The Family Charitable Remainder Trust: Achieving Wealth Transfer and Charitable Goals in an Income Tax–Efficient Manner

*By Clay R. Stevens**

Clay R. Stevens discusses a strategy for combining a charitable remainder trust, sale to a defective grantor trust and family limited partnership to create income tax and estate tax benefits while benefiting charity.

"The report of my death was an exaggeration," once uttered by Mark Twain, may now be applicable to the federal estate tax.[1] Because of the uncertainty regarding the estate tax,[2] many taxpayers are reluctant to proceed with techniques designed to reduce their overall estate tax despite the fact their estates are growing rapidly. For those willing to do some planning, however, several planning ideas are becoming more widely used, including grantor retained annuity trusts (GRAT) and sales to defective grantor trusts (DGT) since such vehicles minimize any resulting gift tax.[3] However, these techniques may not work well for some assets, such as highly appreciated marketable securities portfolios, since such assets typically cannot produce significant income without being sold at a gain.[4]

On the income tax side, charitable remainder trusts (CRT) have been available as a charitable planning vehicle since 1969.[5] However, their effectiveness as an income tax planning vehicle has steadily decreased with the most dramatic changes occurring in 1997.[6] The most significant change was the added requirement that the present value of the charitable remainder be equal to at least 10 percent of the fair market value of the property contributed, which effectively decreased the use of CRTs for taxpayers without significant charitable intent.[7] Additionally, the reduction of the federal income tax rates since 2001 also decreased the income tax benefit of the CRT by reducing the value of the income tax deduction available for the contribution.[8] As a result, these factors discourage taxpayers without substantial charitable intent from using CRTs.[9] While some taxpayers have sought out more aggressive uses of CRTs and charitable entities to increase the tax benefit and therefore justify their use, most of these have been legislatively shut down or challenged.[10] One such technique that was shut down involved the combination of a CRT with a wealth transfer vehicle in an attempt to provide a dual income tax and wealth transfer benefit.[11] However, at least one technique, the "Family Charitable Remainder Trust,"[12] does increase the overall tax benefit of the CRT without subjecting it to increased scrutiny by combining the CRT with well-accepted estate planning techniques in a unique way.

As this article will explore, the Family Charitable Remainder Trust (FCRT) allows a taxpayer with an

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appreciated asset and a desire to both diversify his portfolio and pass wealth to successive generations to achieve both goals without any immediate income tax and without substantial transfer tax. Additionally, the use of the FCRT will provide the taxpayer an immediate income tax deduction and provide a significant benefit to the taxpayer's favorite charity, which might include the taxpayer's own private foundation. This article will first examine the various well-established techniques utilized within the structure: (i) the charitable remainder trust, (ii) a family limited partnership, and (iii) a sale to a defective grantor trust. Then, the article will demonstrate both narratively and numerically how the various structures can be combined to achieve these results for various assets. Lastly, the article will explore how the FCRT differs from other techniques and discuss the main considerations in implementing the structure.

I. Tax Planning Structures

A. Use of Entities in Transfer Tax Planning

The use of entities such as family limited partnerships and limited liability companies (herein, "FLP")[13] as part of a wealth transfer plan is widespread.[14] These entities are created for a variety of reasons,[15] one of which is the use of entities to facilitate wealth transfers of the underlying assets without transfer of control.[16] Typically, these transfers garner minority and marketability discounts and thereby reduce the overall transfer tax cost of the transfer.[17] The IRS is constantly seeking ways to challenge a taxpayer's ability to reduce his estate by using these fractional interest discounts.[18] To date, however, these efforts have been unsuccessful in completely eliminating their use in lifetime planning.[19]

Much of the IRS's recent effort has shifted to challenging the magnitude of the discount taken or attempting to include the assets in poorly designed or administered plans in the taxpayer's estate upon his death.[20] However, if a taxpayer creates an entity well in advance of death, transfers only a portion of his assets to the entity, does not retain direct control over the entity, and administers the entity properly, the IRS will have fewer reasons to challenge the use of such entities in a transfer tax planning context.[21] Therefore, unless Congress acts to amend the rules permitting the use of such entities in a transfer tax planning context,[22] these entities will continue to be part of legitimate estate planning strategies.

B. Charitable Remainder Trusts

Charitable remainder trusts are statutorily approved vehicles that taxpayers can use to defer recognition of income tax on the sale of appreciated property.[23] To the extent appreciated assets are contributed to the charitable remainder trust in advance of disposition,[24] a taxpayer can effectively diversify his holdings and defer recognition of any gain until the taxpayer receives distributions from the charitable trust.[25] In fact, depending upon the future investment of the sale proceeds, the gain might be permanently deferred.[26]

The rules governing charitable remainder trusts broadly define "taxpayer" to permit individuals as well as entities to create such vehicles.[27] However, if an entity creates the charitable remainder trust, the rules limit the term of the retained interest to 20 years.[28] At the end of the term, the balance of the trust must be distributed to charity.[29] While charity can include a taxpayer's own private foundation,[30] some portion of the benefit of the deferred income tax effectively will pass to charity. For this reason, the taxpayer receives a charitable income tax deduction equal to the value of the remainder interest upon creation of the trust.[31] Even with this immediate charitable deduction, however, a traditional charitable remainder trust is not the best planning vehicle if a taxpayer does not have strong charitable intent due to the lower payout rates necessitated by the 10-percent remainder requirement.[32] In fact, assuming the reinvested assets of a standard charitable remainder annuity trust produce a 10-percent total return, it may take as many as 18 years before the taxpayer breaks even, when the after-tax benefit to the donor is better than if the donor had not used the charitable remainder trust.[33] While the charitable remainder trust provides a substantial benefit to charity at the end of the term, a standard charitable remainder trust may not provide enough of a benefit alone to justify its use for a nonphilanthropic taxpayer.

C. Sale to Defective Grantor Trust

A grantor trust in its most simple form is a trust containing certain "prohibited" provisions causing all income of the trust to be taxed to the taxpayer who transferred property to the trust. While all revocable trusts, such as living trusts, are automatically grantor trusts, certain irrevocable trusts are also grantor trusts. The grantor trust rules were originally adopted to curb

income tax abuse, but taxpayers began using the trusts for estate planning purposes shortly thereafter. The benefit is derived from the dichotomy whereby the grantor retains prohibited rights over the trust, causing it to be "defective" for income tax purposes, but such rights do not prevent the trust from being "effective" for estate tax purposes in that the trust is not included in the grantor's estate.

When a trust contains provisions requiring it to be classified as a grantor trust, two main income tax characterizations result. First, any income generated by the trust must be taxed to the grantor and is not imposed on the trust.[34] As a result, the trust assets compound income tax–free and any income tax otherwise payable the trust and imposed on the grantor is effectively a gift tax–free transfer from the grantor to the trust.[35] Second, and most importantly, the grantor and grantor trust are treated as one entity for all income tax purposes so that transfers between the grantor and the grantor trust have no income tax consequences.[36] This can be significant since it allows a grantor to sell appreciated assets to the trust for an installment note, effectively "freezing" the value of the asset, without recognizing any income tax on the sale. To the extent the sale is made for full fair market value, the grantor also is not deemed to have made a taxable gift upon the transfer.[37] The ability to "freeze" the value of an asset in this way makes this structure one of the most powerful estate planning tools available.

The benefits of using such structure to "freeze" the value of certain property can be dramatic. The benefits derive from several factors. First, because the grantor is required by law to pay all the income tax of the trust, the trust receives the income generated by the contributed assets tax-free.[38] If the property contributed produces significant pre-tax income, the assets can be used to repay the notes issued to the grantor more quickly and any income generated after the notes have been repaid accumulate solely for the benefit of the trust beneficiaries. Second, to the extent the taxpayer believes the value of the contributed property will appreciate significantly in the future, any appreciation above the interest rate required on the promissory notes will also accumulate to the benefit of the trust beneficiaries.

