



Exempt Organizations Technical Guide

TG 70: Charitable Trusts

This document is not an official pronouncement of the law or the position of the IRS and cannot be used, cited, or relied upon as such. This guide is current through the revision date. Changes after the revision date may affect the contents of this document and users should consider any subsequent resources to ensure technical accuracy. All references to "Section" in this document refer to the Internal Revenue Code of 1986, as amended, unless specifically noted otherwise. The taxpayer names and addresses shown in examples within this publication are fictitious.

Technical Guide Revision Date: 5/30/2025

Table of Contents

I. Overview.....	4
A. Background / History.....	4
A.1. Elements of a Trust	4
A.2. Possible Reasons for Trust Creation.....	6
A.3. Legislative History	7
B. Relevant Terms	9
C. Law / Authority	11
II. Requirements.....	13
A. Non-Exempt Charitable Trusts (NECT)	13
A.1. Definition	13
A.2. Exemption Requirements	16
A.3. Required Returns.....	17
A.4. Unrelated Business Income Tax (UBIT).....	17
A.5. Excise Taxes	18
B. Split-Interest Trusts	19
B.1. Definition	19
B.2. Exemption Requirements	22
B.3. Required Returns.....	22
B.4. Unrelated Business Income Tax (UBIT).....	23
B.5. Excise Taxes	23
C. Types of Split-Interest Trusts	24

C.1. Charitable Remainder Trust (CRT)	24
C.2. Charitable Remainder Annuity Trust (CRAT)	25
C.3. Charitable Remainder Unitrust (CRUT).....	26
C.4. Net Income Charitable Remainder Unitrust (NICRUT).....	27
C.5. Net Income Makeup Charitable Remainder Unitrust (NIMCRUT)	27
C.6. “Flip” Unitrust	27
C.7. Charitable Lead Trust (CLT)	28
C.8. Charitable Lead Annuity Trust (CLAT).....	29
C.9. Charitable Lead Unitrust (CLUT)	29
C.10. Pooled Income Fund (PIF)	30
III. Examination Techniques	31
A. Pre-Examination.....	31
B. Information Document Request.....	32
C. Initial Interview	33
D. Field / Office Correspondence	35
E. Procedures	36
IV. Issue Indicators / Audit Tips.....	36
A. Issue Indicators.....	37
B. Audit Tips	38
C. Abusive Trusts	39
V. Sample Trust Instruments for CRUT and CRATs	40

I. Overview

- (1) Trusts may be devoted to charitable purposes, noncharitable purposes, or a combination of both charitable and noncharitable purposes.
- (2) Trusts devoted entirely to charitable purposes as described in Section 170(c)(2)(B) may be exempt from taxation under Section 501(c)(3). Purposes described in Section 170(c)(2)(B) include religious, charitable, scientific, literary, or educational purposes, or to foster national and international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or the prevention of cruelty to children or animals.
- (3) However, this Technical Guide discusses non-exempt charitable trusts (NECTs) and split-interest trusts. These trusts are subject to certain excise taxes under Chapters 41 and 42 pursuant to Section 4947. See Section 4947(a)(1) (NECTs) and (a)(2) (split-interest trusts).
- (4) In order to provide context for the discussion of NECTs and split-interest trusts, this Technical Guide provides an overview of trusts in general, Section 4947, the common characteristics and different varieties of NECTs and split-interest trusts, and examination suggestions. It also discusses issues that may arise for trusts described in Sections 4947(a)(1) and (a)(2).

A. Background / History

- (1) This section introduces the elements of a trust, possible reasons for trust creation, and the legislative history behind Section 4947.

A.1. Elements of a Trust

- (1) A trust is a three-party arrangement involving:
 - a. The grantor (settlor or creator) of a trust;
 - b. The trustee (manager) of a trust;
 - c. The beneficiary or beneficiaries of a trust. See e.g. Restatement (2d) of Trusts (1959) and Black's Law Dictionary, 11th edition.
- (2) The grantor creates the trust by gratuitously transferring his or her title to specified property to a trustee and signing a legal document known as the trust instrument, thus memorializing the grantor's relinquishment of title. The trust instrument is also known as the "trust document" or "governing instrument." A grantor creates a testamentary trust by transferring property to the trustee upon death under the terms of the grantor's will.
- (3) Title in the specified property passes to the trustee – a person or entity designated by the trust instrument. The phrase "placing property in trust,"

describes this transaction. The trust may take effect during the grantor's lifetime (inter vivos) or upon the grantor's death (testamentary).

- a. The trustee must protect and conserve the property on behalf of the beneficiaries to whom the trustee must ultimately distribute the property pursuant to the language of the trust instrument.
 - b. The trustee owes fiduciary duties to the beneficiaries such as a duty of loyalty and a duty of prudence, and the beneficiaries can pursue a civil judgment against a trustee who breaches any of these duties.
 - c. Any person or entity that can legally hold title to property may serve as trustee. A trustee must accept his or her appointment. A court will appoint a trustee if a vacancy arises (this tends to happen more often with testamentary trusts created via a grantor's will).
- (4) The property placed in the trust by the grantor is known as the corpus of the trust. Synonyms for corpus include "principal" and "res." Any transferable property interest is a valid corpus. A trust must contain property as corpus, even if only a dollar. See Am. Jur. 2d "Trusts" § 47.
- (5) The trust instrument may vest an individual (often the trustee) with a power of appointment. A power of appointment permits the holder of the power to control the specific disposition of property from a trust.
 - a. In the context of charitable trusts, a power of appointment may permit the holder to distribute the trust property to specific charities within a broad class designated by the grantor in the trust instrument.
 - b. For example, a trust instrument may provide for the trust property to go to "any Section 501(c)(3) organization." A trustee with an appropriate power of appointment could then decide which specific Section 501(c)(3) organizations would receive the trust property.
- (6) Beneficiaries can be natural persons (humans) or entities. Frequently, human beneficiaries are relatives of the grantor, and entity beneficiaries are charitable organizations or other types of nonprofits.
- (7) While a beneficiary does not necessarily need to appear in the trust instrument by name, the beneficiary must at least be a member of an identifiable class referenced in the trust instrument. An identifiable class includes, for example, "my siblings," or "any organization described in Section 501(c)(3)."
- (8) A beneficiary may have a current or future interest in the trust. Generally, as this Technical Guide will discuss, a beneficiary with a current interest receives income from the trust, and a beneficiary with a future interest (also called a "remainder" interest) receives the remaining trust corpus when the trust terminates. Tension can arise between current and future beneficiaries as their interests do not necessarily coincide and may even be in opposition with respect to investment strategies and other decisions of the trustee.

- (9) State laws govern the formation and administration of domestic trusts. Thus, it is important to be aware of the situs (location) of any trust. The trust instrument contains a provision stating the situs. For example, "This trust shall be administered according to the laws of the State of Ohio."
- (10) The Internal Revenue Code (IRC) governs taxation of trusts at the federal level. As this Technical Guide will discuss, trusts that are not tax-exempt entities in their own right are nevertheless subject to some or all of the rules governing private foundations (PFs) if they are described in Sections 4947(a)(1) or (a)(2).
- (11) A non-grantor trust is a separate legal entity that incurs federal income tax liability separately from the grantor.
- (12) A trust is a "United States person" for purposes of the IRC if (i) a court within the United States is able to exercise primary supervision over the administration of the trust and (ii) one or more United States persons have the authority to control all substantial decisions of the trust. See Section 7701(a)(30)(E).
- (13) Frequently, a trust holds amounts directed in whole or in part to charitable organizations which the trust designates as beneficiaries. When a trust receives income and distributes it to charitable interests, the trust may take a charitable deduction to reduce trust income tax liability for the taxable year in which the distribution occurred.
 - a. Charitable trusts that are exempt from tax are carefully defined in the tax laws. Trusts are not exempt charitable trusts if they do not satisfy the requirements of the tax law, including the requirement that their true purpose be to benefit charity.
 - b. Supposed charitable payments made by a trust are not deductible charitable contributions where the payments are really for the benefit of the owner or the owner's family members. See *Fausner v. Commissioner*, 55 T.C. 620 (1971).

A.2. Possible Reasons for Trust Creation

- (1) Trusts take a variety of different structures and can serve many purposes for grantors. Common reasons for trust creation include:
 - a. Estate planning,
 - b. Organizing assets,
 - c. Facilitating eventual transfer of assets to desired beneficiaries.
- (2) Funds or property placed in trust can aid in decreasing tax burden for both grantors and beneficiaries. Potential decreases in tax burden include:
 - a. Income,
 - b. Gift,
 - c. Estate,

- d. Generation-Skipping Transfer (GST) Tax.
- (3) In addition, trusts can assist grantors in achieving various nontax objectives. These include, but are not limited to:
 - a. Providing for family members,
 - b. Protecting beneficiaries (particularly children and disabled adults),
 - c. Maintaining control over the use of property,
 - d. Directing the future use of property, and
 - e. Protecting assets from creditors, divorce settlements, and adverse outcomes in litigation.
- (4) Although the vast majority of trust arrangements are legitimate, there exists widespread potential for fraud and abuse.
 - a. Abusive trust arrangements often use trusts to hide the true ownership of assets and income or to disguise the substance of transactions. Although these schemes give the appearance of separating responsibility and control from the benefits of ownership, as would be the case with legitimate trusts, the taxpayer in fact controls them.
 - b. These arrangements frequently involve more than one trust, each holding different assets of the taxpayer (the taxpayer's business, equipment, home, automobile, and similar property), as well as interests in other trusts. The trusts are vertically layered, with each trust distributing income to the next layer. Funds may flow from one trust to another trust by way of rental agreements, fees for services, purchase and sale agreements, and distributions. The goal is to use inflated or nonexistent deductions to reduce taxable income to nominal amounts.
 - c. Taxpayers should be aware that abusive trust arrangements will not produce the tax benefits advertised by their promoters and that the IRS is actively examining these types of trust arrangements. Furthermore, in appropriate circumstances, taxpayers and/or the promoters of these trust arrangements may be subject to civil and/or criminal penalties.

A.3. Legislative History

- (1) Congress enacted Section 4947 as part of the Tax Reform Act of 1969 (P.L. 91-172). The House version of P.L. 91-172 described NECTs in Section 4947(a)(1) and imposed all the PF excise taxes upon trusts described in Section 4947(a)(1). It also described split interest trusts in Section 4947(a)(2) and subjected them to all the PF excise taxes other than Sections 4940 and 4942. See H.R. Rep. No. 91-413 at 18. However, under P.L. 91-172, the PF excise taxes do not apply with respect to the following amounts in split-interest trusts:
 - a. Amounts paid to income beneficiaries for which no charitable deduction was allowed.

