Vanderbilt Law Review

Volume 25
Issue 5 *Issue 5 - October 1972*

Article 4

10-1972

Charitable Remainder Trusts--A Need for Further Reform?

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Recommended Citation

R. Frank Murphy, II, Charitable Remainder Trusts--A Need for Further Reform?, 25 *Vanderbilt Law Review* 1025 (1972)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol25/iss5/4

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NOTES

Charitahle Remainder Trusts—A Need for Fnrther Reform?

I. INTRODUCTION

The Tax Reform Act of 1969 replaced the loosely structured charitable remainder trust with a more formalized tripartite arrangement consisting of the annuity trust, unitrust, and pooled income fund. The changes were designed to eliminate uncertainties in valuing the charitable remainder, which usually arose from discretionary accounting, investment, and invasion of corpus powers given to the trustee, and were intended to provide a better correlation between the amount of the charitable deduction and the value of the interest ultimately received by charity. As is often the case with new revenue legislation, however, it is questionable whether the desired results have been attained. Moreover, the difficulties of implementing the new law are revealed by the absence of finalized Treasury Regulations in every area except the pooled income fund. Several uncertainties regarding the recent legislation therefore continue to exist among writers and estate planners, raising doubts about both its requirements and its effectiveness. The 1969 changes regarding charitable remainder trusts presumably were intended as a panacea, but an analysis of their effectiveness indicates that further modifications may be necessary.

This Note will consider first the charitable remainder trust as it existed under the law prior to 1969, along with recent litigation involving such trusts. Secondly, the specific legislative changes will be set out and an examination made of situations in which the designated purpose of these changes apparently has not been achieved. Following a consideration of several problems that remain unresolved by the 1969 Act and the current regulations thereunder, there is a discussion of the criticism directed at the new law from a policy standpoint, which points up the need for a continued re-evaluation of the law in this area. Finally, there are some proposed changes that seek to retain the familiarity and to eliminate the weaknesses of charitable remainder trust law prior to 1969.

II. Recent Litigation Under Pre-1969 Law

A. *The Legal Framework*

In the usual charitable remainder trust drafted before the Tax Reform Act of 1969 [hereinafter referred to as the 1969 Act] became law, the grantor made an indirect charitable contribution by leaving property either under an inter vivos or a testamentary trust to provide income to private individuals for a period of time with the remainder to go to a charity. A charitable deduction from federal income, estate, and gift taxes generally was available for the remainder interest. The amount of the deduction was based on the present value of the remainder interest. This value is determined by first using actuarial life expectancy tables and an assumed rate of return to compute the value of the income beneficiary's interest and then subtracting that amount from the total amount transferred in trust.

In paying the trust income to a private beneficiary, the trustee was often given the power to invade corpus in favor of this beneficiary. The existence of such power created considerable controversy over what circumstances should exist before the charitable remainder could be valued accurately and a deduction could be granted. The basic test under the law prior to the 1969 Act was whether the value of the charitable remainder interest was "presently ascertainable" when the transfer in trust was made.[1] In order for the value of a charitable remainder of a trust in which the trustee was given power to invade corpus to be presently ascertainable, definite conditions or standards governing the trustee's power had to be incorporated in the will or instrument of transfer. The courts then considered the language of the governing instrument to determine whether the standards provided would adequately restrict the trustee's discretion. If the standards were found to be sufficiently definite, the power of invasion could be overlooked and the deduction determined as though such power did not exist. Improbability of actual invasion, perhaps because of additional income to the noncharitable beneficiary from sources other than the charitable remainder trust, became a determinative factor only if the transfer instrument was found to have set a definite standard for invasion. This form of charitable giving and the tests for allowing deductions for such gifts are reflected in a plethora of current litigation under the pre-1969 law governing

1. For good general discussions of the application of this test see Morrison & Marcus, *Estate Planning Considerations for Charitable Trusts and Charitable Remainder Trusts under the Tax Reform Act of 1969*, 75 DICK. L. REV. 185, 203-09 (1971); Warm, *"Ascertainable Standard": Its Use and Misuse in Charitable Trust Remainders*, 31 J. TAX. 32 (1969); 46 N.C.L. REV. 168 (1967).

charitable remainder trusts.