To the extent the contributed property has significant prior appreciation, the "freezing" of the asset value can be accomplished without the need for the grantor to recognize any gain on the contribution since the transfer between the grantor and the trust has no income tax consequences.[39] However, because interest and principal payments must be made on the promissory notes issued by the trust, the contributed property must often be sold to generate sufficient cash to make such payments. For example, if the taxpayer contributes appreciated securities to the trust that are expected to have great future appreciation but do not produce a substantial dividend, the securities may need to be sold at a substantial gain to repay the balance due on the notes issued by the trust.[40] For that reason, defective grantor trusts work best for property that produces significant income or property the grantor is likely to sell in the future. But, if the taxpayer does not have income-producing property and is adverse to selling highly appreciated property and recognizing the gain, this technique is not ideal. Therefore, other options should be explored for such property.[41]

II. Family Charitable Remainder Trust

As discussed above, the family limited partnership, charitable remainder trust and sale to defective grantor trust are all long-established planning techniques. The FCRT in its most simple form combines these established structures in a unique way.

The technique is ideal for a philanthropically minded taxpayer with appreciated property who is interested in transferring wealth to future generations, but who is hesitant to sell such property and incur a taxable gain. Unlike the standard charitable remainder trust that now requires significant charitable intent to produce a net tax benefit, any income tax benefit of the FCRT is compounded by the significant estate and generation-skipping transfer tax benefits. However, the charitable remainder trust is a necessary component of the structure since it allows the sale of the underlying property without immediate gain recognition. Therefore, the fact that the taxpayer's chosen charity, which can often include a private foundation, will receive a substantial benefit is only a collateral benefit, and therefore strong charitable intent is not required.

The FCRT strategy typically involves 10 steps. Many of these steps are similar to the steps necessary to implement a traditional sale to a defective grantor trust:

(1) The taxpayer must first select the appropriate property to contribute to the structure. For a traditional sale to a DGT, ideal candidates

are (i) property that produces a large amount of income relative to its value or (ii) property the grantor expects will increase substantially in value in the near future. The property often includes fractional interests in entities, such as partnerships or limited liability companies, or partial interests in real estate. For the FCRT, a good candidate for contribution is highly appreciated non–income-producing property a taxpayer is interested in selling. Ideally, the client would own such asset in a previously created family limited partnership wherein the taxpayer had previously relinquished the controlling general partnership interest to his children or trusts for the benefit of his children. Alternatively, such highly appreciated property could be placed in a newly created family limited partnership or limited liability company. However, if such property was transferred to a newly created family limited partnership, more careful attention must then be paid to mechanics of the structure to avoid the partnership assets being included in the estate of the taxpayer under a Code Sec. 2036 retained interest argument.[42] In either case, the taxpayer presumably would hold all the limited partnership interests in the entity and such interest would represent 99 percent of all interests in the entity.[43]

(2) The taxpayer must create the irrevocable trust and include certain provisions, like the power of the grantor to exchange trust property for other property of equal fair market value[44] or the power of an independent person to add charitable beneficiaries,[45] which causes the trust to be treated as a grantor trust. The grantor should not be a beneficiary of the trust, but may choose to serve as a Trustee to the extent any powers of distribution are limited to an ascertainable standard.[46] However, it is often safest for the grantor not to serve as his own Trustee and instead to simply retain the right to remove and replace the Trustee with another independent Trustee as desired. To the extent the taxpayer would eventually like the assets to pass to future generations and not be subject to estate taxation at his children's death, the trust might provide no outright distributions and instead hold the assets in trust for the benefit of each child during the child's lifetime. The child can be given broad access to the trust's assets and even serve as his or her own trustee if such distributions are limited to health, education, support and maintenance.[47] Then, the child may be given the power to appoint the property upon the child's death,[48] and absent such appointment the property can pass to such deceased child's children. If generation-skipping transfer tax exemption is properly allocated to any gifts to the trust, trust property can eventually pass estate tax–free to the taxpayer's grandchildren.

(3) The taxpayer then gifts cash or property to the trust to "seed" the trust. The transfer would be a taxable gift by the taxpayer and presumably would utilize a portion of the taxpayer's unified credit.[49] The exact amount needed to seed the trust is undetermined, but many practitioners and commentators suggest that the initial gift should be as much as 10–11 percent or more of the amount to be later sold to the trust.[50] To the extent the grantor does not wish to make such a large gift, or the grantor does not have sufficient unified credit or GST exemption, it might be possible for some third party, including a trust beneficiary or another irrevocable trust, to guarantee the debt on some portion of a later sale in order to reduce the overall gift necessary.[51] A more complicated method to reduce the size of the initial gift for larger transfers would be to first recapitalize the entity being contributed into a preferred partnership qualified under Code Sec. 2701 and transfer only the nonpreferred interest of the entire entity to the Trust. To the extent the nonpreferred interest equals 10 percent of the entire asset value,[52] the "seed" gift could be as little as one percent of the entire entity value. Assuming the grantor desires the trust be held for multiple generations, the grantor would want to allocate his generation-skipping transfer (GST) tax exemption to the gift to insulate future distributions from GST tax.[53] To the extent the taxpayer gifts cash to the trust, the trust could later use such cash as a down payment on any subsequent sale. Alternatively, if the taxpayer gifts property to the trust, such property could be used to guarantee the note issued upon any subsequent sale.

(4) With a traditional sale to a defective grantor trust, the next step would be the sale of the nonvoting interests in the entity to the trust in

exchange for an interest-bearing promissory note. With the FCRT, however, the entity being contributed to the trust would first itself create a 20-year fixed term charitable remainder unitrust.[54] The entity itself would then contribute the appreciated property to the trust in exchange for such unitrust payment.[55] Depending on the current applicable federal rate, it is typical for the trust to make annual unitrust payments to the entity equal to approximately 11 percent of the value of the charitable remainder trust, updated annually.[56] The charitable remainder trust might then sell the contributed property for diversification purposes. Since the charitable remainder trust is a tax-exempt entity, none of the gain on the sale of the appreciated property would be immediately recognized. Additionally, any charitable deduction produced by the contribution by the entity passes through the entity directly to the shareholders.[57]

(5) The taxpayer would then sell his nonvoting interests in the entity to the grantor trust for a secured promissory note bearing adequate interest.[58] The property originally gifted to "seed" the grantor trust could be used as a down payment on the sale or as collateral guaranteeing the note. In order to determine the fair market value of the interest, an outside appraiser is usually engaged to render an independent determination of fair market value of the nonvoting interests sold to the trust. In the case of the typical FCRT, the appraiser would need to determine the fair market value of a nonvoting interest in an entity holding not marketable securities but a future expectancy from a charitable remainder trust. It has been argued that any marketability discount applicable to the transfer of the nonvoting interests with the FCRT would be equal to, if not greater than, the marketability discount applicable to a standard family limited partnership holding marketable securities.[59] Additionally, the face value of the promissory note will not include the fair market value of the remainder interest passing to charity, which is equal to at least 10 percent of the fair market value of the contributed property, since the remainder interest will no longer be owned by the entity. As a result, the face value of the promissory note will be less than the fair market value of the property held by the charitable remainder trust. To minimize any potential claim by the IRS that the property was sold at less than fair market value and that a taxable gift was created upon the transfer, some commentators suggest including some type of adjustment clause in the sale document.[60] As discussed above, because the trust is a grantor trust, no gain is recognized on the sale regardless of the appreciation in the underlying property sold.[61] The note can be fully amortized, but more commonly requires only that interest payments to be made annually with a balloon payment of principal at the end of the term. However, the notes likely provide no prepayment penalty and permit the trust to repay the notes more quickly to the extent desirable.