- b. Amounts for which the trust could not claim a charitable deduction (if segregated from amounts for which the trust could claim such a deduction). This segregation requirement does not apply to amounts transferred in trust prior to May 27, 1969. See H.R. Rep. No. 91-413 at 18.
- (2) The Senate Finance Committee explained that if Congress did not subject NECTs and split-interest trusts to the rules binding PFs, then taxpayers could avoid the entire regime of PF rules simply by structuring their entities as NECTs or split-interest trusts. See S. Rep. No. 91-532 at 93. While adopting the House bill almost in its entirety, the Senate added two amendments limiting the applicability of certain excise taxes to split-interest trusts:
 - a. Sections 4943 and 4944 do not apply to split-interest trusts if the charity is only an income beneficiary, and its beneficial interest is less than 60% of the trust property.
 - b. Sections 4943 and 4944 do not apply to split-interest trusts if the charity is only a remainder beneficiary *until the remainder interest vests*. Once the remainder interest vests, Sections 4943 and 4944 apply. See S. Rep. No. 91-532 at 94.
- (3) The final version of P.L. 91-172 largely tracked the Senate version, including the amendments mentioned above. See H.R. Rep. No. 91-782 at 296-297 (Conf. Rep.). In its General Explanation of the Tax Reform Act of 1969, the Staff of the Joint Committee on Taxation noted the Act would take effect on January 1, 1970. Moreover, it added that a donor could only claim a charitable deduction for a contribution to a trust if the trust instrument contained language prohibiting the trust from violating the restrictions and requirements binding PFs to which it was subject under Chapter 42. See JCS-16-70 at 88-89.
- (4) The degree to which Chapter 42 applies to a trust depends on whether the trust is an NECT under Section 4947(a)(1) or a split-interest trust under Section 4947(a)(2).
- (5) Public Law 96-603 imposed certain obligations for NECTs and split-interest trusts. It required NECTs to make their annual information return (Form 990 or Form 990-PF, as the case may be) public in accordance with Section 6104. See Section 6104(d)(8). It also required split interest trusts to file an annual information return under Section 6034. See Section 6034(a). In addition, P.L. 96-603 mandated penalties for noncompliance with respect to both NECTs and split-interest trusts.
- (6) The Pension Protection Act of 2006 (PPA) (P.L. 109-280) made the following changes that impacted charitable trusts and Section 509(a)(3) supporting organizations:
 - a. The PPA excluded from the gross income of certain Individual Retirement Account (IRA) holders up to \$100,000 of distributions from such accounts made for charitable purposes. The exclusion applied only to the 2006 and 2007 taxable years.

- b. The PPA increased the penalties assessed against NECTs and split interest trusts for failure to file required information returns.
- c. The PPA added Section 6652(c)(2)(C), which imposes a penalty for failure to file and failure to file complete and correct returns. The IRS can also impose this penalty on trustees who are required to file a return but knowingly fail to do so. The penalty is \$20 for each day the failure continues up to a maximum of \$10,000 per return. For trusts with gross income greater than \$250,000, the penalty is \$100 for each day the failure continues up to a maximum of \$50,000 per return. The IRS may demand, in writing, a trustee file a delinquent return, or furnish an information return, specifying a time to comply with the demand. If the trustee fails to comply with the demand by the specified date, the trustee can be assessed a penalty of \$10 for each day the failure continues up to a maximum of \$5,000 per return.
- d. Under the PPA, split-interest trusts no longer have to file Form 1041-A. All the information previously reported on Form 1041-A is now included on Form 5227, which is still filed by split-interest trusts.

B. Relevant Terms

- (1) **Trust:** As used in the IRC, the term “trust” generally refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting it or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts at the state level. Generally, an arrangement will be treated as a trust under the IRC if it can be shown that the purpose of the arrangement is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. See Treas. Reg. 301.7701-4(a).
- (2) **Grantor:** The grantor includes any person who either creates the trust or directly or indirectly transfers the trust property to the trustee in exchange for less than its fair market value. See Treas. Reg. 1.671-2(e). Synonyms for grantor include trustor, donor, creator, settlor, or founder. Income from a trust remains taxable to a grantor if the grantor retains certain levels of interest in or control over the corpus of the trust. See Sections 671-679 and Treas. Reg. 1.671-1.
- (3) **Beneficiary:** Beneficiaries are the persons or entities that receive payments or assets from a trust. Beneficiaries can be either charitable or non-charitable and can be either an income beneficiary or a remainder beneficiary. Income beneficiaries receive income from the trust during the period in which the trust is in existence. Remainder beneficiaries receive assets from the trust upon termination of the trust. Usually, the beneficiaries do no more than accept the benefits of the trust. See Treas. Reg. 301.7701-4(a).

- (4) **Trustee:** The trustee is the individual or entity responsible for holding and managing the trust property for the benefit of the beneficiaries. The trustee holds legal title to the trust property. As such, the trustee has a fiduciary duty to the beneficiaries with respect to the trust property. In the event of a breach of fiduciary duty, a trustee may be personally liable. Possible breaches include failing to pay out required distributions or misappropriating trust property. Trustees coordinate the preparation, verification, and submission of all required state and Federal tax forms and legal documents. A trust frequently has multiple trustees. A corporate fiduciary or any competent individual who is not a minor can serve as trustee. See Section 7701(a)(6).
- (5) **Corpus:** The corpus (also called the principal or property) of a trust consists of the assets transferred into the trust. It can include cash, securities, real property, tangible personal property, and life insurance policies. Corpus is the Latin word for “body.” Thus, the term “body” often appears interchangeably with corpus and the corpus is also referred to as the body of the trust. The corpus may also generate income streams, typically via investments. The terms of the governing instrument or applicable governing law determine the allocation of receipts and disbursements attributable trust assets between income and corpus. A trust must have some assets comprising its corpus, even if only a dollar.
- (6) **Trust Instrument:** This term refers to the document created by a grantor to establish the trust. It provides the governing guidelines, identifies the grantor(s), beneficiaries, powers of the trustees, and others involved with the trust. It should also include a listing of the assets transferred to the trust and constitute the corpus of the trust. The trust instrument is also known as the “trust document,” “trust indenture,” or “governing instrument.”
- (7) **Remainder:** A remainder is the right of a third party to receive the use or control of property after termination of an intervening interest in that property, usually a life estate or following the close of a defined term of years. In many split-interest trusts, the remainder beneficiaries are charitable organizations.
- (8) **Inter Vivos:** This Latin term means “during life” and refers to any trust created and in effect during the grantor’s life. See Treas. Reg. 301.7701-4(a).
- (9) **Testamentary:** This term refers to any trust created by a last will and testament. It takes effect when the grantor dies. See Treas. Reg. 301.7701-4(a).
- (10) **Irrevocable Trust:** A trust which the grantor, pursuant to the terms of the trust instrument, does not have the power to revoke.
- (11) **Revocable Trust:** A trust in which the grantor retains the power to revoke the trust and revest the trust assets in the grantor. In other words, a trust in which the grantor can reclaim the assets for himself or herself. The grantor pays tax on the income for a revocable trust. Assets in a revocable trust comprise part of the grantor’s gross estate for federal estate tax purposes. Also called “living trusts”, they function primarily as a will substitute. See Sections 671-679.

- (12) **Non-Exempt Charitable Trust (NECT):** An NECT is a trust that is not exempt from taxation under Section 501(a), for which all of the unexpired interests are devoted to one or more of the purposes described in Section 170(c)(2)(B), and for which a charitable deduction was allowed under certain specified sections of the IRC. The NECT makes charitable distributions annually until it expends all of its assets and income. See Section 4947(a)(1).
- (13) **Split-Interest Trust:** A split-interest trust is a trust that has both charitable and non-charitable beneficiaries. The amount and timing of the distributions depends on the type of trust arrangement. The two categories of split-interest trust are charitable remainder trust (CRT) and charitable lead trust (CLT). Varieties of CRT include charitable remainder annuity trust (CRAT), charitable remainder unitrust (CRUT), net income charitable remainder unitrust (NICRUT), and net income with makeup charitable remainder unitrust (NIMCRUT). Types of CLT include charitable lead trust (CLT), charitable lead annuity trust (CLAT), and charitable lead unitrust (CLUT). In addition, a pooled income fund (PIF) is similar to a CRT. Refer to Section II.C of this Technical Guide for more information on the specific characteristics of each type of split-interest trust. See Section 4947(a)(2).
- (14) **Annuity Trust:** An annuity trust is a trust in which the payments for the duration of the trust, either to a private or charitable beneficiary, are of a fixed amount. The trustee(s) determine the payment amount by multiplying a specified percentage by the initial net fair market value of all property placed in trust. See Treas. Reg. 1.664-2.
- (15) **Unitrust:** A trust in which the payments to the beneficiaries fluctuate with the fair market value of assets in the trust. The trustee calculates the amount payable each year by multiplying the fair market value of assets in the trust as of the year in question by the designated percentage set forth in the trust instrument (called the unitrust percentage). See Treas. Reg. 1.664-3.
- (16) **Pooled Income Fund (PIF):** A trust administered by a charity in which multiple donors pool assets for investment. The trustees distribute the resulting income to donors on a prorated basis until their deaths, upon which the trust transfers assets to the charity. It is similar to a CRT. See Section 642(c)(5).

