

# exempts

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# COOKIE JARS AND CHARITABLE REMAINDER

The early termination of a charitable remainder trust is becoming ever more common.

## TRUSTS—BUILT TO BE BROKEN INTO?

ROBERT T. NAPIER and RITA E. LUCE

**P**icture the smiling face of a child staring at a cookie jar. What joy to see the cookies loaded in, knowing that, in time, the occasional cookie will be dispensed. Now imagine the joy on that same child's face when he or she raids the cookie jar, cradling as many cookies as a child can hold.

Fast forward a few decades. The child has grown and is no longer focusing on cookie jars, but on the charitable remainder trust (CRT) sitting on his or her office shelf. Like the cookie jar, it was great fun to load the trust with assets, and the occasional payout certainly is appreciated. But how wonderful it would be to get inside the CRT and again hold the assets inside.

The exempt organization (EO) named as the remainder beneficiary also is watching the CRT, as it is watching the donor who created the trust. The EO is entitled to whatever CRT assets the donor does not take, but knows there may be only crumbs left in the CRT at the end of the trust's term. Of course, the EO is hungry for funds now. Furthermore, the EO knows that most CRTs contain provisions allowing for the removal and replacement of the EO with other charities. At the end of the trust term, the EO might not get any cookies at all.

What if the cookie jar was emptied and the contents distributed right now? Both the EO and the donor would receive their respective shares immediately. Fortunately for the donor and EO, there is a way to break into this cookie jar.

This raiding of the CRT cookie jar, more professionally known as the early termination of a charitable remainder trust, is becoming ever more common. With early termination of a CRT, the grantor takes back a large share of the trust assets, and the EO remainder beneficiary takes its share at the same time. EOs that understand the early termination procedure can help themselves to some cookies by helping their CRT donors gain access to the cookie jar.

### Early termination of charitable remainder trusts

It may seem counterintuitive that a CRT—necessarily an irrevocable trust—can be terminated prior to the date stated in the irrevocable trust agreement. Nevertheless, it can be done if certain procedures are followed. In some states,

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such as Illinois, it is possible to do so without obtaining an IRS private letter ruling or a court ruling approving the early termination.<sup>1</sup>

The CRT early termination procedure results in the donor immediately reacquiring CRT assets equal to the present value of the term interest in the CRT, and the designated charity immediately receiving assets equal to the present value of its remainder interest. When warranted by the donor's circumstances, early termination of a CRT is advantageous both to the grantor of the CRT and to the EOs named as remainder beneficiaries. EOs familiar with the requirements for early termination of CRTs may be able to benefit both themselves and their donors by advising their donors about the early termination procedure.

In its simplest iteration, a charitable remainder trust is established when a donor creates an irrevocable trust (the CRT), transfers assets to the CRT, retains certain rights to income and principal payments from the CRT for a period of time (the "term interest period"), provides that at the end of the term interest period the assets remaining in the CRT pass to the donor's designated EO (the "remainder beneficiary"), and receives a current charitable deduction based on the value of the CRT assets that eventually will pass to the remainder beneficiary.<sup>2</sup> During the term interest period, the donor can receive from the CRT only those payments permitted by the CRT agreement.<sup>3</sup> The designated charity typically receives nothing from the CRT until the expiration of the term interest period.<sup>4</sup>

### Why terminate early?

There are many reasons a donor may want to explore early termination of a CRT. The CRT may not be producing the income necessary to make the payments owed to the donor (or to whomever the donor designated in the CRT agreement) during the term interest period. This can occur if the CRT was created when investment returns were higher than they are currently. Accordingly, the donor may be interested in reacquiring the CRT assets in order to be free of the under-performing investment arrangement.

Other possibilities are that the donor who created the CRT may be experiencing financial difficulties, may have an investment opportunity or other immediate need for access to principal, or may want to ensure that the CRT assets pass to the charity or charities of his or her choice.<sup>5</sup> The donor may simply wish to be relieved from the investment restrictions surrounding CRTs.<sup>6</sup> Some donors who have created CRTs recognize that the current capital gains tax rates are lower than they were when the CRTs were created. A few fortunate others now find themselves living in a state with a lower or no state income tax. Still others are delighted to see some assets from their CRT make their way to their favorite EO now, rather than later. Any one of these reasons may encourage CRT grantors to consider early termination of the CRTs they previously created. Furthermore, if the estate tax exemption materially increases, those donors who originally sought the estate tax benefits of a CRT no longer need the trust for that purpose and may choose early termination.