(6) It is contemplated that the property contributed to the charitable remainder trust will be liquidated and the sales proceeds reinvested into a diversified portfolio of investments. In addition to avoiding immediate recognition of the gain on the initial sale, the charitable remainder trust will not recognize any future gain from the reinvested portfolio of investments. Gain will only be recognized upon each annual distribution from the charitable remainder trust as required by the terms of the trust.[62] The distribution can be made in cash or property, but typically is made in cash since cash can be generated at the CRT level without tax and a distribution of appreciated property causes gain recognition to the recipient regardless. If the investments are properly managed, most of the gain the recipient recognizes will be capital gain and/or qualified dividends.[63] In the case of an FCRT, the entity would therefore receive a cash distribution at the end of the year equal to approximately 11 percent of the value of the reinvested portfolio.

(7) The entity that receives the charitable remainder trust distribution can either reinvest the proceeds at the entity level or can distribute some or all of the cash received to its partners. Since distributions from the entity would likely be made *pro rata* according to the ownership of the entity, 99 percent of such cash would then be distributed to the defective grantor trust. The taxable income created by the distribution from the charitable remainder trust (regardless of whether the cash also is passed to the partners) passes *pro rata* to the partners. As a result, the taxable income passes one percent to the

general partner and 99 percent to the defective grantor trust. Since all income of the defective grantor trust passes through and is taxed to the grantor under the grantor trust rules, the defective grantor trust effectively receives 99 percent of the benefit of the charitable remainder trust distribution income tax-free.

(8) Upon receipt of a distribution from the entity, the Trustee of the defective grantor trust can use the distribution to repay the grantor any interest required under the terms of the promissory note issued above. However, because the trust is a grantor trust, the payment results in no income tax consequences to either the grantor or the trust.[64] To the extent the distribution exceeds the required interest payment, the Trustee could invest the excess and any investments would compound income tax–free to the trust since any income generated would be taxable to the grantor. Alternatively, the Trustee could use the excess amount to repay principal on the promissory note to the grantor. To the extent the Trustee used all the excess distribution to repay principal, the grantor would receive up to 99 percent of the charitable remainder trust distribution until the note had been fully repaid. To the extent the grantor does not have significant liquid assets, the grantor might require some principal payments on the note to ensure the grantor has sufficient cash to cover the income tax liability passing through the grantor trust. Lastly, the Trustee might use the excess to make distributions to the beneficiaries of the trust to allow for their current consumption.[65]

(9) The grantor could use the note payments received from the trust to pay the income taxes created by the charitable remainder trust and passing through to him.[66] Any additional amounts distributed from the trust could be used to satisfy the grantor's other spending needs or could be saved to cover future income tax liability following the full repayment of the interest and principal on the notes. Depending on the growth rate on the diversified assets inside the charitable remainder trust, the interest rate required on the promissory note at the time of sale, and the portion of the distribution used to repay interest and principal on the note, the note might be completely satisfied in eight to 12 years.[67] Following the complete repayment of the promissory note, all remaining distributions can be accumulated and reinvested at either the entity or trust level or distributed outright to the trust beneficiaries. If GST exemption was allocated to the original gifts, the trust beneficiaries could include multiple generations of descendants of the grantor.

(10) Upon the conclusion of the 20-year fixed term of the CRT, the payments to the family entity cease and the balance of the CRT assets are payable to the charitable organization(s) designated in the trust, which may include the donor's private foundation.[68] The grantors can also retain the power to change the designated charitable organizations anytime prior to the final distribution.[69] Depending upon the rate of the return of the diversified portfolio in the CRT, the amount distributable to charity can be substantial and can be used to satisfy the grantors' lifetime charitable desires.

In the end, the FCRT allowed the grantors to liquidate out of an appreciated asset without immediate recognition of the gain and convert the asset into an income stream payable to them.

III. Economics of the Family Charitable Remainder Trust

The FCRT combines both income tax and transfer tax benefits. To best illustrate these benefits, a detailed financial model must be used due to the number of variables and multiple structures. The assumptions used in creating the model will directly impact the result. The main assumptions affecting the results will be the growth rate on the assets, the grantor's income tax rates, the current minimum interest rate required for inter-family loans, and any minority and marketability discounts applicable to the contributed asset. Unlike some techniques that require overly aggressive assumptions to be effective,[70] the FCRT can produce a positive tax benefit even with more modest assumptions.

This modeling assumes the taxpayer has a family investment partnership holding $5 million of publicly traded securities with a low income tax basis of $500,000.[71] The partnership has a desire to sell the stock and diversify the investments without recognizing the state and federal capital gains tax of 23 percent. It is assumed that the current minimum interest rate is five percent[72] and the pre-tax return on the diversified portfolio provides

a total return of eight percent (one percent income and seven percent growth).[73] It is also assumed that the appraised fair market value of a transfer of nonvoting limited partnership interests in the entity will be discounted by 25 percent for minority and marketability discounts. With respect to the CRT, it is assumed to be a 20-year unitrust providing annual payments of 11.3 percent per year. Lastly, the model assumes a flat estate tax rate of 45 percent, that the taxpayer has yet to utilize any of his unified credit equivalent or GST exemption, and that the taxpayer survives the 20-year term of the CRT.[74]

Chart 1 (Family Charitable Remainder Trust) illustrates the contribution of $5 million in securities to the CRT in Year 1 and the sale without immediate income taxation. The payment in year 1 is $575,000, which represents $50,000 of ordinary income and $525,000 capital gains. Since the assets are appreciating at less than the required 11.5 percent rate of payout, the principal balance of the CRT decreases annually during the 20 years and the balance remaining at the end of the 20-year term is distributed to charity. Note that under these assumptions, all of the pre-contribution capital gains are exhausted by year 12 and some of the additional distributions are distributed as return of basis.

Chart 2 (Result to Entity with Plan) shows that all distributions from the CRT during the 20-year period would pass to the FLP and then be distributed *pro rata* to the partners according to the new ownership percentage. As a result, the DGT would receive 99 percent of the distribution and the General Partner (who in this example is not the Grantor) would receive one percent. The General Partner, however, is not obligated to make such distributions and may instead withhold some or all for working capital or future investment.

Chart 3 (Result to Defective Grantor Trust with Plan) demonstrates the effect of the plan on the DGT. The DGT receives its 99-percent distribution from the FLP and then uses all of that distribution for the first nine years to repay the interest and principal on the notes. The notes typically require that interest-only payments be made, but in this case all the excess distribution is used to repay principal. As a result, the notes would be fully repaid by year 10 and all future distributions would be accumulated in the DGT for the benefit of the trust beneficiaries. Assuming the excess is accumulated and is invested with the same total return of eight percent, the value of the trust would grow to more than $6.7 million by the end of the 20-year term.

Chart 1. Family Charitable Remainder Trust

Client: John Smith — Date: 12.1.09

Chart 1: Charitable Remainder Trust, 11.5% payout, 7% growth, 1% income, 20% turnover

Year	FMV of CRT Assets at BOY	Basis of CRT Assets at BOY	Unitrust Payment Due EOY	Tier 1 Distribution from CRT	Tier 2 Distribution from CRT	Tax-free Distribution from CRT
2009	5,000,000	500,000	575,000	50,000	525,000	0
2010	4,825,000	4,545,000	554,875	48,250	506,625	0
2017	3,760,006	1,776,015	432,401	37,600	394,801	0
2018	3,628,406	1,433,854	417,267	36,284	380,983	0
2019	3,501,411	1,103,670	402,662	35,014	367,648	0
2020	3,378,862	785,041	388,569	33,789	332,345	22,435
2028	2,540,908	0	292,204	25,409	117,198	149,598
Totals:	2,683,199					

Chart 2. Result to Entity with Plan

Client: John Smith — Date: 12.1.09

Chart 2: Family Limited Partnership

Year	Ordinary Income from CRT	Capital Gain from CRT	Tax-Free Return from CRT	Distribution From Entity To DGT/GP
2009	50,000	525,000	0	575,000
2010	48,250	506,625	0	554,875
2017	37,600	394,801	0	432,401
2018	36,284	380,983	0	417,267
2019	35,014	367,648	0	402,662
2020	33,789	332,345	22,435	388,569
2028	25,409	117,198	149,598	292,204
Totals:				

Chart 4 (Result to Grantor with Plan) illustrates the effect of the plan on the Grantor. The Grantor receives only the note payments from the DGT and uses a portion of the note payments to cover the income tax liability associated with the FLP interests held by the DGT. The Grantor also receives the benefit of the $500,000 income tax deduction in year 1 as well. The net after-tax amount is then assumed to be invested at the same rate of return. As noted, the note payments from the DGT cease in year 10 and the Grantor must use the accumulated amounts to repay his continuing tax obligation from the DGT. To the extent the DGT assets produce a greater return or there is greater turnover inside the portfolio, the Grantor would bear the additional tax—although the estate planning result to the DGT would not be affected.

