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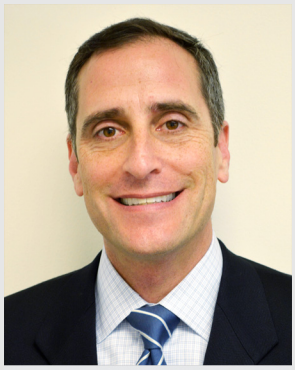

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In this report, Hesch, Breitstone, and Jacobson discuss how to value interests in charitable remainder unitrusts upon an early termination, and they address the self-dealing considerations when there is an early termination.

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On December 18, 2015, President Obama signed a bipartisan bill, the Protecting Americans From Tax Hikes (PATH) Act,[1] which provides a definitive method for valuing the interests in some charitable remainder trusts (CRTs) that terminate before the end of their stated terms.[2] The relevant statutory language, added to section 664(e), is terse but unequivocal:

> In the case of the early termination of a trust which is a charitable remainder unitrust by reason of subsection (d)(3), the valuation of interests in such trust for purposes of this section shall be made under rules similar to the rules of the preceding sentence [referring to the valuation method on contribution].

The statutory clarification ends uncertainty created by the lack of regulatory guidance and by the IRS's no-rule policy on early terminations of CRTs, first adopted in 2008.

[1] The House passed the PATH Act on December 17 by a vote of 318 to 109; the Senate approved the PATH Act on December 18 by a vote of 65 to 33.

[2] The amendment clarified the valuation of the charitable remainder interest for net income make-up charitable remainder unitrusts (NIMCRUTs) and net income charitable remainder unitrusts (NICRUTS).

Some commentary has suggested the need for administrative guidance on several aspects of early terminations.[3] Although guidance would be welcome, we believe there is sufficient authority for taxpayers to now rely on section 664(e) and that there is no need to address self-dealing in most early terminations.

This report discusses the issues that have been resolved by section 664(e) and explains how established principles of statutory construction (and the relevant legislative history) may be relied on to fill in the blanks on the key elements of early terminations. We conclude that noncharitable beneficiaries holding an annuity interest or unitrust interest (the lead interest) and charitable remainder beneficiaries may rely on the clear import of sections 664(e) and 4947(a)(2)(A) to proceed with early terminations and that they need not wait for further administrative guidance in most instances. Although administrative guidance should confirm our conclusions and may be necessary to address some unusual issues, most early terminations of CRTs should be able to proceed in the absence of that guidance.

## Background of CRTs

CRTs are formed under section 664. CRTs are typically required to make distributions of an annuity amount or unitrust amount to a noncharitable beneficiary for the life of an individual or individuals, or for a fixed period of 20 years or less, after which the assets of the CRT are distributed to a charitable remainder beneficiary. The noncharitable beneficiary is often the settlor of the trust.[4] The settlor may name others as beneficiaries of the lead interest, including a spouse and children, but the settlor would be subject to gift tax on the value of the gifted interest to a child. Upon the termination of the noncharitable interest or interests, the remainder must either be held in continuing trust for charitable purposes or be paid to or for the use of one or more charitable organizations that qualify under section 170(c).

Although CRTs are generally exempt from income tax, any distributions of trust income made to the noncharitable beneficiary are includable in income by the beneficiary using a passthrough approach under the four-tier system of section 664(b). This is often called the worst-in, first-out method because income taxed at higher rates is deemed to be distributed before income taxed at lower rates. Each distribution is deemed to exhaust (1) any previously undistributed tier 1 income, such as ordinary income and dividends (including qualified dividends), then (2) tier 2 income, which includes both short- and long-term capital gains, then (3) any tier 3 income, which is tax-free income, and finally, (4) tier 4 distributions, which are distributions of trust principal.[5]

The two types of CRTs permitted by section 664 are charitable remainder annuity trusts (CRATs), which provide for payment of a fixed amount at least annually, and charitable remainder unitrusts (CRUTs), which provide for payments determined by a fixed percentage of the value of trust principal, revalued annually. A CRUT may also include a provision that reduces the annual unitrust distribution by directing the trustee to pay the beneficiary only the trust's net income if trust income is less than the unitrust amount (NICRUTs).[6] Also, a CRUT may authorize the trustee to make up any shortfall if net income in later years exceeds the fixed unitrust amount in that later year (NIMCRUTs).[7]

On the contribution of assets to a CRT, the settlor is entitled to an income tax charitable deduction, an estate tax charitable deduction, or both, based on the present value of the remainder interest ultimately passing to charity.[8] The settlor is also entitled to a gift tax charitable deduction of

[3] *See* Richard L. Fox's letter to IRS Commissioner John Koskinen, requesting clarification of the recent amendment (Mar. 1, 2016). *See also* Fox and Jonathan G. Blattmachr, "New Valuation Rules for NICRUT/NIMCRUT Early Termination," 43 *Est. Plan.* 7 (July 2016), providing a thoughtful analysis of the issues that may need clarification. *See* Kevin Matz and Jessica Galligan Goldsmith, Taxation Committee of the New York State Bar Association, "Recommendations for Guidance Addressing Treatment of Early Terminations of Charitable Remainder Trusts" (Apr. 6, 2017).

[4] A CRT cannot be a grantor trust under subpart E. Reg. section 1.664-1(a)(4). Therefore, a CRT is a separate taxpayer for federal income tax purposes.

[5] If trust principal consists of pre-contribution gains later realized by the trust, a distribution of trust principal will carry out that realized gain.

[6] Section 664(d)(3)(A).

[7] Section 664(d)(3)(B).