<sup>1</sup>The IRS has issued numerous private letter rulings evaluating and allowing early termination of CRTs. See, e.g., Ltr. Rul. 200127023, Ltr. Rul. 200208039, Ltr. Rul. 200252092, Ltr. Rul. 200314021, Ltr. Rul. 200324035, Ltr. Rul. 200403051, Ltr. Rul. 200408031. The Service's focus in the letter rulings has been on ensuring that the charitable beneficiary is treated equitably. At this time, it should be fairly well-settled that, provided the proper methodology for valuing the term and remainder interests is employed and state law does not prohibit the early termination, the IRS permits early terminations of CRTs. Illinois law does not prohibit modification or termination of irrevocable trusts, nor does it require court approval of same. Additionally, the Second Restatement of Trusts, § 335 and 336, permits the termination of an irrevocable trust if the purpose of the trust cannot be fulfilled, and § 337 and 338 permit the termination or modification of a trust if the grantor and all the trust beneficiaries agree (without regard to accomplishment of the trust purpose). In this sense, the CRT trust agreement is treated like a contract between the grantor and the beneficiaries that can be modified by the consent of all parties thereto.

<sup>2</sup>Section 170(c) allows an income tax charitable deduction for assets passing to CRTs. Sections 664(d)(1) and (2) define charitable remainder annuity trusts and char-

itable remainder unitrusts. Regs. 1.664-1 through 1.664-3 provide the rules governing CRTs. Reg. 1.664-4 provides the rules for valuing the CRT remainder interest.

<sup>3</sup>Regs. 1.664-3(a)(3) and (4), -2(a)(3) and (4).

<sup>4</sup>The CRT trust agreement may allow for distributions to the exempt organization during the term interest period. Regs. 1.664-3(a)(4), -2(a)(4).

<sup>5</sup>With a charitable remainder annuity trust, a fixed amount of the assets transferred to the CRT trust, based on the initial value of the assets at the time they were transferred into the CRT, must be distributed to the donor each year. If the assets inside the CRT are not appreciating or producing income at a rate greater than or equal to the amount payable to the donor, the principal of the CRT will be eroded, potentially leaving very little to pass to the designated charity. Additionally, the CRT trust agreement may grant another person the power to change the charitable remainder beneficiary after a donor's death. If the power were exercised after the donor's death, the CRT assets might not pass to the charitable organization of the donor's choice.

<sup>6</sup>For example, a CRT cannot be a shareholder in a subchapter S corporation (Rev. Rul. 92-48, 1992-1 CB 301; Rev. Rul. 92-73, 1992-2 CB 224) and a CRT will be subject to income taxes if it has unrelated business taxable income (Reg. 1.664-1(c)).

From the EO's perspective, charities realize that they may wait a long time after a CRT is created before they receive any assets from it. Absent early termination, the charity typically does not receive its remainder interest until the term interest period expires. The term interest period may not expire until a set number of years (up to 20) has passed, until the death of the donor, or until after the death of the last to die of the donor and one or more other persons named in the CRT agreement.<sup>7</sup> Early termination of the CRT, however, results in the immediate distribution of funds to the charity.

Additionally, EOs should be aware that the donor usually reserves the right in the CRT agreement to change the CRT's charitable beneficiary.<sup>8</sup> Other persons also are sometimes given the right to change the charitable remainder beneficiary. Thus, a charity's position as a remainder beneficiary of a CRT is subject to change at the whim of the donor or others. The EO named in the CRT agreement will not necessarily be the organization that receives the CRT assets at the expiration of the term interest period. If the CRT is terminated early, this uncertainty vanishes. The chosen charity is locked in as part of the early termination procedure.

Accordingly, there are factors motivating both EOs and donors of CRTs to prematurely terminate CRTs. This mutuality is important because the CRT donor and the EO will need to sign the termination agreement consenting to the early termination and its distribution terms. Before deciding to enter into such an agreement, it will be important to the EO and the CRT grantor to know how much of the CRT assets each of them will receive. There are two primary steps to answering this question.

### Determining the distribution amounts

The first step in determining the amount of CRT assets the EO will receive in an early termination

is to determine which EO will be the recipient. The CRT grantor will need to irrevocably designate at least one qualified EO as the remainder beneficiary.<sup>9</sup> The second step is to calculate the present value of the remainder beneficiary's interest.

