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Memorandum

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subject: Abusive charitable remainder annuity trust structure

This advice may not be used or cited as precedent.

SUMMARY: You have requested assistance from the national office concerning a marketed structure which purports to use a § 664 charitable remainder annuity trust (CRAT) to permanently eliminate capital gain on the sale of highly-appreciated property. CC:PSI, CC:EEE, CC:FIP, and CC:ITA initially discussed the provided promotional materials and sample trust and its tax return with you on 7/18/18. You subsequently provided additional materials and there have been several supplemental discussions between technical and operating Division Counsel about this structure. This memorandum describes the structure and sets forth the reasons why it does not produce the claimed tax results. Although we reviewed specific taxpayers' documents and reference the terms of one trust and marketing materials in this memorandum, we understand this same structure has been replicated numerous times. Therefore, this is a general discussion which does not rely on any facts unique to those specific taxpayers

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and we do not include any taxpayer identifying information. Our legal conclusions are based on the summarized materials, and may change if a particular case offers different facts.

This memorandum is limited to the income tax (and ancillary gift tax) aspects of the structure. We do not discuss any of the following:

1. Whether in any particular case the existence of the trust might be challenged as a threshold matter under “sham trust” principles. We assume, solely for the sake of this memorandum, that the taxpayers are observing the formalities of their trust instruments and other relevant documents and contracts. To the extent that they are not, such that their control over the property transferred to the trust does not really change, the trusts might be disregarded, with all claimed tax benefits dependent on the trust’s validity being vitiated. See Zmuda v. Commissioner, 731 F.2d 1417 (1984), and Markosian v. Commissioner, 73 T.C. 1235 (1980), for the factors used to determine that a trust arrangement is a sham.

2. Whether the transaction in general or any particular instance of it might fall into any of the categories of “reportable transactions” provided in §1.6011-4, such as a “confidential transaction” or “transaction with contractual protection.”

3. The possible application of the termination tax under § 507 or of any excise tax provision applicable to organizations described in §4947.

DESCRIPTION OF STRUCTURE: Taxpayer creates and funds a trust which is purported to qualify as a CRAT. The trust is funded with interests in a closely-held business, with farmland, and/or with the crops produced by farmland. The trust resembles the model CRAT described in the appropriate revenue procedure (for an inter vivos CRAT for one measuring life, this would be Rev. Proc. 2003-53, 2003-2 C.B. 230, which is cited in the promotional materials), with the following significant modifications:

Article 5B provides that the trustee may provide for the annuity amount by purchasing one or more annuities (including without limitation one or more single premium immediate annuities (SPIAs)), with the total cost of such annuity or annuities to be less than 90% of the initial fair market value (FMV) of the trust property, which will guarantee to pay to the beneficiaries or beneficiaries’ children as applicable, the annual annuity amount during the five year annuity period.

Article 5F provides that in each taxable year of the trust, the trustee shall pay “to the beneficiary for during the [annuity period], during their lifetime for a period of five years,”[1] an annuity amount equal to the greater of (1) 10% of the initial FMV of all

[1] The quoted language is confusing. As the promotional materials cite Rev. Proc. 2003-53, the promoters apparently view it as creating a CRAT for one measuring life, but it more closely resembles a CRAT for a term of years described in Rev. Proc. 2003-54, 2003-2 C.B. 236.

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property transferred to the trust; or (2) the payments received by the trustee from one or more SPIAs purchased by the trustee as provided in Article 5B, provided however, that such annuity payments cannot exceed 49% of the initial FMV of the trust property valued as described above. Upon the death of the last surviving initial beneficiary prior to the end of the annuity period, the annuity amount shall be paid in equal shares, per stirpes and not per capita to the grantor's children for the remainder of the annuity period.

Article 5L provides that in lieu of the remainder distribution to the charitable organization, the trustee, upon the availability of adequate funding in cash, may pay to the charitable organization a cash sum equal to 10% of the initial FMV of the trust property plus $100. The trustee shall not make a distribution in kind to satisfy this cash distribution.

The promotional materials are in the form of a series of memoranda from the taxpayer's tax and financial advisors. We include excerpts of the memoranda in apparent chronological order to show what the advisors claimed were the benefits of the CRAT funded with a SPIA. We have standardized use of acronyms and symbols, compressed short paragraphs, omitted repetitions, and corrected typographical errors. All emphases are in the original.