[8] Section 170(f)(2)(A); section 2055(a) and (e).

the same amount if the transfer has been completed for gift tax purposes.[9]

For a CRAT, the present value of the charitable remainder interest (for purposes of the income, gift, and estate tax deductions) is determined by subtracting the present value of the noncharitable annuity interest from the fair market value of the principal contributed to the CRAT (the subtraction method).[10] The present value of the annuity interest is determined using factors based on the annuity amount and the expected term of the income interest.[11] The valuation method for CRUTs also relies on the difference between the FMV of trust principal and the present value of the unitrust interest. The present value of the remainder interest is determined by multiplying the value of trust principal by a factor based on the unitrust payout rate and term of the CRUT.[12] For NICRUTs and NIMCRUTs, the fact that distributions may be less than the amount determined by the unitrust payout rate is disregarded.[13]

### Termination of CRTs

A CRT terminates on the death of the measuring life or the expiration of a term of years, as provided in the trust instrument. Upon the termination of the noncharitable interest or interests, the remainder is typically paid to one or more charitable organizations that qualify under section 170(c), although it may be held in continuing trust for charitable purposes.

Sometimes both the noncharitable beneficiary and the charitable remainder beneficiary decide it is best to terminate the trust before the end of the CRT term. Perhaps the charity would like to accelerate the charitable distribution instead of delaying receipt until the end of the CRT term.[14] Sometimes the trustee would like to make investments that a CRT cannot make. And frequently the noncharitable beneficiary would like to accelerate the payments because he may have an immediate need for more cash.[15] When both the income beneficiary and charitable remainderman want to receive the value of their respective interests currently, the CRT may terminate "early."

When a CRT terminates before its stated term, the trust assets are apportioned between the term interest holder and charitable remainderman based on the relative present values of their respective interests.[16] The charity receives the present value of its remainder interest, and the term interest holder receives the present value of his interest. Before 2008, the proper method for calculating the present values of the remainder and term interests was the subject of numerous private letter rulings.[17]

[9] Section 2522(a) and (c)(2)(A). If the grantor retains the right to alter the interests of the charitable remaindermen, the gift is incomplete and the gift tax charitable deduction is deferred until the charity is irrevocably designated. *See* reg. section 25.2511-2(b)-(c).

[10] The subtraction approach is explained in reg. sections 1.664-2(c) and 20.2031-7(d)(l). The subtraction approach is also used in section 2702 for grantor retained annuity trusts.

[11] *See* reg. sections 1.664-2(c) and 20.2031-7(d).

[12] Reg. section 1.664-4(e)(5)(i). *See generally* reg. section 1.664-4. *See also* reg. sections 1.7520-1(a)(3), 20.7520-1(a), and 25.7520-1(a). The term of the CRUT will be a fixed term of years or will be measured by the life expectancy of the income beneficiary.

[13] Section 664(e). The assumption that the retained unitrust interest will pay out the maximum amount each year reduces the value of the charitable remainder interest in the event trust accounting income is less than the unitrust amount. If there is a shortfall in net income, neither the NICRUT nor the NIMCRUT can invade trust principal. So the shortfall is primarily to the detriment of the noncharitable beneficiary.

[14] *See, e.g.*, LTR 200152018 (in a non-gratuitous termination, the charitable remainderman preferred early termination because it was "currently in need of funds to be used for the construction of an academic building"); LTR 200205008 (in a gratuitous termination, the charitable remainderman "asked Donor for help with its immediate funding needs").

[15] There may be an income tax benefit to the noncharitable beneficiary upon an early termination. If the unitrust amount continues until the end of the CRT term, the four-tier ordering rule will most likely characterize the income as ordinary income. Upon an early termination, the present value of the presumed future distributions is characterized as capital gain. This result is no different from that on the sale of an income-producing asset. *See McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946), *acq.*, Rev. Rul. 72-243, 1972-1 C.B. 233; and Douglas A. Kahn, "Gain From the Sale of an Income Interest in a Trust," 30 *Va. Tax Rev.* 445 (2010).

[16] A CRT may also terminate before its stated term when the noncharitable beneficiary gratuitously assigns the lead interest to the charity. On a gratuitous transfer, the noncharitable beneficiary is considered to have made a charitable contribution of its interest in the CRT to the charity and is entitled to an income and gift tax charitable deduction for contributing an asset to charity equal to the value of its noncharitable interest, also determined by using the subtraction method. *See* reg. section 1.170A-7(a)(2)(i); and Rev. Rul. 86-60, 1986-1 C.B. 302. *See also* section 170(a)(1); section 2522(a) and (c)(2)(A).

[17] Many rulings state that the values should be determined using the method under reg. section 1.664-4 (which applies on contribution) and the section 7520 rate in effect at the time. *See, e.g.*, LTR 200304025, LTR 200252092, and LTR 200208039. Others were more ambiguous. *See, e.g.*, LTR 200152018 and LTR 200205008.

In 2008, however, the IRS began to narrow the scope of CRT termination issues on which it would rule,[18] and it ultimately decided to not rule on any issues concerning nongratuitous early CRT terminations "in which the trust beneficiaries receive their actuarial shares of the value of the trust assets."[19] So by the time the PATH Act was enacted, the IRS had stopped providing guidance on valuing interests in early CRT terminations. That no-rule position continues today.[20]

The method by which the respective interests must be valued is now provided in section 664(e), as amended by the PATH Act. Because valuation is now comprehensively covered by statute, there is no longer any need for clarifying administrative guidance.

