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Reforming Charitable Remainder Trusts in Colorado Under the New IRS Procedures
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On December 10, 1998, the Internal Revenue Service ("IRS") issued Final Regulations governing charitable remainder trusts ("CRTs").[1] The Final Regulations adopt the proposed amendments to the CRT Regulations issued in April 1997[2], with some substantial revisions. The Final Regulations address:

- "flip unitrusts," including provisions for reforming certain existing CRTs into qualifying flip unitrusts;
- the time for paying the annuity or unitrust amount;
- valuation of unmarketable assets held by a CRT;
- the application of Internal Revenue Code ("Code") § 2702 to certain CRTs;
- the prohibition on allocating pre-contribution gain to trust income for net income charitable remainder unitrusts ("NICRUTS") and net income with make-up charitable remainder unitrusts ("NIMCRUTS"); and
- whether the "make-up amount" under a NIMCRUT must be treated as a liability.

This article focuses on the provisions of the Final Regulations regarding flip unitrusts, specifically the requirements for reformation of existing CRTs to qualify as flip unitrusts under Colorado law. A brief summary of the other topics addressed by the Final Regulations also is included.

The "New" Flip Unitrusts

A "flip unitrust" is a charitable remainder unitrust that starts out as a net income method unitrust (a trust that pays the non-charitable beneficiary the lesser of the annual net income or a fixed percentage based on the fair market value of the trust assets) or a net income with make-up trust (a trust that pays the non-charitable beneficiary the lesser of the annual net income or a percentage amount plus any amount of income that exceeds the current year's fixed percentage amount to make up for any shortfall in payments from prior years) and then switches to a fixed percentage payout on a certain date or on the happening of a certain event.

There are several situations where a flip unitrust might be advantageous to a client. The situation most often considered is where the trust is to be initially funded with unmarketable and/or perhaps low- income or no-income-producing assets that will later be sold by the trust. A straight percentage unitrust could cause the trust to have to distribute some of the trust property in satisfaction of the unitrust amount if the net income is not sufficient to cover the required distributions. A flip unitrust would avoid this result by providing for income-only distributions until a certain date or event (such as the sale of the assets), at which time the trust would "flip" and begin paying the full unitrust amount thereafter.

In the past, many practitioners have used the NIMCRUT in this situation. However, with a NIMCRUT, the trustee may find it difficult to meet the non-charitable beneficiary's current distribution expectations, which require investing in income-producing assets, while at the same time preserving the charitable remainderman's expectations, which would require investing for growth. With a flip unitrust, the trustee can invest in growth assets after the "flip" date without affecting the non-charitable beneficiary's distribution expectations. Another situation where a flip unitrust may be useful is where the client does not need a fixed distribution at the current time, but would like the certainty of a fixed distribution at some time in the future, such as on retirement, attaining a certain age, or a specific life event.

Prior to the issuance of the Proposed Regulations, the IRS had ruled privately that a flip unitrust did not qualify as a charitable remainder unitrust under Code § 664.[3] The 1997 Proposed Regulations breathed new life into flip unitrusts by allowing such trusts to qualify as a CRT if certain requirements were met. First, at least 90 percent of the fair market value of the assets held by the trust immediately after a contribution to the trust had to be unmarketable. "Unmarketable assets" were defined as assets other than cash, cash equivalents, or marketable securities [within the meaning of § 731(c)]. Second, the triggering event for the switch from the net income method to the fixed percentage unitrust method had to occur on the earlier of (1) the sale of a specified unmarketable asset (or group of unmarketable assets) that was originally contributed to the trust; or (2) the sale of unmarketable assets resulting in the remaining unmarketable assets being worth no more than 50 percent of the value of the trust assets. Third, the switch in method had to occur in the first taxable year following the year in which the sales occurred. Fourth, any make-up amount had to be forfeited on the switch.[4]

Although the Proposed Regulations were more lenient than the IRS's previous position, a number of issues and concerns with the new rules were raised by practitioners during the period for comments to the Proposed Regulations. In particular, a number of practitioners requested that flip unitrusts be permitted for all net income method CRUTs, regardless of the marketability of the trust assets. Others suggested that the regulations be clarified as to whether the proposed rule was a safe harbor or the exclusive circumstance for which a flip unitrust would be permitted. In response to practitioners' concerns, the IRS broadened the availability of the flip unitrust under the Final Regulations.