A discussion of these cases is relevant since many unsettled estates will be affected by the 1969 Act's provision for a deduction under pre-1969 rules for estates of decedents whose wills were executed before October 9, 1969, if the decedent dies prior to October 9, 1972. Consequently, the principles of these decisions will assist lawyers who, for the next several years, will be engaged in litigation regarding deductions for charitable remainder trusts drafted under the old law. Finally, if the 1969 changes prove unsatisfactory, and Congress decides to make further changes, there may be a shift back to some form of the charitable remainder trust as it existed prior to the 1969 Act. For these reasons, a review of the recently decided cases should be helpful.

In determining whether powers granted to a trustee make the value of a charitable remainder presently unascertainable and thus destroy the deduction, the courts generally rely on two basic factors: (1) the language of the trust instrument and (2) state trust law doctrines and practices regarding the duties of a fiduciary. The ensuing discussion of recently decided cases, therefore, rather than providing a detailed analysis of each opinion, will focus on the courts' consideration of these two factors.

Because of variously worded powers to invade and investment clauses among trust instruments, the axiom that "each case must be examined on the basis of its special facts" is particularly applicable to the case law involving charitable remainder trusts prior to the 1969 Act. Significant, but sometimes subtle, differences in the governing instruments preclude the adoption of a polarized position that broad administrative powers either always or never prevent the charitable deduction. Moreover, the applicable state trust law dictates the fiduciary obligations of the trustee of a charitable remainder trust and thus imposes limitations on the extent of the powers granted him by the trust document.[2] Consequently, as variously worded trust instruments governed by the laws of different states are considered by the courts, the inevitable result is a group of decisions whose variety is necessitated by the assorted factual situations under which they arose. Moreover, as the law is applied to the facts, a difference in judicial attitudes toward the extent to which flexibility in the administration of trusts will be permitted without disallowance of the charitable deduction is revealed in the current litigation in this area.

2. *E.g.*, Peoples Trust Co. v. United States, 311 F. Supp. 1197, 1199 (D.N.J. 1970): "No court in New Jersey would permit the trustee to so use its power to deplete trust corpus in order to benefit the life beneficiary."

B. Cases Denying the Charitable Deduction

In three companion cases decided by the Fifth Circuit, the taxpayers were denied estate and gift tax deductions for charitable remainders. In *Florida Bank v. United States*,[3] the trustee was required to pay over capital gains produced by the trust corpus to the life beneficiaries. Normally, capital gains are considered increments of corpus and cannot be allocated to the income account.[4] Because of this mandatory provision in the decedent's will, as opposed to a clause merely granting the trustee the power to distribute capital gains, the court found that the question whether the trustee actually did realize capital gains was insignificant.[5] Without making any reference to the trustee's fiduciary duty under state trust law, the court concluded that the directive to the trustee precluded a determination that the charitable beneficiaries would receive an amount equal to the claimed deduction.[6]

The trustees in *Miami Beach First National Bank v. United States*[7] were authorized to invest in investment trusts, were required to designate capital gains distributions from mutual funds as income, and were empowered in their sole discretion to allocate to income or principal all receipts and expenses.[8] The court found that the first two of these powers would constitute an invasion of corpus to the extent that current dividends from investment trust or mutual fund shares would include, for example, any gains received by an investment trust upon the disposition of its underlying investments, if all dividends were considered as income by the trustees.[9] The court stated that the powers regarding investments and treatment of dividends as well as the authorization to charge expenses against corpus were not, if exercised, limited by the principles of fiduciary management under Florida law.[10] The Fifth Circuit therefore reversed the trial court and held that the possibility of a significant reduction of corpus resulting from the exercise of the above powers precluded the granting of a charitable deduction.

A will giving trustees the power to charge disbursements against

3. 443 F.2d 467 (5th Cir. 1971).
4. UNIFORM PRINCIPAL AND INCOME ACT, § 3(b)(1) (1962 version).
5. 443 F.2d at 473.
6. *Id.*
7. 443 F.2d 475 (5th Cir. 1971).
8. Excerpts from the provisions in the trust instrument, describing the trustee's powers in detail, are set forth in the text of the opinion. *Id.* at 476-77.
9. *Id.* at 478, citing the position of the Internal Revenue Service on mutual funds as set out in Rev. Rul. 385, 1960-2 CUM. BULL. 77. This position is discussed and criticized in Morrison & Marcus, *supra* note 1, at 207-08.
10. 443 F.2d at 479.