C. Law / Authority

- (1) Section 4947(a)(1) defines an NECT and subjects it to all of the Chapter 42 excise taxes that apply to private foundations. It also permits an NECT to receive recognition as a supporting organization described in Section 509(a)(3). An NECT that receives such recognition is not subject to the PF excise taxes. See also Treas. Reg. 53.4947-1(b).
- (2) Section 4947(a)(2) defines a split-interest trust, carves out exceptions for certain segregated amounts and amounts payable to income beneficiaries, and subjects it to the following provisions that apply to private foundations:
- a. Section 4941, Taxes on Self-Dealing,

- b. Section 4943, Taxes on Excess Business Holdings, (unless an exception in Section 4947(b)(3) applies),
 - c. Section 4944, Taxes on Investments which Jeopardize Charitable Purposes, (unless an exception in Section 4947(b)(3) applies), and
 - d. Section 4945, Taxes on Taxable Expenditures.
- (3) Treas. Reg. 53.4947-1(a) states the general rule for subjecting trusts described in Section 4947 to the rules applicable to private foundations. It notes that the basic purpose of Section 4947 is to prevent individuals from using such trusts to avoid the requirements and restrictions that apply to private foundations.
- (4) Treas. Reg. 53.4947-1(b) elaborates on the definition of NECT under Section 4947(a)(1). It clarifies that an NECT is subject to the tax on net investment income imposed by Section 4940(b), rather than Section 4940(a). It also contains several examples.
- (5) Treas. Reg. 53.4947-1(c) explains the rules for split-interest trusts under Section 4947(a)(2) and contains guidance for determining whether the exceptions described in Section 4947(a)(2)(A), (B), and (C) apply. It also includes several examples.
- (6) Section 170(c)(2)(B) lists the charitable purposes to which a Section 501(c)(3) organization may devote its efforts and, by extension, the purposes for which a donation made by a donor is eligible for a charitable deduction. They are:
 - a. Religious,
 - b. Charitable,
 - c. Scientific,
 - d. Literary,
 - e. Educational,
 - f. Fostering national or international amateur sports competition (as long as no part of activities include providing athletic facilities or equipment), and
 - g. Prevention of cruelty to children or animals.
- (7) Section 508(e) states the requirements for governing instruments of PFs. It requires such instruments to contain a statement requiring the PF to abide by the provisions of Sections 4941-4945. All trusts described in Section 4947 must include a statement satisfying the requirements of Section 508(e) in their trust instruments.
- (8) Section 545(b)(2) permits a deduction for charitable contributions made from undistributed personal holding company income. It outlines certain limitations on the permitted contributions and clarifies the meaning of “contribution base” in the context of personal holding company income.
- (9) Section 642(c) allows a charitable deduction for amounts in a trust or estate paid for a charitable purpose or permanently set aside for a charitable purpose.

It also contains the definition of Pooled Income Fund (PIF), discussed further in Section II.C. of this Technical Guide.

- (10) Section 664 provides the rules for a charitable remainder trust (CRT). It determines the treatment of distributions, imposes an excise tax of 100% on any unrelated business taxable income (UBTI), and states requirements that a charitable remainder annuity trust (CRAT) and charitable remainder unitrust (CRUT) must follow. These rules also apply to the NICRUT and NIMCRUT varieties of CRUT. In addition, Section 664 discusses proper valuation of interests.
- (11) Treas. Reg. 1.664-1(a) contains an explanation of a CRT and the scope of the rules that regulate it. It also provides additional requirements, definitions, and several examples to illustrate the operation of the rules governing CRTs.
- (12) Section 2055 provides a charitable deduction for transfers from a taxable estate that are for public, charitable, and religious uses.
- (13) Section 2106(a)(2) provides a charitable deduction for transfers for public, charitable, and religious purposes from the taxable estate of a nonresident not a citizen.
- (14) Section 2522 provides for a charitable deduction with respect to any applicable gift taxes for inter vivos gifts made by U.S. citizens or residents to charitable organizations for the charitable purposes described in Section 170(c)(2)(B).

II. Requirements

- (1) This section discusses the requirements for NECTs and split-interest trusts. It also presents the different varieties of split-interest trusts.

A. Non-Exempt Charitable Trusts (NECT)

- (1) This section discusses the requirements applicable to NECTs.

A.1. Definition

- (1) Pursuant to Section 4947(a)(1), an NECT is a trust that:
 - a. Is not exempt from taxation under Section 501(a),
 - b. For which all unexpired interests are devoted to one or more of the purposes described in Section 170(c)(2)(B), and
 - c. For which a charitable deduction was allowed under certain specified IRC sections.
- (2) Under Treas. Reg. 53.4947-1(b)(2)(vii), an NECT's unexpired interests may be devoted to Section 170(c)(3) purposes and/or Section 170(c)(5) purposes together with Section 170(c)(2)(B) purposes. Treas. Reg. 53.4947-1(a) includes Section 170(c)(1) purposes within the scope of Section 170(c)(2)(B) purposes. Moreover, any payments made under the terms of the governing instrument to

an organization described in Section 170(c)(3) or 170(c)(5) does not violate any provision of Chapter 42, including Section 4945(d)(5). In addition, any such payments constitute qualifying distributions under Section 4942.

- (3) Under Section 4947(a)(1), the trust must hold amounts for which charitable deductions were allowed under the following IRC sections:
 - a. Section 170: charitable contributions and gifts,
 - b. Section 545(b)(2): charitable contributions from personal holding companies,
 - c. Section 642(c): deduction for amounts of gross income paid or permanently set aside for a charitable purpose,
 - d. Section 2055: transfers for public, charitable, and religious uses (estate and trust excise taxes),
 - e. Section 2106(a)(2): transfers for public, charitable, and religious uses (estate and trust excise taxes for non-citizens and nonresidents), or
 - f. Section 2522: charitable and similar gifts (gift taxes).
- (4) Deductions for contributions to an NECT are valid so long as the trust instrument governing the NECT satisfies Section 508(e). See Section 508(d)(2)(A). Although taxable, an NECT is treated in Section 4947(a)(1) as an organization described in Section 501(c)(3). This organization may qualify as a PF under Section 509 or may request treatment as a Section 509(a)(3) supporting organization. A subsequent chart will illustrate the different treatment when the NECT is treated as a PF or a Section 509(a)(3) organization.
- (5) A trust may be initially created as an NECT. See Treas. Reg. 53.4947-1(b)(2) Example 1. In addition, a CRT in which the remainder interest is held in trust for a charity, will become an NECT after the noncharitable interest terminates. See Treas. Reg. 53.4947-1(b)(2) Example 2. Example 2 also indicates that the remainder interest held in trust may also apply for recognition of Section 501(c)(3) status. Moreover, an NECT may succeed an estate or another trust if all the assets in the surviving trust are required to be held in trust for charitable beneficiaries.
- (6) If an NECT does not distribute the entirety of its income for charitable purposes in a particular tax year, then it would report certain income each year as taxable. And, since an NECT is not tax-exempt, any income it receives and does not subsequently distribute for charitable purposes is taxable under Subtitle A – regardless of the source.
- (7) Treas. Reg. 53.4947-1(b)(2)(i) provides that an estate from which the executor or administrator is required to distribute all of the net assets in trust to such beneficiaries will not be considered a charitable trust under Section 4947(a)(1) during the period of estate administration or settlement, except as provided in Treas. Reg. 53.4947-1(b)(2)(ii). A charitable trust created by will shall be considered a charitable trust under Section 4947(a)(1) as of the date of death of

the decedent-grantor, except as provided in Treas. Reg. 53.4947-1(b)(2)(v) (relating to trusts that wind up). For the circumstances under which segregated amounts are treated as charitable trusts, see Treas. Reg. 53.4947-1(c)(3)(iii).

- (8) When an estate from which the executor or administrator is required to distribute all of the net assets in trust for charitable beneficiaries, or free of trust to such beneficiaries, is considered terminated for Federal income tax purposes under Treas. Reg. 1.641(b)-3(a), then the estate will be treated as a charitable trust under Section 4947(a)(1) between the date on which the estate is considered terminated under Treas. Reg. 1.641(b)-3(a) and the date final distribution of all of the net assets is made to or for the benefit of the charitable beneficiaries. This does not affect the determination of the tax liability under Subtitle A of the beneficiaries of the estates. See Treas. Reg. 53.4947-1(b)(2)(ii).

- (9) Treas. Reg. 53.4947-1(b)(2)(ii)(B) provides the following example:

X bequeaths his entire estate, including 100 percent of the stock of a wholly owned corporation, to M, an organization described in Section 501(c)(3), under a will which gives his executor authority to hold the stock and manage the corporation for a period of up to 10 years for the benefit of M prior to its ultimate disposition. A deduction for the charitable bequest was allowed to X's estate under Section 2055. The executor is vested with a full range of powers, including the power of sale. Upon the death of X, his executor distributes X's assets to M except for the stock of the corporation, which he holds for 5 years prior to its disposition. The continued holding of the stock of the corporation by the executor after the expiration of a reasonable time for performance of all the ordinary duties of administration causes the estate to be considered terminated for Federal income tax purposes pursuant to Treas. Reg. 1.641(b)-3(a) and thereby subjects it to the provisions of Section 4947(a)(1) from the date of such termination to the date of final disposition of the stock of the corporation.

- (10) A revocable trust that becomes irrevocable upon the death of the decedent-grantor, or a trust created by will, from which the trustee is required to distribute all of the net assets in trust for or free of trust to charitable beneficiaries is not considered a charitable trust under Section 4947(a)(1) for a reasonable period of settlement after becoming irrevocable. After that period the trust is considered a charitable trust under Section 4947(a)(1). See Treas. Reg. 53.4947-1(b)(2)(v).
- (11) A revocable trust that becomes irrevocable upon the death of the decedent-grantor in which all of the unexpired interests are charitable and under the terms of the governing instrument of which the trustee is required to hold some or all of the net assets in trust after becoming irrevocable solely for charitable beneficiaries is not considered a trust under Section 4947(a)(1) for a

reasonable period of settlement after becoming irrevocable except that Section 4941 may apply if the requirements of Treas. Reg. 53.4941(d)-1(b)(3) are not met. After that period, the trust is considered a charitable trust under Section 4947(a)(1). See Treas. Reg. 53.4947-1(b)(2)(vi).

A.2. Exemption Requirements

- (1) NECTs described in Section 4947(a)(1) are not exempt from taxation under Section 501(a). See Section 4947. Thus, NECTs do not apply for exemption.
- (2) If an NECT receives treatment as a PF, then the termination provisions of Section 507 and governing instrument provisions of Section 508(e) apply. See Section 4947(a)(1).
- (3) An NECT that wants recognition as a Section 509(a)(3) supporting organization must file Form 8940, Request for Miscellaneous Determination, and pay the applicable fee. See Section 3.01(11) of Rev. Proc. 2022-5.
 - a. The NECT must meet the same requirements as any organization requesting classification under Section 509(a)(3).
 - b. Section 1241(c) of the Pension Protection Act of 2006 (PPA) (P. L. 109-280) Section 1241(c) eliminated the alternative responsiveness test (charitable trust test) for Section 509(a)(3) Type III supporting organizations. Consequently, as of August 17, 2007, some NECTs previously classified as Section 509(a)(3) Type III supporting organizations may receive treatment as PFs as a result of the PPA. Based on PPA provisions, an NECT requesting a determination that it is a Section 509(a)(3) supporting organization must demonstrate how it meets the requirements for classification as a Type I, Type II, or Type III supporting organization in the absence of relying on the charitable trust test.
 - c. **Note:** For further information, see TG 3-31: Foundation Classification – Type I Supporting Organizations – IRC Section 509(a)(3); TG 3-32: Foundation Classification – Type II Supporting Organizations – IRC Section 509(a)(3); TG 3-33: Foundation Classification – Type III Supporting Organizations – IRC Section 509(a)(3).
- (4) An NECT's receipt of a foundation classification as a supporting organization described in Section 509(a)(3) is not equivalent to receiving recognition of tax-exempt status under Section 501(c)(3). It simply means the NECT receives treatment as a public charity for filing and excise tax purposes, and files a Form 990 or Form 990-EZ. See Rev. Proc. 72-50 and Rev. Proc. 76-34 (modified and superseded by Rev. Proc. 2011-10) for a full description of procedures for an NECT to request a determination that it is a Section 509(a)(3) supporting organization.
- (5) For purposes of Section 509(a)(3)(A), treat an NECT as if organized on the day it first became subject to Section 4947(a)(1). See Treas. Reg. 53.4947-1(b)(3).