### Tax Consequences of Early Terminations

Another issue raised by early terminations is whether the termination constitutes an act of self-dealing under section 4941. CRTs are treated as private foundations for purposes of specific excise taxes. One such tax is imposed on any act of self-dealing between a CRT and a disqualified person under section 4941.[21] The noncharitable beneficiary of a CRT will often be the settlor, or a person related to the settlor, and will therefore be a disqualified person for the CRT.[22]

Transactions between the noncharitable beneficiary and the CRT typically constitute self-dealing.[23] For example, an act of self-dealing may occur when the assets of a CRT are transferred to a disqualified person,[24] such as through a loan or sale.[25] Section 4947(a)(2)(A) expressly excludes from the section 4941 self-dealing rules "amounts payable under the terms of such trust" (including annuity and unitrust amounts). Without that statutory exception, the payments of the annuity or unitrust amounts to the noncharitable beneficiary would violate the self-dealing rules.

Concerns about self-dealing in early CRT terminations led many taxpayers to obtain private letter rulings.[26] Before initiating its no-rule policy, the IRS, relying on section 4947(a)(2)(A), recognized that the act of terminating early is not itself self-dealing. Because the noncharitable beneficiary's periodic receipt of the annuity or unitrust payments does not constitute self-dealing, these letter rulings logically concluded that "anticipatory" payment of the present value of those same amounts on an early termination should similarly not be treated as self-dealing.

The specific value apportioned to each beneficiary on an early termination must also satisfy the self-dealing rules. Accordingly, the IRS in its private letter rulings described how the charitable and noncharitable interests should be valued. The IRS wanted to ensure that the method of calculating the actuarial present value was accurate and did not increase the amount paid to the lead beneficiary at the expense of the charity.[27] The agency consistently ruled that to avoid an act of self-dealing, the charitable remainder beneficiaries must receive the actuarial present value of their remainder interests, calculated as discussed below, with the remaining funds paid out to the noncharitable beneficiary.[28] The PATH Act's amendment to section 664 indirectly addresses the absence of self-dealing, at the least in straightforward early terminations.

[18] *See* Rev. Proc. 2008-3, 2008-1 C.B. 110, sections 4.01(40)-(41) and 5.10.

[19] Rev. Proc. 2015-3, 2015-1 IRB 129, section 3.01(68).

[20] Rev. Proc. 2017-3, 2017-1 IRB 130, section 3.01(73), (88), and (93).

[21] *See* section 4947(a)(2); reg. section 53.4947-1(c)(2)(i).

[22] Section 4946(a)(1)(A) provides that substantial contributors are disqualified persons, and section 507(d)(2) provides that creators of trusts are substantial contributors regarding the trusts.

[23] Section 4947(a)(2); reg. section 53.4947-1(c)(2)(i).

[24] The noncharitable income beneficiary of a CRT will often be the grantor of the CRT (or related to the grantor of the CRT) and thus will be classified as a disqualified person for the CRT.

[25] *See* reg. section 53.4941(d)-2(f)(1).

[26] *See, e.g.*, LTR 200833012; LTR 200739004; LTR 200525014; LTR 200441024; LTR 200403051; LTR 200324035; LTR 200314021; LTR 200252092; and LTR 200127023.

[27] In the context of private foundations, reg. section 53.4941(d)-1(a) states that "it is immaterial whether the transaction results in a benefit or a detriment to the private foundation." However, in the context of CRTs, the IRS in TAM 9825001 stated that reg. section 53.4941(d)-1(a) is incompatible with section 4947(a)(2)(A). With CRTs, a violation of the self-dealing rules can occur only in the presence of an unreasonable effect on the charity. Moreover, the interests of the noncharitable income beneficiary and the charitable remainderman are always in conflict — it is baked into the structure of all CRTs. Finding self-dealing when the charity is unharmed would make CRTs impossible to administer.

[28] *See, e.g.*, LTR 200209039, LTR 200912036, and LTR 201325018.

### Valuation Method Before the PATH Act

Before the PATH Act, neither the code nor the Treasury regulations directly specified the method for valuing interests in an early CRT terminations. And in the absence of statutory and regulatory authority, the IRS had been inconsistent in its valuation approach in various private letter rulings.[29]

In earlier private letter rulings, the IRS applied the method provided in the code and regulations for valuing the charitable remainder interest *upon the trust's formation*.[30] The reasoning was that interests in CRTs should be valued using the same method, regardless of whether the valuation occurs on the date the trust is created or on the date it is terminated.

In rulings involving NICRUTs or NIMCRUTs, the present values of the noncharitable unitrust interests were determined by assuming the trusts would earn and annually pay to the unitrust beneficiary an amount equal to the unitrust amount until the end of the trust term. Using the unitrust percentage and ignoring the potential for reduction in the unitrust payment resulted in a higher valuation for the noncharitable beneficiary's unitrust interest and was arguably generous to the unitrust beneficiary, since the income limitation might have reduced or deferred future payments. This method was, however, congruent with the method of valuing the charitable contribution deduction at inception, which also ignores the income limitation, thereby reducing the tax deduction for the value of the charitable remainder interest. Applying this method consistently on formation and termination avoids penalizing either party for fluctuations in the rate of return over the life of the CRUT.

More recently, but before announcing that it would not rule on early CRT terminations,[31] the IRS applied an approach less favorable to the noncharitable beneficiary. In LTR 200725044 and LTR 200733014, the IRS observed that "one reasonable approach" for valuing the unitrust interest was to assume the trust would earn income at the section 7520 rate in effect for the month of the NIMCRUT termination. When the section 7520 rate for the month of termination is less than the stated unitrust rate, the deemed annual payment to the noncharitable beneficiary used to compute the present value of the unitrust interest results in a lower valuation, without regard to any possible increase in trust income and the potential for receiving a make-up payment. The section 7520 approach assumes that the lowest amount possible is being distributed to the noncharitable beneficiary.