principal or income, treat liquidating dividends as income, and buy bonds and other securities at a premium was considered by the court in *First National Bank v. United States.*[11] In exercising the last of these powers, the trustees were directed to pay the entire interest or income from the securities to the life beneficiary without deduction for the amortization or recoupment of the excess of the cost or value of the bond when purchased over the principal amount.[12] The granting of this power was one of several provisions in the will relied on by the Government as particularly indicative of the trustees' power to invade corpus for the benefit of the life tenant. The court found that the purpose of giving such extraordinary powers to a trustee is to modify the general rule regarding the fiduciary obligation to avoid discriminatory treatment of the life tenant and remainderman of a trust.[13] Thus, as in the *Miami Beach* case, the court concluded that the trustees' exercise of the powers granted to them in the will would not be limited by generally recognized fiduciary principles and that this invasion of corpus would make impossible an accurate valuation of the charitable remainder interest.[14]

In *Rand v. United States*,[15] decided by the Second Circuit, the trustee was also the life beneficiary. The trustee was given broad powers to manage and reinvest principal at his sole discretion in any type of investments, to charge all operating and maintenance expenses against trust corpus, and to loan any part or all of the trust estate to anyone, for any purpose and on any terms. Further, the will excused the trustee from the obligation to render periodic accounts to any court.[16] The district court, in granting a judgment for the taxpayer, had found that, under Vermont law, these broad administrative powers did not permit the trustee to deal otherwise than impartially between the life beneficiary and the charitable remaindermen.[17] The court of appeals, however, was of the opinion that Vermont law would permit the trustee to do exactly what he was empowered to do under the express language of the

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11. 443 F.2d 480 (5th Cir. 1971).

12. *Id.* at 483. The court also provided an illustration of how this provision could result in reducing corpus in favor of the life beneficiary. "At that time [date of death] he [decedent] owned a $10,000 bond of the Standard Oil Company of Indiana. It was valued for estate tax purposes at $11,408.33. If this bond was held until maturity and the trustees did not amortize the premium, the corpus of the trust would suffer a loss of $1,408.33." *Id.*

13. *Id.* at 484.

14. *Id.* at 485.

15. 445 F.2d 1166 (2d Cir. 1971).

16. *Id.* at 1167.

17. *Id.* at 1168.

will.[18] Thus, having decided that the broad administrative powers could be exercised by the trustee and noting that an extensive utilization of the power to loan corpus, for example, by itself could deplete the charitable interest, the court held that the value of the remainder could not be ascertained with any reasonable degree of certainty.

The litigation in *Shafer v. United States*,[19] decided by the Seventh Circuit, concerned a decedent's will that provided both a narrow and a broad standard for invasion of corpus for the income beneficiary. Under the former standard, the trustees could invade corpus as "shall be necessary for the care, maintenance and support"[20] of the income beneficiary. To ensure absolutely the degree of care that the testatrix intended to be exercised for the income beneficiary, she provided the additional standard that the "well being [of the income beneficiary] shall have priority over every other consideration."[21] The district court found that the latter standard actually determined the extent to which the trustee could invade corpus and that it effectively nullified the definiteness of the former provision.[22] The reasoning of the district court in denying the deduction was adopted and approved by the Seventh Circuit in a per curiam affirmance. The court of appeals did add, by way of dictum, a warning to lawyers who draft charitable remainder instruments to use their own legally precise language, rather than permitting lay clients to dictate the wording.[23]

In *Jacobs v. United States*,[24] a charitable contribution deduction was disallowed when the trust instrument gave the trustee broad administrative powers, allowing him to invest in wasting assets, to charge trust expenses against principal, and to allocate cash dividends, including capital gains dividends, to income. The trust res consisted of regulated investment company stock. The Government argued that the trust corpus would be diminished to an indeterminate extent through the paying

18. 445 F.2d at 1169. The following quotation was relied on to support this conclusion of the court: "A trust deed takes effect when it is made and the construction that would be given to it at that time holds true throughout the life of the instrument. . . . The trust instrument must be construed to give effect to the grantor's intent as manifested by the language used." 445 F.2d at 1169, citing Destitute of Bennington County v. Henry W. Putnam Memorial Hospital, 125 Vt. 289, 293, 215 A.2d 134, 137 (1965).

19. 452 F.2d 666 (7th Cir. 1971).

20. *Id.* at 667.