**Irrevocably designate a charitable beneficiary.** For the first step, irrevocably designating the charitable remainder beneficiary may require the CRT grantor to execute one or more documents. If the CRT instrument allows the grantor (or another person) the right to change the named charitable remainder beneficiary, that right must be released. This is accomplished by executing and delivering a document to the CRT trustee releasing the right to change beneficiaries. If the charity currently named in the CRT instrument is still the charity the donor wants to benefit, this release may be the only document required for the first step.

If, however, the grantor wants to change the named charitable remainder beneficiary, a document designating the new charitable beneficiary will be required. The change of beneficiary document, if any, should be executed prior to the release document.

If the donor wants to name an as yet unestablished family foundation or supporting organization as the charitable remainder beneficiary, additional measures will be necessary to ensure that the designated entity is a qualified EO on the early termination date. The ability to name a supporting organization as the charitable remainder beneficiary may be additional incentive for early termination of a CRT.

Neither the designation nor the release documents are complicated instruments. The point is that, in order for the early termination to work, an existing charity must be irrevocably named as the remainder beneficiary. Additionally, if an EO will be expending time and resources reviewing termination documents, it should have the assurance of knowing that it actually will be receiving CRT assets.

**Calculating the value of the remainder interest.** The second step for determining the amount the CRT donor and designated charity will receive may be the most important and technically complicated aspect of the early termination procedure. The main component of this step involves determining the present value of the remainder interest passing to the



**EOS FAMILIAR WITH THE REQUIREMENTS FOR EARLY TERMINATION OF CRTS MAY BE ABLE TO BENEFIT BOTH THEMSELVES AND THEIR DONORS BY ADVISING THEIR DONORS ABOUT THE CRT EARLY TERMINATION PROCEDURE.**

<sup>7</sup> Regs. 1.664-1, -2(a)(5), -3(a)(5).

<sup>8</sup> A trust will be treated as a CRT as long as it qualifies as either a charitable remainder unitrust or annuity trust under the rules of Regs. 1.664-2 and -3 (Reg. 1.664-1(a)(2)). Regs. 1.664-2 and -3 do not prohibit the CRT grantor from changing the charitable remainder beneficiary; they require only that the remainder interest be irrevocably payable to an organization described in Section 170(c).

<sup>9</sup> The charitable beneficiary of a CRT must be an organization described in Section 170(c). All references in this article to a charitable recipient of a CRT refer to an organization described in Section 170(c).

charity. This is calculated by using the methodology of Reg. 1.664-4 and the actuarial tables and discount rates of Section 7520 in effect for the month in which the termination occurs. Once the portion passing to the charity is determined, the balance is what passes to the donor.

**Example.** In October 2000, a donor created a CRT for a 20-year term and retained an annual payout from the CRT of 11.7%. The donor decided to terminate the CRT in April 2005. The Section 7520 rate published by the Treasury Department for April 2005 was 5.00%. In April 2005, four and one-half years of the 20-year term interest had expired and 15.5 years of the term interest remained.

Using commercial software designed to calculate the value of a CRT remainder interest, inputting the above data produces a "factor." That factor, expressed as a percentage, is the portion of the CRT that will pass to the charitable remainder beneficiary. Because the CRT is terminating mid-year, rather than on its anniversary date, an additional step is necessary. The factors for a 15-year term interest and a 16-year term interest are obtained. The difference between the 15- and 16-year factors is determined by subtracting the 16-year factor from the 15-year factor. That difference is multiplied by 0.5 (for the one-half of the year in the 15.5-year term remaining). The resulting product is subtracted from the 15-year factor to arrive at the factor for 15.5 years. That factor represents the percentage of the CRT assets that pass to the designated charity on the termination of the CRT in April 2005.

Using actual numbers, the 15-year factor (produced by the software) is 0.154771. The 16-year factor is 0.136670. The difference between the two years is 0.018101. The difference multiplied by 0.5 for the half year adjustment is 0.009050. The 15-year factor minus the half year adjusted factor is 0.145721, which is the factor for the 15.5 years. If the CRT had terminated on its anniversary date, only the full year factor would be required.

The factor for 15.5 years multiplied by the total value of the CRT assets on the early termination date is the amount that passes to the designated charity on the termination of the CRT. The total value of the assets of the CRT, less the amount passing to charity, is the amount that will pass back to the donor of the CRT. Thus, if the value of the CRT assets in this

example on the April 2005 termination date was \$5 million, the charity would immediately receive \$728,605 ( $0.145721 \times \$5,000,000$ ) and the donor would immediately receive \$4,271,395 ( $\$5,000,000 - \$728,605$ ).