In their analysis, LTR 200733014 and LTR 200725044 erroneously identified regulations under section 7520 as authority for this position.[32] The section 7520 valuation method directly contradicted the valuation method imposed on taxpayers at formation of the CRT when calculating the value of their tax deductions for the gifted CRT remainder interest. When these letter rulings were written, the method used by section 664(e) to value the charitable remainder interest at the CRT's inception valued the term interest assuming distributions are made at the

[29] For additional detail on the inconsistent valuation approaches and recommended solutions, see the April 4, 2008, letter to the IRS from the New York City Bar Association Estate and Gift Taxation Committee.

[30] *See, e.g.*, LTR 200304025, LTR 200252092, LTR 200208039, and reg. section 1.664-4(b)(3) ("The assumption that the amount described in Section 1.664-3(a)(1)(i)(a) is distributed in accordance with the payout sequence described in the governing instrument.").

[31] *See* Rev. Proc. 2008-3, sections 4.01(40)-(41) and 5.10; Rev. Proc. 2009-3, 2009-1 IRB 107, sections 4.01(40)-(41) and 5.09; Rev. Proc. 2010-3, 2010-1 IRB 110, section 4.01(39) and (42)-(43); Rev. Proc. 2011-3, 2011-1 IRB 111, section 4.01(39) and (42)-(43); Rev. Proc. 2012-3, 2012-1 IRB 113, section 4.01(37)-(39); Rev. Proc. 2013-3, 2013-1 IRB 113, section 4.01(40) and (44)-(45); Rev. Proc. 2014-3, 2014-1 IRB 111, section 4.01(37), (42), and (44); Rev. Proc. 2015-3, 2015-1 IRB 129, section 3.01(68), (82), and (87); Rev. Proc. 2016-3, 2016-1 IRB 126, section 3.01(71), (86), and (91); and Rev. Proc. 2017-3, 2017-1 IRB 130, section 3.01(73), (88), and (93).

[32] LTR 200733014 and LTR 200725044 cited reg. section 1.7520-3(b)(1)(ii), which requires that the valuation of a "restricted beneficial interest" take into account any contingency, power, or restriction to which the interest is subject when it is inappropriate to use any standard actuarial method to value an interest. The regulation does not address which of two actuarial methods should be used. In fact, in applying the section 7520 rate to the valuation of income interests in CRUTs in LTR 200733014 and LTR 200725044, the IRS used an actuarial method that was precisely what reg. section 1.7520-3(b)(1)(ii) provides is *not* done if the interest in question is "restricted." Further, neither a NICRUT nor a NIMCRUT interest is properly classified as a restricted interest under this regulation. The example in the regulation, which concerns a CRT measured on the life of a terminally ill income beneficiary, does not suggest otherwise.

unitrust rate. Under the section 7520 approach, the value of the charitable remainder interest upon termination of the CRT would be significantly greater than the value reached using the unitrust percentage as the valuation factor.

It was difficult to reconcile the prior ruling approach with the more recent rulings, which used the generally low section 7520 rate to value the noncharitable unitrust interest in an early termination. For example, assume a NIMCRUT has 10 years remaining on its term. The trust is required to make annual distributions in an amount equal to the lesser of 8 percent of the value of the trust assets or the trust accounting income. The trust currently holds $1 million, and the trustee, the unitrust beneficiary, and the charity agree to terminate the trust in October 2016, when the section 7520 rate is 1.6 percent. The valuation method used by the IRS in its earlier rulings disregarded any limitation on net income. That is, the IRS would assume that the income beneficiary would receive precisely the unitrust rate (8 percent in our example).[33] In its more recent rulings, the IRS's valuation method assumed that the unitrust beneficiary would still receive an amount based on a percentage, but the amount was deemed by the IRS to be the lesser of the section 7520 rate (1.6 percent in our example) or the unitrust rate (8 percent in our example).[34]

| Valuation Discount Factor | Present Value of Income Interest | Present Value of Charity's Interest |
|---|---|---|
| 7520 rate (1.6 percent) | $149,124 | $850,876 |
| Unitrust rate (8 percent) | $434,388 | $565,612 |

As illustrated, the different valuation methods produce vastly different results. And because the section 7520 method was used for the early termination, there is no charitable income tax deduction for the increase in value of the charitable interest.

[33]Reg. section 1.664-4(b)(3) requires that the present value of a remainder interest passing to the charity be determined without regard to the net income limitation.

[34]The IRS's approach appears even more inappropriate because it does not consider the effect of any prior performance exceeding the unitrust rate.

## The IRS's No-Rule Position

The IRS, apparently aware of the ambiguity of the CRT early termination rulings, first adopted its no-rule position in Rev. Proc. 2008-3. This no-rule position has continued through the most recent no-rule revenue procedure, Rev. Proc. 2017-3, in spite of the PATH Act amendment to section 664(e), which resolved the valuation issue.

In 2008 the IRS stated that it would not ordinarily rule on the amount of gain or loss upon termination of a CRT or whether, upon the early termination of a CRT, the deemed sale of a term interest is the sale of a capital asset defined under section 1221.[35] It also placed in the "issues under further study" category (for which no rulings are generally issued until the IRS reaches a conclusion) the following question: "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 section 664."[36] In 2010 the IRS officially announced that it would not ordinarily rule on this issue.[37] Finally, in 2015, the IRS stated that it would no longer issue rulings on the tax consequences of the early termination of a CRT in a transaction in which the income beneficiary and charitable remainderman receive their respective shares of the value of the trust assets.[38] The IRS reiterated that position in Rev. Proc. 2017-3, section 3.01(73).

[35]Rev. Proc. 2008-3, section 4.01(40)-(41). In Rev. Proc. 2008-4, 2008-1 IRB 121, the IRS similarly stated that it will not issue private letter rulings under section 4941 or 4945 (or section 507) on the tax consequences of the termination of a CRT 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.