> "SPIA -- A SPIA is a contract between you and an insurance company. By paying a lump sum of money you are guaranteed to receive a series of payments over a period of time. The amount of the payment is determined by both the current interest rate at the time your contract is issued and by choices you make from a wide variety of payment options.
>
> If non-qualified funds are used to purchase a SPIA, the income payments you receive are only partially taxable. The non-taxable portion of each payment is a level percentage that represents the return of principal over the life of the contract. Depending on your age and the payment option you chose, this percentage will vary. [Cite to website.]
>
> The tax-free return of principal is determined by a formula using the IRS life expectancy table. It is just a matter of crunching the numbers. For older taxpayers, 70%-80% of the annual payments to them are tax-free. The example I ran for a single, male taxpayer, age 72, yielded tax savings of 74.5% for the first 15 years.
>
> The stumbling block is that it seems too good to be true. The only funds that are prohibited are qualified (retirement) funds on which regular income taxes have never been paid. When used with a CRAT the SPIA becomes an alternative to Wall Street investments; and it is guaranteed. The CRAT was designed to encourage charitable giving by allowing the donor to avoid capital gains taxes. Once highly appreciated stock or farm land has been contributed to the CRAT it is no longer subject to capital

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gains taxes. The funds that are used to purchase the SPIA are considered principal, thereby allowing a partial, though significant tax deduction for the annuity payments."

…..

"Per IRS Notice 2008-99, which was issued by the IRS to make the public aware of transactions involving CRTs that had 'the potential for tax avoidance or evasion,' the basis in the trust of the new assets (the assets acquired from the funds provided by the sale of the original appreciated assets contributed to the trust) is the amount paid for those new assets, not the basis of the grantor in the appreciated assets. I quote from page 2 of IRS Notice 2008-99: 'Because a CRT generally is a tax-exempt entity under § 664, Trust's sale of appreciated assets is exempt from income tax, and Trust's basis in the new assets is the price Trust pays from those new assets.'

That is the bright line setting forth the doctrine! In addition, the IRS issued a Technical Advice Memorandum (TAM 9825001) in which it approved an arrangement whereby the trust of a CRUT invested trust assets in two tax deferred annuity contracts for the purpose of controlling the timing of the amount of trust income distributions. The IRS concluded that 'the purchase of deferred annuity policies… does not constitute an act of self-dealing under § 4941 of the Code,' and 'does not adversely affect the trust's qualification as a CRT under § 664 of the Code and the current regulations thereunder for federal income tax purposes.' Although this TAM dealt specifically with a CRUT, it would apply to a CRAT also, since they are the only two types of CRTs.

Also, in PLR 9237030, the IRS addressed the tax treatment of immediate annuities. I have highlighted a few lines for emphasis. On page 18, there are two important conclusions: (1) the guaranteed income payments 'will be treated as amounts received as an annuity,' and (2) 'the exclusion ratio for the contract will be applied … to determine the portion of the amounts received as an annuity which is excludable from gross income.' So, the normal treatment of annuity distributions was confirmed; part of it is a return of corpus and excludable from income tax.

In conclusion, it cannot be argued that the wealth preservation strategy designed by [Promoter] is legitimate [sic]. Even the IRS acknowledges that the basis in the new assets purchased from the funds derived from the sale of the contributed, appreciated assets is the price of those assets. Hence, all the funds used to purchase a SPIA are principal. Accordingly, they would follow the well-established IRS formula, based on age, for determining the allocation of the annual distributions between ordinary income and return of principal, or corpus. Every year (until the principal is

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recovered), part of the distribution to the beneficiary is a non-taxable return of corpus. This strategy is a legal way to avoid capital gains taxes on appreciated assets that Congress provided decades ago."

…..

"1. Prepayment of the charitable remainder interest – According to § 664(d)(1)(C): 'following the termination of the payments described in § 664(d)(1)(A), the <u>remainder interest</u> in the trust is to be transferred to… [the charity].' Under the [Promoter Name] CRAT Strategy, a payment to the charity of choice is often the first check written by the trust. How can this payment (early in the life of the trust) be considered the payment of a 'remainder interest?'

IRS Revenue Procedure 2003-53, § 5.02(5) issued August 4, 2003 is excerpted below:

'Early distributions to charity. The trust instrument may provide that an amount other than the annuity shall be paid (or may be paid in the discretion of the trustee) to an organization described in § 170(c). If such a distribution is made in kind, the adjusted basis of the property distributed must be fairly representative of the adjusted basis of the property available for distribution on the date of distribution. Section 1.664-2(a)(4).'

The title of this subsection reads: 'Early distributions to charity.' How much clearer can it be?

Additionally, prepayment is supported by PLR 201126007. Although PLRs are not binding as precedent, one would hope that approximately equal facts would yield the same decision. The IRS is asked to comment on the addition of a paragraph (referred to as Provision in Trust) to the Trust agreement. The key portions are recorded below:

'The Trustee shall have the discretion to provide for the annuity payment to the Trustor by allocating a portion of the trust assets to purchase an annuity contract which will guarantee to pay to the trust a sum equal to or greater than the Trustor's computed annual annuity payout for the duration of the trust.