It has been suggested that the interpolated calculation used above is unnecessary and that the charity's remainder interest can be calculated as of the last annual anniversary of the trust; October 2004 in the example. That view has the effect of ignoring the charity's partial year interest in the CRT and increasing the amount distributable to the term interest holder. The authors do not find support for that result in the Code or regulations. Moreover, given that a ready method exists for calculating the factor for a partial year, the emphasis in the private letter rulings on protecting the charity's interest in early terminations, and the general obligations of a state attorney general's office to protect charities' interests, practicality dictates using a conservative method in calculating the charity's remainder interest.

If the CRT term interest is based on the life expectancy of one or more persons, the calculation is slightly different. Again, an example will best illustrate the calculation.

**Example.** In October 2000, a donor created a CRT and retained a life estate with an annual payout from the CRT of 11.7%. The donor decided to terminate the CRT in April 2005. The donor was 65 years old at that time. The Section 7520 rate published by the Treasury Department for April 2005 was 5.00%. Using those facts, the factor for the remainder interest in the CRT at the time of termination is 0.20505. If the value of the CRT assets is \$5 million at termination, the EO beneficiary will receive \$1,025,250 ( $0.20505 \times \$5,000,000$ ).

When life estates, rather than a set number of years, determine the term interest period, the CRT early termination procedure also requires affidavits from each life estate holder and his or her physician. These must state that the life estate holder does not have a known condition that is expected to shorten his or her life expectancy. Actuarial tables and the standard annuity factor derived from Section 7520 are valid for measuring the life estate of only those persons not known to have a life expectancy shorter than that indicated



**A CHARITY'S POSITION AS A REMAINDER BENEFICIARY OF A CRT IS SUBJECT TO CHANGE AT THE WHIM OF THE DONOR OR OTHERS.**

by the tables.<sup>10</sup> A health condition that shortens the term interest period has the effect of increasing the value of the charitable remainder interest and the corresponding effect of decreasing the donor's retained interest. Accordingly, a physician's affidavit for each life estate interest holder, and affidavits from the life estate holders, are necessary to determine if the actuarial tables can be used to calculate the value of the term and remainder interests in the CRT early termination procedure.

### Valuing the CRT assets

To avoid the expense of obtaining a qualified appraisal and other problems related to "in kind" distributions, the CRT may want to convert its assets to cash prior to the early termination. If not all of the CRT assets will be converted to cash, the assets will have to be valued. For publicly traded securities, market values can be used. For unmarketable assets, a qualified appraisal by a professional appraiser should be obtained.<sup>11</sup> A schedule listing the in-kind assets, their values, and their distribution should be made part of the early termination agreement as documentation that assets were valued and distributed properly.

If the asset values are susceptible to manipulation by the CRT grantor, trustee, or others, or if there is an inequality in the distribution, the early termination may be disallowed, set aside, or otherwise contested. Converting the CRT assets to cash avoids these issues, as well as the expense of an appraisal, the extra steps of equalizing in-kind distributions, and the administrative procedures of re-titling assets.

Therefore, absent an important reason to retain in-kind assets, CRT assets should be converted to cash prior to executing the early termination agreement.

### Drafting the early termination agreement

After determining how much the CRT donor and charitable beneficiary will receive, the next step is to draft the early termination agreement. The termination agreement should recite the relevant parties (the CRT donor, trustee, term interest holders, and designated charitable remainder beneficiaries), the relevant original term interest provisions of the CRT (a life estate or dates for term of years), and the intended early termination date. The agreement should state that the determination of the distribution amounts will be calculated for the early termination date based on the Section 7520 discount rate then in effect and the Reg. 1.664-4 valuation procedure. The CRT donor and other parties should, of course, be represented by separate counsel.

To make the transaction completely transparent, a schedule showing the calculations and proposed distributions should be made part of the early termination agreement. The agreement should include a provision stating that all parties agree that no fees, costs, or expenses related to the CRT early termination were paid from the CRT.<sup>12</sup> If affidavits from a physician and life estate holder are required, those should be attached to the early termination agreement. The designation of new charitable beneficiaries and the release of rights to change charitable beneficiaries can be attached as exhibits to the early termination agreement. The approval of the state attorney general (discussed below), if obtained, also can be attached to the agreement. The CRT grantor, all term interest holders, the CRT trustee, and each designated charitable remainder beneficiary should sign the early termination agreement.