[36]Rev. Proc. 2008-3, section 5.10.

[37]Rev. Proc. 2010-3, section 4.01(39).

[38]Rev. Proc. 2015-3, section 3.01(68). The IRS also moved from the "ordinarily will not rule" category to the no-rule category the issues under sections 1001 and 1221 regarding recognition and character of gain on termination. *Id*. at (82) and (87).

The presence of these issues on the IRS no-rule list, combined with the lack of regulatory guidance, created uncertainty that discouraged early terminations.[39]

## PATH Act Amendment to Section 664

Before its amendment by the PATH Act, section 664(e) stated that "for purposes of determining the amount of any charitable contribution, the remainder interest . . . shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year." Any income limitation was ignored in determining the charitable income tax deduction *upon formation*.[40]

Section 344 of the PATH Act simply extended this valuation rule to early terminations:

> Section 664(e) is amended—
>
> (1) by adding at the end the following: "*In the case of the early termination of a trust* which is a charitable remainder unitrust by reason of subsection (d)(3), the valuation of interests in such trust for purposes of this Section shall be made under rules similar to the rules of the preceding sentence," and
>
> (2) by striking "FOR PURPOSES OF CHARITABLE CONTRIBUTION" in the heading thereof and inserting "OF INTERESTS." [Emphasis added.]

Section 664(e), as amended, mandates that the value of a beneficiary's income interest on the early termination of a NICRUT or NIMCRUT be determined in the same manner as if the trust were a standard (fixed percentage) CRT that required distributions without reference to trust income. That is, whether valuing the charitable remainder interest upon formation or upon termination, the net income limitation is disregarded, and the unitrust percentage is used to determine the present value of the noncharitable and charitable interests.

## 'Early Termination' Under Section 664(e)

The term "early termination" used in the PATH Act amendment to section 664(e) is not defined in the statute. As noted earlier, a CRT may terminate early in two different ways. The noncharitable beneficiary can gratuitously transfer his interest to the charitable remainderman (a gratuitous transfer). Alternatively, a CRT may terminate early when the trust assets are allocated and distributed among the noncharitable beneficiary and charitable remainderman (a nongratuitous transfer). Although early termination is not defined, the term unambiguously applies to both gratuitous and nongratuitous early terminations. Any other interpretation of the statute would ignore the plain meaning of the words, contrary to the established rules of statutory interpretation.

Statutory interpretation must begin with the text itself,[41] and the ordinary and plain meaning of the statutory language should govern its interpretation.[42] If the meaning is plain from the text, the court does not need to look for other sources of meaning; there is no need for construction.[43] Other sources — such as legislative intent or issues of justice — are less informative than the text,[44] so they should generally be

[39] *See, e.g.*, New York City Bar Association letter, *supra* note 29 (requesting clarity on the proper valuation of CRT interests).

[40] *See* section 664(e); reg. section 1.664-4.

[41] *Desert Palace Inc. v. Costa*, 539 U.S. 90, 98 (2003).

[42] *United States v. Lehman*, 225 F.3d 426 (4th Cir. 2000). A long line of decisions, both in the federal tax area and other contexts, stands for the principle that courts will not look behind a statutory pronouncement if the language of the statute is clear and unambiguous. And several courts have applied the plain meaning standard even when the statutory result is contrary to the policy underlying enactment of the statute. *See TRW Inc. v. Andrews*, 534 U.S. 19 (2001); *Petroleum Tide Rock Corp. of Texas Inc. v. United States*, 939 F.2d 1165 (5th Cir. 1991); *Biehl v. Commissioner*, 118 T.C. 467 (2002); *Coggin Automotive Corp. v. Commissioner*, 292 F.3d 1326 (11th Cir. 2002), *rev'g* 115 T.C. 349 (2000); *Brown Group Inc. v. Commissioner*, 77 F.3d 217, 222 (8th Cir. 1996); and *Hillman v. Commissioner*, 250 F.3d 228, 234 (4th Cir. 2001). This well-accepted approach was recently followed in *Summa Holdings Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2017).

[43] *Rubin v. United States*, 449 U.S. 424, 430 (1981); *United States v. Wittberger*, 18 U.S. 76, 95-96 (1820); *Caminetti v. United States*, 242 U.S. 470, 490 (1917); and *United States v. Missouri Pacific Railroad Co.*, 278 U.S. 269, 278 (1929).

[44] Keith E. Whittington, *Constitutional Interpretation: Textual Meaning, Original Intent, and Judicial Review* (2001); Steve R. Johnson, "Statutes Requiring 'Plain Meaning' Interpretation," *State Tax Notes*, Sept. 14, 2009, p. 763.

avoided whenever the language of the statute itself is clear.[45]

These seminal rules of statutory interpretation are exemplified in the federal tax context by *Gitlitz*,[46] in which the Supreme Court focused on the text of the statute and its plain meaning. In its opinion, the Court applied the plain meaning principle, agreeing with the taxpayer's oral argument:

> I submit, Your Honor, a plea on behalf of tax practitioners in this country. They should be able to read the Code as written. They shouldn't have to speculate as to whether or not a result that is called for on the plain language of the statute is too good to be true or is a windfall. The tax laws are too complicated to get into that kind of speculation.[47]

The Supreme Court stated that because "the Code's plain text permits the taxpayers here to receive these benefits, we need not address this policy concern."[48] In reaching its conclusion, the Court cited *Chevron*,[49] which held that "the courts should ask whether Congress has 'directly addressed the precise question at issue.' That is, if the meaning of the statute is clear, then it must be given effect."