After securing such contract, the Trustee may distribute any amount other than the amount described in § 1.664-2(a)(1) to the Charities named in Schedule B any time during the term of the trust.'

In referring to the excerpt above, the IRS said, '… we conclude that inclusion of Provision in Trust will not prevent Trust from qualifying as a CRAT under § 664(d)(1).'

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Section 1.664-2(a)(4) ends with the following sentence: '… the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon death of one or more of the recipients, to an organization described in § 170(c).' Section 1.664-3(a)(4) ends with the same sentence: [quotation omitted].

So, early distributions are not forbidden. Again regarding CRTs, PLR 200124010 contains essentially the same wording: 'a portion of the trust assets may be distributed currently…' So, hopefully you see that we have gotten over the first hurdle. The charitable remainder interest is allowed to be prepaid.

Thinking about it, this makes sense. The trustee of a split-interest trust, such as a CRAT, has the unenviable task of weighing the needs of two opposing interests: the recipient and the charity. The immediate payment of the 10% interest to the charity benefits the charity in two ways. It gets funds to the charity now, and assures that there will be funds to go to the charity.

Because the market is unpredictable and volatile, sometimes investments lose money. If current or accumulated earnings are not enough to pay the required annual payment, then principal must be invaded as provided by the terms of the trust agreement. If this went on for a period of years (caused by a bad economy or poor investments) then the assets in the trust could fall below 10% of the value of the original gift which funded the trust. If the trust ended with less than 10% of the original value then the trust would cease to be a CRAT. Although remedies exist, this would be bad. One way to avoid this outcome and avoid the tension placed upon the trustee would be to prepay the charity. Historically, the courts have upheld the interests of the charities. It seems charities would prefer their money now rather than perhaps twenty years later. So society would benefit if the charity received their preference: a prepayment of the remainder interest.

2. Purchase of an annuity rather than investments – The brilliance of the [Promoter Name] CRAT Strategy lies in how the cash from the donated asset is invested. So the question is: are immediate annuities allowable investments for a CRAT? As you will notice below, any provision in the trust document to limit the types of investments available to the trustee are forbidden.

In TAM 9825001, two related issues are raised and two favorable conclusions are reached. The issues and conclusions excerpted from an 8-page document are below:

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‘Issue 1: Does the purchase of the deferred annuity policies from [Life Insurance Company] constitute acts of self-dealing when the named annuitants are disqualified persons?

Issue 2: Would the purchase of the annuity policies jeopardize the trust’s qualification as a CRUT under § 664 for federal income tax purposes?

Conclusion 1: The purchase of the deferred annuity policies, based on particular facts of this case as described in the preceding paragraphs, does not constitute an act of self-dealing under § 4941 of the Code.

Conclusion 2: The purchase of the annuity contracts does not adversely affect [CRUT’s] qualification as a CRT under § 664 of the Code and the current regulations thereunder for federal income tax purposes.’

A Bloomberg/BNA analysis of CRTs regarding restrictions on investments is excerpted below. (BNA Portfolio 865-2nd: CRTs and Pooled Investment Funds, Part I, IV, G. Restrictions on Investments.)

‘A provision that restricts the trustee to a certain type of investment (e.g., tax-exempt bonds) will disqualify the trust. The IRS has ruled that a provision in a CRAT giving the trustee discretion to allocate a portion of the trust assets to purchase an annuity contract to fund the annual annuity payments (to the trust’s grantor) would not prevent the trust from qualifying under § 664(d)(1). PLR 201126007. The PLR indicated that the CRAT would possess all incidents of ownership in the annuity contract, be entitled to all the payments from the annuity, and receive such payments each year for the trust’s duration in an amount equal to or greater than the trust’s annual annuity payout.’

This seems to exactly support the [Promoter Name] CRAT Strategy by validating the purchase of annuity contracts by the CRAT.

3. Tax treatment of amounts paid by the annuity – Section 664(b) sets forth the character of distributions in this order: 1. Ordinary income; 2. Capital gains; 3. Nontaxable income; 4. Return of principal (distribution of corpus).

For decades, the trustee took the funds from the sale of the donated assets and invested them in traditional stocks and bonds. The earnings on these investments were accounted for separately by the trust and were distributed to the recipient as ordinary income. When the trustee moved in and out of different investment vehicles, this gave rise to capital gains and losses, which were also accounted for on behalf of the trust. When ordinary earnings were not great enough to meet the annual payment to the recipient, then capital gains were used and reported as such to the

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recipient. Next, nontaxable income was distributed, then finally principal was returned as part of the required annual payment.