The Final Regulations provide that a CRUT can "flip" from a net income method trust to a fixed percentage method trust if the date or event triggering the conversion is outside the control of the trustee or any other person.[5] Certain events are specifically defined in the regulations as not within the control of any person. These events include the sale of unmarketable assets (now defined as assets other than cash, cash equivalents, or assets that can be readily sold or exchanged for cash or cash equivalents), or the marriage, divorce, death, or birth of a child with respect to an individual.[6] Other events that would not be within anyone's control would include a specific date or obtaining a certain age. The Final Regulations retain the requirement that any make-up amount will be forfeited when the trust switches methods.[7] The new regulations apply to CRTs created on or after December 10, 1998.[8]

Reformation of Existing Trusts

In addition to allowing flip unitrusts to be created after the effective date of the Final Regulations, the Final Regulations allow certain existing CRTs to be reformed to meet the requirements of a flip unitrust. A flip unitrust that was created before December 10, 1998, that does not meet the requirements for a flip unitrust under the regulations may be reformed as a net income method trust at anytime, or the trust may be reformed as a flip unitrust if legal proceedings for reformation of the trust are initiated by a certain date and as long as the triggering event under the reformed instrument does not occur in a year prior to the year of reformation.[9] Since these trusts will not qualify as CRTs without being reformed, all such trusts should be reformed as soon as possible.

In addition, the regulations allow any net income method unitrust to be reformed to qualify as a flip unitrust if legal proceedings for reformation of the trust are initiated by a certain date and the triggering event does not occur in a year prior to the year of the reformation.[10] The date provided by the Final Regulations for initiating reformation proceedings was June 8, 1999.[11]

The IRS has once again heeded requests by practitioners relating to the new final regulations on CRTs. On May 21, 1999, the IRS issued Notice 99-21, which extended the deadline for beginning judicial proceedings to reform existing charitable remainder trusts from June 8, 1999, to June 30, 2000. In addition, the Notice also clarifies that the term "legal proceedings" in the Final Regulations includes a non-judicial reformation that is valid under state law, if completed by June 30, 2000. This should make it easier in many states, including Colorado, to reform an existing CRT.

To determine whether an existing CRT may be reformed, an analysis of the state law requirements for reformation must be made. The Colorado Revised Statutes specifically allow a charitable trust to be amended to conform to the provisions of Code § 664 without application to any court.[12] The consent of all of the beneficiaries under the trust agreement is required for such an amendment.[13] However, the statute specifically provides that the consent of beneficiaries who are not living at the time of the amendment or charitable beneficiaries that are not named in the trust instrument or not in existence at the time of the amendment is not required.[14] This avoids the necessity of obtaining a court-appointed guardian *ad litem* for unascertained beneficiaries.

The question arises as to whether this requires the consent of a charity named in the trust agreement, but which has subsequently been replaced pursuant to authority provided in the trust instrument. Although a literal reading of the statute might imply that such a beneficiary would have to consent, it is this author's opinion that a charity that has been replaced is no longer a "beneficiary" under the trust agreement and, therefore, its consent is not required. However, as long as the amendment to the trust agreement could be revoked or changed, it would be prudent to obtain the consent of the original charity named in the agreement. While this could be awkward, it ensures that all necessary parties to the reformation have been given notice and have consented to the reformation.

If a non-charitable beneficiary is a minor or otherwise not competent to give consent to the amendment, the consent of such beneficiary's guardian or conservator is sufficient.[15] If such a beneficiary does not have a guardian or conservator, a court-appointed guardian *ad litem* would be required. As with many states, Colorado also requires that the state attorney general be notified of the proposed amendment.[16] The attorney general has sixty days to object to the proposed amendment. If the Attorney General objects to the proposed amendment, the amendment must be approved by a court having jurisdiction over the trust.[17] If any trustee or beneficiary does not consent to the reformation, or if there are no named beneficiaries, then a trustee or any beneficiary can petition a court having jurisdiction over the trust to reform the trust on the court's finding that the testator's or grantor's intent would not be defeated by the reformation.[18]

Accordingly, reforming a CRT under Colorado law can be done without court order in most instances, assuming the attorney general has no objections to the reformation. However, since a non-judicial trust reformation must be completed by June 30, 2000, the practitioner should provide for adequate time to allow the attorney general to respond to the notice of reformation, and, if he or she objects, to file a reformation proceeding with the court having jurisdiction before the June 30, 2000, deadline.

Payment by Year End

In order for a trust to qualify as a CRT, the annuity or unitrust payments must be made at least annually.[19] Prior to the proposed amendments, the treasury regulations provided that the trust would not be disqualified as long as the payments were made within a "reasonable time after the close of the taxable year."[20] A "reasonable time after the close of the taxable year" was defined as not extending beyond the date for filing the Split Interest Trust Information Return.[21] The proposed regulations would have changed this to provide that the annuity or fixed percentage unitrust payment must be made by the close of the taxable year.[22]

A significant number of comments opposed to this proposed rule were received by the IRS. Practitioners expressed concern that this would place a significant burden on many trusts. In response to the comments received on the proposed amendments, the IRS issued Notice 97-68, which provided guidance on complying with the proposed rules for the 1997 tax year.[23] The Final Regulations continue to allow the annuity or fixed percentage unitrust payments to be made within a reasonable time after the close of the taxable year as long as the character of the payment in the recipient's hands is income under Code § 664(b)(1), (2), or (3) and/ or the trust distributes property (other than cash) that it owned as of the close of the taxable year in satisfaction of the required payment and the trustee elects to treat any income generated by the distribution as occurring on the last day of the taxable year for which the payment is due.[24]

In addition, the Final Regulations provide that for CRATs and fixed percentage CRUTs created before December 10, 1998, the annuity or untitrust payment may be paid within a reasonable time after the close of the taxable year if the percentage used to calculate the annuity or unitrust amount is 15 percent or less.[25] These rules apply to distributions for taxable years ending after

April 18, 1997.