In order to accurately analyze the result, a similar analysis is done assuming a sale of the asset without use of the FCRT. Chart 5 (Result to Grantor with No Plan) demonstrates the result if neither the CRT nor the DGT is used. In this case, the sale of the asset reduces the investment assets immediately by the capital gains tax imposed on the sale. The after-tax amount is reinvested and is presumed to grow at the same rate over the 20-year period.

Chart 6 (Summary Comparison) compares the income tax and charitable benefits of the FCRT with the "do nothing" strategy. As noted, no capital gains tax is imposed on the initial assets and the full $5 million is reinvested inside the CRT. There is also an income tax benefit associated with the charitable deduction available to the grantor. As a result, the net cash benefit to the grantor from using the FCRT is $41,788 under these assumed return assumptions. While this number is relatively small (due to the required 10-percent charitable remainder), the amount passing to charity at the end of the term is over $2.6 million. Therefore, the total benefit to the grantor and charity from the structure is not insignificant. But, one of the main benefits to the structure is the wealth transfer effect as demonstrated in Chart 7.

Chart 7 (Summary Comparison) illustrates the net transfer tax benefit of the FCRT compared to the "do nothing" strategy where 100 percent of the grantor's assets are subject to estate tax. As noted, at the end of the 20-year term, the DGT holds over $6.75 million, which is excluded from the grantor's estate for estate tax purposes. Referring back to Chart 6, it is noted that this wealth transfer only utilized $371,250 of the grantor's lifetime unified credit and thus

Chart 3. Result to Defective Grantor Trust with Plan

Client: John Smith — Date: 12.1.09

Chart 3: Defective Grantor Trust, same pre-tax growth/income assumptions as CRT

Year	Share of Distribution from Entity	Income/Gain on Accumulation	Payments Made on Note	Net After-Tax Cash Available to DOT	Accumulated After-Tax FMV to DOT
2009	569,250	0	(569,250)	0	0
2010	549,326	0	(549,326)	0	0
2017	428,077	0	(82,045)	346,032	346,032
2018	413,094	27,683	0	440,777	786,808
2019	398,636	62,945	0	461,580	1,248,389
2020	384,683	99,871	0	484,555	1,732,943
2028	289,282	478,934	0	768,217	6,754,895
Totals:					6,754,895

Chart 4. Result to Grantor with Plan

Client: John Smith — Date: 12.1.09

Chart 4: Result to Grantor with Plan, same growth/income assumptions as CRT

Year	Amount Paid To Grantor from Notes	Ordinary Income from DOT	Capital Gain from DOT	Income/Gain from Accumulation	Cumulative Income Tax to Grantor	Net After-Tax Cash Available to Grantor	Accumulated After-Tax Cash Available to Grantor
2009	569,250	49,500	519,750	0	(4,543)	564,708	529,708
2010	549,326	47,768	501,559	42,377	(139,351)	452,352	982,059
2017	82,045	37,224	390,853	327,068	(160,355)	248,758	4,337,114
2018	0	39,382	382,017	346,969	(166,709)	180,260	4,517,374
2019	0	42,532	378,863	361,390	(173,792)	187,598	4,704,973
2020	0	45,935	358,412	376,398	(176,492)	199,906	4,904,879
2028	0	85,022	378,444	551,656	(244,055)	307,601	7,203,301
Totals	4,115,569						7,203,301

provided leverage equal to 18 times the unified credit utilized. Additionally, to the extent GST exemption was allocated to the initial $371,250 gift, the amount in the DGT is also exempt from future GST tax. As a result, the full $6.75 million plus any future growth can pass generation to generation transfer tax-free. The net transfer tax benefit of the structure is over $5.9 million.

To the extent the pre-tax return on the investments is instead 10 percent (two-percent income and eight-percent growth) per year, both the income tax and transfer tax benefits increase. As noted in the revised Chart 6 and Chart 7, the income tax benefits increase primarily due to the large increase in the resulting charitable remainder to over $3.9 million. But, the main benefit of the increased return is that the DGT increases to over $10,867,000. As a result, the net transfer tax benefit increases to over $9.7 million. The results increase exponentially if the pre-tax return is even greater. Even if the pre-tax return on the investments is only six percent per year, the DGT will still end up with over $3,991,000 in assets, and the charity will receive over $1.7 million.

Chart 5. Result to Grantor with No Plan

Client: John Smith — Date: 12.1.09

Chart 5 No Plan, Result to Grantor, same assumptions as with FCRT

Year	Beginning FMV of Assets	Beginning Basis of Assets	Ordinary Income from Assets	Growth from Assets	Capital Gain Recognized From Assets	Cumulative Income Tax to Grantor	Net After-Tax Cash Available to Grantor	Accumulated After-Tax Cash Available to Grantor
2009	3,965,000	3,965,000	39,650	277,550	55,510	(29,420)	4,252,780	4,252,780
2010	4,252,780	4,030,740	42,528	297,695	103,947	(41,769)	4,551,233	4,551,233
2017	6,674,933	5,408,720	66,749	467,245	346,692	(107,774)	7,101,154	7,101,154
2018	7,101,154	5,714,387	71,012	497,081	376,770	(116,482)	7,552,765	7,552,765
2019	7,552,765	6,045,686	75,528	528,694	407,154	(125,367)	8,031,619	8,031,619
2020	8,031,619	6,403,001	80,316	562,213	438,166	(134,511)	8,539,637	8,539,637
2021	8,539,637	6,786,973	85,396	597,775	470,088	(143,567)	9,078,822	9,078,822
2028	13,093,717	10,318,684	130,937	916,560	758,319	(224,607)	13,916,408	13,916,408
Totals								13,916,408

Chart 6. Summary Comparison

Client: John Smith — Date: 12.1.09

Chart 6: Net Income Tax and Charitable Benefits

Year		No Plan	FCRT
2009	Gross Proceeds	$ 5,000,000	N/A
	Capital Gains Tax	(1,035,000)	N/A
	Tax Savings from Charitable Deduction	N/A	318,000
	Initial Taxable Gift	N/A	371,250
	Gift Tax on Contribution	N/A	0
		3,965,000	0
2029	Grantor's Outside Balance		
	Net Growth Outside Charitable Remainder Trust	16,389,998	N/A
	Net Distributions to Grantor from Structure	N/A	10,366,273
	Total Tax Liability	(2,473,590)	(3,162,973)
		13,916,408	7,203,301
	Liquidation Value of Defective Grantor Trust	N/A	6,754,895
	Total Outside Balance	13,916,408	13,958,196
NET INCOME TAX BENEFIT TO DONOR			41,788
DISTRIBUTION TO CHARITY			2,683,199
TOTAL BENEFIT COMPARED TO OUTRIGHT SALE			2,724,987

Chart 7. Summary Comparison

Client: John Smith — Date: 12.1.09

Chart 7. Net Transfer Tax Results

	No Plan	FCRT
Taxable Estate		
Grantor's Total Outside Balance	$ 13,916,408	$ 7,203,301
Estate Tax on Assets Held Outside Trust	(6,095,321)	(3,241,485)
	7,821,087	3,961,815
Non-Taxable Estate	N/A	6,754,895
	7,821,087	10,716,711
Net Benefit to Estate Upon Distribution to 1st Generation		2,895,624
Potential Generation-Skipping Transfer Tax on Assets Held in DGT	(3,039,703)	0
Potential Asset Transfer to 2nd Generation	0	6,754,895
Additional Net Generation-Skipping Transfer Benefit		3,039,703
TOTAL NET TRANSFER TAX BENEFIT		5,935,327