In contrast, the [Promoter Name] CRAT Strategy avoids the requirements of § 664(b) by investing in a vehicle that has its own set of rules. [Cite to website for the information]

[Citing website], 'Taxation of immediate annuities – Taxation of immediate annuities is done under what is called an 'exclusion ratio.' This method of calculating taxes reduces the amount of taxes you pay on your annuity payments. Under an exclusion ratio, a portion of the income you receive from an immediate annuity is a return of principal. A portion of it is interest. Because the payment is split like this, you only pay taxes on the interest you receive—which represents the gain you realize. The exclusion ratio will depend on a variety of factors, including your age and what annuitization option you've chosen.'

Typically, depending primarily on the age of the client, we see taxable interest of 15%-25%, leaving 75%-85% as a return of principal. When the entire principal has been paid out, the non-interest portion of the annual payment becomes subject to capital gains tax.

The taxation of immediate annuities is established law. It is nothing new or revolutionary. Since annuities are allowable as an investment of the CRAT funds, then the tax structures of annuities must also stand. [Cite.]

Historically, immediate annuities have excluded from income that portion of the payout which is computed to be a return of principal, also referred to as a distribution of corpus."[2]

LAW:

CRATs in general

Internal Revenue Code § 664(d)(1) defines a CRAT as a trust:

(A) from which a sum certain (which is not less than 5% nor more than 50% of the initial net FMV of all property placed in trust) is to be paid, not less often than annually, to one

[2] In addition to their reading of §§ 664 and 72, we understand that the promoters also maintain that the transfer of the appreciated assets to the purported CRAT in and of itself gives those assets a step-up in basis to FMV as if they had been sold to the trust resulting in "cost basis" under § 1012. There is no technical basis for this assertion; under §§ 1015(a) and (d), appreciated property transferred by gift (whether or not in trust) retains the basis it held in the hands of the donor, increased by any gift tax paid on the transfer. As the examples of this structure provided to us all involve inter vivos transfers by the donors, there also would be no step-up available under § 1014, relating to property received from a decedent.

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or more persons (at least one of which is not an organization described in § 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individuals;

(B) from which no amount other than the payments described in § 664(d)(1)(A) and other than qualified gratuitous transfers described in § 664(d)(1)(C) may be paid to or for the use of any person other than an organization described in § 170(c);

(C) following the termination of the payments described in § 664(d)(1)(A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in § 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in § 664(g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in § 4975(e)(7)) in a qualified gratuitous transfer (as defined by § 664(g)); and

(D) the value (determined under § 7520) of such remainder interest is at least 10% of the initial FMV of all property placed in the trust.

Under § 664(c)(1), the CRAT itself is not subject to ordinary income taxation, although any unrelated business taxable income is subject to a 100% excise tax under § 664(c)(2).

Under § 664(b), amounts distributed by the CRAT are treated in the hands of the annuity recipient as follows: (1) First, as amounts of income (other than gains, and amounts treated as gains, from the sale or other disposition of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; (2) Second, as a capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain (determined on a cumulative net basis) of the trust for prior years; (3) Third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and (4) Fourth, as a distribution of trust corpus.

Section 170(f)(2)(A) denies the income tax charitable deduction for remainder interests in trusts unless the trust is a CRAT or charitable remainder unitrust (CRUT) (collectively, charitable remainder trusts (CRTs)) described in § 664 or a pooled income fund (PIF) described in § 642(c)(5). Section 2522(c)(2)(A) similarly denies the gift tax charitable deduction for remainder interests other than in a CRT or PIF.

Section 1.664-1(a)(4) of the Income Tax Regulations provides that in order for a trust to be a CRT, it must meet the definition of and function exclusively as a charitable remainder trust from the creation of the trust.

Section 1.664-2(a)(1)(i) requires the governing instrument to provide that the trust will pay a sum certain not less often than annually to person or persons described in § 1.664-2(a)(3) for each taxable year of the period specified in § 1.664-2(a)(5).

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Section 1.664-2(a)(3)(i) generally provides that if the annuity amount described in § 1.664-2(a)(1) is to be paid to an individual or individuals, all such individuals must be living at the time of the creation of the trust.

Section 1.664-2(a)(3)(ii) provides that a trust is not a CRAT if any person has the power to alter the amount to be paid to any named person other than an organization described in § 170(c) if such power would cause any person to be treated as the owner of the trust, or any portion thereof, if subpart E, Part 1, subchapter J, chapter 1, subtitle A of the Code [the "grantor trust" rules of §§ 671-679] were applicable to such trust.