Applying the approach used by the Supreme Court in *Gitlitz*, the meaning of section 664(e), as amended, is plain and unambiguous: Amended section 664(e) applies to early terminations, without qualification. The title of section 344 of the PATH Act expressly states that it is a "Clarification of Valuation Rule for Early Termination of Certain Charitable Remainder Unitrusts."[50] Likewise, section 344, as quoted earlier, provides that for the early termination of a CRUT as a result of section 664(d)(3), the valuation of interests in that trust for purposes of section 664(e) will be made under rules similar to the rules governing the valuation of interests upon the formation of CRTs. And the meaning of early termination is self-evident: a termination that occurs before the term stated in the CRT, regardless of whether it is a gratuitous or non-gratuitous termination.

Accordingly, the appropriate method for valuing interests in CRTs is the same, regardless of whether the valuation occurs upon creation of the trust or upon the trust's (gratuitous or non-gratuitous) early termination. In either event, any net income limitation, whether as a NICRUT or NIMCRUT, is disregarded.

We believe that the statute unambiguously applies to both gratuitous and non-gratuitous early terminations. But even if the statute was ambiguous, the extrinsic evidence — the introductory statement of the bill (H.R. 4192) that ultimately led to the section 664(e) amendment — permits no other conclusion.[51] The sponsors of the bill unequivocally expressed their intent that the same valuation method used in determining the present value of the interests in CRTs upon creation be used upon early termination (gratuitous or otherwise).

House Ways and Means Committee member Patrick J. Tiberi, R-Ohio, introduced the bill on December 18, 2015, with the following floor statement, titled "Increasing Charities' Access to Funds":

> Charitable remainder trusts present an opportunity for donors to transfer assets

[45] *See* Robert A. Katzmann, "Response to Judge Kavanaugh's Review of *Judging Statutes*," 129 *Harv. L. Rev.* 388 (2016); Brett M. Kavanaugh, "Book Review: Fixing Statutory Interpretation," 129 *Harv. L. Rev.* 2118 (2016); Katzmann, *Judging Statutes* (2014). Kavanaugh (a judge on the D.C. Circuit) and Katzmann (chief judge for the Second Circuit) share the perspective that "courts are not to substitute their preferences for that of the elected branches. When the language of a statute is plain and clear, our work is generally straight-forward." 129 *Harv. L. Rev.* at 388.

[46] *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

[47] Transcript of Oral Argument, *Gitlitz*, 531 U.S. 206 (2001) (No. 99-1295).

[48] *Gitlitz*, *supra* note 46.

[49] *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[50] The change in the heading for revised section 664 and (e) is also telling: It was previously "Valuation for Purposes of Charitable Contributions," and is now "Valuation of Interests."

[51] *See Fishgold v. Sullivan Drydock & Repair Corporation*, 328 U.S. 275 (1946). When a statutory provision seems to permit multiple interpretations, courts may use information from other sources to try to deduce what the enacting legislature meant; courts use "imaginative reconstruction" to clarify what would otherwise be ambiguities in statutory language. *See* William N. Eskridge Jr., Philip P. Frickey, and Elizabeth Garrett, *Legislative and Statutory Interpretation* 218-220 (2000); and James J. Brudney and Corey Ditslear, "The Warp and Woof of Statutory Interpretation: Comparing Supreme Court Approaches in Tax Law and Workplace Law," 58 *Duke L.J.* 1231 (2009).

> for the benefit of charity. Lack of certainty regarding the tax consequences of early terminations of these trusts has deterred early terminations, which has deferred the transfer of substantial assets to charity. Early terminations of charitable remainder trusts should be encouraged because they permit charities to access their share of the trust's assets earlier (and, in some instances, decades earlier) than otherwise would be the case. This is particularly compelling given that, under current economic conditions, many charities have been forced to cut back on many deserving programs. My bill provides that, *on an early termination of a charitable remainder trust, the donor and the charity will apportion the value of the trust using the same methodology that was used to determine the value of the remainder interest on formation*. The donor will recognize capital gain on the total value received, the charity will receive its share of the trust's assets, and *the early termination will not constitute self-dealing* or otherwise disqualify the charitable remainder trust.[52] [Emphasis added.]

The introductory statement repeatedly refers to "early terminations." Moreover, it discusses how to "apportion the value of the trust" between the income beneficiary and the remainderman. This could occur only on a termination before the expiration of the income interest's term — that is, in an early termination.[53]

Also, the introductory statement clearly contemplates a non-gratuitous transfer. In a gratuitous transfer, all value goes to the charity; there is nothing to apportion. Only in a non-gratuitous transfer, in which the value of the trust assets is split between the lead and remainder beneficiaries, is there any need to apportion value. The introductory statement supports the plain meaning of the PATH Act amendment — that the amended language applies to all early terminations, both gratuitous and non-gratuitous.

### Section 664(e), Prohibition Against Self-Dealing

Before the IRS adopted its no-rule position, taxpayers could obtain private letter rulings on early CRT terminations to alleviate any concerns about potential self-dealing issues.[54] Once the IRS stopped ruling on most early termination issues, this option was no longer available to taxpayers. Indirectly, the PATH Act has offered an answer. As noted above, the PATH Act expressly addressed only the method applicable in valuing the unitrust interest for CRTs described in section 664(d)(3) (that is, NIMCRUTs and NICRUTs). Still, the PATH Act amendment clearly implies that early terminations can be accomplished without violating the prohibition against self-dealing.