21. *Id.*

22. *Id.*

23. "This case is a striking, albeit sad, illustration of the result that may well follow when a lawyer permits a lay client to dictate wording in instruments which require legalistic precision of meaning and which are subject to equally legalistically precise construction." 452 F.2d at 668.

24. 334 F. Supp. 388 (S.D.N.Y. 1971).

out of capital gains and retention of capital losses.[25] In accepting this contention, the District Court for the Southern District of New York held that New York law did not provide an adequate standard by which to ascertain the extent to which corpus would be depleted.[26]

The most recent reported case denying a charitable deduction for the remainder interest of a trust was decided by the United States District Court for the Eastern District of Michigan. In *Detroit Bank & Trust Co. v. United States*,[27] thc trustees were given considerable freedom in the handling of all real and personal property belonging to the estate.[28] They also had powers to invest in investment trusts or investment companies and to allocate receipts and disbursements between income and principal. With respect to the last two powers, the fiduciaries' discretion was to be absolute and without regard to statutes or rules of law to the contrary. The court held that the Michigan Revised Uniform Principal and Income Act would not prevent the trustees from allocating receipts and disbursements between income and principal in such a manner as the trustees themselves deemed just and equitable, relying on a recent decision by the Michigan Supreme Court thus construing the Act.[29] The *Detroit Bank* court further noted that while the courts certainly would intervene if bad faith or collusion by the trustees were shown, the taxpayers had pointed to no Michigan decisions that required any more than that fiduciaries act in good faith. The court thus held that the trustees were not prevented by law from exercising their powers to shift the beneficial interests in the trust, thereby creating the possibility of a steady attrition of the trust corpus that would render the value of the remainder not presently ascertainable.

C. Cases Allowing the Charitable Deduction

The recent cases involving the deductibility of charitable remainders under pre-1969 law have not all been decided against the taxpayers, as the decision of the Third Circuit Court of Appeals in *Peoples Trust Co. v. United States*[30] demonstrates. In *Peoples Trust*, the trustee was given broad investment powers and was directed to consider capital gain

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25. *Id.* at 392.
26. *Id.* at 393.
27. 71-2 U.S. Tax Cas. ¶ 12,821 (E.D. Mich. Nov. 30, 1971).
28. The trustees received the power "[t]o sell, exchange, convey, mortgage, lease and grant options with respect to any and all real and personal property belonging to the estate for such consideration as may seem fair and reasonable to the fiduciary. . . ." *Id.* at 8338.
29. *Id.* at 8339. The decision cited by the district court is Donovan v. National Bank, 384 Mich. 595, 185 N.W.2d 354 (1971).
30. 444 F.2d 193 (3rd Cir. 1971).

dividends derived from mutual fund investments as income.[31] Furthermore, the trustee was authorized to act in all circumstances as it deemed advisable, "even though such act may not be appropriate for fiduciaries under any statutory or other rule of law or court, but for this power."[32] Recognizing that the critical issue was whether the trustee had a power to divert corpus from the charities to the life tenant—not whether, as a result of the trustee's investment policies, the trust corpus would at the end of the life estate be greater or less than when the remainder interest vested—the court felt compelled to view the trust instrument as it would be viewed by a New Jersey state court in relation to any power to divert corpus.[33] Contrary to the Government's contentions, the court in *Peoples Trust* found neither an intention that the trustee prefer the life beneficiary nor the absence of any legal inhibition on the trustee should it decide to make such a preference. After a general reference to the investment policies of mutual funds, the court stated that the clause directing the treatment of capital gain distributions from mutual funds as income reflected as much an intention to protect the life beneficiary from reduction of income as an intention to prefer him over the remainderman.[34] Moreover, relying heavily on New Jersey decisional law, the court of appeals reaffirmed the obligation of a fiduciary to deal impartially between successive trust beneficiaries, even where the provisions of a trust agreement seek to lend finality to the fiduciary's actions.