Section 1.664-2(a)(4) provides that no amount other than the annuity amount may be paid to or for the use of any person other than an organization described in § 170(c). An amount is not paid to or for the use of any person other than an organization described in § 170(c) if the amount is transferred for full and adequate consideration. The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in § 170(c). Notwithstanding the preceding sentence, the grantor may retain the power exercisable only by will to revoke or terminate the interest of any recipient other than an organization described in § 170(c). The governing instrument may provide that any amount other than the annuity amount shall be paid (or may be paid in the discretion of the trustee) to an organization described in § 170(c) provided that, in the case of distributions in kind, the adjusted basis of the property distributed is fairly representative of the adjusted basis of the property available for payment on the date of payment. For example, the governing instrument may provide that a portion of the trust assets may be distributed currently, or upon the death of one or more recipients, to an organization described in § 170(c).

Taxation of annuities

Section 72(a)(1) generally provides that gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Section 72(b)(1) generally provides that gross income does not include that part of any amount received as an annuity under an annuity, endowment, or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). Section 72(b)(2) provides that the portion of any amount received as an annuity which is excluded from gross income under § 72(b)(1) shall not exceed the unrecovered investment in the contract immediately before the receipt of such amount.

Section 72(u)(1) generally provides that if any annuity contract is held by a person who is not a natural person (A) such contract shall not be treated as an annuity contract for purposes of subtitle A (other than subchapter L [concerning insurance companies]), and (B) the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year. For

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purposes of § 72(u)(1), holding by a trust or other entity as an agent for a natural person shall not be taken into account.

Section 72(u)(3)(E) provides that § 72(u) shall not apply to any annuity contract which is an immediate annuity. Section 72(u)(4) defines the term “immediate annuity” for purposes of § 72(u) as an annuity (A) which is purchased with a single premium or annuity consideration, (B) the annuity starting date (as defined in § 72(c)(4)) of which commences no later than one year from the date of the purchase of the annuity, and (C) which provides for a series of substantially equal periodic payments (to be made not less frequently than annually) during the annuity period.

ANALYSIS:

Analysis under §§ 664 and 72 The trust does not meet the requirements of § 664

The threshold problem with the marketed structure is that the deviations from the standard CRAT template made in order to effectuate the marketed structure independently disqualify the trust under § 664, regardless of its actual administration. The trust described in the promotional materials has two provisions which violate the CRT requirements:

Excessive authorized payments/Payment not a sum certain: Article 5F of the trust agreement described above provides that in each taxable year of the trust, the trustee shall pay to the beneficiary “during their lifetime for a period of five years” an annuity amount equal to **the greater of** (1) 10% of the initial FMV of all property transferred to the trust or (2) the payments received by the trustee from one or more SPIAs purchased by the trustee. Even if the trust was being correctly administered, this provision allowing a payment to the income beneficiary in excess of the amount determined at the funding of the trust based on a percentage of the initial FMV of the trust assets causes the trust to fail to qualify under § 664(d)(1)(B) since such excess payments are not described in § 664(d)(1)(A). This determination is not dependent on whether any excess payments are ever actually made. Additionally, Article 5F does not satisfy the “sum certain” requirement of § 1.664-2(a)(1)(i), as the amount payable could change if the trust purchases an SPIA.

Prepayment: Article 5L provides that **in lieu of** the remainder distribution to the charitable organization, the trustee may pay to the charitable organization a cash sum equal to 10% of the initial FMV of the trust property plus $100. This provision and the description of the structure in the promotional materials indicate that after a payment of 10% of the initial FMV of the trust assets to charity, the charity has no further rights under the trust and will not receive the remainder at the end of the trust term. Under § 664(d)(1)(C), the payment of the remainder to charity is a mandatory definitional requirement for a CRAT. A trust which does not require such payment is disqualified without regard to any actual distributions which it may make to charity during or at the end of its term. Section 664(d)(1)(D) provides that the value of the remainder calculated at the creation of the trust must be at least 10% of FMV; it neither states nor implies

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that a current payment of that amount to charity vitiates the requirement to also pay the remainder at the end of the term. The cited publications, such as Rev. Proc. 2003-53 and PLR 200124010, do not support the promoters' contentions, as the provisions described therein clearly authorize payments to charity in addition to, not in lieu of, the payment of the remainder, such additional payments being consistent with § 664(d)(1)(B) and explicitly authorized by § 1.664-2(a)(4).[3]

Sections 72 and 664 do not operate as suggested by the promoters

Even if there were no problems with the terms of the trust, the promoters are misreading the rules governing CRTs and the interaction of those provisions with § 72 in situations in which a CRT's assets include an annuity contract. None of the authorities cited in the promotional materials support the claimed ultimate benefit of permanently avoiding taxation on the gain inherent in the appreciated property donated to the trust.