- (6) However, for purposes of applying the rules contained in Treas. Regs. 1.509(a)-4(d)(2)(iv)(a), and 1.509(a)-4(i)(1)(ii) and (iii)(c), consider the previous relationship between the NECT and the Section 509(a)(1) or (a)(2) organizations it benefits or supports. See Treas. Reg. 53.4947-1(b)(3).
- (7) As described in Rev. Proc. 2011-10, when applying for a determination under Section 509(a)(3) on Form 8940, the NECT provides the following information from the date that it first became described under Section 4947(a)(1):
 - a. Form 990, Schedule A, Parts I, IV-VI, with respect to the most recently completed tax year.
 - b. A list of all trustees who have served.
 - c. A statement declaring whether these trustees were disqualified persons within the meaning of Section 4946 (other than foundation managers).
 - d. A copy of the original trust instrument and all subsequently adopted amendments to the instrument.
 - e. Other information as required under Rev. Proc. 2022-5, or any successor revenue procedure. See Page 6 of the Instructions for Form 8940, Request for Miscellaneous Determination.

A.3. Required Returns

- (1) An NECT must comply with the filing requirements of Section 6033 in the same manner as an organization described in Section 501(c)(3). See Section 6104(d)(8). An NECT receives treatment as a PF unless it obtains a determination that it is a supporting organization under Section 509(a)(3). The following table summarizes the filing requirements for an NECT:

Treated as Supporting Organization	Treated as PF
NECT files Form 990, Return of Organization Exempt From Income Tax or Form 990-EZ, Short Form Return of Organization Exempt From Income Tax	NECT files Form 990-PF, Return of Private Foundation (or Section 4947(a)(1) Nonexempt Charitable Trust Treated as Private Foundation)
NECT files Form 1041, U.S. Income Tax Return for Estates and Trusts, if the trust has taxable income	NECT files Form 1041, U.S. Income Tax Return for Estates and Trusts, if the trust has taxable income
NECT files Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the IRC, if there is liability for Chapter 41 or 42 taxes	NECT files Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the IRC, if there is liability for Chapter 42 taxes

A.4. Unrelated Business Income Tax (UBIT)

- (1) Since an NECT is not exempt from taxation under Section 501(a), it is not subject to the unrelated business income (UBI) rules contained in Sections 511-515. See Section 511(b)(2).

- (2) Any undistributed income earned by an NECT is taxable. If an NECT earns any taxable income or gross income of \$600 or more, it must file Form 1041, U.S. Income Tax Return for Estates and Trusts, for the tax year(s) in question. See Section 6012(a)(4).

A.5. Excise Taxes

- (1) Unless it successfully files for recognition as a supporting organization described in Section 509(a)(3), then the NECT is treated as a PF and is subject to the same excise taxes under chapters 41 and 42 that a PF is subject to. If the NECT is liable for any of these taxes (except the Section 4940 tax), then it reports these taxes on Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code. Taxes paid by the trust on Form 4720 or on Form 990-PF (the Section 4940 tax) can't be taken as a deduction on Form 1041. See Section 4947(a)(1) and Treas. Reg. 53.4947-1(b); and Instructions to Form 1041.
- (2) The determination that an NECT is a supporting organization under Section 509(a)(3) impacts the potential excise tax liabilities of the NECT and its disqualified persons. The following table summarizes the tax obligations of these two types of NECTs:

Tax	NECT Treated as Supporting Organization	NECT Treated as PF
Employment taxes	Yes	Yes
Income tax	Yes	Yes
Section 4911 (excess lobbying expenditures)	Yes	No
Section 4912 (disqualifying lobbying expenditures)	Yes	No
Section 4940(b) (net investment income)	No	Yes
Section 4941 (self-dealing)	No	Yes
Section 4942 (mandatory distributions)	No	Yes
Section 4943 (excess business holdings)	Yes	Yes
Section 4944 (jeopardizing investments)	No	Yes
Section 4945 (taxable expenditures)	No	Yes

Tax	NECT Treated as Supporting Organization	NECT Treated as PF
Section 4955 (political expenditures)	Yes	Yes
Section 4958 (excess benefit transactions)	Yes	No
Section 4965 (prohibited tax shelter transactions)	Yes	Yes
Section 4966 (taxable distributions – donor advised funds)	Yes	No
Section 4967 (prohibited benefits – donor advised funds)	Yes	No

B. Split-Interest Trusts

(1) This section discusses the requirements applicable to split-interest trusts.

B.1. Definition

- (1) Section 4947(a)(2) discusses the application of certain private foundation rules to split-interest trusts. Split-interest trusts have unexpired interests devoted to both charitable and non-charitable beneficiaries.
- (2) Split-interest trusts are divided into three income-tax categories based on the method and timing of distributions – information about each of these categories appears later in Section II.C of this Technical Guide:
 - a. Charitable Remainder Trust (CRT) described in Section 664,
 - b. Charitable Lead Trust (CLT) described in Section 170(f)(2)(B), and
 - c. Pooled Income Funds (PIF) described in Section 642(c)(5).
- (3) Section 4947(a)(2) does not apply to:
 - a. Any amounts payable under the terms of the split-interest trust to income beneficiaries, unless a deduction was allowed under Sections 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B);
 - b. Any amounts in trust other than amounts for which a deduction was allowed under Sections 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such amounts are segregated from amounts for which no deduction was allowable; or
 - c. Any amounts transferred in trust before May 27, 1969. See Section 4947(a)(2)(A)-(C).
- (4) For the exception for segregated amounts to apply, the following must be true:

- a. Assets for which no charitable deduction was allowed are separately accounted for (within the meaning of Section 4947(a)(3) and Treas. Reg. 53.4947-1(c)(4)) from assets for which such a deduction was allowed for any income or remainder interest; and
 - b. By reason of the separate accounting the trust can be treated as two separate trusts, one of which is devoted exclusively to noncharitable income and remainder interests and the other of which is a charitable trust described in Section 4947(a)(1) or a split-interest trust described in Section 4947(a)(2). See Treas. Reg. 53.4947-1(c)(3)(ii).
- (5) If the exception for segregated amounts applies, only the “trust” which is devoted exclusively to noncharitable income and remainder interests will be considered a segregated amount which, under Section 4947(a)(2)(B), is not subject to Section 4947(a)(2) and Treas. Reg. 53.4947-1(c)(3)(i).
- (6) If an amount held in trust which is devoted exclusively to charitable income and remainder interests is segregated (under Section 4947(a)(2)(B)) from an amount held in trust which is devoted exclusively to noncharitable income and remainder interests, then the amount devoted exclusively to charitable purposes is treated as an NECT subject to Section 4947(a)(1). See Treas. Reg. 53.4947-1(c)(3)(iii).
- (7) If an amount held in trust which is devoted to both charitable income or remainder interests and noncharitable income or remainder interest is segregated (under Section 4947(a)(2)(B)) from an amount held in trust which is devoted exclusively to noncharitable income and remainder interests, then the amount devoted to both charitable and noncharitable purposes is treated as a split-interest trust subject to Section 4947(a)(2). See Treas. Reg. 53.4947-1(c)(3)(iv).
- (8) Treas. Reg. 53.4947-1(c)(v) provides the following examples:
 - a. H creates a trust under which the trustees are required to pay over annually 5 percent of the net fair market value of M building, valued annually, to W, H’s wife, for life, remainder to S, H’s son. The other asset in the trust is N building, with respect to which the trustees are required to pay over annually 5 percent of the net fair market value of the building, valued annually, to X, a Section 501(c)(3) organization, for a period of 15 years, remainder to S. Each asset is separately accounted for under Section 4947(a)(3) and Treas. Reg. 53.4947-1(c)(4). H received a deduction under Section 2522 for the value of X’s income interest in N building. Under these circumstances, M building is considered segregated (within the meaning of Section 4947(a)(2)(B)) from N building and is not subject to Section 4947(a)(2). The remainder interest of S in N building is not considered segregated from the income interest of X in N building since both are interests in the same asset. N building is considered held in a split-interest trust which is subject to Section 4947(a)(2) and Treas. Reg. 53.4947-1(c)(1)(ii).

- b. H transfers \$50,000 in trust to pay \$2,500 per year to Z, a Section 501(c)(3) organization, for a term of 20 years, remainder to S, H's son. H is allowed a deduction under Section 2522 for the present value of Z's income interest. The income interest of Z in the trust asset cannot be segregated (within the meaning of Section 4947(a)(2)(B)) from the remainder interest of S since both are interests in the same asset. Therefore, the entire trust is subject to Section 4947(a)(2) and Treas. Reg. 53.4947-1(c)(ii).
- (9) The IRS published sample trust instrument provisions that, if followed, satisfy Section 508(e) requirements. See Rev. Proc. 2003-53 through Rev. Proc. 2003-60, 2003-2 C.B. 230-274. and Rev. Proc. 2005-52 through Rev. Proc. 2005-59, 2005-2 C.B. 339-412.
- (10) A split-interest trust in which all of the unexpired interests are charitable remainder interests and in which some or all of the charitable beneficiaries are not entitled to distributions of corpus shall continue to be treated as a split-interest trust under Section 4947(a)(2) rather than a charitable trust under Section 4947(a)(1) for a reasonable period of settlement after the expiration of the noncharitable interest. Thus, a split-interest trust which under its terms is to continue to hold assets for charitable beneficiaries after the expiration of the noncharitable interest rather than distributing them is given a reasonable period of settlement before being treated as a charitable trust. The term "reasonable period of settlement" means that period reasonably required (or if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of the rights of the subsequent beneficiaries. See Treas. Reg. 53.4947-1(b)(2)(iv)(A).
- (11) Treas. Reg. 53.4947-1(b)(2)(iv)(B) provides the following example:
- On January 15, 1971, A creates a charitable remainder annuity trust described in Section 661(d)(1) under which the trustees are required to distribute \$10,000 a year to B, A's wife, for life, remainder to be held in trust for the use of M, an organization described in Section 501(c)(3). A is allowed a deduction under Section 170 for the amount of the charitable interest, and the trust is, therefore, treated as a split-interest trust under Section 4947(a)(2) from the date of its creation. B dies on February 10, 1975. On April 15, 1975, the trustees complete performance of the ordinary duties of administration necessary for the settlement of the trust brought about by the death of B. These duties include, for example, an accounting for and payment to the estate of B of amounts accrued by B while alive during 1975. However, the trustees do not distribute the corpus to M by April 15, 1975. The trust shall continue to be treated as a split-interest trust under

Section 4947(a)(2) until April 15, 1975. After April 15, 1975, the trust shall be treated as a charitable trust under Section 4947(a)(1).