The *Peoples Trust* court distinguished its recent decision in *Stewart v. Commissioner*[35] by noting that the trust investment in *Stewart* was governed by New York law, which was held not to impose any fixed and ascertainable standard for control of the conduct of the trustee under the broad language of the instrument.[36] Although the *Florida Bank* and the *Miami Beach First National Bank* decisions were cited as cases in which the Government's contentions regarding provisions for the treatment of capital gains distributions of mutual funds, similar to the provi-

31. The trustee also was empowered to pay or expend for the benefit of the settlor's husband " 'such part or parts or all of the principal of the Trust Estate as it shall judge to be necessary, in its discretion, to provide adequately for the said husband of the Settlor and for his support, maintenance, health and needs.' " *Id.* at 195. The Government, however, did not contend in this appeal that the dispositive provisions of the trust, including the power to invade corpus, rendered the charitable remainder unascertainable. *Id.*

32. *Id.*

33. *Id.* at 197.

34. *Id.* at 198.

35. 436 F.2d 1281 (3rd Cir. 1971).

36. 444 F.2d at 196. The *Peoples Trust* court stated further that "[i]f in the instant case the trust instrument, construed as it would be in New Jersey, vested the trustee with powers to make significant diversions from corpus, and if that power were in no way limited by the New Jersey law, the *Stewart* case would control." *Id.*

sion in *Peoples Trust*, were accepted,[37] the Third Circuit concluded that the law of Florida regarding fiduciary obligations apparently differed from that of New Jersey.

In allowing the charitable deduction in *Estate of Toulmin v. United States*,[38] the District Court for the Southern District of Ohio relied strongly on its finding that the applicable estate law would require the trustees to administer the trust in a manner consistent with the testator's intent to leave the trust corpus to charity. Among other provisions,[39] the will in *Toulmin* contained a simple allocation clause granting the trustees discretionary power to allocate all receipts and disbursements between income and principal and between the separate trusts that were established, but included no express provision authorizing the trustees to depart in whole or in part from any rule of law. Finding no measurable standard in the decedent's will that limited the trustees' discretion in the exercise of their administrative powers, the court felt that the dispositive question was whether Ohio law imposed definite restrictions on the exercise of the trustees' powers. After noting that Ohio does not have a statute equivalent to the New York law that grants extremely broad powers to trustees[40]—a statute which was the decisive factor in the *Stewart* case—the *Toulmin* court concluded that the restrictions imposed on the trustees by Ohio law were sufficient to make the value of the charitable remainder presently ascertainable.

In *Worcester County National Bank v. King*,[41] the only controversy was over the trustee's power to allocate receipts and disbursements to corpus or income "*not withstanding any rule of law* . . . ."[42] Relying on earlier cases involving similar clauses, the Supreme Judicial Court of Massachusetts held that, under Massachusetts law, this power may not be used either to shift beneficial interests in the trust or to favor one beneficiary over the other. Finally, the court stated that this opinion was designed to dissolve any doubts concerning the supervision that Massachusetts courts sitting in equity will exercise over trusts containing broadly phrased clauses on the administrative or management powers of trustees.[43]

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37. *Id.* at 199.
38. 326 F. Supp. 1028 (S.D. Ohio 1971).
39. The parts of the will that define the trustee's powers are set out in the opinion. *Id.* at 1030.
40. *Id.* at 1037.
41. 268 N.E.2d 838 (Mass. 1971).
42. *Id.* at 839 (emphasis added by the court).
43. *Id.* at 841.

In *Doss v. United States*,[44] the District Court for the Northern District of Texas considered a will that sought to remove state law limitations on permissible trustee investments to allow the trustee more flexibility in the management of the estate than the strict statutory standards would otherwise demand. The trustee was not given a discretionary power to allocate income. The main controversy, therefore, was over the trustee's power to invest in such wasting assets as oil, gas, and other mineral rights and royalties. The court noted that there was nothing in the will that allowed a deviation from the standard incorporated in the Texas Trust Act, which prevents a trustee from investing in anything that would prove detrimental to the trust estate.[45] The court thus concluded that the powers granted by the will would not allow the corpus to be depleted to the detriment of the charitable remainderman without a violation of the trustee's fiduciary obligation. In making this determination, the court distinguished the broader powers granted the trustees in the trilogy of Florida cases recently decided by the Fifth Circuit.[46] Since there was no provision in the *Doss* will permitting an invasion of the remainder estate, and since no invasion power could be derived from local law, the remainder was ascertainable and deductible.