Amounts received under an immediate annuity that meets certain requirements and is described under § 72(u)(3)(E), which the annuities purchased as part of this structure appear to be, are taxed under the general rules of §§ 72(a)(1) and 72(b)(1). That is, each payment under the annuity will consist of an ordinary income portion and an excluded portion representing return of investment, until such time as the entire investment has been recovered. *See*, generally, § 1.72-1. A CRT is exempt from ordinary income taxation itself, but its distributions to the annuity or unitrust recipients, as the case may be, are taxable to the extent that those distributions are treated as coming from the potentially taxable tiers in § 664(b): current and accumulated ordinary income and current and accumulated capital gain. Note that the promoters' paraphrase of § 664(b) quoted above omits the "accumulated" element of each of these tiers.[4]

Applying the rules of § 664 and § 72 together to the standard facts described in the promoters' materials, in which the appreciated asset is contributed to the CRAT, sold shortly thereafter, and the proceeds used to purchase the SPIA, would result in annual ordinary income being added to the § 664(b)(1) tier each year from the annuity, and a large one-time amount being added to the § 664(b)(2) tier from the sale of the asset (assuming the asset is of a kind to produce capital gain). Assuming no other activity, the annual annuity distributions would take out current and any accumulated ordinary

[3] We understand that some of the purported CRATs in the examined cases may not include the "in lieu of" language, and therefore would not fail to be qualified under § 664 based on that provision. The remaining analysis in this memorandum would continue to apply. If a trust that does not include this language nonetheless fails to make the distribution required by its instrument at the end of the trust term, its qualification would be subject to challenge for this operational failure under the doctrine of the Atkinson case, described below in the main text.

[4] The promoters' citation to Notice 2008-99 is simply misleading in that they quote it for the correct statement that a CRT is exempt from ordinary income taxation and has a cost basis in purchased assets, without noting that the gain on assets sold will be added to the § 664 tiers and thus preserved for taxation to the income beneficiaries as distributions are made. Similarly, they draw a false implication from the accurate summary of the § 72 rules regarding immediate annuities in PLR 9237030, that those rules somehow override the § 664 tier structure in cases where a CRT holds such an annuity.

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income from the annuity and then accumulated capital gain from the sale, only reaching non-taxable corpus to the extent these two accounts have been exhausted.[5]

Instead, the promoters are treating the capital gains as being trapped in the CRAT, with the income beneficiaries only taxed on the ordinary annuity income each year as if they were themselves the owners of the SPIA, rather than it being an asset of the CRAT funding their annuity payments *from the trust*. To reach this result, they are misinterpreting the cited TAM and PLRs. In those documents discussing a CRT holding an annuity contract, it is clear that the annuity income is included in the income of the trust, thus entering the § 664(b) tiers, not bypassing the trust and appearing directly on the income beneficiaries' returns. Put differently, the annuity is a funding mechanism for the CRT's required payments to the income beneficiaries, not an income stream of the beneficiaries in lieu of such payments.

For example, in TAM 9825001, a CRUT purchased two deferred annuity contracts which designated the CRUT as owner and beneficiary. The CRUT's two individual beneficiaries (the husband and wife who created the CRUT) were named the annuitants. However, "[i]n order to eliminate the possibility of any annuity payment being made directly to [the individual beneficiaries]" they assigned their interest as annuitants to the CRUT. The TAM also discusses other aspects of control the CRUT had over the annuity policies. Generally, this TAM discusses self-dealing issues under § 4941, but concludes with minimal discussion that the purchase of the contracts does not adversely affect the trust's qualification under § 664.

In PLR 9009047, a CRUT invested its assets in a deferred annuity contract. Because this was not an immediate annuity within the meaning of § 72(u)(3)(E), the income was taxable under the less favorable rules of § 72(u) rather than the general annuity regime of § 72(a) and (b). The ruling concludes that "[the CRUT] shall include in **its** ordinary income for any tax year the 'income on the [annuity] contract' (within the meaning of § 72(u)(2)…" [emphasis added]. There is no justification for reaching a different result in the case of a CRAT funded with an immediate annuity.

In PLR 201126007, a CRAT to be initially funded with appreciated real property sought approval to include a provision in the trust that allowed the trustee to provide for the annuity payment by:

> "allocating a portion of the trust assets to purchase an annuity contract which will guarantee to pay to the trust a sum equal to or greater than the Trustor's computed annual annuity payout for the duration of the trust. If the Trustee chooses to provide for the Trustor's annuity payment in this manner, the Trustee may only purchase such contract from an insurer with an A.M. Best Company Insurer Financial Rating Strength of 'Superior' (A++, A+) or 'Excellent' (A, A). After securing such contract, the Trustee may distribute any amount other than

[5] In the case of a contribution of crops, it is likely that a cash basis taxpayer expensed all the production costs prior to the transfer to the trust and accordingly the sale of the crop results in ordinary income.

