CHARITABLE REMAINDER TRUSTS CAN BE DIVIDED UPON DIVORCE WITHOUT RISKS OF SELF-DEALING OR A TERMINATION TAX

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EXECUTIVE SUMMARY:

When divorces occur a division of the assets takes place. But what happens when the spouses each have rights to payments from a charitable remainder unitrust? The divorcing spouses would likely want to "split" the CRT (and its assets) in half so that each spouse could receive payments from his or her own CRT and have the sole right to select the charitable organization to receive the payments upon his or her death. A recent private letter ruling, PLR 200824022, immediately followed by Revenue Ruling 2008-41, demonstrates that such a division of an existing CRT can be done without unfavorable tax consequences. In addition, these rulings are instructive since they point out the rules affecting private foundations that also apply to charitable remainder trusts.

FACTS:

The Revenue Ruling presented two Situations.

In Situation 1, either a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) was assumed to exist (the "Trust"). The Trust had two or more individual beneficiaries ("recipients") with equal shares of the annuity or unitrust distributions. The share of a recipient who died would be split equally between or among the surviving recipients. The last surviving recipient would have rights to the entire annuity or unitrust payouts. The assets of the Trust would be paid to a charitable organization described in IRC section 170(c) upon the death of the surviving recipient. A state court then approves a pro rata division of the Trust assets among separate but equal trusts and each new separate trust qualifies as the same CRAT or CRUT as the Trust. Importantly each asset of the Trust is equally divided among the separate trusts. Each new separate trust has the same governing provisions as the Trust but there are significant differences. First, each separate trust has only one recipient (i.e. non-charitable beneficiary). Second, each separate trust is administered and invested independently by its own independent trustee. Third, and very interestingly, upon the death of a recipient, the assets of that respective separate trust, instead of going to a charity, is split equally and distributed to the remaining separate trust(s), resulting in an increase in the distributions to the surviving recipient of each respective separate trust. Only upon the death of the last surviving recipient are the assets distributed to the remainder beneficiary, the charity ("Charity"). This Charity (whether one or more) is the same for the Trust and each of the separate trusts. Thus a recipient of a separate trust does not have the right to change the remainder charity. Each recipient is to receive the same annuity or unitrust amount that was to be distributed to that recipient by the Trust. In essence then, "the recipients and the remainder beneficiaries are entitled to the same benefits after the division of the Trust as before." Finally, but importantly, all costs associated with this division of the Trust, and the creation and funding of the separate trusts, will be paid by the recipients only. The trustee(s) will pay none of these costs.

In Situation 2, the facts are the same as in Situation 1 except the Trust has only two recipients, a married couple, who are obtaining a divorce. In addition, upon the death of a recipient, the assets of that recipient's separate trust will be distributed to the remainder beneficiary as is typical. But similar to Situation 1, each recipient (spouse) will receive the same annuity or unity trust amount as would have been received under the Trust. However, any "survivorship rights" that may have existed with the Trust are relinquished upon the division into separate trusts.
These facts differ in a couple of interesting ways from the facts in the PLR. First, the PLR only dealt with the split of the CRT upon the divorce of Husband and Wife. Second, under the CRT in the PLR, the Husband was the sole current beneficiary and the Wife's rights arose only upon the death of the Husband. Third, each spouse retained a survivorship interest in the other's unitrust amount from the separate trust. Fourth, each spouse could name and then change the remainder beneficiary of his or her own separate trust but could not change the remainder beneficiary of the other spouse's separate trust. Finally, the trustee of Trust paid a portion of the legal fees and filing fees incurred with respect to the PLR.

DISCUSSION:

