[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8926]

RIN 1545-AX62

Prevention of Abuse of Charitable Remainder Trusts

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document finalizes regulations that modify the application of the rules governing the character of certain distributions from a charitable remainder trust. These regulations are necessary to prevent taxpayers from using charitable remainder trusts to achieve inappropriate tax avoidance. The regulations affect charitable remainder trusts described in section 664 and certain beneficiaries of those trusts.

EFFECTIVE DATES: These regulations are effective January 5, 2001. For dates of applicability of these regulations, see §§1.643(a)-8(d), 1.664-2(a)(1)(i)(e), and 1.664-3(a)(1)(i)(l).

FOR FURTHER INFORMATION CONTACT: Catherine Moore (202) 622-3070.

SUPPLEMENTARY INFORMATION:

Background

On October 18, 1999, proposed regulations (REG-116125-99) to amend §§1.643(a)-8 and 1.664-1 of the Income Tax Regulations (26 CFR Part 1) were published in the **Federal Register** (64 FR 56718) . Several written comments were received in response to the notice of proposed rulemaking, and a public hearing was held on February 9, 2000. After considering all the comments, the proposed regulations under sections 643 and 664 are adopted as revised by this Treasury decision. The comments received and the revisions made are discussed below.

Explanation of Provisions and Summary of Comments

I. General Background

The proposed regulations were issued in response to certain abusive transactions that attempt to use a section 664 charitable remainder trust to convert appreciated assets into cash while avoiding tax on the gain from the disposition of the assets. In these abusive transactions, a taxpayer typically contributes highly appreciated assets to a charitable remainder trust having a relatively short term and a relatively high payout rate. Rather than sell the assets to obtain cash to pay the annuity or unitrust amount to the beneficiary, the trustee borrows money, enters into a forward sale of the assets, or engages in some similar transaction. The borrowing, forward sale, or other similar transaction does not result in current income to the trust; thus, the parties attempt to characterize the distribution of cash to the beneficiary as a tax-free return of corpus under section 664(b)(4). The proposed regulations provide that, in this situation, the trust shall be treated as having sold a pro rata portion of the trust assets.

II. Public Comments

One commentator argued that the transactions targeted by the regulations are not abusive because they comply with the statutory changes made to section 664 by the Taxpayer Relief Act of 1997 (1997 Act), Public Law 105-34, 111 Stat. 788 (1997). Those statutory changes require that the annual payout rate to noncharitable beneficiaries not exceed 50 percent of the value of the property contributed to the charitable remainder trust and that the actuarial value of the charity's remainder interest be not less than 10 percent of the value of such property. Although the charitable remainder trusts involved in transactions targeted by the proposed regulations are drafted to comply with these statutory changes, the transactions result in the same kind of abuse that Congress was concerned about in the 1997 Act. It does not follow that because Congress did not anticipate in 1997 this latest abuse that Congress intended to allow it.

In the legislative history to the 1997 Act, Congress labeled the accelerated charitable remainder trusts it was targeting as "abusive and . . . inconsistent with the purpose of the charitable remainder trust rules." S. Rep. No. 33, 105th Cong., 1st Sess. 201 (1997). Congress noted the efforts of the Treasury Department and the IRS to combat abuse in the area through issuing proposed regulations in 1997, stating:

> The Committee intends that the provision of the Committee bill does not limit or alter the validity of regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address this or other abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries.

S. Rep. No. 33 at 201. Thus, Congress has neither prohibited nor discouraged further regulatory activity in the charitable remainder trust area. To the contrary, based on the legislative history to the 1997 Act, Congress intended the Treasury Department to continue to take all necessary action to prevent abuses in this area.

Several commentators questioned the authority to issue the regulations under section 643(a)(7). Two commentators maintained that the proposed regulations overstep the bounds of administrative rulemaking in that section 643(a)(7) was enacted along with the foreign trust provisions of the Small Business Job Protection Act of 1996 (SBJP Act), Public Law 104-88, 110 Stat. 1755 (1996), and therefore applies only to foreign trusts. One commentator, citing the introductory clause of section 664(a), "[n]otwithstanding any other provision of this subchapter," argued that the Treasury Department and the IRS are prohibited from applying section 643(a)(7) to charitable remainder trusts. Some commentators maintained that section 643(a)(7) does not authorize the promulgation of regulations imposing a deemed sale where no actual sale has occurred. These commentators implied that regulatory authority under section 643(a)(7) should be limited to the concept of distributable net income (DNI). The Treasury Department and the IRS disagree with these views.