B.2. Exemption Requirements

- (1) Split-interest trusts are not exempt from taxation under Section 501(a).
- (2) However, a CRT may file a Form 1023 when its non-charitable interests expire, and request recognition as a Section 501(c)(3) organization in order to obtain public charity status, thus avoiding the excise tax restrictions and certain reporting requirements that apply to PFs.
- (3) In addition, a CRT will become an NECT when its non-charitable interests expire if (1) its charitable assets are held in trust instead of being distributed to designated charitable beneficiaries, and (2) it does not obtain recognition as a Section 501(c)(3) organization.

B.3. Required Returns

- (1) All split-interest trusts annually file Form 5227, Split-Interest Trust Information Return, to report financial activity. See Section 6034(a).

Note: A split-interest trust created before May 27, 1969, need not file Form 5227 if no transfers of funds to the trust took place after that date.

Note: Per the Pension Protection Act of 2006 (PPA), split-interest trusts no longer have to file Form 1041-A, as all of the information previously reported on it is now included in Form 5227.

- (2) Information reported on Form 5227 includes asset holdings, income, and distributions, as well as information needed to determine whether the split-interest trust should receive treatment as a PF for certain excise tax purposes. All information reported on Form 5227 is available to the public. The only exception is Schedule A, which includes details of accumulations of income for CRTs, distributions to noncharitable beneficiaries, and information about donors and assets contributed during the year. See Page 1 of Instructions for Form 5227, Split-Interest Trust Information Return.
- (3) Form 5227 does not calculate tax liability. See Page 1 of Instructions for Form 5227, Split-Interest Trust Information Return.
- (4) A split-interest trust other than a CRT must file Form 1041, U.S. Income Tax Return for Estates and Trusts, for any tax years in which it earns gross income of \$600 or more, pursuant to Section 6012(a)(4). Split-interest trusts subject to the Form 1041 filing requirement are:
 - a. Charitable Lead Trusts (both CLATs and CLUTs) and
 - b. Pooled Income Funds.

B.4. Unrelated Business Income Tax (UBIT)

- (1) Since a split-interest trust is not exempt under Section 501(a), it is generally not subject to the UBI rules contained in Sections 511-515. See Section 511(b)(2). This holds true unless the trust is a CRT.
- (2) However, CRTs must pay an excise tax equal to 100% of UBTI. See Section 664(c)(2). The rules contained in Sections 511-515 apply to determining the UBTI of CRTs. See Section 664(c)(2).
- (3) Any CRT subject to the Section 664(c)(2) excise tax must file Form 4720 and pay the tax imposed. The following types of trusts are subject to the Section 664(c)(2) excise tax:
 - a. CRAT,
 - b. CRUT,
 - c. NICRUT, and
 - d. NIMCRUT.

B.5. Excise Taxes

- (1) All split-interest trusts are subject to Sections 4941 and 4945, as well as the provisions of Sections 507 and 508(e). See Section 4947(a)(2).
- (2) Pursuant to Section 4947(b)(3), Sections 4943 and 4944 apply unless one of the following two statements is true:
 - a. All of the income interests (and none of the remainder interests) are charitable and all amounts held in trust for which a charitable deduction was allowed have a value of not more than 60% of the aggregate fair market value of all amounts in the trust.
 - b. A charitable deduction was allowed for amounts payable under the terms of the trust to every remainder beneficiary, but not to any income beneficiary.
- (3) Treas. Reg. 53.4947-2(b) notes that if a pooled income fund described in Section 642(c)(5) or a charitable remainder trust described in Section 664(d)(1) does not make payments to any income beneficiary described in Section 170(c), then these trusts will generally meet the exception found in paragraph B.5(2)b, above. Section 4940 does not apply to split-interest trusts. See Treas. Reg. 53.4947-1(c)(1)(ii).
- (4) Any split-interest trust that incurs excise tax liability must file Form 4720 for the tax year(s) in question. See Sections 4947(a)(2) and 6033(d)(2), as well as Treas. Reg. 1.6033-2(a)(2)(ii)(J).
- (5) Note: This includes CRTs that owe the excise tax on UBIT imposed by Section 664(c)(2). The tax is equal to 100% of UBTI.

- (6) The Pension Protection Act of 2006 (PPA) added Section 6652(c)(2)(C), which imposes a penalty for failure to file and failure to file complete and correct returns. The IRS can impose this same penalty on trustees who must file a return, but knowingly fail to do so.
- a. The penalty is \$20 for each day the failure continues up to a maximum of \$10,000 for any one return.
 - b. If the trust has gross income greater than \$250,000, the penalty is \$100 for each day the failure continues up to a maximum of \$50,000 for any one return.
 - c. The IRS may demand, in writing, that a trustee file a delinquent return, or furnish an information return, within a specified period of time. If the trustee fails to comply by the specified date, the trustee can face a penalty of \$10 for each day the failure continues up to a maximum of \$5,000 for any one return.

C. Types of Split-Interest Trusts

- (1) This section introduces the different varieties of split-interest trusts.

C.1. Charitable Remainder Trust (CRT)

- (1) A CRT is irrevocable and consists of two distinct parts:
- a. A non-charitable interest in the form of a right to a stream of payments from the trust for life or a term certain (not in excess of 20 years). A charity may be the recipient of a portion of the annuity or unitrust amount so long as there is at least some of the amount going to a non-charitable beneficiary each year. In addition, the annuity or unitrust payment amount may go to the guardian of a minor. See Treas. Regs. 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i).
 - b. A charitable interest in the assets remaining in the trust either held in continuing trust for charitable purposes or payable to or for the use of an organization or organizations described in Section 170(c) at the expiration of the preceding non-charitable interest. See Sections 664(d)(1)(C) and 664(d)(2)(C).
- (2) The CRT may satisfy the annuity or unitrust amount by distributing property rather than cash. A property distribution to satisfy the annual payout requirement receives treatment as a sale or exchange by the trust. See Treas. Reg. 1.664-1(d)(5).
- (3) Upon creation of a CRT, the trust instrument can reserve a power for the non-charitable beneficiary to appoint, by will, the charitable remainder beneficiaries. See Rev. Rul. 76-7, 1976-1 C.B. 179.
- (4) Upon creation of an inter vivos CRT, the grantor may reserve a power to substitute another charity as the remainder beneficiary in place of the charity named in the trust instrument. See Rev. Rul. 76-8, 1976-1 C.B. 179.

- (5) The exact name of the beneficiary does not need to appear in the trust instrument and the trustee may hold the power to name the charitable recipient of the remainder interest, pursuant to criteria specified in the trust instrument. The trust instrument may refer to the beneficiaries by class (for example, “any organization exempt under Section 501(c)(3)”). There is no requirement that any named charity know of its impending gift. However, all CRTs must provide that the trustee will transfer the remainder to a qualified charitable organization if a named organization is not qualified at the time the trust intends to pay funds to it. See Treas. Regs. 1.664-2(a)(6)(iv) and 1.664-3(a)(6)(iv).
- (6) The grantor may serve as trustee or retain the power to substitute himself or herself as trustee. See Rev. Rul. 77-285, 1977-2 C.B. 213.
 - a. However, only an independent trustee may hold the power to allocate the annuity or unitrust amount among the various named recipients. See Rev. Rul. 77-73, 1977-1 C.B. 175.
 - b. The grantor may not retain the power to name himself or herself as trustee if the trustee has the power, pursuant to the trust instrument, to allocate the annuity or unitrust among the various named recipients. See Rev. Rul. 77-285, 1977-2 C.B. 213.
- (7) The non-charitable interest is payable to a “person.” In addition to an individual, the definition of “person” includes a trust, estate, partnership, association, company, or corporation. See Section 7701(a)(1). If the income recipient is not an individual (or is a combination of an individual and charities), then the term of the trust must be a term of years, up to 20 years. See Sections 664(d)(1)(A) and 664(d)(2)(A).
- (8) The trust instrument may also give the trustee discretion to distribute a part of the annuity or unitrust income amount to a charitable recipient. However, in all cases, there must be at least one non-charitable recipient of the annuity or unitrust income amount. See Sections 664(d)(1)(A) and 664(d)(2)(A).
- (9) If a CRT described in Section 664 has any unrelated business taxable income (UBTI), then the trust is liable for an excise tax equal to 100% of the UBTI and must file Form 4720. See Section 664(c)(2).
- (10) Any organization described in Section 170(c) is a permissible remainder beneficiary. See Treas. Regs. 1.664-2(a)(6) and 1.664-3(a)(6).
- (11) Commonly, the annuity or unitrust payment is payable, in succession, to the grantor and the grantor’s spouse for life. The grantor may reserve the right to revoke, by so directing in the grantor’s last will and testament, the right of the grantor’s spouse to income in the trust. See Rev. Rul. 74-149, 1974-1 C.B. 157.

C.2. Charitable Remainder Annuity Trust (CRAT)

- (1) A CRAT pays a specific amount of money to the non-charitable beneficiary every year. The annuity can be either a stated dollar amount or a fixed

percentage of the assets' fair market value on the date contributed to the trusts. The annuity may not be less than 5%. See Section 664(d)(1)(A).

