

# Notice of Proposed Rulemaking and Notice of Public Hearing

## Prevention of Abuse of Charitable Remainder Trusts

REG-116125-99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed 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. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by January 19, 2000. Requests to speak (with outlines of oral comments) at the public hearing scheduled for February 9, 2000, at 10 a.m. must be submitted by January 19, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-116125-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-116125-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: [http://www.irs.ustreas.gov/tax\\_regs/regslst.html](http://www.irs.ustreas.gov/tax_regs/regslst.html). The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Catherine Moore, (202) 622-3070; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

### SUPPLEMENTARY INFORMATION:

This document proposes to amend sections 643 and 664 of the Income Tax Regulations (26 CFR Part 1) to provide additional rules regarding charitable remainder trusts.

#### *Background*

Section 664, added to the Internal Revenue Code (Code) by section 201(e) of the Tax Reform Act of 1969 (Public Law 91-172, (83 Stat. 487, 562-64)), contains the rules for charitable remainder trusts. In general, a charitable remainder trust provides for a specified periodic distribution to one or more noncharitable beneficiaries for life or for a term of years, with an irrevocable remainder interest held for the benefit of charity. The amount distributed to the noncharitable beneficiaries may be either a sum certain, in the case of a charitable remainder annuity trust, or a fixed percentage of the net fair market value of the trust's assets valued annually, in the case of a charitable remainder unitrust. Section 664(b) provides rules for determining the character of amounts distributed by a charitable remainder trust in the hands of the beneficiary to whom the distribution is made. In general, a distribution is taxable to the beneficiary if it represents a distribution of ordinary income or capital gain of the trust. A distribution generally is not taxable to the beneficiary if it represents a distribution of tax-exempt income of the trust or of trust corpus. Section 664(c) provides that a charitable remainder trust is exempt from all taxes under subtitle A of the Code for any taxable year except a taxable year in which the trust has unrelated business taxable income under section 512.

Section 643(a)(7), added to the Code by section 1906(b) of the Small Business Job Protection Act of 1996 (Public Law

104-188, (110 Stat. 1755, 1915)), authorizes the Secretary of the Treasury to issue regulations 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.

#### *Explanation of Provisions*

##### *A. Tax-Avoidance Arrangements Using Charitable Remainder Trusts*

The IRS and the Treasury Department are aware of 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 transactions, a taxpayer typically contributes highly appreciated assets to a charitable remainder trust having a relatively short term and 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. Because the borrowing, forward sale, or other similar transaction does not result in current income to the trust, the parties attempt to characterize the distribution of cash to the beneficiary as a tax-free return of corpus under section 664(b)(4). Distributions may continue to be funded in this manner for the duration of the trust term (which is usually short, so as to meet the 10-percent remainder requirement of section 664(d)(1)(D) or 664(d)(2)(D)). The appreciated assets may be sold and the transaction closed out (e.g., the loan is repaid) in the last year of the trust, or the trustee may distribute the appreciated assets, subject to a contractual obligation to complete the transaction (e.g., the forward sale contract), to the charitable beneficiary.

A mechanical and literal application of rules and regulations that would yield a result inconsistent with the purposes of the charitable remainder trust provisions will not be respected. When section 664 was amended by the Revenue Reconciliation Act of 1997, Congress indicated that

a scheme that, in effect, attempts to convert appreciated assets to a tax-free cash distribution to the non-charitable beneficiary is “abusive and is inconsistent with the purpose of the charitable remainder trust rules.” S. Rep. No. 33, 105th Cong., 1st Sess. 201 (1997). Although the particular scheme that was the focus of Congress’s attention in 1997 involved an attempt to exploit the interplay of rules under section 664 governing the timing of income and the character of trust distributions, the attempted result of the scheme (commonly referred to as an “accelerated charitable remainder trust”) was the same as that claimed by the promoters of the transactions described above—that is, a literal application of rules governing trust distributions in an attempt to convert appreciated trust assets into tax-free cash in the hands of the non-charitable beneficiary. The latest schemes involving charitable remainder trusts are no less “abusive” or “inconsistent with the purpose of the charitable remainder trust rules” than were the accelerated charitable remainder trust schemes addressed by Congress in 1997.