Although the SBJP Act included dramatic changes in the foreign trust area, the trust anti-abuse rule was not limited to foreign trusts and in fact contains no reference to foreign trusts. Furthermore, the Treasury Department and the IRS believe that Congress put the anti-abuse rule in section 643 because that section contains the rules applicable to all of Part 1 of Subchapter J of the Internal Revenue Code. Section 643(a)(7) gives the Secretary of the Treasury the authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this *part*, including regulations to prevent avoidance of such purposes” (emphasis added). "Part" in this context refers to Part 1 of Subchapter J and encompasses sections 641 through 685, including section 664 governing charitable remainder trusts. The legislative history to the SBJP Act clarifies that the anti-abuse rule is not limited to foreign trusts or the DNI rules. The House Conference Report states:

> [The rule] authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or appropriate to carry out the purposes of the rules applicable to estates, trusts, and beneficiaries, including regulations to prevent the avoidance of those purposes.

H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 335 (1996).

In addition, the plain language of section 664(a) does not prohibit the promulgation of regulations that apply section 643(a)(7) to abusive charitable remainder trust transactions. Section 664(a) states in full:

> Notwithstanding any other provision of this subchapter, the provisions of this section shall, in accordance with regulations prescribed by the Secretary, apply in the case of a charitable remainder annuity trust and a charitable remainder unitrust.

This language provides that the provisions of section 664 apply in the case of a charitable remainder annuity trust and charitable remainder unitrust. The Treasury Department and the IRS, however, do not view this language as providing that no other provisions of subchapter J can apply in the case of abusive charitable remainder trust transactions. Applying these regulations to abusive charitable remainder trust transactions does not conflict with or override the provisions of section 664.

Accordingly, the Treasury Department and the IRS believe that the plain language of section 664(a) does not prohibit promulgation of these regulations.

After considering the comments questioning the authority to promulgate and finalize the proposed regulations, the Treasury Department and the IRS have concluded that the regulations are an appropriate exercise of their regulatory authority and are authorized by the regulatory authority granted to them under section 643(a)(7) and 664(a).

Another commentator, while supporting the proposed regulations in general, suggested that the regulations contain a more precise definition of the targeted abuse. In response to this comment, the stated purpose in §1.643(a)-8(a) has been modified to include a specific reference to the rules regarding the characterization of distributions from charitable remainder trusts in the hands of the recipients.

That same commentator requested clarification of whether a deemed sale by a charitable remainder trust under §1.643(a)-8(b) would generate unrelated business taxable income (UBTI) within the meaning of section 512. Section 664(c) provides that whether a charitable remainder trust has UBTI for any taxable year, and thus is subject to tax for that year, is determined under the normal rules of sections 512, 513, and 514. The proposed regulations do not affect this general rule. However, an example in the final regulations clarifies that, to the extent that a borrowing by a charitable remainder trust is recharacterized as a deemed sale by the trust under §1.643(a)-8(b), the borrowing is not “acquisition indebtedness” within the meaning of section 514(c).

Another commentator suggested eliminating the provisions in

§§1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g) of the regulations requiring that the annuity amount or the fixed percentage unitrust amount generally be paid by the end of the year for which it is due. That commentator contended that the payment rule is no longer necessary in light of the proposed regulations.

The Treasury Department and the IRS believe that the proposed regulations serve a function different from the payment rule. The proposed regulations seek to eliminate tax-free distributions from charitable remainder trusts due to manipulation of the character of distributions from those trusts. The payment rule, on the other hand, eliminates tax-free distributions from charitable remainder trusts due to manipulation of the timing of the distributions. A particular distribution could run afoul of either of these rules, or both rules.

In response to this comment, and to further clarify the different functions of the two rules, some minor changes have been made to the proposed regulation to eliminate references to timing and to clarify the application of the deemed sale rule. In addition, in order to make it less likely that a non-abusive trust would violate the payment rule, two new exceptions have been added to §§1.664-2(a)(1)(i)(a) and 1.664-3(a)(1)(i)(g). These new exceptions provide that a distribution of cash made within a reasonable period of time after the close of the year may be characterized as corpus under section 664(b)(4) to the extent it was attributable to (i) a contribution of cash to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, or (ii) a return of basis in any asset contributed to the trust with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522, and sold by the trust during the year for which the annuity or unitrust amount was due.

One commentator asserted that the proposed regulations should not apply to charitable remainder trusts established prior to the date the proposed regulations were published in the **Federal Register**. This commentator compared the effective date of the proposed regulations to the effective date of the 1997 Act's trust provisions. Each of the changes made by the 1997 Act applies to transfers made to trusts after the date specified in the 1997 Act, while the regulations apply to distributions made by trusts after October 18, 1999.