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> the amount described in § 1.664-2(a)(1) to the charities named in Schedule B any time during the term of the trust. Upon termination of all noncharitable interests, the Trustee shall distribute all of the principal and income of the trust (other than any amount due to the Annuity Recipient or the estate of the Annuity Recipient) to the charitable organizations, in the percentages designated."

The PLR further clarified that the trustee would "purchase an annuity contract over which Trust possesses all incidence of ownership and **is entitled to all payments, that the annuity contract will pay the annuity amount annually to Trust, and that the trustee of Trust will then pay the annuity amount to the trustor for the trustor's life**." [Emphasis added.] The ruling concluded that the addition of the provision would not prevent Trust from qualifying as a CRAT under § 664(d)(1).

Promoters cite two of these rulings for the indisputable proposition that a CRT may purchase an annuity, but then do not explain that the trust will be the owner of the annuity contract and the income therefrom. Moreover, none of these rulings address the taxation of any distributions from the CRAT to the individual beneficiaries. Thus, none of cited authorities in the promotional materials support taxing the payments under the annuity contract solely under § 72 without running them through the § 664(b) tier system. Rather, the taxable portions of the annuity payments are income to the trust, which would mechanically fall into the first tier as ordinary income, with distributions from the trust first coming from ordinary income before dipping into the other tiers, including capital gain, until the entire distribution is accounted for.

Leaving aside the basic question of the CRAT's qualification under § 664, there are two possible alternative treatments of taxpayers taking an incorrect reporting position based on the promoter materials. The first alternative is to treat the CRAT as actually having distributed the entire annuity contract to the individual beneficiaries. CRTs may make in-kind distributions to satisfy their income distribution requirements, but the value of the policy would far exceed the beneficiaries' required annuity payment for the year and thus would violate the prohibition of § 1.664-2(a)(4) that no amount other than the annuity amount may be paid to or for the use of any person other than charity. This and any subsequent failure to make annuity payments would be operational failures disqualifying the CRAT retroactively under the rule of Atkinson v. Commissioner, 115 T.C. 26 (2000), *aff'd* 309 F.3d 1290 (11th Cir. 2002).

In Atkinson, the decedent grantor was the initial annuity beneficiary of a purported CRAT, with the annuity divided among several other individuals after her death. The trust failed to make the required payments during the decedent's life, and then made payments to satisfy the obligations of her estate after her death, including state death taxes and federal estate taxes.[6] The court held that these failures disqualified the trust under § 664 with retroactive effect, thus disallowing the estate tax charitable deduction originally taken under § 2055 for the value of the remainder interest. Applying Atkinson

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[6] Rev. Rul. 82-128, 1982-2 C.B. 71, specifically concludes that a trust is not qualified as a CRT under § 664 if death or estate taxes may be paid from its assets.

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to taxpayers using the marketed structure would result in the trust being treated as a taxable trust described in § 661 for all years. Any gain on the sale of the appreciated assets would be taxable to the trust in the year of sale, except to the extent that such gains are included in the trust's distributable net income (DNI) within the meaning of § 643(a) and deemed to be distributed to the beneficiaries as the part of the annuity payment, in which case that portion of the gain would be includible to the beneficiaries under § 662.[7]

We are advised that in many of the current cases that have used the marketed structure, the annuity contract lists the trust as the owner of the contract and the individual beneficiaries of the trusts as the annuitants who receive payments under the annuity contract, with the Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., being issued to the trusts and the annuity payments made directly to the individuals.[8] To the extent that the trusts argue that their record ownership of the annuity contracts prevents the Service from asserting that the CRATs made in-kind distributions of the annuity contracts to the income beneficiaries, we note that it could create a new set of hazards for them. If the trusts have retained a right to change the recipient of the annuity, then the CRTs will be disqualified for not meeting the requirements of §§ 1.664-2(a)(3)(i) and (ii). Under § 1.664-2(a)(3)(i), individual beneficiaries must be living at the time of trust creation, but the trust's retained power to substitute annuitants would allow it to direct the annuity payments to beneficiaries who were born after the creation of the trust. Under § 1.664-2(a)(3)(ii), no person can retain a power which would cause the trust to be a grantor trust; the retained power to change the annuity recipient would generally create a grantor trust as a power to control "beneficial enjoyment" of the trust under § 674(a) and none of the exceptions provided in §§ 674(b), (c), and (d) appear to apply. Additionally, distributions of trust assets to individuals other than those named in the trust instrument would be another Atkinson operational failure.

The second alternative is simply to treat the payments under the annuity contract as if they had been correctly routed through the CRAT, taking out the tiers. Assuming that in any given case, the contributed assets are highly appreciated and are sold shortly after contribution, this would result in the distributions consisting of a thin layer of ordinary income with the balance being current or (in years after the year of sale) accumulated capital gain. We understand that some examinations have conceded the validity of the CRAT under § 664, in which cases this alternative would become the primary argument. Even if the CRATs are valid, this does not validate the attempt to trap the capital gains at the entity level.