- a. The payout does not vary. Similarly, it does not matter how much income the trust earns during the year. If assets the trust holds produce substantial gains, the non-charitable income beneficiary will not benefit. If income is insufficient to support the payout, the difference comes from the corpus (principal) of the trust.
 - b. Since the CRAT pays a fixed annuity, the non-charitable income recipient receives no benefit from any annual trust asset appreciation.
- (2) The exact amount that passes to the charity is not known until the non-charitable income interest expires. Refer to applicable actuarial tables in Treas. Regs. 1.664-4 and 1.664-4A to determine the present value of the remainder interest is determined at the time of the contribution.
 - a. If the assets have appreciated, the charity will benefit.
 - b. If the trustees invaded the corpus to pay the non-charitable beneficiary, there may be little left for the charity.
- (3) For transfers made after June 18, 1997, the annuity may not exceed 50% of the fair market value of trust assets as of the date of the transfer of assets to the trust. See Section 664(d)(1)(A).
- (4) A CRAT may not receive additional property contributions either during the grantor's life or upon the grantor's death. See Treas. Reg. 1.664-2(b).
- (5) In 2003, the IRS issued a series of Revenue Procedures with approved sample trust instruments covering the various scenarios a CRAT typically involves. See Rev. Proc. 2003-53 through 2003-60, 2003-2 C.B. 230-274.

C.3. Charitable Remainder Unitrust (CRUT)

- (1) A CRUT pays a fixed percentage (at least 5%) of the fair market value of the trust's net assets valued annually. For transfers after June 18, 1997, the percentage may not exceed 50%. The dollar value of the unitrust payout differs each year because the payout depends on an annual valuation. See Section 664(d)(2)(A).
- (2) If the value of the unitrust assets increases, the payout to the non-charitable beneficiary will increase. The unitrust thus serves as a hedge against inflation, potentially benefiting the non-charitable income beneficiary.
- (3) As with the CRAT, the exact amount the charity will receive from a CRUT is unknown until the non-charitable interest terminates. The non-charitable interest terminates upon the death(s) of named person(s) or after a term of years (up to 20). See Section 664(d)(2)(A).
- (4) An inter vivos CRUT may receive additions to the trust assets by property transfers made during the grantor's life or upon the grantor's death by a provision in the grantor's will if the provisions of Treas. Reg. 1.664-3(b) are met.

- (5) In 2006, the IRS issued a series of Revenue Procedures with sample trust instruments for various scenarios involving CRUTs. See Rev. Proc. 2005-52 through 2005-59, 2005-2 C.B. 339-412.
- (6) General Counsel Memorandum 202233014 concluded that a decedent's estate could claim neither an estate tax deduction under Section 2055 nor a marital estate tax deduction under Section 2056 for the portion of a unitrust interest of a CRUT that the trustee could distribute to either a charity or decedent's spouse pursuant to the trustee's discretion. It noted that the same analysis and conclusion would apply under Section 2523 for a completed gift transfer to a CRUT with similar terms.

C.4. Net Income Charitable Remainder Unitrust (NICRUT)

- (1) Instead of a fixed percentage, the trust instrument may provide that the trustee pays annually the lesser of the unitrust amount or trust accounting income. See Section 664(d)(3)(A) and Treas. Reg. 1.664-3(a)(1)(i)(b)(1). Any amounts the trust earned in excess of the amount paid to the income beneficiary become part of the corpus and increase the amount the charity receives at the end of the trust term.
- (2) Trust accounting income is the amount of income for the tax year as determined under the terms of the trust instrument and applicable state law. See Section 643(b) and Treas. Reg. 1.664-3(a)(1)(i)(b)(3). When computing trust income, the trust includes most passive income but not capital gains, unless defined to the contrary in the trust instrument or under applicable state law. See Section 643(b) and Treas. Reg. 1.664-3(a)(1)(i)(b)(3).
- (3) Depending on the applicable state law, the trustee may charge expenses against trust income when determining the payout amount. These include administrative, management, and trustee expenses, as well as amounts expended to preserve trust property. See Treas. Reg. 1.643(b)-1.

C.5. Net Income Makeup Charitable Remainder Unitrust (NIMCRUT)

- (1) The NIMCRUT follows the same rules as the NICRUT – but with a key difference. When the trust income is less than the fixed percentage amount for any given year, a shortfall occurs because the beneficiary receives less than the fixed percentage amount. In a NIMCRUT, the trustee may “make up” this shortfall in a later year; however, the makeup funds must come from extra trust accounting income, not from principal. See Section 664(d)(3)(B) and Treas. Reg. 1.664-3(a)(1)(i)(b)(2).
- (2) **Example:** Trust A has a unitrust payout of 5%. In years 1 through 4, the trust has no net income and the unitrust payout is \$0.00. In year 5, the trust earns 8%. The trustee can use the extra 3% to make up the shortfall.

C.6. “Flip” Unitrust

- (1) A “flip” unitrust starts as either a NICRUT or a NIMCRUT. When a specific event mentioned in the trust instrument occurs, the trust “flips” or converts

automatically to a fixed percentage unitrust. This trust design is valid under Treas. Reg. 1.664-3(a)(1)(i)(c) if the trust meets certain conditions.

- (2) Generally, these conditions include linking the change in unitrust payment method to a specific date or by a single event whose occurrence is not discretionary with, or in the control of, the trustees or any other persons. See Treas. Reg. 1.664-3(a)(1)(i)(c).
- (3) Treas. Reg. 1.664-3(a)(1)(i)(d) contains a list (not all-inclusive) of permissible triggering events. These include:
 - a. Sale of unmarketable assets,
 - b. Marriage or divorce,
 - c. Death, and
 - d. Birth of a child.
- (4) Reformation of a trust to add a flip provision could result in a self-dealing transaction under Section 4941 unless the trust instrument permits such a reformation. A flip unitrust qualifying under the requirements of Section 664 and the regulations thereunder will not constitute an act of self-dealing. This includes trust reformations occurring under the effective date provisions of Treas. Reg. 1.664-3(a)(1)(i)(f). See Treas. Reg. 1.664-3(a)(1)(i)(f)(3).

C.7. Charitable Lead Trust (CLT)

- (1) Defined in Section 170(f)(2)(B), a CLT is a split-interest trust that reverses the design of the CRT. In a CLT, the charitable payment is a guaranteed annuity or fixed percentage of the fair market value of trust property, valued annually. The trust pays this amount to a charity either for a term of years or for the life or lives of specified individuals. See Section 170(f)(2)(B).
- (2) The charity receives payment first. When the trust terminates, the trustee pays the remainder interest in the trust to non-charitable beneficiaries – often the grantor or the grantor’s heirs.
- (3) In a non-grantor CLT, the trust pays the tax on income from the trust. The grantor does not receive an income tax charitable deduction for the transfer to the trust. The trust may claim a charitable deduction for any amount of gross income paid to a charity during the year. See Section 170(f)(2)(B) and Section 671.
- (4) In a grantor CLT, the grantor pays the tax on the income from the trust. The grantor gets an income tax charitable deduction for the present value of the annuity or unitrust at the time of asset transfer. Grantor CLTs are, by their nature, inter vivos trusts. See Section 170(f)(2)(B) and Section 671.
- (5) All CLTs are irrevocable. There are no net income and net income makeup variants of CLTs. See Treas. Regs. 1.170A-6(c)(2)(i)(A) and 1.170A-6(c)(2)(ii)(A).

- (6) In a CLT, there are no minimum or maximum payout rate limitations. The trust instrument states whether it permits additional contributions. Treas. Regs. 1.170A-6(c)(2)(i)(A) and 1.170A-6(c)(2)(ii)(A).

C.8. Charitable Lead Annuity Trust (CLAT)

- (1) In a CLAT, the trust pays a fixed guaranteed annuity payment to the charity. Pursuant to Treas. Reg. 1.170A-6(c)(2)(i)(A), a guaranteed annuity is an arrangement under which a determinable amount is paid at least annually, for a specified term of years or for the life or lives of certain individuals, each of whom must be living at the date of transfer and are ascertainable (identifiable) on such date.
- (2) The trust's term may be a set number of years, the lifetime of either the grantor or grantor's spouse, or a lineal ancestor (or spouse of such an ancestor) of all the non-charitable beneficiaries. See Treas. Reg. 1.170A-6(c)(2)(i)(A).
- (3) The trustee determines the amount paid to the charity based on the initial fair market value of the assets placed into the trust. Income and asset appreciation become part of the corpus. As a result, the payment to the charity becomes a smaller percentage of the trust's value over time, assuming appreciation occurs.
- (4) To determine the present value of the annuity, use the applicable interest rate listed in the tables referenced in Section 7520(c) for the month in which the grantor establishes the trust. For guidance on computing the present value of the annuity, refer to Publication 1457, Actuarial Valuations (Version 3A).
- (5) In a CLAT, it is uncommon to see a provision permitting additional contributions. Once funded, the donor cannot claim additional charitable contributions. See Treas. Regs. 1.170A-6(c)(2)(i)(C), 20.2055-2(e)(2)(vi)(d), and 25.2522(c)-3(c)(2)(vi)(d).
- (6) For examples of a CLAT trust instrument, see Rev. Proc. 2007-45, 2007-29 I.R.B. 89, as well as Rev. Proc. 2007-46, 2007-29 I.R.B. 102.

C.9. Charitable Lead Unitrust (CLUT)

- (1) In a CLUT, the trust pays a fixed percentage of the fair market value of the trust's assets to the charity. See Treas. Reg. 1.170A-6(c)(2)(ii)(A).
 - a. The trust instrument specifies the percentage value.
 - b. The trust annually revalues the assets to determine the amount of the payment.
- (2) The income generated (if any), the growth or diminishment of trust assets, and the fluctuation in market values all affect the amount paid to a charity from a CLUT. The following table shows the relationship between Return on Investment (ROI), the fixed percentage amount, and the remaining assets paid to the non-charitable remainder beneficiary.

If ROI is	Then
Positive but consistently less than the percentage payout amount	The FMV of the assets at the end of the trust term are less than the original FMV.
Always negative	The larger the loss on ROI, the less the final FMV of the assets. In all cases, the FMV will be less than the original FMV of the assets.

- (3) If the ROI is negative or less than the required percentage amount, the trustee pays the difference out of corpus.
- (4) If the ROI exceeds the payment to the charity for the year, the trust pays income tax on the excess.
- (5) In a CLUT, it is uncommon to see a provision permitting additional contributions. Once funded, the donor cannot claim additional charitable contributions. See Treas. Regs. 1.170A-6(c)(2)(ii)(C), 20.2055-2(e)(2)(vii)(d), and 25.2522(c)-3(c)(2)(vii)(d).
- (6) For examples of a CLUT trust instrument, refer to Rev. Proc. 2008-45, 2008-30 I.R.B. 224 as well as Rev. Proc. 2008-46, 2008-30 I.R.B. 238.