The Revenue Ruling discussed and analyzed five separate issues. A brief review of each follows.
ISSUE 1: Does the division of the original CRT that qualified under IRC section 664(d) cause that CRT and the new separate trusts to fail to qualify as CRTs under IRC section 664(d). The Revenue Ruling first reviews the various criteria for qualifying as a charitable remainder annuity trust (CRAT) or as a charitable remainder unitrust (CRUT). The differences between the two are also pointed out, i.e. the distribution from a CRAT is an amount equal to a percentage (no less than 5% but not greater than 50% of the net fair market value of the assets placed in the trust) while the distribution from a CRUT is determined by applying that percentage against the FMV of the assets of the CRUT each year. It is also noted that no additional contributions can be made to a CRAT but additional contributions can be made to a CRUT if certain requirements are satisfied. After reviewing the various criteria, the pertinent facts are pointed out. First, each asset of the Trust will be divided on a pro rata basis among the separate trusts. Second, each separate trust has (i) the same governing provisions as the Trust, with specified exceptions, (ii) the same recipients and (iii) the same remainder beneficiaries, collectively, as the Trust. The Service notes that because of the pro rata division the total annuity amount or unitrust percentage paid after the division will be the same as under the Trust. As a result, each recipient and remainder beneficiary will have the same beneficial interest after the division as before. Very interestingly, the Service then concludes that the transfer of assets among the separate trusts at the death of a recipient in Situation 1 will not be treated as a "transferred remainder interest that would violate IRC sections 664(d)(1)(C) or 664(d)(2)(C), and will not be treated as a prohibited additional contribution to a CRAT. With respect to Situation 2, the Service concludes that the annuity amount or the unitrust percentage will be the same both before and after the division, except that each spouse will have relinquished his or her respective survivorship right. Based on the above, the Service concludes that contemplated divisions will not result in disqualifying the Trust nor the separate trusts as CRTs.

ISSUE 2: When a CRT is divided pro rata into two or more separate trusts, will each separate trust obtain the same pro rata share of the basis of each asset received as the basis for that share would have been if retained in the Trust, and will each separate trust's holding period for each asset

received include the holding period of the Trust before the division? IRC section 1015(b) provides that if property is acquired by transfer in trust, the basis will remain the same as before the transfer (unless there was any recognized gain or loss). Then, if the same basis is retained because there was no gain or loss from a sale or exchange, IRC section 1223(2) states that the holding period of the transferor will be included in the holding period of the transferee. Here, the transferor is the Trust and the transferee(s) are the separate trusts created by the division. The Service then states that the pro rata division of Trust into separate trusts is not a sale, exchange or other disposition producing gain or loss. Consequently, the basis of each separate trust's share of each asset received is the same share of the basis of that asset as held by the Trust immediately before the division. Thus the holding period of each asset received by a separate trust will include the holding period of the Trust with respect to that asset.

ISSUE 3: Does the pro rata division of the CRT into separate trusts result in the termination of the CRT under IRC section 507(a)(1) as a trust described in, and subject to, the private foundation provisions of IRC section 4947(a)(2) with the further result of incurring the excise tax under IRC section 507(c)? Since the CRT is a split-interest trust described in section 4947(a)(2), it is treated as if it were a private foundation and thus subject to section 507 termination rules. This is so despite the fact that the CRT is not a section 501(c)(3) nor a section 4947(a)(1) private foundation. But this treatment as a "private foundation" does not apply with respect to any amounts payable under the terms of a CRT to its income beneficiaries (unless a deduction was allowed for those distributions under IRC sections 170(f)(2)(B), 2055(e)(2)(B) or 2522(e)(2)(B)). A "termination" of a private foundation occurs either by: (1) notifying the Service, or (2) the Service involuntarily terminates the foundation because of willful and flagrant acts. If such a termination happens then a "termination tax" is imposed. But the IRS concluded that the proposed transfer of 100% of the assets of the original CRT to the separate trusts would qualify as transfers meeting the requirements of a "significant disposition of assets" under sections 1.507-3(c)(1) and (2)(ii). Based on being "significant disposition of assets", the transfers of the Trust's assets to the separate trusts will not result in the new separate trusts being treated as newly created private foundations but, rather, will succeed to the Trusts aggregate tax benefit under IRC section 507(d). In addition, the IRS ruled that there would not be an imposition of an excise tax under section 507(c) because the transferor trust, CRT, will not be giving notice of its intent to terminate. Consequently, based on the above findings, the division of the CRT will not result in a tax under section 507(c) since that section is only applicable upon a termination of a charitable remainder trust's status as a private foundation. But it is important to note that the Service again stressed that the separate trusts had the same governing provisions as the Trust, and collectively, had the same recipients, remainder beneficiaries and assets as the Trust. Moreover, the benefits for the recipients and the remainder beneficiaries would be the same after the division as before. In summary, the Trust did not terminate its private foundation status because of the division (or in Situation 1, a subsequent consolidation of the separate trusts resulting from the death of a recipient) because no notice of termination would be required to be filed. With no "notice of termination," no excise tax would be imposed under IRC section 507(c).
ISSUE 4: If a CRT is divided pro rata into two or more separate trusts, does the division constitute an act of self-dealing under IRC section 4941? The importance of IRC section 4947(a)(2) is again highlighted since it this section that makes split-interest trusts, like CRTs, subject to the self-dealing rules of IRC section 4941 (except for the non-deductible distributions to the income beneficiaries). Self-dealing occurs when an "act of self-dealing" is completed between a private foundation and a