### *B. The Proposed Regulations*

Section 643(a)(7) authorizes the Secretary to prescribe regulations to carry out the purposes of the provisions of the Code relating to the taxation of estates, trusts, and beneficiaries, including regulations to prevent avoidance of such purposes. The proposed regulations exercise this authority by modifying the treatment of certain distributions by charitable remainder trusts for purposes of section 664(b) to prevent a result that, as discussed above, is inconsistent with the purposes of the charitable remainder trust rules.

The proposed regulations provide that, to the extent that a distribution of the annuity or unitrust amount from a charitable remainder trust is not characterized in the hands of the recipient as income from the categories described in section 664(b)(1), (2), or (3) (determined without regard to the rules in these proposed regulations) and was made from an amount received by the trust that was neither a return of basis in any asset sold by the trust (determined without regard to the rules in these proposed regulations) nor attributable to a contribution of cash to the trust with re-

spect to which a deduction was allowable under section 170, 2055, 2106, or 2522, the trust shall be treated as having sold, in the year for which the distribution is due, a pro rata portion of the trust assets. Any transaction that has the purpose or effect of circumventing this rule will be disregarded. For example, a return of basis in an asset sold by a charitable remainder trust does not include basis in an asset purchased by the charitable remainder trust from the proceeds of a borrowing secured by previously contributed assets.

The proposed regulations include examples that illustrate the application of the above rule. The IRS and the Treasury Department request comments on whether there are situations where the application of this rule would be inappropriate.

These proposed regulations adopt a pro-rata sale approach to determine the amount of gain on the distribution of funds acquired in advance of income recognition. The IRS and the Treasury Department also considered an approach that more directly related the distributed funds to the asset that is the subject of the borrowing or forward sale. Comments are requested on this alternative approach.

### *C. Proposed Effective Date*

The regulations are proposed to apply to distributions made by charitable remainder trusts after October 18, 1999.

However, to the extent that a charitable remainder trust financed a distribution to a beneficiary by borrowing funds or entering into a forward sale or other similar transaction prior to the effective date of these regulations, the IRS may apply an appropriate legal doctrine to recast the entire transaction, to characterize the distribution as gross income rather than corpus, or to challenge the qualification of the trust under section 664. In appropriate circumstances, the IRS may impose the tax on self-dealing transactions under section 4941. Additionally, the trust may be treated as having unrelated business taxable income under section 512 from the transaction. The IRS will also apply any applicable penalties to the participants in the transaction.

### *Special Analyses*

It has been determined that this notice of proposed rulemaking is not a signifi-

cant 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 IRS and Treasury Department 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### *Comments and Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 9, 2000, at 10 a.m. in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit timely written comments and an

outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by January 19, 2000.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

*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.

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*Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 1 is proposed to be 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:

*§1.643(a)–8 Certain distributions by charitable remainder trusts.*

(a) *Purpose and scope.* This section is intended to prevent the avoidance of the purposes of the charitable remainder trust rules 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) *Deemed sale by trust.* (1) For purposes of section 664(b), a charitable remainder trust shall be treated as having sold, in the year for which a distribution of an annuity or unitrust amount from the trust is due, a pro rata portion of the trust assets to the extent that the distribution of the annuity or unitrust amount—

(i) Is not characterized in the hands of the recipient as income from the cate-

gories described in section 664(b)(1), (2), or (3), determined without regard to this paragraph (b); and

(ii) Was made from an amount received by the trust that was not—

(A) A return of basis in any asset sold by the trust, determined without regard to this paragraph (b); or

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

(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 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 a return of basis in any asset sold by the trust (determined without regard to paragraph (b) of this section) or a cash contribution to the trust with respect to which a charitable deduction was allowable. 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).

*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 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.

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Charles O. Rossotti,  
*Commissioner of  
Internal Revenue.*

(Filed by the Office of the Federal Register on October 18, 1999, 11:16 a.m., and published in the issue of the Federal Register for October 21, 1999, 64 F.R. 56718)