IV. Considerations Involved with FCRT

A discussion of any estate planning technique would be remiss without a discussion of the potential negative tax consequences of the strategy. The issues concerning the FCRT relate more to the nature of the assets being contributed and corresponding value than the actual structure.[75]

With the transfer of any fractional interest in a family-owned entity, the most likely challenge will be to the minority and marketability discounts taken on the contribution. To the extent the IRS successfully challenges the valuation provided for the sale to the DGT, the IRS will argue that the difference is a taxable gift by the grantor. If the grantor does not have sufficient unified credit remaining, the excess will result in gift tax to the grantor. While the taxpayer may be able to independently adjust the purchase price and therefore reduce the gift tax due, the IRS is likely to challenge the use of any adjustment clause. Therefore, to minimize this risk, it is recommended that the taxpayer have a well-qualified appraiser value the interest being contributed. Additionally, the taxpayer can be less aggressive on the size of the discount taken. But, some of the recent cases suggest that a standard family limited partnership holding marketable securities should warrant a discount of as much as 32 percent.[76]

The next issue that could arise relates to the recent Code Sec. 2036 arguments against the use of family entities in general upon the death of the grantor. While the IRS has recently advanced this position in a wide array of cases involving family entities, this argument likely can be avoided with proper planning and administration.[77] A detailed analysis of such options is beyond the scope of this article, but any taxpayer entering into a transaction involving a family entity should be mindful of these rules.

The main issue relating to the substance of the DGT transaction relates to the value of the initial gift compared with the value of the assets sold to the trust. As discussed above, to the extent the "seed" gift represents at least 10 percent of the amount being sold, the size of the taxable gift should suffice. If the grantor does not have sufficient unified credit or the size of the transaction is so large that a 10-percent gift would subject the grantor to immediate gift tax, the grantor may seek some of the other alternatives such as a guarantee by a child or separate irrevocable trust. In any case, this issue is no different with the FCRT than any sale to a DGT.

The last concern relates to the potential tax consequences if the grantor does not survive the 20-year term. Clearly, the tax benefits of the structure will not be the same should the grantor pass away prior to the end of the 20-year term since the trust will no longer be a grantor trust and the trust will have to pay its own income tax on the CRT distributions. This risk can often be minimized by the purchase of term life insurance to cover the possibility of death during the 20-year term. There is an additional risk to the extent the grantor passes away prior to the notes being repaid. Unlike a Grantor Retained Annuity Trust that requires survival,[78] a premature death will not negate all the benefits of the structure. Instead, the unpaid note balance will simply be included in the estate and not the value of the CRT.[79] However, it is unclear whether the existence of the outstanding note triggers any income tax. The issue is unsettled but the IRS could argue that gain should be recognized to the extent of the unpaid note balance because the nature of grantor trust terminates at death and the grantor previously sold appreciated property to the trust without recognizing the gain due to the nature of the grantor trust.[80] On the other hand, it has been argued that death is not an income recognition event and in fact the trust should receive a stepped-up basis on the assets in the trust to the extent the notes were included in the estate.[81] The more widely accepted view is that no income tax is recognized at death, but that the trust simply takes the grantor's income tax basis in the assets contributed. Losing the step-up in basis in the FCRT is less of an issue than a standard DGT since all of the appreciated property originally contributed to the family entity is being sold inside the CRT without income tax.

V. Conclusion

Although the estate tax rules are currently in flux, it is widely accepted that some form of estate tax will be imposed on larger estates in the future. Planning techniques are available to help reduce the estate tax, but some assets, such as appreciated marketable securities, do not lend themselves to many of these strategies. While the appreciated marketable securities could be sold, income tax would be imposed on such sale. The FCRT is a technique that allows the taxpayer to defer immediate recognition of income tax gain on the sale of such property, pass a considerable sum to the charity of their choice, and transfer a significant amount of wealth to his children and grandchildren in a very highly tax-advantageous way.

ENDNOTES

[1] N.Y. JOURNAL, June 2, 1897.

[2] The estate tax was eliminated in the year 2010 under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 (P.L. 107-16). However, without new legislation, those provisions in EGTRRA are "sunset" in 2011, and the estate tax system reverts to the system in place in 2001. There have been many proposals to change the estate tax system since 2001 and most involve fixing the unified credit for estate tax purposes at between $2 million and $3.5 million. One such bill, H.R. 436, was proposed by Representative Earl Pomeroy in the House of Representatives on January 9, 2009, to that effect. That bill also included a provision eliminating the applicability of minority and marketability discounts applicable for the use of closely held entities such as family limited partnerships. It is uncertain whether any new estate tax bill will include such discount provisions. While the analysis in this article assumes that discounts for fractional interests in family entities have not been eliminated, the results provided still provide a positive, albeit less advantageous, wealth transfer even if Congress eliminates such discounts.

[3] The GRAT has increased in use and popularity after the *Walton* case was decided in 2000 as it effectively allowed a taxpayer to zero out the taxable portion of a gift in trust. *See* Carlyn S. McCaffrey, Lloyd Leva Plaine and Pam H. Schneider, *The Aftermath of Walton: The Rehabilitation of the Fixed-Term, Zeroed-Out GRAT*, 95 J. TAX'N 325 (Dec. 2001). Sales to DGTs have grown in popularity and usage since first introduced in print in a 1996 ESTATE PLANNING article, Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 ESTATE PLANNING 3 (Jan. 1996). *See* Rondald D. Aucutt, *Installment Sales to Grantor Trusts*, BUS. ENTITIES, Mar./Apr. 2002, at 28.

[4] GRATs and sales to DGTs require annual distributions of either annuity payments or note payments that often cannot be met solely by the dividends generated off the property. Other attempts to distribute property in-kind to satisfy the payment requirements can create valuation problems and decreases the overall planning benefit of the structures.

[5] The rules governing charitable remainder trusts were made effective on July 31, 1969. *See* Code Sec. 664, P.L. 91-172, Act Sec. 201(e)(1) (1969).

[6] *See* Jonathan G. Blattmachr and Howard M. Zaritsky, *Estate Planning After the Taxpayer Relief Act of 1997*, 87 J. TAX'N 133 (Sept. 1997).

[7] *See* Code Sec. 664(D)(2)(d); *see* Blattmachr, *supra* note 6. The 10-percent remainder interest requirement reduces the payout percentage a taxpayer can retain in a CRT. For example, with a six-percent applicable federal rate, a couple in their mid-50s can retain a payout percentage for a charitable remainder unitrust of no more than 8.2 percent annually for life. For a couple in their mid-40s, the maximum payout drops to 6.1 percent. For a couple in their mid-30s, they are actually prevented from doing a joint-life charitable remainder unitrust since the maximum payout would be below 5.0 percent, which is the statutory minimum under Code Sec. 664(d)(1)(A).

[8] The value of the charitable remainder, which now must be at least 10 percent of the value of property contributed, can be used to offset other capital gains and ordinary income of the taxpayer. With the substantial reduction in the tax rates since 2001, however, the benefit of the charitable deduction has decreased proportionally. Additionally, one of the other income tax benefits of the charitable remainder trust is a deferral of immediate recognition upon the sale of any appreciated property contributed to the CRT. But, the new lower tax rates also substantially reduced the cost of selling such assets outside the CRT. However, to the extent some of the capital gains tax rate reductions expire and are not renewed, the cost of selling appreciated property will increase and the CRT may become more beneficial as an income tax deferral technique.

[9] Depending on the growth rate assumed for the property, it can take as many as 19 years (or more) for a taxpayer to reach the break-even point whereby he is better off economically in utilizing a CRT than simply selling the property outside the entity and paying the capital gains tax.

