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— *47th year* —

Tax Deductions for Volunteers' Expenses. For a specimen letter to volunteers telling about deductible expenses incurred in their volunteer work, go to www.taxwisegiving and click on Publications. *Taxwise Giving* subscribers have permission to adopt (or adapt) the letter.

CRT CAPITAL GAIN AVOIDANCE PLAN ON IRS RADAR

- **Participants must notify IRS**
- **Costly penalties for notification failure**
- **Avoidance or evasion?**
- **Your views solicited**

The meek shall inherit the earth and with a stepped-up basis. So for appreciated assets inherited at death, an heir gets a basis equal to the then fair market value (rather than taking over the decedent's lower basis). But a decedent has to give his life to achieve this.

Can the donor (or other beneficiary) of a charitable remainder unitrust or annuity trust during his lifetime step up the basis of appreciated assets used to fund the CRT and then on an early termination of the trust get back proceeds equal to his interest in the trust free of capital gains tax? That's what concerns the IRS in Notice 2008-99, the subject of this article.

Three scenarios follow. Scenario 3 troubles the IRS. Scenarios 1 and 2 are for background.

Scenario 1 — no problem. Every schoolchild knows that a donor can transfer appreciated assets to a charitable remainder unitrust or annuity trust and avoid capital gain on the trust's funding, and not be taxed on the capital gain on a subsequent sale by the trust. The capital gain is, however, taxable to the donor or other beneficiary (recipient) but only to the extent that the gain is deemed distributed to the recipient under the four-tier taxation regime in satisfaction of the annual unitrust or annuity trust amount.

Scenario 2 — no problem. Some recipients terminate their CRTs before the end of the specified term and the trust assets are divided between the recipient and the charitable remainder beneficiary according to their respective interests at the CRT's termination. A number of letter rulings have sanctioned this. The termination is treated as a sale of the recipient's term interest (generally measured by his life but sometimes a term-of-years interest). The recipient is deemed to have a zero basis and has long-term capital gain if the trust was created more than one year before its termination.

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A harbinger of Scenario 3. In January 2008, to the annual list of areas under study in which rulings will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations or otherwise, IRS added:

> •*IRC §664. — Charitable Remainder Trusts.* Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, causes the trust to have ceased to qualify as a charitable remainder trust within the meaning of §664.

Something to think (and worry?) about. What bad consequences can befall the donor and a CRT that terminates early and has ceased to qualify as a charitable remainder trust within the meaning of §664*?*

Note. The IRS's work plan (to-do list) for the period of July 1, 2007 to June 30, 2008 stated that a revenue ruling on the termination of charitable remainder trusts under IRC §664 and the division of the assets between the life beneficiary and the charitable remainder organization will be issued. Could Notice 2008-99 be the forerunner to a revenue ruling or other binding authority?

Scenario 3 — a big problem. The IRS and the Treasury announce in Notice 2008-99 that they are aware of a transaction (described soon) in which a sale or other disposition of all interests in a charitable remainder trust (subsequent to the contribution of appreciated assets to the trust and their sale and reinvestment by the trust) results in the donor or other noncharitable recipient getting the value of that person's trust interest and claiming to recognize little or no taxable gain. "The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion*, but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction." The IRS identifies this transaction and substantially similar transactions as transactions of interest for purposes of Reg. §1.6011-4(b)(6) and IRC §§6111 and 6112. IRS also alerts persons involved in these transactions to certain responsibilities that may arise from their involvement. More about transactions of interest, listed transactions and reportable transactions later. To keep this article from becoming a book, I won't explain all the Code and regulation sections cited in Notice 2008-99 regarding required notifications to the IRS. Suffice it to say if you're involved in this type of transaction, you'll want to study them.

*Evasion is more serious than avoidance. Avoidance can be achieved by taking advantage of tax-saving methods specified in the Code. Sometimes it is achieved by a loophole (something that Congress didn't think of — but kosher until the loophole is closed by legislation, regulation, revenue ruling, etc.). Tax evasion, on the other hand, can end you up in a federal gated community.

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Here's the transaction of interest to the IRS and the Treasury. *Step 1.* Donor creates a CRT and contributes Appreciated Assets to Trust. Donor retains an annuity or unitrust interest (Term Interest) and designates Charity as the remainder beneficiary. Charity may, but need not, be controlled by Donor; he may, but need not, reserve the right to change the Charity designated as the remainder beneficiary.