The most recent case under pre-1969 law permitting a charitable deduction when the trust contained an invasion of corpus provision is the decision of the Fourth Circuit Court of Appeals in *Greer v. United States*.[47] The Government contended in *Greer* that the trustees' powers to invest generally in any type of property in any proportion and specifically in an annuity contract for the benefit of the life beneficiary, and to allocate and apportion expenses and receipts to principal and income in their uncontrolled discretion, made the value of the charitable remainder presently unascertainable.[48] There were also provisions in the will that the trustees' annual accounting need be made only to the life beneficiary and that the trustees were to be permitted to invade corpus to maintain the income beneficiary's standard of living. Although the Government conceded that the latter provision was limited by an ascertainable standard,[49] the court still looked to this provision to determine the testator's intent. Noting that corpus could be invaded only after the trustee had considered the income beneficiary's other sources of income and principal, the court found that the decedent clearly intended to

44. 326 F. Supp. 1320 (N.D. Tex. 1971).
45. *Id.* at 1325.
46. *Id.* at 1324-25.
47. 448 F.2d 937 (4th Cir. 1971).
48. *Id.* at 944-46.
49. *Id.* at 944 (the plaintiff's previous standard of living).

create and preserve a charitable remainder.[50] The court thus held that the specific intention embodied in the grant of the trustees' express power limited their more general powers and, therefore, that North Carolina law would prevent the trustees from exercising any administrative power to the detriment of the charitable remainder.

III. LEGISLATIVE CHANGES IN 1969

A. Congressional Purpose

Cases decided under the old law reflect the variation in powers given to trustees when transferors attempted to extend control over trust property beyond the date of death so that the income beneficiaries were protected. These different means of control used by donors interjected an indefinite element into the determination of deductions for charitable remainder interests. One of the criticisms of this indefiniteness was that it sometimes resulted in unequal deductions for substantially equal charitable contributions. Consequently, Congress became dissatisfied with the "presently ascertainable" standard for determining the allowability of charitable deductions and considered changes in this area as part of the Tax Reform Act of 1969.[51]

Congress wanted to eliminate substantial contingencies that might affect the amount of the charitable remainder and also uncertainties in the valuation of this interest. Congress, therefore, realized that there was a need to minimize the chances of manipulation—through a trustee's selection of high-income, high-risk investments or a misuse of his accounting power, for example—in favor of the intervening income interest. The purpose of these changes was to achieve a better correlation between the amount of the charitable deduction and the true value of the remainder ultimately received by charity. The legislative scheme that was created to reach this end was designed to do away with the familiar discretion given to a trustee to invade corpus for the benefit of an income beneficiary, regardless of any objective standard limiting that power. Moreover, Congress felt that any conflict between the income and remainder interests could be ended by abolishing the necessity, for tax purposes, of accounting for corpus and income separately.

B. Specific Statutory Requirements

To effectuate the changes just discussed and to achieve the desired

50. *Id.* at 946-47.

51. H.R. REP. No. 91-413, 91st Cong., 1st Sess. 58 (1969).

purpose of correlation, Congress created a rather rigorous format with which gifts of charitable remainders must comply.[52] In order to receive the charitable deduction for federal income, gift, and estate tax purposes,[53] the transfer of a remainder interest to charity must meet the requirements of an annuity trust, unitrust, or pooled income fund. An exception from these requirements is granted, however, for contributions of a remainder interest in a personal residence or farm, or an undivided portion of the taxpayer's entire interest in property.

1. *Annuity Trust.*[54]—An annuity trust is a trust from which a sum certain is paid at least annually to one or more noncharitable beneficiaries living at the creation of the trust. The specified dollar amount cannot be less than five percent of the initial net market value of all property placed in the trust. This amount may be expressed as a percentage of the initial net fair market value if the governing instrument provides for adjustment of an incorrect valuation, when the initial net fair market value has been incorrectly determined in good faith. Moreover, the annuity must be paid either for the life or lives of the named noncharitable beneficiary or beneficiaries or for a term not to exceed twenty years.[55] The noncharitable beneficiary cannot receive from the trust any amount other than the stated annuity. There is also a restriction that the governing instrument must contain a prohibition against future contributions to the annuity trust. Upon termination of the annuity pay-

52. The effective dates of the new provisions are as follows:

"For income tax purposes the 1969 Act applies to transfers to trusts made after July 31, 1969.

"For gift tax purposes the 1969 Act applies to transfers made after July 31, 1969.