The Treasury Department and the IRS do not believe this assertion has merit. These effective dates are not comparable because the 1997 Act and these regulations apply to different aspects of charitable remainder trusts. The 1997 Act changed the requirements a trust must meet to qualify as a charitable remainder trust. Whether a trust qualifies as a charitable remainder trust is determined at the time property is transferred to the trust. As a result, it was appropriate to set the effective dates for the 1997 Act with respect to the time that transfers were made to a trust. The regulations, on the other hand, change the character of a distribution from a charitable remainder trust. The character of a distribution from a charitable remainder trust is not determined until after the distribution is made. Accordingly, the regulations can be applied, without being retroactive, to distributions made after the date the proposed regulations were filed with the **Federal Register**. Section 7805(b)(1). Furthermore, the Treasury Department and the IRS would have had the authority under section 7805(b)(3) to write regulations that take effect retroactively to prevent abuse. The abuse targeted by these regulations is well documented in Notice 94-78 (1994-2 C.B. 555), the legislative history to the 1997 Act, the changes to the charitable remainder trust regulations that were finalized in 1998 (TD 8791, 1999-5 I.R.B. 7), and Notice 2000-15 (2000-12 I.R.B. 826).

Finally, the preamble to the proposed regulations requested comments on two specific issues: (1) whether there are situations where the application of the proposed regulation would be inappropriate, and (2) whether an approach that more directly related the distributed funds to the asset that is the subject of the borrowing or forward sale would be more appropriate. No comments were received on either of these issues.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the understanding of the Treasury Department and the IRS that the number of charitable remainder trusts engaging in transactions affected by these regulations is not substantial, and none are small entities within the meaning of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the preceding notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Mary Beth Collins and Catherine Moore, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.643(a)-8 also issued under 26 U.S.C. 643(a)(7). * * *

Par. 2. Section 1.643(a)-8 is added to read as follows:

<u>§1.643(a)-8 Certain distributions by charitable remainder trusts</u>.

(a) <u>Purpose and scope</u>. This section is intended to prevent the avoidance of the purposes of the charitable remainder trust rules regarding the characterizations of distributions from those trusts in the hands of the recipients and should be interpreted in a manner consistent with this purpose. This section applies to all charitable remainder trusts described in section 664 and the beneficiaries of such trusts.

(b) <u>Deemed sale by trust</u>. (1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year in which a distribution of an annuity or unitrust amount is made from the trust, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount would (but for the application of this subparagraph (b)) be characterized in the hands of the recipient as being from the category described in section 664(b)(4) and exceeds the amount of the previously undistributed

(i) cash contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), plus

(ii) basis in any contributed property (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522) that was sold by the trust.

(2) Any transaction that has the purpose or effect of circumventing the rules in this paragraph (b) shall be disregarded.

(3) For purposes of paragraph (b)(1) of this section, "trust assets" do not include cash or assets purchased with the proceeds of a trust borrowing, forward sale, or similar transaction.

(4) Proper adjustment shall be made to any gain or loss subsequently realized for gain or loss taken into account under paragraph (b)(1) of this section.

(c) Examples. The following examples illustrate the rules of paragraph (b) of this section:

Example 1. Deemed sale by trust. Donor contributes stock having a fair market value of $2 million to a charitable remainder unitrust with a unitrust amount of 50 percent of the net fair market value of the trust assets and a two-year term. The stock has a total adjusted basis of $400,000. In Year 1, the trust receives dividend income of $20,000. As of the valuation date, the trust's assets have a net fair market value of

$2,020,000 ($2 million in stock, plus $20,000 in cash). To obtain additional cash to pay the unitrust amount to the noncharitable beneficiary, the trustee borrows $990,000 against the value of the stock. The trust then distributes $1,010,000 to the beneficiary before the end of Year 1. Under section 664(b)(1), $20,000 of the distribution is characterized in the hands of the beneficiary as dividend income. The rest of the distribution, $990,000, is attributable to an amount received by the trust that did not represent either cash contributed to the trust or a return of basis in any contributed asset sold by the trust during Year 1. Under paragraph (b)(3) of this section, the stock is a trust asset because it was not purchased with the proceeds of the borrowing. Therefore**,** in Year 1, under paragraph (b)(1) of this section, the trust is treated as having sold $990,000 of stock and as having realized $792,000 of capital gain (the trust's basis in the shares deemed sold is $198,000). Thus, in the hands of the beneficiary, $792,000 of the distribution is characterized as capital gain under section 664(b)(2) and $198,000 is characterized as a tax-free return of corpus under section 664(b)(4). No part of the $990,000 loan is treated as acquisition indebtedness under section 514(c) because the entire loan has been recharacterized as a deemed sale.