[7] We do not include a detailed discussion of DNI and the distribution deduction and inclusion provisions of §§ 661-662 here, but note that DNI does not normally include capital gains, so in the ordinary case the income on the sale of the contributed assets will be taxed at the level of the now non-exempt trust.
[8] We understand that there is not uniformity among the examined cases as to which parties (trust, grantors, or other persons) are identified as the "owners," "annuitants," "recipients," and "beneficiaries" of the contracts.

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Although this memorandum is primarily concerned with the proper taxation of the sale of the appreciated property to the beneficiaries and/or the trust, we do note that the disqualification of the trust under § 664, either by its terms or because of operational failures, also vitiates any charitable income and gift tax charitable deductions under §§ 170 and 2522 claimed by the donors on funding, and any examination in a particular case should cover whether such deductions were claimed and whether the relevant taxable years are still open.

Analysis under assignment of income principles (in general)

Although our primary discussion of the structure concerns the promoters' interpretations of §§ 664 and 72, we note another issue which may be present in some individual cases of taxpayers who have used the CRAT structure described above.

Rev. Rul. 78-197, 1978-1 C.B. 83, announced that the Service would follow the decision in Palmer v. Commissioner, 62 T.C. 684 (1974), *aff'd on another issue*, 523 F.2d 1308 (8th Cir. 1975). In Palmer, a taxpayer had voting control of both a corporation and a tax-exempt private foundation and, pursuant to a plan, donated the corporation's stock to the foundation and then caused the corporation to redeem that stock. The Service characterized this transaction as a taxable redemption of the taxpayer under § 301 followed by a gift of the proceeds to the foundation. The Tax Court rejected this position and respected the form of the transaction because the foundation was not a sham, the transfer was a valid gift, and the foundation was not bound to go through with the redemption.[9] The Service indicated that it would treat the proceeds of a redemption of stock under facts similar to Palmer as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

If facts in a given examination indicate that a purported CRAT was legally bound to sell the contributed property prior to its funding, the Service should consider making an argument that any income realized on such sale is taxable to the grantors rather than to the trust or its beneficiaries. We note, however, that the Service would have to meet a very high standard to successfully make this argument. *See* Rauenhorst v. Commissioner, 119 T.C. 157 (2002), where based on similar facts, the court determined that the donees were not legally bound, nor could they be compelled to sell contributed assets.

Analysis under assignment of income principles (SECA tax)

With regard to those cases in which a trust has been funded with crops, we note a special assignment of income issue concerning the possible application of Self-Employment Contributions Act (SECA) tax imposed upon self-employment income. Self-employment income generally consists of the net earnings from self-employment,

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[9] The Service had previously lost several similar cases, including Behrend v. U.S., 73-1 U.S. Tax Cas. (CCH) P9123 (4th Cir. 1972), Carrington v. Commissioner, 476 F.2d 704 (5th Cir. 1973), and Grove v. Commissioner, 490 F.2d 241 (2nd Cir. 1973).

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which in turn is generally defined under § 1402(a) as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by subtitle A which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss described in § 702(a)(8) from any trade or business carried on by a partnership of which the individual is a member.

Because SECA tax provisions are triggered by the receipt of gross income derived from a trade or business, SECA tax liability may arise, under assignment of income principles, if the trust does not meet the requirements of § 664. Under these circumstances, any gross income to the donor resulting from the transfer of the crops to a trust not meeting the requirements of § 664 would be subject to SECA tax if it falls under the general application of the SECA tax provisions. For example, income that results from a transfer of crops to a trust not meeting the requirements of § 664 by a farmer engaged in the trade or business of farming would be income to the farmer subject to SECA tax.

RECOMMENDATION: In all cases using this structure, the validity of the CRAT should be challenged both on the basis of disqualifying terms in the instrument and subsequent operational failures, with the result under both theories being (1) the disallowance of any charitable deductions claimed for the value of the remainder and (2) the treatment of the trust as a taxable entity from its creation, causing the sale of any appreciated donated assets to be currently taxable to the trust (or its beneficiaries, if the gain is included in DNI) in the year of sale. In appropriate cases, an assignment of income argument should be made to tax the gain of the sale of assets by the trust to the grantors or to assert SECA tax liability against the trust grantors. A whipsaw argument should also be included that if the trust is a qualified CRAT, the beneficiaries have reported incorrectly by only including the § 72 ordinary income on the annuity contract and not current or accumulated capital gain on the sale of the assets as part of their § 664(b) distribution.

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Please call Charles D. Wien at (202) 317-5279 if you have any further questions.

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