C.10. Pooled Income Fund (PIF)

- (1) Public charities establish and maintain PIFs to pay income to the grantor or an individual beneficiary named by the grantor, and to pass the remainder interest to charity. See Sections 642(c)(3) and 642(c)(5).
- (2) The grantor contributes property to a commingled fund (pooled income). Yearly, the charity pays out income earned by the fund to each donor or other named beneficiary in proportion to the assets each donor contributed. See Section 642(c)(5) and Treas. Reg. 1.642(c)-5(b)(2).
- (3) Upon the death of the grantor or other named income beneficiary, a portion of the assets attributable to the income interest severs from the fund and transfers to the charity. See Section 642(c)(5) and Treas. Reg. 1.642(c)-5(b)(8).
- (4) There are several differences between a CRT and a PIF.
 - a. For the PIF, the income beneficiary receives his or her full proportionate share of all trust accounting income earned by the PIF. See Section 642(c)(5)(F) and Treas. Reg. 1.642(c)-5(c)(1).
 - b. There is no predetermined annuity or fixed percentage payment amount for a PIF. See Section 642(c)(5) and Treas. Reg. 1.642(c)-5(b)(7).
 - c. Since payment from a PIF is based on income, there is never any invasion of corpus. If a PIF does not earn income in a given year, then it does not make a payment for that year. See Treas. Reg. 1.642(c)-5(b)(7).
 - d. The public charity manages the PIF (typically with help from a professional investment company). In contrast, virtually anyone (including the grantor)

can manage or serve as trustee for a CRT. See Treas. Reg. 1.642(c)-5(b)(6).

- (5) PIFs file Form 5227. However, a PIF created before May 27, 1969, does not file Form 5227 if no transfers of funds to the PIF occurred after that date. See Section 4947(a)(2)(C).
- (6) If a PIF has any taxable income, gross income of \$600 or more (regardless of taxable income), or a beneficiary who is a nonresident alien, it must file Form 1041. See Sections 6012(a)(4) and 6012(a)(5).
- (7) Section 4 of Rev. Proc. 2022-3, 2022-1 I.R.B. 111, lists issues on which the IRS ordinarily will not issue letter rulings. The issues include whether a PIF satisfies the requirements of Section 642(c)(5) and whether a transfer to a PIF is deductible as a charitable contribution under Sections 170(f)(2)(A), 2055(e)(2)(A), and 2522(c)(2)(A). In lieu of seeking advance IRS approval of PIFs, taxpayers should follow the sample trust provisions for a PIF in Rev. Proc. 88-53, 1988-2 C.B. 712. Taxpayers who follow the sample trust provisions of Rev. Proc. 88-53 are assured that the IRS will recognize the trust as meeting all the requirements for a PIF under Section 642(c)(5), provided the trust operates consistently with the terms of the trust instrument and is a valid trust under local law.

III. Examination Techniques

- (1) This section presents helpful practices for Revenue Agents conducting an exam.

A. Pre-Examination

- (1) Before examining a trust, review Training 10920-102, Fiduciary/Abusive Domestic Trusts (Participant Guide).
- (2) For guidance on domestic trusts from the Small Business/Self Employed (SB/SE) perspective, visit the Trusts Knowledge Base on the IRS Virtual Library. For guidance on trusts that may be treated as Private Foundations, visit the Private Foundations Knowledge Base and choose trusts under Section 4947.
- (3) For all cases, follow the guidance in the Internal Revenue Manual, Exempt Organization Pre-contact Procedures, for general case development.
- (4) If the trust has an ownership interest in any entity, pull Integrated Data Retrieval System (IDRS) research on the entity or entities the trust owns.
- (5) Prepare Letter 3407, Letter Requesting Copy of Trust Instruments under Regulation 1.6012, to request the following items from the trustee(s). Issuance of Letter 3407 does not constitute an examination.
 - a. The will or trust instrument, along with any amendments;
 - b. A list of assets used to initially fund the trust;

- c. A list of beneficiaries;
- d. A list of trustees;
- e. Any minutes or resolutions amending the trust; and
- f. A written declaration of the trustee(s), signed under penalty of perjury, that the trust document copies are true and complete.

B. Information Document Request

- (1) When writing the initial information document request (IDR), ask for the following items:
 - a. A complete copy of the trust instrument, including all attachments, schedules, and any amendments made to date. Treas. Reg. 1.6012-3(a)(2) requires a trustee to furnish these documents to the IRS upon request. See also Letter 3407, discussed above.
 - b. A completed and signed Form 56, Notice Concerning Fiduciary Relationship, for the current trustee(s). Where a trust instrument appoints more than one trustee, the names of all trustees must appear on Form 56 and all must sign the form. This requirement does not apply if the trust instrument provides that fewer than all trustees have authority to sign agreements and bind the trust. See Instructions to Form 56, Notice Concerning Fiduciary Relationship. Even if the fiduciaries have not signed Form 56, any written notice that includes the required information suffices. See Treas. Reg. 301.6903-1.
 - c. A completed and signed Form 2848, Power of Attorney and Declaration of Representative (if applicable).
 - d. All trustees' minutes and resolutions from the creation of the trust to the present. These include records relating to trustees' appointment, resignation, or termination, all assets transferred into the trust, and the ownership of all certificates of beneficial interest.
 - e. The identification of all former and current trustees, from the creation of the trust to the present – including the name, address, and telephone number (both business and personal) for each trustee.
 - f. A list of all certificate holders (beneficiaries) of the trust, including name, address, and Social Security Number (SSN) or Employer Identification Number (EIN).
 - g. Copies of the trust information/income tax return for the year(s) under examination. Request prior and subsequent years if applicable.
 - h. Copies of all information/income tax returns (Forms 1041, 5227, 990PF, 990, 1065, 1120, 1120S, and similar forms) filed by any entity in which the trust held an interest for the year(s) under examination.

- i. Copies of all Forms 1099 received by the trust for the year(s) under examination.
- j. Bank statements, deposit slips, debit/credit memos, and cancelled checks for all trust accounts whether U.S. or foreign, including checking and savings for the year(s) under exam.
- k. All accounting books and records for the trust for the year(s) under exam. Records should include check registers, disbursement journals, receipt journals, the general ledger, and other workpapers used to prepare the tax returns and financial statements of the trust, as well as other similar documents.
- l. A list of all entities in which the trust holds an ownership interest.
- m. Payroll ledgers and related records for the years under exam.
- n. Copies of any lease agreements entered into or in effect during the years under exam.
- o. Loan documents, including promissory notes, deeds of trust, security agreements, financial statements, and similar items, for all loans entered into or in effect during the years under exam.
- p. Records to establish the basis of all assets held by the trust, whether acquired from the grantor or otherwise, from the creation of the trust through the end of the year under exam. This includes proof of funding, invoices, purchase agreements, and the names and addresses of the persons who transferred property to the trust. For property acquired from the grantor, this includes information showing the grantor's basis in the property immediately before the transfer.
- q. Records for sales or other transfers of property during the year(s) under exam.
- r. A statement explaining the purpose of any businesses operated within the trust. If a non-trustee manages the business, the statement should include that person's name, address, and SSN. It should also explain the extent of the non-trustee business manager's ability to control the funds and other property of the trust.
- s. Copies of any contracts for business services rendered by or for the trust during the years under exam.

C. Initial Interview

- (1) When drafting the initial interview, include the following questions, as applicable:
 - a. When was the trust created?
 - b. For what purpose was this trust created?
 - c. How did you find out about trusts?

- d. Were any tax benefits of trusts explained to you?
 - e. What made you think the information you received was accurate?
 - f. Who helped you in forming this trust? (Obtain names of all involved in creation of the trust.)
 - g. Did you consult with an attorney or certified public accountant (CPA)? If so, whom? If not, why?
 - h. What advice did they give you? Was it written? If so, please provide copies.
 - i. Did you use a trust package? If so, from whom was it purchased?
 - j. What services did the individuals from whom you bought the trust package provide?
 - k. How much were you charged for these services?
 - l. Do you have a copy of the invoice for the services rendered?
 - m. Who paid for the services? How were the services paid for?
 - n. Did you deduct this amount? If so, where?
 - o. Did you receive any promotional materials, software or instructional manuals? If yes, describe and provide copies.
 - p. What assets were contributed or transferred into this trust, and by whom?
 - q. Was control of these assets relinquished? If so, who controls the assets now?
 - r. What, if anything, was received in exchange for these assets?
 - s. Did you file gift tax returns reporting the assets transferred into the trust? If not, why? If so, provide copy of return.
 - t. Who appointed the trustee(s)? Why was he or she selected?
 - u. Is there any relationship between the trustee(s) and the grantor?
 - v. Explain the trustee's participation, if any, in the operation of any businesses conducted by the trust.
 - w. Please provide the following information with respect to any and all trusts associated with this trust: name, taxpayer identification number (TIN), trustee, protector, beneficiaries, situs of trust (domestic or foreign).
 - x. Please provide the names and TINs of all other trusts in which you have any type of involvement as a grantor, investor, trustee, beneficiary, manager, protector, or similar capacity.
- (2) During the initial interview, also include, as applicable, the following questions with respect to financial, banking, and business activities conducted by the trust:

- a. Who manages the business? Is the manager a trustee?
- b. Who controls the business assets?
- c. Who makes the day-to-day decisions?
- d. Where does the trust do its banking? (Obtain bank name and account number.)
- e. Who has signature authority over the trust bank accounts?
- f. How are bills approved for payment?
- g. How are the checks signed? (Clarify whether rubber stamped, signed in advance, by whom, and similar details.)
- h. Do you hold any position with respect to this trust, such as general manager, agent, or employee?
- i. Are you compensated by this trust in any way?
- j. Do you have possession or use of any of the trust's assets?
- k. Does the trust pay rent for any property? If so, what property does the trust rent and for what amount?
- l. Does the trust make payments for services or products to any other trust?
- m. Were any loans made out of this trust? If so, to whom, when, and for what amount?
- n. Has the trust received repayment for any loans it made?