[10] In 1994, the IRS issued Notice 94-78, 1994-2 CB 555, challenging the use of so-called accelerated CRTs as a method to avoid income tax realization from the sale of property inside a high-payout short-term CRT. This technique was later shut down legislatively through the adoption of a maximum 50-percent payout percentage pursuant to revisions to Code Sec. 664(d)(1)(A) and (2)(A). Other more aggressive uses of charitable entities, including the use of charitable family limited partnerships, have also come under additional scrutiny. *See* Carolyn D. Duronio, *Let the Donor Beware of the Charitable Family Limited Partnership*, 12 J. TAX'N EXEMPT ORG. 272 (June 2001).

[11] Prior to May of 1997, an increasingly popular technique was a near-zero charitable remainder trust whereby the taxpayers could increase the tax benefits of a CRT by utilizing a net-income makeup charitable remainder unitrust (NIMCRUT) to achieve estate tax savings. This was accomplished by creating a fixed-term 20-year NIMCRUT, gifting the final year of the trust to one's children, investing in non–income-producing assets for the initial years of the trust, and allowing the makeup amount to pass to one's children just prior to the end of the term. The IRS effectively shutdown this technique by amending the regulations to Code Sec. 2702 to no longer exclude interests in NIMCRUTs from the grantor retained annuity trust rules. *See* Reg. §25.2702-1(c)(3). *See also* Simon Levin and Jay A. Soled, *Near-Zero CRUT Expands the Estate Planning Possibilities of Charitable Trusts*, 83 J' TAX'N 24 (July 1995); Christopher P. Cline, *On the Flip Side: A New Spin on Charitable Remainder Trusts*, 11 PROB. & PROP. 6, 11 (Dec. 1997).

[12] The so-called FCRT was developed by the author in 1999 in response to a taxpayer who had a desire to diversify his appreciated stock portfolio and transfer wealth to multiply generations, but who was unwilling to pay the income tax associated with the sale necessary to achieve his goals.

[13] Any references to family limited partnerships and limited liability companies are used interchangeably throughout this article since the transfer tax planning issues relating to both types of entities are substantially the same.

[14] While the exact number of family limited partnerships used for wealth transfer purposes is impossible to determine, one can assume their use is widespread given the large number of recent cases and articles written on the subject. *See A. Strangi Est.*, CA-5, 2005-2 USTC ¶60,506, 417 F3d 468, *aff'g*, 85 TCM 1331, Dec. 55,160(M), TC Memo. 2003-145 (2003); *V.A. Bigelow, Est.*, 89 TCM 954, Dec. 55,974(M), TC Memo. 2005-65; *I. Abraham, Est.*, TC Memo 2004-39, *aff'd*, CA-1, 2005-1 USTC ¶60,502, 408 F3d 26; *D.A. Kimbell, Est.*, CA-5, 2004-1 USTC ¶60,486, 371 F3d 257; *T.R. Thompson, Est.*, CA-3, 2004-2 USTC ¶60,489, 382 F3d 367 (2004); Milford B. Hatcher, Jr. & Edward M. Manigault, *The Tax Court's "Practical Control" Test in Bongard: More than FLPs Are in the Balance*, 102 J. TAX'N 261 (May 2005); J. Joseph Korpics, *The Practical Implications of Strangi II for FLPs—A Detailed Look*, 99 J. TAX'N 270 (Nov. 2003); J. Joseph Korpics, *For Whom Does Kimbell Toll—Does Section 2036(a)(2) Pose a New Danger to FLPs?* 98 J. TAX'N 162 (Mar. 2003); Louis A. Mezullo, *Is Strangi a Strange Result or a Blueprint for Future IRS Successes Against FLPs?* 99 J. TAX'N 45 (July 2003); Jerald David August and Guy B. Maxfield, *The IRS Continues its Section 2036 Assault on Family Limited Partnerships*, BUS. ENTITIES, at 20, 2005 WL

2722849 (Oct. 2005).

[15] Family limited partnerships are often structured for legitimate nontax reasons, such as centralized management, asset protection, pooling of resources to reduce overall investment expenses, pooling of resources to gain broader access to certain types of investments and to facilitate education of younger family members. Recent case law suggests that having nontax motivations for creating a family limited partnership may prevent estate tax inclusion of the partnership in the taxpayer's estate at death under Code Sec. 2036(a). *See W.C. Bongard Est.*, 124 TC 95, Dec. 55,955; *see also* Hatcher & Manigault, *supra* note 14, at 262–66; *but see V.M. Miller Est.*, 97 TCM 1602, Dec. 57,835(M), TC Memo. 2009-119 (managing marketable securities could be a legitimate business purpose).

[16] From a gift tax perspective, family limited partnerships can help facilitate transfer of wealth by allowing a taxpayer to easily transfer small fractional interests in the underlying assets of the entity to family members without giving up control over the underlying assets. Even if the taxpayer only retains indirect control of the entity, such as when control is held in an S corporation or irrevocable trust, it allows the taxpayer to involve the donee in the income and appreciation of the underlying asset without passing control. While most of these benefits can also be achieved by holding such interests in irrevocable trusts, the control issues with an irrevocable trust are different.

[17] *See* Edward M. Manigault and Joseph G. Hodges, Jr., *Valuation Discounts—An Analysis of the Service's Position Compared With Litigated Cases*, 91 J. TAX'N 26 (July 1999). One recent case involved discounts for a transfer of a family limited partnership interest holding mostly marketable securities held that a combined 32-percent discount should be applied to a fractional interest in the partnership. *W.E. Kelly Est.*, 90 TCM 369, Dec. 56,163(M), TC Memo. 2005-235; *see also T.H. Holman*, 130 TC —, No. 12, Dec. 57,455 (May 27, 2008) (discount for partnership holding a single stock).

[18] In the past, the IRS had challenged based on 2703 grounds as well as gift on formation issues.

[19] *See* Mitchell M. Gans and Jonathan G. Blattmachr, *Family Limited Partnership Formation: Dueling Dicta*, 35 CAP. U. L. REV. 1, 4–5 (Fall 2006) (dismissing the gift on formation issue).

[20] *See* Brant J. Hellwig, *On Discounted Partnerships Interests and Adequate Consideration*, 28 VA. TAX. REV. 531, 540 (Winter 2009). ("Having failed in its effort to disregard family limited partnerships as entities separate from their owners for transfer tax purposes, the IRS retreated to a statutory argument that would accomplish the same goal of eliminating entity-related discounts: inclusion of the partnership property in the transferor's estate under section 2036.")

[21] *See T.R. Thompson Est.*, CA-3, 2004-2 USTC ¶60,489, 382 F3d 367 (challenge based on fact that nearly all taxpayer's assets, including a personal residence, contributed to partnership giving taxpayer few other assets for lifestyle needs and thereby requiring the assets in the partnership to be used to maintain taxpayer's lifestyle); *M.B. Harper Est.*, 83 TCM 1641, Dec. 54,745(M), TC Memo. 2002-121 (challenge based on excessive powers retained by taxpayer over partnership affairs); *Kimbell, supra* note 14 (same); *Strangi, supra* note 14 (challenge because partnership formed and funded when transferor elderly and/or very poor health); *W.C. Bongard Est.*, 124 TC 95, Dec. 55,955 (2005) (challenge because no nontax business reasons evident for creating entity); *D.M. Schauerhamer Est.*, 73 TCM 2855, Dec. 52,061(M), TC Memo. 1997-242 (challenge based on lack of respect for formalities of structure); *M.W. Senda*, CA-8, 2006-1 USTC ¶60,515, 433 F3d 1044 (2006) (same); *V.M. Miller Est.*, 97 TCM 1602, Dec. 57,835(M), TC Memo. 2009-119 (management of marketable securities an acceptable business purpose, except where done in contemplation of death). *See also* Commie E. Stevens, Family *Limited Partnerships: An Update*, 8 J. PRAC. EST. PLAN. 35 (Aug. 2006); Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531 (Winter 2009).