Valuation of Unmarketable Assets

Prior to the proposed amendments to the regulations, the legislative history to Code § 664 indicated that unmarketable assets held by a CRT must be valued by an independent trustee.[26] The proposed and Final Regulations incorporate this rule but also expand it by allowing the trust's unmarketable assets to be valued by a qualified appraiser in the alternative.[27] The trust instrument must specifically require one of these two alternatives in order to qualify as a CRT if the trust holds unmarketable assets. This new rule is effective for trusts created on or after December 10, 1998.

The option of having an appraiser value unmarketable assets is not automatically available for trusts in existence as of December 10, 1998. However, the regulations provide that existing trusts that require an independent trustee to value unmarketable assets may be amended or reformed to permit a qualified appraisal of the assets.[28] The regulations do not provide any time frame for such an amendment.

Application of Code § 2702

The Final Regulations provide that only certain CRTs continue to remain exempt from the special valuation rules under Code § 2702. For transfers made on or after May 19, 1997, § 2702 will not apply to a transfer to a CRAT, a fixed percentage CRUT, or a NICRUT or NIMCRUT if the NICRUT or NIMCRUT only has two consecutive non-charitable beneficiaries and the transferor holds the second interest or the only non-charitable beneficiaries are the transferor, the transferor's U.S. citizen spouse, or both.[29] A flip unitrust also will be exempt if it meets one of the exceptions for the net income CRTs.

If the CRT does not fall within one of these exceptions, the value of the donor's retained interest cannot be subtracted from the value of the taxable gift to the non-charitable beneficiary. However, a taxable gift may be avoided if the donor retains the right to revoke the interests of any successor non-charitable beneficiaries, since this will cause the gift to be incomplete.

Allocation and Liability Issues

The Final Regulations also clarify that any proceeds received from the sale or exchange of assets held by a CRUT must be allocated to principal, and not income, to the extent of pre-contribution gain on such assets.[30] The trust agreement may provide that any post-contribution gain can be allocated to trust income. This is permitted under Colorado law.[31] In addition, the Preamble to the Final Regulations provides that the make-up amount under a NIMCRUT no longer must be treated as a liability when valuing the assets of the trust.

Conclusion

The Final Regulations provide several new planning opportunities for practitioners. In particular, the new rules allowing flip unitrusts will prove useful in many instances and, given the non-judicial procedures available under Colorado law, practitioners should consider notifying clients with existing CRUTs of the window of opportunity for reforming such CRUTs to flip unitrusts.

Other provisions in the Final Regulations, such as using a qualified appraiser to value unmarketable assets and allowing for post contribution gain to be allocated to income instead of principal, should be incorporated into the practitioner's forms for use with new CRTs.

NOTES

1. Treas. Dec. Int. Rev. 8791 (1998).

2. Prop. Treas. Reg. § 1.664, 62 Fed. Reg. 19072 (1997).

3. *See* PLR 9506015.

4. Prop. Treas. Reg. § 1.664-3(a)(1)(i)(c).

5. Treas. Reg. § 1.664-3(a)(1)(i)(c)(1).

6. Treas. Reg. § 1.664-3(a)(1)(i)(d).

7. Treas. Reg. § 1.664-3(a)(1)(i)(c)(3).

8. Treas. Reg. § 1-664.3(a)(1)(i)(f)(1).

9. Treas. Reg. § 1.664-3(a)(1)(i)(f)(2).

10. Treas. Reg. § 1.664-3(a)(1)(i)(f)(3).

11. *Id.*

12. CRS § 15-1-1002(3).

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. CRS § 15-1-1002(4).

19. I.R.C. § 664(d)(1) and (2) (1986).

20. Treas. Reg. § 1.664-2(a)(1) and Treas. Reg. § 1.664-3(a)(1) (pre-December 10, 1998).

21. *Id.*

22. Prop. Treas. Reg. § 1.664-2(a)(1)(i) and § 1.664-3(a)(1)(i)(e), 62 Fed. Reg. 19072 (1997).

23. 1997-48 I.R.B. 11.

24. Treas. Reg. § 1.664-2(a)(1)(i)(a) and Treas. Reg. § 1.664-3(a)(1)(i)(g).

25. Treas. Reg. § 1.664-2(a)(1)(i)(b) and Treas. Reg. § 1.664-3(a)(1)(i)(h).

26. HR Rep. No. 413, 91st Cong. 1st Sess 60 (1969).

27. Treas. Reg. § 1.664-1(a)(7).

28. Treas. Reg. § 1.664-1(f)(4).

29. Treas. Reg. § 25.2702-1(c)(3).

30. Treas. Reg. § 1.664-3(a)(1)(i)(b)(4).

31. CRS § 15-1-405.

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