Courts have generally refused to interpret congressional acts such that they have no meaning or effect.[55] By amending section 664(e) to expressly provide a method to determine the value of the interests in a CRT on early termination, Congress implicitly recognized that an early termination should not be an act of self-dealing. Otherwise, if every early termination constituted self-dealing, Congress's clarification of the appropriate valuation method would be without effect — a result that the courts have consistently rejected. Accordingly, any such reading of section 664(e) must be rejected as irrational, and the only logical conclusion is that a taxpayer who uses the valuation method of section 664(e) cannot be found to have committed an act of self-dealing.[56]

[52] 161 *Cong. Rec.* 177, E1726 (Dec. 8, 2015) (Tiberi statement).

[53] At the expiration of the term provided in the trust instrument, the remainderman receives all remaining assets. The lead interest has no remaining value at the expiration of the full term provided in the trust instrument.

[54] *See, e.g.*, LTR 200833012, LTR 200739004, LTR 200525014, LTR 200441024, LTR 200403051, LTR 200324035, LTR 200314021, LTR 200252092, and LTR 200127023.

[55] *See, e.g.*, *Stone v. Immigration and Naturalization Service*, 514 U.S. 386, 397 (1995) ("When Congress acts to amend a statute, we presume it intends its amendment to have real and substantive effect."). *See also Montclair v. Ransdell*, 107 U.S. 147, 152 (1883).

[56] Cases since *Church of the Holy Trinity v. United States*, 143 U.S. 457 (1892), and *United States v. Weber*, 443 U.S. 193 (1979), have rejected statutory interpretations that lead to irrational results. Recently, in *Yates v. United States*, 135 S. Ct. 1074 (2015), the Supreme Court refused to apply a statute designed to protect the investing public in the aftermath of the Enron collapse to a commercial fisherman accused of throwing undersized fish overboard to avoid prosecution. *See* Matz and Goldsmith, *supra* note 3, and text accompanying notes 43-46.

Further, this treatment comports with the proper interpretation of section 4947(a)(2)(A). Because the PATH Act's amendment of section 664(e) does not expressly refer to self-dealing,[57] the only explicit textual authority for the self-dealing issue is found in section 4947(a)(2)(A), which provides that any amounts payable to income beneficiaries under the trust terms are not self-dealing. In a CRT, the trust terms do not provide for an early termination. Yet one cannot read the language in section 4947(a)(2)(A) so narrowly that it would exclude accelerated unitrust payments, because this would strip the PATH Act amendment of meaning.[58] Thus, the plain meaning approach to statutory interpretation has its limitations.[59]

Judges generally will not follow the plain meaning approach if a literal interpretation of a statute would lead to a cruel or absurd result.[60] For example, in *Holy Trinity*,[61] the Supreme Court refused to interpret a federal statute by its strict meaning when doing so would lead to absurd results.[62] Instead, it interpreted a statute by its spirit and by determining the intent of the Congress. In making the "soft plain meaning" rule of statutory construction, Justice David J. Brewer stated, "It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers."

The flexible statutory interpretation approach of *Holy Trinity* and its progeny supports interpreting section 4947(a)(2)(A) in a manner consistent with the PATH Act amendment of section 664(e): that a prepayment under early termination is a payment under the trust terms. This also comports with the IRS's prior application of section 4947(a)(2)(A) to early terminations.[63] Because there is nothing in section 4947(a)(2)(A) or any other code section that addresses an early termination payment as self-dealing, statutory construction principles should prohibit the IRS from reading that into the statute.[64]

Lastly, the introductory statement by the bill's sponsors clearly reflects their intent that an early termination not constitute self-dealing: "The early termination will not constitute self-dealing or otherwise disqualify the charitable remainder trust."[65] Moreover, the purpose of the amendment was to encourage early terminations to accelerate payments to charity. Treating an early termination payment as an act of self-dealing would defeat the purpose of the PATH Act amendment.

That is not to say that an early termination could never constitute an act of self-dealing. Rather, when sections 664(e) and 4941 are read together, the self-dealing prohibition would be contradictory if *all* early terminations were somehow deemed to constitute acts of self-dealing. However, an early termination of a CRT

[57] Interestingly, the issue of self-dealing in early terminations arises in part because the IRS has taken the view that the early termination of a CRT is in effect a sale by the income beneficiary of his interest in the trust to the charitable remainder beneficiary. *See, e.g.*, LTR 200127023. If the charitable remainder beneficiary is a private foundation, the deemed sale may be between a disqualified person and a private foundation, which would otherwise be a prohibited self-dealing transaction. Perhaps this problem would be avoided if the IRS viewed the early termination as division between the parties of their respective interests, with each simply taking what is already his, rather than a sale.

[58] *See* Menahem Pasternak and Christophe Rico, "Tax Interpretation, Planning, and Avoidance: Some Linguistic Analysis," 23 *Akron Tax J.* 33 (2008) (examining linguistic and semantic theory to analyze gaps between legal terms and the practical application of language).

[59] In *King v. Burwell*, 135 S. Ct. 2480 (2015), the Supreme Court showed that it was willing to depart from what would otherwise be the most natural meaning of a phrase when the context and the structure of a statute require it. It stated, "oftentimes the meaning — or ambiguity — of certain words or phrases may only become evident when placed in context of the whole statutory scheme." *Id.* at 2489. For a broader discussion of the plain meaning approach and interpretive flexibility, see Kent Greenwalt, *Legislation — Statutory Interpretation: 20 Questions* (1999); and Eskridge, Frickey, and Garrett, *supra* note 51.

[60] *See Church of the Holy Trinity v. United States*, 143 U.S. 457 (1892). *See also United Steelworkers of America v. Weber*, 443 U.S. 193 (1979); and *Fishgold v. Sullivan Drydock*, 328 U.S. 275.

[61] *Holy Trinity*, 143 U.S. 457.

[62] *See e.g., United Steelworkers of America v. Weber*, 443 U.S. 193 (1979).

[63] *See supra* text accompanying note 28.