disqualified person. Examples of self-dealing include (i) sales, exchanges or leasing between the private foundation and the disqualified person, and (ii) transfers to the disqualified person of the income or assets of the private foundation. The IRS first noted that under IRC section 4946, the recipients of the Trust (and likely the separate trusts after division) might be disqualified persons with respect to Trust. But the IRS then stated that the only interest that recipients have in the Trust is the payment of the annuity or unitrust amount pursuant to section 664(d)(1) or (2). Then the IRS again emphasized: (1) each separate trust would hold a pro rata (in these cases, equal) share of each asset of the Trust, (2) after the division each recipient receives his or her annuity or unitrust payment from only one of the separate trusts, and (3) the annuity or unitrust payment a recipient receives from the separate trust remains equivalent to that recipient's share of any annuity or unitrust payment from the Trust if no division occurred (with the exception of the relinguished survivorship rights initially existing in Situation 2). The IRS then concludes: (1) the annuity or unitrust interests or distributions are insulated from the self-dealing rules, (2) because of the equal division of the Trust's assets among the separate trusts, none of the possible disqualified persons (i.e. the recipients) receives a disproportionate interest in the Trust assets, (3) the division does not constitute a self-dealing transaction(e.g. a sale or exchange between a private foundation and a disqualified person), (4) the remainder interests are preserved exclusively for charitable interests and these interests are not diminished by the division, (5) all legal and other expenses and costs incident to the division are paid by the recipients and not by the trustees of the Trust or separate trusts (this point seems to be in contrast to the PLR where the IRS approved the payment of a reasonable part of the costs of obtaining the PLR by the various trustees. The significance, if any, of this difference will have to be explored later.) and (6) the principal of the Trust is not affected by any of the described transactions. Thus, the division of the Trust is not an act of self-dealing, nor is the subsequent consolidation of the separate trust resulting from the deaths of the recipients. This re-merging of the once separate trusts will likely also receive further analysis.

ISSUE 5: When a CRT is divided pro rata into two or more separate trusts, does this division constitute a taxable expenditure under IRC section 4945? A CRT (whether a CRAT or a CRUT), being a split-interest trust, is made subject to the taxable expenditure rules of IRC section 4945 as if it were a private foundation by IRC section 4947(a)(2) (but excluding its non-deductible distributions). IRC section 4945(d) provides that a taxable expenditure includes any amount paid or incurred by a private foundation as a grant to an organization unless the granting foundation exercises expenditure responsibility over such grant to make sure the oversight requirements of IRC section 4945(h) are satisfied. In ruling that there will not be a "taxable expenditure" stemming from the division of CRT, the IRS again points to section 507(b)(2) and related regulations which state that a transfer of assets pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization or reorganization to an organization that is treated as a section 501(c)(3) private foundation by virtue of section 4947 is not a "taxable expenditure" under section 4945(d). For example, under one regulation, if a CRT treated as a private foundation has disposed of all of its assets, then during that period when it has no assets, neither the "taxable expenditure" nor the "expenditure responsibility" rules will apply to the CRT or the grantee. In addition, if a CRT, a deemed private foundation, transfers all of its assets to another private foundation which is controlled by the same person(s) controlling the CRT, then this transferee private foundation will not be viewed as a new private foundation but simply as if it were the transferring private foundation. This is based on section 507(b)(2) which states that in the case of any of the above listed transactions between two

private foundations, the transferee private foundation will not be treated as a newly created organization. Consequently, the IRS concludes that the division of CRT and the transfer of its assets to the separate trusts will not be "taxable expenditures" and, as a result, will not impose "expenditure responsibility" on the original CRT. With no prior distributions subject to expenditure responsibility, the separate trusts do not inherit any expenditure responsibility. The IRS again notes that the above favorable analysis will also apply to the subsequent consolidation of the separate trusts as the recipients pass away.

CONCLUSION:

The IRS has presented an interesting solution to a likely intractable problem of addressing a CRT in a divorce so long as the rules regarding pro rata asset division and retention of original recipients and remainder beneficiaries, and their respective benefits, are followed. The requirement in Situation 1 for re-merging or consolidating the separate trusts, created upon the original division, as the recipients pass away will likely generate some interesting analysis as time goes on.

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