Example 2. Adjustment to trust's basis in assets deemed sold. The facts are the same as in Example 1. During Year 2, the trust sells the stock for $2,100,000. The trustee uses a portion of the proceeds of the sale to repay the outstanding loan, plus accrued interest. Under paragraph (b)(4) of this section, the trust's adjusted basis in the stock is $1,192,000 ($400,000 plus the $792,000 of gain recognized in Year 1). Therefore, the trust recognizes capital gain (as described in section 664(b)(2)) in Year 2 of $908,000.

Example 3. Distribution of cash contributions. Upon the death of D, the proceeds of a life insurance policy on D's life are payable to T, a charitable remainder annuity trust. The terms of the trust provide that, for a period of three years commencing upon D's death, the trust shall pay an annuity amount equal to $x annually to A, the child of D. After the expiration of such three-year period, the remainder interest in the trust is to be transferred to charity Z. In Year 1, the trust receives payment of the life insurance proceeds and pays the appropriate pro rata portion of the $x annuity to A from the insurance proceeds. During Year 1, the trust has no income. Because the entire distribution is attributable to a cash contribution (the insurance proceeds) to the trust for which a charitable deduction was allowable under section 2055 with respect to the present value of the remainder interest passing to charity, the trust will not be treated as selling a pro rata portion of the trust assets under paragraph (b)(1) of this section. Thus, the distribution is characterized in A's hands as a tax-free return of corpus under section 664(b)(4).

(d) Effective date. This section is applicable to distributions made by a charitable remainder trust after October 18, 1999.

Par. 3. Section 1.664-1 is amended as follows:

1. Paragraph (d)(1)(iii) is redesignated as paragraph (d)(1)(iv).

2. New paragraph (d)(1)(iii) is added.

The addition reads as follows:

§1.664-1 Charitable remainder trusts.

* * * * *

(d) * * *

(1) * * *

(iii) Application of section 643(a)(7). For application of the anti-abuse rule of section 643(a)(7) to distributions from charitable remainder trusts, see §1.643(a)-8.

* * * * *

Par. 4. §1.664-2 is amended as follows:

1. Paragraphs (a)(1)(i)(a)(1) and (a)(1)(i)(a)(2) are revised.

2. Paragraph (a)(1)(i)(a)(3) is added.

3. Paragraph (a)(1)(i)(e) is amended by adding a sentence at the end.

The revision and additions read as follows.

§1.664-2 Charitable remainder annuity trust.

(a) * * *

(1) * * * (i) * * *

(a) * * *

(1) The trust pays the annuity amount by distributing property (other than cash) that it owned at the close of the taxable year to pay the annuity amount, and the trustee

elects to treat any income generated by the distribution as occurring on the last day of the taxable year in which the annuity amount is due;

(2) The trust pays the annuity amount by distributing cash that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); or

(3) The trust pays the annuity amount by distributing cash received as a return of basis in any asset that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), and that is sold by the trust during the year for which the annuity amount is due.

* * * * *

(e) * * * Paragraphs (a)(1)(i)(a)(2) and (3) of this section apply only to distributions made on or after January 5, 2001.

* * * * *

Par. 5. §1.664-3 is amended as follows:

1. Paragraphs (a)(1)(i)(g)(1) and (a)(1)(i)(g)(2) are revised.

2. Paragraph (a)(1)(i)(g)(3) is added.

3. Paragraph (a)(1)(i)(l) is amended by adding a sentence at the end.

The revision and additions read as follows.

* * * * *

(g) * * *

(1) The trust pays the unitrust amount by distributing property (other than cash) that it owned at the close of the taxable year, and the trustee elects to treat any income

generated by the distribution as occurring on the last day of the taxable year in which the unitrust amount is due;

(2) The trust pays the unitrust amount by distributing cash that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522); or

(3) The trust pays the unitrust amount by distributing cash received as a return of basis in any asset that was contributed to the trust (with respect to which a deduction was allowable under section 170, 2055, 2106, or 2522), and that is sold by the trust during the year for which the unitrust amount is due.

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(l) * * * Paragraphs (a)(1)(i)(g)(2) and (3) of this section apply only to distributions made on or after January 5, 2001.

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Commissioner of Internal Revenue

Approved:

Secretary of the Treasury