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Improperly Drafted Charitable Reminder Unitrust (CRUT) Results in Loss of Estate Tax Charitable Deduction

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Overview

The United States Court of Appeals for the Seventh Circuit has affirmed the Tax Court and denied an estate's claimed charitable deduction for a nonqualified charitable remainder trust.[1] In the process, the court also rejected the estate's argument that the deduction should be allowed based on substantial compliance with the tax code.

CRUT details

A CRUT is a trust in which the income goes to individuals during their lifetimes (or some other period), with any remaining amounts passing to charity. Until 1969, the value of the estimated present value of the remainder was deductible on the decedent's federal estate tax return. However, in 1969, the Congress established specific rules detailing the form a CRUT must take to derive a tax deduction for the grantor.[2] Under those rules, no more than a specified percentage of the fair market value of the trust's assets (as determined annually), for a specified period, can pass to non-charitable beneficiaries. Everything else must pass to a charity.[3] Under § 664(d)(1) a charitable remainder unitrust is a trust that has four characteristics:

- The payment from the trust must be a fixed percentage that is at least 5 percent and no more than 50 percent of the initial fair market value of all of the property in the trust, and must occur at least annually to one or more persons at least one of which is not a charity.[4] For payments to individuals, payment must be made to persons who are living at the time of the trust's creation, and must be for a term of up to 20 years or for the life of such person.[5]
- No other payments are made from the trust other than the required payments or qualified gratuitous transfers described in the remainder interest transfer requirement unless it is an organization described in I.R.C. §170(c).[6]
- Upon the termination of the required trust payments, the remainder interest in the trust is transferred to or for the use of a qualified charity (as defined by I.R.C. §170(c)).[7]
- The value of the remainder interest is at least 10 percent of the initial fair market value of all property placed in the trust.[8]

Later, the Congress provided that a charitable remainder trust that was not in the unitrust form could, if changed to that form, qualify for the deduction. However, unless the only change involves a correction of some merely technical error in the original trust instrument, a judicial proceeding must be brought to change the trust into the proper unitrust form. That proceeding must be filed not later than 90 days after the decedent's estate tax return is required to be filed (including extensions).[9]

Facts of Tamulis[10]

The decedent died in 2000, leaving an estate of $3.4 million. His will left the bulk of his estate to his living trust. The trust was to continue for the longer of 10 years or the joint lives of his brother and the brother's wife. During that period they would have a life estate in a house

that the trust owned, and the trust would pay the real estate taxes on the house. The net income of the trust was to go to two of the brother's and sister-in-law's grandchildren (the decedent's grandnieces), minus $10,000 a year, which would go to their third child until she graduated from medical school. Upon the trust's termination, the assets would pass to charity.

The estate tax return, filed in 2001, claimed a charitable deduction of $1.5 million, which was the present value of the charitable remainder - described on the return as the "residue following 10 year term certain charitable remainder unitrust at 5% quarterly payments to two grand nieces." For the years 2001 through 2004, the trust distributed no more than 5 percent of the fair market value of the trust's assets, as valued at the beginning of each year, to the grandnieces and for the payment of the real estate taxes on their parents' home. IRS refused to allow the $1.5 million charitable deduction on the basis that the charitable remainder, as defined in the trust instrument, was not a CRUT because it did not specify either a fixed dollar amount, or the percentage of the trust's fair market value, that would go to the income beneficiaries -- to the grandnieces in cash and to their parents in the form of a life estate in the house and payment of the real estate taxes on it, which would be paid out of the trust's income. This was a fundamental defect, correctable only by a judicial proceeding to reform the trust, filed within 90 days after the estate tax return was due.[11]

The trustee (who was also the executor of the decedent's will) and the charity realized that there was a problem. However, more than eight months elapsed before the executor prepared a complaint to file in state court to reform the trust, and then the complaint was never filed. Instead, in 2003 the executor circulated to the income beneficiaries a proposed reformation of the trust to bring it into compliance with the Code. But the third grandniece did not sign it, and so the trust was never reformed, with or without a judicial proceeding, although the trustee continued to administer the trust in accordance with the requirements of the Code, as the original trustee (who subsequently died) had stated on the estate tax return that he was doing. The trustee's argument was that the statement on the return, coupled with the trustee's continued administration of the trust as if it were a qualified unitrust, should be deemed substantial compliance with the Code even though it was not literal compliance.

The Substantial Compliance Doctrine

It is true that a doctrine of substantial compliance exists that excuses technical non-compliance with the often intricate and obscure provisions of the Internal Revenue Code. However, the courts have routinely stated that the doctrine should not be allowed to spread beyond cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute."[12] The estate could not satisfy that test.[13] Indeed, the executor-trustee was represented by counsel and was aware that a substantial tax deduction was at stake. As such, the executor had no excuse for failing to bring the required judicial proceeding to reform the trust. The court noted that the CRUT requirements are important - they protect against efforts to bend trust law to get a tax benefit - and they are stated clearly in the Code and regulations . As such, until the trust was reformed, compliance with the spirit of the Code's provisions dealing with charitable remainder trusts had depended largely on the trustee's good faith. The court reasoned that the doctrine of substantial compliance "seek[s] to preserve the need to comply strictly with regulatory requirements that are important to the tax collection scheme and to forgive noncompliance for either unimportant and tangential requirements or requirements that are so confusingly written that a good faith effort at compliance should be accepted." Those facts simply were not present in this case.

Summary

The outcome of the case is unfortunate. The grandnieces and the charity suffered a major loss due to the payment of federal estate tax which should have been largely avoided. The drafting attorney could have easily created a life estate for the brother and sister in the residence and a 5 percent term of twenty years CRUT for the grandnieces. That would have resulted in greater benefit to the grandnieces and would have qualified for the 1.5 million charitable estate tax deduction.

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[1] Estate of Tamulis v. Comr., No. 06-4141, 2007 U.S. App. LEXIS 27466 (7th Cir. Nov. 29, 2007), *aff'g*, T.C. Memo. 2006-183.

[2] I.R.C. §664(d).

[3] Id. The Congress was concerned that the trustee might invest the trust's assets in a way calculated to maximize current income, with the result that when finally received by the charity, the remainder would be worth less than the estimated actuarial value on which the deduction from estate tax had been based.

[4] I.R.C. §664(d)(1)(A).

[5] Id.

[6] I.R.C. §664(d)(1)(B).

[7] I.R.C. §664(d)(1)(C).

[8] I.R.C. §664 (d)(1)(D).

[9] I.R.C. §2055(e)(3)(C)(iii).

[10] Estate of Tamulis v. Comr., No. 06-4141, 2007 U.S. App. LEXIS 27466 (7th Cir. Nov. 29, 2007), *aff'g*, T.C. Memo. 2006-183.

[11] I.R.C. §2055(e). Assuming a six-month extension to the nine-month filing period plus the 90 days, the applicable time period to file for judicially-approved reformation would have been approximately 18 months after the decedent's death.

[12] *See, e.g.*, Prussner v. United States, 896 F.2d 218 (7th Cir. 1990); Volvo Trucks of North America, Inc. v. United States, 367 F.3d 204 (4th Cir. 2004); Estate of Hudgins v. Comr., 57 F.3d 1393 (5th Cir. 1995).

[13] The court stated that the "substantial compliance" standard is met if there is a failure to comply with "an important requirement or one unclearly or confusingly stated in the regulations or the statute."