[64] The IRS has referred to non-gratuitous CRT terminations as "early terminations" over a long period. *See* LTR 200208039, LTR 200314021, LTR 200304025, LTR 200543061, LTR 200616035, LTR 200725044, LTR 200733014, LTR 200739004, LTR 200816032, LTR 200912036, and LTR 201325018. Although a private letter ruling cannot be cited as authority, it should be evidence for what is the common understanding of that term in the context where it is used.

[65] Tiberi statement, *supra* note 52.

in which the charitable remainderman is a private foundation requires additional scrutiny, because one could argue that an early termination in that situation does not fulfill the congressional objectives of immediately distributing trust assets to a public charity.

In his introductory statement, Tiberi stressed that early CRT terminations should be encouraged "because they permit charities to access their share of the trust's assets earlier (and, in some instances, decades earlier)." If the designated charity is a private foundation, it is not required to distribute all its funds for charitable purposes, and one of the objectives of the legislation could be thwarted. Addressing concerns about the ability of private foundations to indefinitely postpone distributions for charitable purposes,[66] the Tax Reform Act of 1969 enacted mandatory payout rules based on the percentage of the private foundation's noncharitable income assets.

Under current law, there is no restriction limiting the designated charity upon an early termination to public charities. An early termination with a private foundation as the remainderman would delay the use of most of the funds distributed to the recipient of the charitable remainder interest. Given that a primary purpose of the PATH Act was to encourage immediate payments for charitable purposes,[67] we believe it would not be inconsistent with the PATH Act amendment for the IRS to provide some oversight to early terminations of a CRT when the remainderman is a private foundation.[68]

When a private foundation is the designated charity and the noncharitable beneficiary is a disqualified person for that foundation, there is a direct transaction between that private foundation and its disqualified person. Because the IRS treats a non-gratuitous early termination as a sale between the charitable and noncharitable beneficiaries, that is per se self-dealing. And because the PATH Act addressed only valuation and had nothing to say about self-dealing, current law treats a transaction between the charitable and noncharitable disqualified person beneficiaries as self-dealing.

### Charity's Interests in an Early Termination

The PATH Act amendment to section 664(e) was intended to allow charities to access trust assets earlier than would otherwise be the case.[69] This raises the question of whether early terminations will benefit or harm charities. In fact, the charity often prefers to receive a share of trust principal now rather than wait for many years.[70] The early termination protects the charity from the risk that the value of the principal will decline over the trust term. Further, an interest that is not receivable until some date in the distant future is unhelpful in budgeting this year's charitable activities. Even if the charity does not intend to use the funds now, it may prefer to control the investment decisions. The charity's investment policy would likely be different than that of the trustee of a CRT, given the trustee's obligations to balance the interests of the income beneficiary and the remainderman.

Although early terminations generally can benefit charities, some specific early terminations could be detrimental. The charity, of course, will determine whether to agree to the early termination. A charity unrelated to the settlor may feel some pressure to satisfy the settlor's wishes but is unlikely to act against its own interests in agreeing to the early termination. Although the same may be true of a private foundation related to the settlor, the absence of third-party decision-makers may give one pause.

This concern may be alleviated by state law, which often protects charitable interests, ensuring that the specific terms of proposed terminations will benefit the charities. For example, in most states, the attorney general serves as the protector for charitable organizations. In this role, the

[66] Treasury report on private foundations, Senate Finance Committee, 89th Cong., 1st Sess. 5 (Feb. 2, 1965).

[67] The floor statement introducing the bill indicates that a significant purpose was to allow charities to receive payments immediately instead of waiting to the end of the CRT term.

[68] Because a distribution to a private foundation does not distribute early termination payments directly for use for charitable purposes, the IRS could address that concern. *See* Matz and Goldsmith, *supra* note 3, and text accompanying notes 60-69.

[69] *See* Tiberi statement, *supra* note 52.

[70] *See, e.g.*, LTR 200152018 (charitable remainderman was "currently in need of funds to be used for the construction of an academic building").

attorney general is often a required party to a transaction involving the early termination of a CRT — either consenting to the termination or issuing a "no objection" letter. The presence of the attorney general may be a sufficient safeguard when the charitable remainderman is a private foundation.

## Conclusion

Congress enacted the PATH Act amendment to section 664(e), expressing its desire to encourage early terminations of CRTs and providing the method to be used for apportioning value between the income beneficiary and remainderman.[71] The amendment provides much-needed clarity on early terminations of NICRUTs and NIMCRUTs.

By its terms, amended section 664(e) applies to all early terminations, both gratuitous and non-gratuitous, and requires that interests in CRTs be valued using the same method on early termination of the trust as on creation. The present value of the remainder interest in a CRAT is determined by valuing the income interest using specified factors (based on the annuity amount and the expected term, as determined under IRS tables) and subtracting this from the net FMV of the CRAT.[72] Likewise, the remainder interest in a CRUT is determined under reg. section 1.664-4 by multiplying the net FMV of the trust by specified factors (based on the payout rate and remaining term of the CRUT, as determined under IRS tables).

The amendment also implies that early terminations do not generally violate the self-dealing rules under section 4941 because if they did, the PATH Act amendment would be moot. Moreover, statutory construction principles and case law support the interpretation that an acceleration of unitrust payments is not self-dealing. However, early terminations in which the remainderman is a private foundation and a disqualified person for the settlor may warrant a different result.

In sum, the PATH Act amendment should end the prior uncertainty created by the absence of regulatory guidance and, more recently, by the IRS's no-rule policy. It should thus facilitate early terminations once again. ■

[71] *See* Tiberi statement, *supra* note 52.

[72] *See* reg. sections 1.664-2(c) and 20.2031-7(d).