[22] *See supra* note 2.

[23] *See* Christopher R. Hoyt, *Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities*, 13 VA. TAX REV. 641, 673–76 (Spring 1994) (describing in detail the requirements for a Charitable Remainder Trust).

[24] *See* Leo L. Schmolka, *Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism*, 40 TAX L. REV. 1, 22–23 (Fall 1984) (discussing the anticipatory assignment of income issues to the extent the assets are not transferred to the charitable trust far enough in advance). While there is no set time period, generally a month or more is a good guideline. However, an argument can be made that even if the transfer occurs only one day prior to the sale that the anticipatory assignment of income may not be violated. *Id.* However, one must be careful when such sale is tied to the sale of other stock (such as in a public offering) where the CRT might be obligated to sell regardless of how soon the shares are added to the trust.

[25] Reg. §1.664-1 (1984). Gain will be recognized upon receipt as either ordinary income, capital gain or tax-exempt income depending on the nature of the assets sold in the charitable remainder trust and the nature of any future income generated inside the trust. *Id.* When the charitable trust distributes cash or property to the beneficiary, the beneficiary will recognize ordinary income to the extent the trust had recognized prior ordinary income on the sale of assets and such ordinary income has not previously been distributed to the beneficiary. *Id.* However, to the extent the donor originally contributed a capital asset to the charitable remainder trust and the trust assets are invested in a way to minimize ordinary income, the distributions can then be characterized as capital gain.

[26] To the extent the investment of the proceeds from the sale of the contributed assets produce capital gain and ordinary income equal to or greater than the annual distribution amount throughout the term, the deferred gain will never be recognized. For example, if the sale of an asset worth $1 million inside a seven-percent charitable remainder annuity trust creates a $900,000 capital gain and the investment of the $1 million sale proceeds produce $20,000 of ordinary income and $60,000 of capital gain, the distribution of $70,000 in year one will consist of the $20,000 in ordinary income and $50,000 of capital gain from year one and none of the prior capital gain will be recognized.

[27] The Internal Revenue Code defines a charitable remainder trust as a trust where one or more "persons" other than a charitable organization must receive the unitrust or annuity payment. Code Sec. 664(d)(2)(A). "Person" is defined by the Internal Revenue Code to include a company, corporation or partnership. Code Sec. 7701(a)(1).

[28] LTR 9205031 (Nov. 5, 1991). On the other hand, if an individual creates a charitable remainder trust, the permissible term is either 20 years or the lives of the recipients. Code Sec. 664(d)(2)(A).

[29] *Id.*

[30] Any charitable organization described in Code Sec. 170(c) qualifies as a permissible remainder beneficiary of a charitable remainder trust and a private nonoperating foundation is listed as under Code Sec. 170(c)(2). *Id.* The charitable remainderman of the trust need not be fixed until the end of the initial retained term and the donor can retain unlimited discretion to remove and replace the chosen charity. Rev. Rul. 76-8, 1976-1 CB 179. But, to the extent a private nonoperating foundation may be chosen as a permissible remainderman, whether or not a public charity is initially named, the taxpayer's income tax deduction may be limited. *See supra* note 31. However, as long as the charitable remainder beneficiary is limited to Code Sec. 170(b)(1)(A) charities,

retaining the right to remove and replace the charitable remainderman will have no negative income tax result. *See* Sanford J. Schlesinger and Martin R. Goodman, *Back to Basics: A Primer for Charitable Remainder Trusts*, EST. PLAN. J. (Mar. 2005).

[31] Depending on the length of the term selected, the size of the retained interest percentage, and the existing applicable federal rates at the time of creation, the tables in Reg. §20.2031-7(d)(7) will determine the value of the remainder interest and thus the amount of the charitable deduction. Mary C. Hester, *Using Charitable Planned Gifts in Estate Planning to Maximize Tax-Efficient Results*, 104 J. TAX'N 94 (Feb. 2006). However, to the extent a private foundation is named as a permissible remainderman of the charitable remainder trust, the taxpayer's income tax deduction for creating the trust will be limited. First, the taxpayer will only be able to use the charitable deduction to offset up to 30 percent of his adjusted gross income in any tax year (as opposed to being able to offset up to 50 percent of adjusted gross income for gifts to public charities). Conrad Teitell, *Charitable Contributions—Windfalls, Pitfalls, and Pratfalls*, SB10 ALI-ABA 643 (1996). Second, to the extent the taxpayer contributes property other than publicly traded securities, the donor's charitable deduction will be limited to the taxpayer's basis in the contributed asset. Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1, 1–3 (Fall 2002).

[32] *See* note 7, *supra*.

[33] As an example, assume that $1 million of property with zero basis is contributed to a 20-year fixed term charitable remainder unitrust with an 11-percent annual payout. The sale of the property outside the CRT would create $250,000 in capital gains tax (assuming a combined state and federal 25-percent capital tax rate) and at 10 percent per year the proceeds would grow after-tax to approximately $2.5 million in 18 years. With the CRT, assuming the 11-percent annual payouts were accumulated and reinvested, it would take 18 years for the outside assets to grow to $2.5 million. In fact, at an eight-percent pre-tax return, the break-even point is 20 years, so the structure only benefits the charitable remainderman.

[34] *See* Code Sec. 671.

[35] Rev. Rul. 2004-64, IRB 2004-27, 7. In fact, if the trust voluntarily pays its own share of the tax or reimburses the grantor for the tax, the IRS could argue that the grantor retained a prohibitive right to the income of the trust causing the trust to be included in the taxpayer's estate for estate tax purposes. *Id.*

[36] Rev. Rul. 85-13, 1985-1 CB 184.

[37] *See* LTR 9543049 (Oct. 27, 1995).

[38] *See supra* note 35.

[39] *See supra* note 36.

[40] One alternative is for the trust to instead transfer some of the shares back to the taxpayer in satisfaction of the obligation due on the notes. However, this can sometimes be administratively cumbersome in that it requires multiple smaller transfers of stock and also may result in additional scrutiny by the IRS of the integrity of the notes. Also, to the extent the underlying property is held in an entity to which a minority or marketability discount was originally applied, any discount would be negated by having to re-transfer interests in the entity back to the taxpayer in satisfaction of the obligation due on the notes.

[41] One increasingly popular estate planning technique that has returned to favor recently is the grantor retained annuity trust or GRAT. The GRAT is designed to produce a similar "freeze" of the contributed assets, except that the note payments owed by the trust are instead replaced with fixed annuity payments. The benefits of the GRAT are that it is a statutory transaction explicitly approved by the Code, the initial gift can be reduced to zero, and the GRAT contains an automatic adjustment clause to minimize the gift tax risk of undervaluing the contributed asset. On the contrary, the DGT provides the grantor greater flexibility in structuring the repayment, does not require the taxpayer's survival of the term to be effective and permits GST planning. In either case, however, the same issues arise with non–income-producing property where the property might need to be sold at a gain to produce sufficient liquid assets to satisfy the annuity payments or the property must be distributed back in-kind.

[42] *See supra* note 21.

[43] The one-percent general partnership interest is best if held by the taxpayer's children or other family members or trusts for the benefit of the taxpayer's children. To the extent the taxpayer continues to hold the general partnership interest in the entity, it would be best for the taxpayer to later gift or sell such interest more than three years prior to death in order to avoid inclusion under Code Sec. 2036 of the underlying property of the partnership.

[44] Code Sec. 675(4).

[45] Code Sec. 674(a).

[46] *M.A. Byrum*, 72-2 USTC ¶12,859, 408 US 125, 156-157 (1972). *See* Louis S. Harrison, *Structuring Trusts to Permit the Donor to Act as Trustee*, EST. PLAN. J., Nov./Dec. 1995.

[47] *See supra* note 46.