D. Field / Office Correspondence

- (1) Conduct a careful review of the trust instrument. The trust instrument should identify the purpose of the trust, the property transferred and the appointment and authority given to the trustees.
- (2) Some trust instruments may discuss the role of a "protector" or similar device to allow the beneficiaries to retain control over the trustees. This person has the power to remove a trustee at the direction of the beneficiary.
- (3) Question any person involved in the operation of businesses conducted by the trust. Determine who has control over the bank accounts, makes the day-to-day decisions, and has use and control over trust assets. Does the trustee exercise control over the business operations?
- (4) Question taxpayers regarding how they learned about trusts as a method of doing business. This could indicate whether they received advice from a knowledgeable professional or whether they bought a trust package from a promoter.
- (5) If an issue arises that falls under the jurisdiction of another business unit, including Large Business and International/Small Business/Self Employed or

Estate and Gift Tax, request assistance via the Specialist Referral System (SRS).

E. Procedures

- (1) Since NECTs described in Section 4947(a)(1) and split-interest trusts described in Section 4947(a)(2) are not exempt from taxation under Section 501(a), they are not subject to revocation procedures. See Section 4947(a).
- (2) Although an NECT described in Section 4947(a)(1) may receive recognition as a Section 509(a)(3) supporting organization, the trust may lose this recognition and consequently receive treatment as a private foundation. Apply final adverse determination letter procedures in this situation.

For example, consider a Section 4947(a)(1) trust that previously qualified for recognition as a Section 509(a)(3) supporting organization (operated in connection with a supported organization). After the Pension Protection Act of 2006, the trust no longer qualified due to the elimination of the alternative responsiveness sub-test 2. Going forward, the trust receives treatment as a private foundation.

- (3) In exams of NECTs or split-interest trusts, consider the following related issues:
 - a. Employment tax cases such as worker reclassification, fringe benefit treatment, and unreported amounts,
 - b. Income tax cases (Form 1041, discrepancy adjustments), and
 - c. Excise tax cases (gaming and/or Chapter 42 taxes). Discuss with the group manager whether to close the related cases separately at the earliest opportunity, or together.
- (4) For NECTs only, a Form 990 can close as a no change/no change with advisory if there is no modification to the foundation status. An NECT that receives recognition as a Section 509(a)(3) supporting organization must file Form 990.
- (5) For NECTs only, a Form 990-PF can close as a no change/no change with advisory if there is no modification to the Section 4940(b) tax or foundation status. An NECT that does not qualify for recognition as a Section 509(a)(3) supporting organization must file Form 990-PF.
- (6) See the Internal Revenue Manual for case closing procedures, case file assembly and other related procedures, applicable to trusts.

IV. Issue Indicators / Audit Tips

- (1) This section presents possible issue indicators and audit tips that apply when examining a trust described in either Section 4947(a)(1) or Section 4947(a)(2). A brief review of Abusive Trusts is also included.

A. Issue Indicators

- (1) A return that lists a trust as the fiduciary or lists the same person or entity as both fiduciary and beneficiary is unusual for an irrevocable trust, and merits attention.
- (2) Be mindful of any indication of involvement with a country that is a known tax haven – for example, a beneficiary or trust located in such a country.
- (3) Generally, a trust should not operate an active business. Two exceptions to this rule are a trust containing a decedent's business and trusts in bankruptcy.

In the case of a decedent's estate, an active business should wind down in a reasonable period of time (generally 2 to 3 years).
- (4) Rental losses and business losses from activities in which the fiduciary fails to participate actively or materially cannot reduce interest, dividends, capital gains, or any other investment income. The trust suspends these losses on Form 8582, Passive Activity Loss Limitations.

Trusts may not take the \$25,000 rental real estate loss.
- (5) If the trust has tax-exempt income, then the trust must allocate expenses for various deductions on its Form 1041.
- (6) Any CRT that reports UBTI deserves scrutiny to determine whether it is in fact a charitable trust.
- (7) In the case of a split-interest trust, ensure that there is at least one unexpired interest that is non-charitable. If all expired interests in the trust are charitable, then it is an NECT, and the trust is subject to more extensive filing requirements and all Chapter 42 provisions.
- (8) For Form 5227, verify the CRT completed Part III of Schedule A if it indicated the return is initial or final.
- (9) Ensure any trust filing Form 5227 distributed income in the correct order:
 - a. Ordinary income
 - b. Capital gain income
 - c. Nontaxable income
- (10) Generally, only investment-type assets should appear on the balance sheet of Form 5227. Look for the same items as when reviewing a Form 990 or Form 990-PF.
- (11) If a business appears to operate through a CRT, consider the Section 664(c)(2) excise tax – as well as any applicable Chapter 42 excise taxes.
- (12) Watch for large reductions in the fair market value of assets without cause. The income payout amount from a CRUT depends on the net fair market value and can fluctuate year to year.

- (13) Chapter 42 permits the assessment of excise taxes under different statutes for the same transaction. For instance, a self-dealing transaction, Section 4941, is frequently also a taxable expenditure under Section 4945, that may also affect the net investment income (Section 4940), and the qualifying distributions (Section 4942). Section 4941 and Section 4945 can commonly occur for the same transaction. Many self-dealing transactions are not for Section 170(c)(2)(B) purposes, thus becoming taxable expenditures. But a taxable expenditure is not necessarily a self-dealing transaction, and vice versa. See Rev. Rul. 77-161, 1977-1 C.B. 358 and Treas. Reg. 53.4944-1(a)(2)(iv).

NECTs are subject to all Chapter 42 provisions, while split-interest trusts are subject to Sections 4941 and 4945 and may be subject to Sections 4943 and 4944.

B. Audit Tips

- (1) For NECTs, ensure the trust has paid its Section 4940 tax on net investment income at the rate specified in Section 4940(b).
- (2) If Schedule A of Form 1041 has an entry for an amount permanently set aside for charitable purposes and the trust came into existence on or after October 2, 1969, the trust may not claim a deduction for that amount.
- (3) If the taxpayer has attached a Section 642(c) election to the Form 1041, confirm the taxpayer properly filed the election in accordance with Treas. Reg. 1.642(c)-1(b).
 - a. If not properly filed, disallow the deduction.
 - b. If properly filed, confirm the trust paid the amounts to qualified charitable organizations in a subsequent year. If the trust did not pay these amounts, disallow the deduction.
- (4) Review the trust agreement to ensure the trust made distributions in accordance with the terms of the trust agreement.
- (5) Ensure the trust has filed all required returns and propose any applicable penalties under the facts and circumstances.
 - a. An NECT must annually file either Form 990 or Form 990-PF and must file Form 1041 if it has taxable income as well as Form 4720 if it has incurred Chapter 42 excise tax liability.
 - b. A split-interest trust must annually file Form 5227 and must file Form 1041 if it has taxable income as well as Form 4720 if it has incurred Chapter 42 excise tax liability. Remember, CRTs do not file Form 1041.
- (6) For all charitable deductions, ask the following questions:
 - a. Did the trust make the contribution to a qualified organization described in Section 501(c)?
 - b. Did the trust actually make the purported contribution?

- (7) A large charitable contribution deduction may indicate the trust is transferring monies to a related entity. Review the applicable trust instrument for authorization of contributions.
- (8) Each type of income retains its character in the trust and when the beneficiary receives it.
- (9) A trust does not distribute losses except for the final year of its existence.
- (10) The Uniform Principal and Income Act (UPIA) considers capital gain income and losses as corpus in most cases. Most states have adopted the UPIA.

However, the trust instrument may permit the trustee to change this allocation.

C. Abusive Trusts

- (1) A trust created for tax avoidance that is set up to take advantage of perceived but nonexistent tax benefits is an abusive trust. If the primary reason for creating the trust was tax avoidance, then the trust should be considered a sham trust and not recognized for tax purposes. A sham trust is a trust where the grantor does not respect the trust as a separate legal entity in accordance with the provisions of the trust instrument and applicable governing law. Indications of a sham trust are:

- a. The trust funds were used to pay the grantor's personal expenses;
- b. The grantor exercises dominion and control over trust assets as if they were the grantor's own assets;
- c. There is no independent trustee; and
- d. The beneficiaries of the trust have no enforceable economic interest in the trust funds.

See *Markosian v. Commissioner*, 73 T.C. 1235 (1980) (holding that the trust was a sham because the parties did not comply with the terms of the trust and the supporting documents and the relationship of the grantors the property transferred did not differ in any material aspect after the creation of the trust); *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984).

- (2) In addition, charitable trusts with egregious self-dealing may be an indicator of an abusive trust. Abusive Section 4947 trusts that meet the elements of a sham may be disregarded for federal income tax purposes.
- (3) In appropriate circumstances, the Service will not respect the form of the transaction. See *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935). Also see final Treas. Reg. § 1.643(a)-8(a), any transaction that has the purpose or effect of circumventing the rules in the regulations will be disregarded. See *Full-Circle Staffing, LLC, Watchman Investment Trust, Financial & Tax Services, Inc., Trustee, Tax Matters Partner, et al. v. Commissioner*, T.C. Memo. 2018-66.

- (4) The relevant factors as to whether trusts are tax-motivated and should be disregarded are whether:
- a. the taxpayers' relationship to their business and other assets changed when the trusts were created;
 - b. the trusts had an independent trustee;
 - c. an economic interest passed to other trust beneficiaries; and
 - d. the taxpayers were bound by any meaningful restrictions on the trusts' operation.

See *AMC Trust v. Commissioner*, T.C. Memo. 2005-180.

- (5) However, certain trusts are considered grantor trusts when the trust instrument provides the grantor with dominion and control over trust assets. In those cases, the grantor's control is not necessarily a sign of an abusive trust. See Sections 671-679.

V. Sample Trust Instruments for CRUT and CRATs

- (1) These revenue procedures contain annotated sample declarations of trust and alternate provisions that meet the requirements of Section 664(d)(1) of the Internal Revenue Code.
- a. Rev. Proc. 2005-52, inter vivos CRUT payable for 1 lifetime
 - b. Rev. Proc. 2003-53, inter vivos CRAT payable for 1 lifetime
 - c. Rev. Proc. 2003-54, inter vivos CRAT payable for a term of years
 - d. Rev. Proc. 2003-55, inter vivos CRAT payable consecutively for 2 lifetimes
 - e. Rev. Proc. 2003-56, inter vivos CRAT payable concurrently and consecutively for 2 lifetimes
 - f. Rev. Proc. 2003-57, testamentary CRAT payable for 1 lifetime
 - g. Rev. Proc. 2003-58, testamentary CRAT payable for a term of years
 - h. Rev. Proc. 2003-59, testamentary CRAT payable consecutively for 2 lifetimes
 - i. Rev. Proc. 2003-60, testamentary CRAT payable concurrently and consecutively for 2 lifetimes