top of the volcano used to be.[44] When the caldera fills with water, the result is a beautiful lake like Crater Lake in Oregon, which the National Park Service says may be the most pristine lake on Earth.[45] The volcano's explosive power is, in the end, replaced by quiet magnificence.

When the CRT terminates, it must distribute the property remaining in the trust to the charitable remaindermen.[46] At the formation of the trust, the donor can name any number of qualified charities as remaindermen, and may also retain the power to change the charitable remaindermen without compromising the tax-exempt nature of the CRT.

The final distribution from the CRT to the charitable remaindermen marks the end of the charitable remainder trust, and with its extinction, the fulfillment of its ultimate charitable purpose. Powerful and inspiring in its own unique way, a CRT that has finished serving the income needs of the donor can, with its final distribution, provide fertile ground for a charity's important work years into the future.

Endnotes

1 "Kilauea," Volcano Hazards Program, United States Geological Survey. https://volcanoes.usgs.gov/volcanoes/kilauea/

2 "Kilauea," Volcano Hazards Program, Geology & History, United States Geological Survey. https://volcanoes.usgs.gov/volcanoes/kilauea/geo_hist_summary.html

3 26 U.S.C. 664(d).

4 26 U.S.C. 2522(c)(2).

5 Treas. Reg. Sec. 1.664-1(a)(2).

6 Treas. Reg. Sec. 1.664-3.

7 26 U.S.C. 664(d).

8 Treas. Reg. Sec. 1.664-2(b).

9 26 U.S.C. 1015 and 26 U.S.C. 664.

10 Treas. Regs. Sec. 1.664-2(a)(1) and Sec. 1.664-3(a)(1).

11 Treas. Reg. Sec. 1.664-2(a)(3)(i).

12 "Ring of Fire," National Geographic Society. https://www.nationalgeographic.org/encyclopedia/ring-fire/

13 Ibid.

14 26 U.S.C. 664(3)(A).

15 26 U.S.C. 664(3)(B).

16 Treas. Reg. §1.664-3(a)(l)(i)(c).

17 Id.

18 Treas. Reg. 1.664-3(a)(l)(i)(d).

19 Treas. Reg. 1.664-3(a)(l)(i)(c)(3).

20 Mary Bagley, "Mount Vesuvius and Pompeii: Facts and History," LiveScience website, June 29, 2016. https://www.livescience.com/27871-mount-vesuvius-pompeii.html

21 145 T.C. No. 4.

22 Id. at 6.

23 Id.

24 Id. at 11.

25 Id.

26 Id. at 13.

27 Id. at 15.

28 Id.

29 Id. at 16.

30 Id. at 17.

31 Id.

32 Id.

33 Jessica Ball, "Mount Etna – Italy," Geology.com.

34 26 U.S.C. 664(d).

35 Treas. Reg. Sec. 1.664-2.

36 Treas. Reg. Sec. 1.170A–1(e); Rev. Rul. 77-374, 1977-2 C.B. 329; see also Ltr. Rul. 8152019.

37 Rev. Proc. 2016-42.

38 Treas. Reg. Sec. 1.664-3.

39 26 U.S.C.664(d)(3)(A).

40 26 U.S.C.664(d)(3)(B).

41 The differing treatment of different types of capital gain adds another layer of complexity to the four-tiered tax structure.

42 26 U.S.C. 664(b); Treas. Reg. Sec. 1.664-1(d)(1).

43 The donor names the trustee, which can be the donor, the charitable remainderman, a third party (e.g., attorney, accountant, relative, etc.), or a financial institution with trust powers. The donor may retain the right to change the trustee.

44 "What Is a Caldera?" Geology.com.

45 "Crater Lake: Deep Water in a Sleeping Volcano," National Park Service. https://www.nps.gov/crla/index.htm

46 26 U.S.C. 664(d)(1)(C) and 26 U.S.C. 664(d)(2)(C).

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