Step 2. Trust sells or liquidates the Appreciated Assets and reinvests the net proceeds in other assets (New Assets) such as money market funds and marketable securities often to acquire a diversified portfolio. Because a charitable remainder trust generally is tax-exempt under IRC §664, Trust's sale of the Appreciated Assets is exempt from income tax, and Trust's basis in the New Assets is the price Trust pays for those New Assets. Some portion of Trust's ordinary income and capital gains may become taxable to Donor as the periodic annuity or unitrust payments are made by Trust (under the rules of IRC §664 and its regulations).

Step 3. Donor and Charity, in a transaction they claim is described in IRC §1001(e)(3), sell or otherwise dispose of their respective interests in Trust to Xenocrates, an unrelated third party, for approximately the fair market value of the Trust's assets including the New Assets.

Step 4. Trust then terminates, and Trust's assets, including the New Assets, are distributed to Xenocrates.

Donor takes these positions regarding the tax consequences of this transaction:

- Donor claims an income tax charitable deduction for the portion of the fair market value of the Appreciated Assets attributable to the remainder interest as of the date of their contribution to Trust.

- Donor claims to recognize no gain from the Trust's sale or liquidation of the Appreciated Assets. When Donor and Charity sell their respective interests in Trust to Xenocrates, Donor and Charity take the position that they have sold the entire interest in Trust within the meaning of IRC §1001(e)(3). Because the entire interest in Trust is sold, Donor claims that IRC §1001(e)(1), which disregards basis in the case of a sale of just the term interest, doesn't apply. Donor also takes the position that, under IRC §1001(a) and related provisions, the gain on the sale of Donor's term interest is computed by taking into account the portion of uniform basis allocable to Donor's term interest under Reg. §§1.1014-5 and 1.1015-1(b), and that this uniform basis is derived from the basis of the New Assets rather than the basis of the Appreciated Assets. (If this works, Donor has achieved Tax Nirvana — a stepped-up basis without giving his life.)

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Variations on a scheme:

- A net-income-with-make-up charitable remainder unitrust (NIM-CRUT) is used.
- Trust may have been in existence for some time prior to the sale of Trust interests.
- The Appreciated Assets may already be in Trust before the commencement of the transaction.
- The recipient and seller of the term interest may be the Donor and/or another person.
- Donor may contribute the Appreciated Assets to a partnership or other passthrough entity and then contribute the interest in the entity to Trust.

Claimed tax treatment of the transaction. The gain on the sale of the Appreciated Assets is never taxed, even though the Donor receives his share of the appreciated fair market value of those assets.

Ordinary folks needn't worry. The IRS and the Treasury aren't concerned about the mere creation and funding of a charitable remainder trust with Appreciated Assets and/or the trust's reinvestment of the contributed Appreciated Assets. Those events alone don't constitute the transaction subject to Notice 2008-99.

Who should be concerned? The IRS and the Treasury "are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets. Accordingly, the type of transaction described in this notice includes a coordinated sale or other coordinated disposition of the respective interests of the [Donor] or other noncharitable recipient and the Charity in a charitable remainder trust in a transaction claimed to be described in §1001(e)(3), subsequent to the contribution of appreciated assets and the trust's reinvestment of those assets. In particular, the IRS and Treasury Department are concerned about [Donor's] claim to an increased basis in the term interest coupled with the termination of the Trust in a single coordinated transaction under §1001(e) to avoid tax on gain from the sale or other disposition of the Appreciated Assets."

Now for Notice 2008-99's teeth — transactions of interest. Transactions that are the same as, or substantially similar to, those described in Notice 2008-99 "are identified as transactions of interest for purposes of §1.6011-4(b)(6) and §§6111 and 6112 effective October 31, 2008, the date this notice was released to the public. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in §1.6011-4. Mate-

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(Cont.)

rial advisors who make a tax statement on or after November 2, 2006, with respect to transactions entered into on or after November 2, 2006, have disclosure and list maintenance obligations under §§6111 and 6112. See §1.6011-4(h) and §§301.6111-3(i) and 301.6112-1(g) of the Procedure and Administration Regulations."

The IRS's and the Treasury's warning. Participants who entered into these transactions at any time may already be in hot water. "Independent of their classification as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in this notice already may be subject to the requirements of §§6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have gathered enough information to make an informed decision as to whether this transaction is a tax avoidance type of transaction, the IRS and Treasury Department may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction."