[48] The beneficiary can avoid estate tax inclusion as long as the beneficiary has no right to appoint the property to himself, his estate, his creditors or the creditors of his estate. Code Sec. 2041. However, the beneficiary can retain the power to appoint among children, to a spouse or an income-only trust for the benefit of a spouse or charity. The inclusion of such rights to appointment is completely at the discretion of the taxpayer when the irrevocable trust is created.

[49] Each taxpayer has a unified credit equivalent sufficient to allow a transfer of up to $1 million during life without gift tax.

[50] *See* Robert S. Keebler and Peter J. Melcher, *Structuring IDGT Sales to Avoid Sections 2701, 2702, and 2036*, EST. PLAN. J., Oct. 2005.

[51] *See* Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (Mar. 2000). For example, it is often suggested that if the total expected sale is $5 million, the grantor might gift $250,000 or five percent to the trust and have a trust beneficiary guarantee $250,000 or five percent of the debt. Unless the guarantee is exercised upon, no gift tax should result from the guarantee. But, some commentators suggest that a commercially reasonable guarantee fee should be paid to help prevent any appearance of a gift, especially if the trust has multiple beneficiaries or the grantor intends it to be GST exempt.

[52] Code Sec. 2701(a)(4).

[53] To the extent a sufficient portion of the grantor's generation-skipping transfer tax exemption is allocated to the original gift to the trust so that it results in a zero inclusion ratio, then the assets of the trust—including any future growth—can eventually pass to the grantor's grandchildren in trust without estate or generation-skipping transfer tax.

[54] An entity, like any taxpayer, may create a charitable remainder trust. Code Sec. 7701(a)(1). *See* LTR 199952071 (Sept. 24, 1999); LTR 9512002 (Sept. 29, 1994); LTR 9205031 (Nov. 5, 1991). The only limitations on the creation of such a trust by an entity is that the term of the trust must be stated as fixed term since the entity can have no life expectancy and the payments during the term must pass directly to the entity. LTR 9205031 (Nov. 5, 1991). As a result, the charitable remainder trust would make annual payments for up to 20 years to the entity.

[55] To the extent the taxpayer would like to further defer the recognition of income, the charitable remainder trust might instead be created as a net-income makeup charitable remainder trust and the property managed in order to further defer the receipt of income and recognition of gain. *See* Christopher P. Cline, *Bulking Up for Retirement: Income Tax Deferred Alternatives to Qualified Plans*, 13 PROBATE & PROPERTY 32, 37 (May/June 1999).

[56] In order to generate a remainder of at least 10 percent to satisfy the Code Sec. 664(d)(2)(D) charitable requirement, the maximum payout for a 20-year fixed term charitable

remainder trust is 11 percent. This number was obtained using Leimberg and LeClair, NumberCruncher (Benchmark Software).

[57] Reg. §1.170A-1(j)(7). As with any charitable remainder trust, the deductibility of the contribution depends on the type of property contributed to the trust and the type of charitable organization designated as a permissible remainderman. Generally, to the extent the contributed property, if sold, would produce a capital gain, the deduction available to the grantor is limited to 30 percent of the donor's adjusted gross income. Code Sec. 170(b)(1)(C). To the extent the designated remainder beneficiary is a private foundation, or may be later changed to a private foundation, the donor's deduction is also limited to the donor's basis in the property. Code Sec. 170(e)(1)(B). An exception applies, however, for contributions of "qualified appreciated stock" such as most publicly traded securities, where the donor's deduction is not limited to basis. Code Sec. 170(e)(5)(A).

[58] Adequate interest is determined under the Code Sec. 7872 rules and depends upon the rate published monthly by the IRS and is based on the length of the note. Proposed Reg. §1.7872-3 (1985). The short-term rate is for demand notes or term notes of three years or less. Code Sec. 1274(d). The mid-term rate applies for notes with a term between three and nine years. *Id.* The long-term rate applies for term loans in excess of nine years. *Id.*

[59] The author himself has successfully made such argument in audit negotiations with the IRS, wherein the IRS agreed to 31-percent minority and marketability discount from the face amount of the securities held by the FCRT.

[60] *See* Michael D. Mulligan, *Formula Transfers: McCord Is Pro-Taxpayer, but Other Developments Are Likely*, EST. PLAN. J., July 2007 (explaining the difference between valuation adjustment clauses and defined value clauses and the opportunities for their usage in minimizing the risk of gift tax on sales or property for fair market value).

[61] *See supra* text accompanying note 36.

[62] The taxation of such distributions will follow the tier system applicable to all charitable remainder trusts, with ordinary income inside the charitable remainder trust being recognized first, then capital gains and nontaxable income such as municipal bond income. Any distribution in excess of these amounts will be a return of basis to the taxpayer.

[63] If the reinvested assets produce little or no short-term capital gain or ordinary income (other than qualified dividends), the lower rates applicable to such types of gain will apply to such distribution.

[64] *See* Rev. Rul. 85-13, 1985-1 CB 184.

[65] To preserve the integrity of the transaction and minimize the risk of challenge, the Trustee should not make distributions to the beneficiaries that might prevent the Trustee from satisfying all of its obligations under the promissory note.

[66] To the extent the grantor does not have significant liquid assets, the grantor might require some principal payments on the note to ensure the grantor has sufficient cash to cover the income tax liability passing through the grantor trust.

[67] *See* detailed model of FCRT, *infra* at text accompanying notes 70–74.

[68] To the extent a private foundation is named as a permissible remainderman of the CRT, the charitable deduction may be limited to the donor's basis in the property. *See supra* note 31. However, to the extent the appreciated property contributed to the CRT are marketable securities, the donor's deduction would not be limited to basis as long as the securities qualify as "qualified appreciated stock." *See id.*

[69] See *supra* note 30.

[70] For example, a charitable lead annuity trust may require an annual return of more than 10 percent to produce a significant estate planning benefit for the family. *See supra* note 33.

[71] One could also use a newly created limited partnership or limited liability company, but the taxpayer must be mindful of satisfying the new Code Sec. 2036 arguments discussed herein. *See supra* note 21.

[72] In this example, Code Sec. 7872 would require the use of the mid-term applicable federal rate for a nine-year interest-only promissory note. While the minimum mid-term interest rates for most of 2009 were below three percent per year, the rates were five percent or more within the past few years.

[73] Some less critical additional assumptions for the models include a state and federal ordinary income tax rate of 43 percent and a 10-percent annual turnover of the capital gain in the portfolio.

[74] To the extent the initial taxable gift to the trust (assumed for this purpose to be 10 percent of the sale portion) exceeds the taxpayer's remaining gift tax exemption equivalent amount, the grantor will owe a gift tax. However, the amount of credit available will not impact the economic results of the model.

[75] In fact, on the only gift tax audit of the FCRT the author has been involved in the prior six years, the IRS did not attempt to challenge any of the structures and instead focused only on the size of the minority and marketability discounts applicable to the interest transferred to the DGT.

[76] *See* David Pratt, *Update on Use of Family Limited Partnerships and Discount Planning*, SP037 ALI-ABA 399 (Feb. 2009) (analyzing the various decisions by the Tax Court in setting the resulting combined minority and marketability discounts for family limited partnership). As discussed *supra* at text accompanying note 59, in this case the argument for a higher discount is more likely since the assets of the entity are no longer marketable securities held by an illiquid interest in a charitable remainder trust.

[77] *See* Pratt, *supra* note 76.

[78] To the extent the grantor of a grantor retained annuity trust passes away during the initial stated term, the retained interest requires that most, if not all, of the trust assets be included in the grantor's estate under Code Sec. 2036. Reg. §20.2036-1(c)(2)(i).

[79] In fact, to the extent the promissory notes were issued at a time when the prevailing interest rate was lower than at the time of death and depending on the length of the remaining term, the fair market value of the notes for estate tax purposes may be less than the current unpaid note balance. Scott A. Harshman, *Planning Opportunities for Notes Receivable in an Estate*, EST. PLAN., Apr. 2003.

[80] *See* Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (1992).

[81] *See* Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT., ESTATE, GIFTS & TRUSTS J. 3 (1999).