### Attorney general approval

Some commentators have suggested that the approval of the state attorney general's office is not required for the termination agreement. Regardless of whether the attorney general's approval is legally required, because neither IRS nor court approval of the early termination is being sought and because public charities



**ABSENT AN IMPORTANT REASON TO RETAIN IN-KIND ASSETS, CRT ASSETS SHOULD BE CONVERTED TO CASH PRIOR TO EXECUTING THE EARLY TERMINATION AGREEMENT.**

<sup>10</sup> Reg. 20.7520-3(b)(3). It is interesting to note that the letter rulings express a more stringent mortality evaluation than that of the regulation. Reg. 20.7520-3(b)(3) states that the Section 7520 rates tables cannot be used if a person has a terminal illness resulting in a 50% or greater chance of death within one year. However, the letter rulings reference physicians' affidavits stating lack of a medical condition expected to result in a shorter longevity than that set forth in the actuarial tables under Section 7520. The difference may be explained by the principal that the early termination must be fair to the charitable beneficiary and should not result in the income beneficiary receiving a greater share of the CRT assets than the income beneficiary would receive if early termination were not allowed.

<sup>11</sup> Reg. 1.664-1(a)(7) allows for valuation by an independent trustee or a "qualified" appraiser, as defined in Reg. 1.170A-13(c)(5). Using a qualified appraiser avoids questions regarding the trustee's capabilities as an appraiser.

<sup>12</sup> During the term of the CRT, no payments may be made to anyone except the term interest holder(s) and the charitable organization(s). Regs. 1.664-2(a)(4), -3(a)(4).

(the CRT itself and the remainder charity) are involved, it may be beneficial for the grantor to obtain the attorney general's approval of the termination agreement. Additionally, some private letter rulings have noted with favor the fact that the state attorney general consented to the proposed termination agreement or was made a party to the proceedings.<sup>13</sup>

In some states, including Illinois, if the parties desire the approval of the attorney general, a copy of the early termination agreement and all relevant supporting material should be sent to the attorney general's office. The consent of the attorney general can be incorporated into the early termination agreement or prepared as a separate document and attached to the agreement. In most, if not all, states where court approval of the termination agreement is required, the attorney general will be a necessary party to the court proceeding.

### **Distribution and post-termination**

After all parties have signed the CRT early termination agreement, the assets should be distributed to the beneficiaries. The CRT should file its final state and federal income tax forms and mark them as "final." For income tax purposes, the CRT donor will treat all assets received from the CRT as a result of the early termination as capital gain from a zero basis asset.<sup>14</sup> The capital gain will be short or long term depending on how long the property was held in the CRT. The capital gain tax on the assets passing back to the donor and the expenses of implementing the early termination procedure are the donor's costs for early termination of the CRT. As discussed above, the CRT itself cannot bear any of the expenses, costs, or fees for early termination. The IRS,

state attorney general, and EO are typically, and understandably, sensitive to this issue.

If the donor is interested in offsetting the capital gain tax, the donor can obtain a charitable deduction by giving part or all of the distribution to a new CRT with current market rates. Alternatively, the donor could give the distribution to the charitable remainder beneficiary of the original CRT in exchange for an annuity directly from the charitable organization.<sup>15</sup> In either case, the donor's charitable deduction will be based on the value of the remainder interest passing to the charity. In both cases, the donor is again benefiting a charity while benefiting the donor.

### **Conclusion**

It is no secret that EOs require adequate cash flow. This need is exacerbated by a poorly performing or sluggish economy. The recent years of low interest rates and yields coupled with heightened IRS scrutiny of charitable organizations have increased the funding difficulties of EOs. Paradoxically, these same factors contribute to creating an ideal environment for implementing the CRT early termination procedure, a procedure that benefits both donors and EOs at minimal risk and expense.

So break into the cookie jar in the right situations. The inner child of the donor can be satisfied, and just imagine the great big smile on the face of the EO when it receives its interest early. ■

<sup>13</sup> See, e.g., Ltr. Rul. 200127023, Ltr. Rul. 200208039.

<sup>14</sup> The distribution to the donor is governed by Sections 1001 and 1015, which operate to treat the distribution as the sale of a term interest by the donor in which the donor's basis is disregarded.

<sup>15</sup> Ltr. Rul. 200152018.