Who are participants? "Under §1.6011-4(c)(3)(i)(E), each recipient of the term interest and Trust are participants in this transaction for each year in which their respective tax returns reflect tax consequences or a tax strategy described in this notice. Charity is not a participant if it sold or otherwise disposed of its interest in Trust on or prior to October 31, 2008. For interests sold or otherwise disposed of after October 31, 2008, under §1.6011-4(c)(3)(i)(E), Charity is a participant for the first year for which Charity's tax return reflects or is required to reflect the sale or other disposition of Charity's interest in Trust. In general, Charity is required to report the sale or other disposition of its interest in Trust on its return for the year of the sale or other disposition. See §6033 and §1.6033-2(a)(ii). Therefore, in general, Charity will be a participant for the year in which charity sells or otherwise disposes of its interest in Trust."

Time for Disclosure. See Reg. §§1.6011-4(e) and 301.6111-3(e).

Material Advisor Threshold Amount. The threshold amounts in Reg. §301.6111-3(b)(3)(i)(B) are reduced to $5,000.

Penalties — the book will be thrown at those who are required to disclose but don't. "Persons required to disclose these transactions under §1.6011-4 who fail to do so may be subject to the penalty under §6707A. Persons required to disclose these transactions under §6111 who fail to do so may be subject to the penalty under §6707(a). Persons required to maintain lists of advisees under §6112 who fail to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under §6708(a). In addition, the IRS may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §6662 or §6662A."

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Treasury and the IRS invite your comments. They say that the government is aware of concerns expressed by commentators on this transaction of interest and are requesting written comments on how the transaction might be addressed in published guidance. One approach might involve issuing regulations under the authority of IRC §643(a)(7) to address the uniform basis rules under IRC §§1014 and 1015 and the regulations thereunder.

Comments should be submitted by January 31, 2009 to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2008-99), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20224. Alternatively, comments may be hand delivered Monday through Friday between 8:00 a.m. and 4:00 p.m. to: CC:PA:LPD:PR (Notice 2008-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC. Comments also may be submitted electronically via this e-mail address:
Notice.Comments@irscounsel.treas.gov. Include "Notice 2008-99" in the subject line of any electronic submissions.

Drafting Information. The principal author of this notice is Allison Carmody, Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information, contact Ms. Carmody at (202) 622-3070.

My opinion. Clearly, Congress didn't intend to allow the capital gains tax avoidance plan described in Notice 2008-99. And that avoidance should be curbed. Any corrective legislation or regulation should, however, also deal fairly with transactions that aren't designed to slide between any loopholes.

Example. Five years ago, a donor transferred securities valued at $1 million to fund a charitable remainder unitrust. The securities were not appreciated and had a $1 million basis (and the CRT took over the donor's basis). The donor and the charity now terminate the CRT by selling their respective interests to a third party for $1 million (the current fair market value).

The donor's life interest is now valued at 60% and the charity's remainder interest is now valued at 40% of the trust's assets. So the donor receives $600,000 and the charity receives $400,000. It would be unfair for the donor's basis to be deemed to be zero. In this case, he hasn't through the CRT stepped up the basis of the assets used to fund the trust. Thus the basis of his share of the trust assets sold to the third party should be $600,000. The same rule should apply if the CRT sold the assets originally used to fund the trust and purchased other assets and at the time the trust is terminated those assets are also worth $1 million (with the donor's then interest being valued at $600,000).

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What should the rule be in the following situation? Donor funds his charitable remainder unitrust with appreciated assets that have a basis of $800,000 and a $1 million fair market value. The funding assets are sold by the trust and the proceeds reinvested in new assets having a $1 million fair market value. Five years after the CRT is created, the donor and the charity sell their respective interests to a third party. At that time, the donor's life interest is worth 60% of the value of the trust assets and he receives $600,000. It would be unfair (not intended by Congress) for him to have no capital gain — nor would it be fair for him to have a zero basis and a $600,000 capital gain. To thicken the plot, suppose the donor as the trust recipient was taxed on some or all of the capital gain when it was deemed distributed to him under tier two of the four-tier rule for taxation of the unitrust amount to the recipient. This should be taken into account in determining the donor's basis on the termination of the CRT.

Suggested solution — fair to the IRS, the Treasury and the recipient (person receiving the value of the term interest) on a sale by the recipient and the charity of the trust assets to a third party. The recipient's basis is his pro rata share of the CRT's basis reduced by his pro rata share of any undistributed amounts then in tier two (capital gain) of the four-tier provision for taxation of unitrust (and annuity) amounts to the trust recipient.