"For estate tax purposes the 1969 Act generally applies to estates of decedents dying after December 31, 1969. The new rules do not apply for estate tax purposes in case of property transferred to a trust before October 10, 1969 in which an irrevocable remainder interest was given to charity. And the new rules do not apply to property passing under a will in existence on October 9, 1969 if the testator died before October 9, 1972 without having republished his will or the testator had no right to change his will after October 9, 1969 or the will was not republished before October 9, 1972 and the testator was incompetent on that date.

. . . .

"The old rules still apply as to a trust or will executed on or before October 9, 1969 where the decedent dies before October 9, 1972 or the will has not been republished by codicil or otherwise." J. BEVERIDGE, TRANSFERS TO CHARITIES UNDER THE TAX REFORM ACT OF 1969, 17-18 (1971).

53. The income tax deduction is provided in INT. REV. CODE OF 1954. § 170(f). The estate and gift tax deductions are found in INT. REV. CODE OF 1954, §§ 2055(d) and 2522(c), respectively.

54. INT. REV. CODE OF 1954, § 664(d)(1). The discussion in the text of each type of charitable remainder trust essentially paraphrases the requirements as set forth in the statute.

55. The interests of the income beneficiaries may exist concurrently or successively. For example, a husband may create an irrevocable charitable trust, with the trust income to be paid to himself and his wife while both are alive, then to the survivor; and, at the survivor's death, the remainder passes to a named charity. 2 CCH 1971 STAND. FED. TAX REP. ¶ 1864.4301.

ments, the entire remainder must be transferred to or for the use of a charity.[56]

2. *Unitrust.*[57]—In a unitrust, a fixed percentage of the net fair market value of the trust assets, valued annually, is paid each year to one or more noncharitable beneficaries living at the creation of the trust. The fixed percentage must not be less than five percent. As in the case of the annuity trust, the annual payout must continue for the life or lives of the noncharitable beneficiary or beneficiaries or for a term not to exceed twenty years. Unlike the annuity trust, however, additional contributions may be made to the trust after the initial contribution, subject to two special rules.[58] With one exception, no amount other than the designated percentage payout may be paid to a noncharitable beneficiary.

Under the one exception, the governing instrument can provide that the annual distribution from the trust be either five percent of the net fair market value of the trust assets valued annually or the amount of trust income, whichever is lower.[59] The trust income is to be determined under the terms of the governing instrument and applicable local law.[60] This alternative payout method prevents the trustee's having to invade corpus when trust income is less than the originally designated percentage. The method of payment must be set out in the governing instrument, however, and cannot be discretionary with the trustee.[61] Following the termination of payments to the noncharitable beneficiary under either method, the entire remainder interest in the trust is to be transferred to or for the use of a charitable organization.

3. *Pooled Income Fund.*[62]—A pooled income fund is a trust set

56. For purposes of the income tax deduction, the list of qualifying charitable organizations is found in INT. REV. CODE OF 1954, § 170(c). The lists of charitable organizations to which gifts can be made that qualify for the estate and gift tax deductions are set forth in INT. REV. CODE OF 1954, §§ 2055(a), 2522(a), respectively. Subsequent references to a "charity" or "charitable organization" are intended to indicate organizations that qualify under each of these sections.

57. INT. REV. CODE OF 1954, § 664(d)(2). *See* note 54 *supra*.

58. "(1) Where there is no valuation date after the time of the contribution, the additional property shall be valued at the time of contribution, and

"(2) the amount payable to the beneficiary or beneficiaries shall be computed by multiplying the fixed percentage by the sum of (a) the net fair market value of the trust's assets (excluding the additional property as of the valuation date but including any earned income from, and any appreciation on, such property and (b) that proportion of the value of the additional property (excluded under (a) above) which the number of days (including the day of transfer) remaining in the taxable year of the trust bears to the total number of days in the taxable year of the trust." 2 CCH 1971 STAND. FED. TAX REP. ¶ 1864.4301, at 24,230-31.

59. INT. REV. CODE OF 1954, § 664(d)(3).

60. INT. REV. CODE OF 1954, § 643(b).

61. Proposed Treas. Reg. § 1.664-3(a)(1)(i)(b), 36 Fed. Reg. 18674 (1971).

62. INT. REV. CODE OF 1954, § 642(c)(5). *See* note 54 *supra*.

up by a charity, to which an individual irrevocably transfers property and retains an income interest in the property for the life of one or more beneficiaries living at the time of the transfer. Each person with such an income interest must be paid annually an amount of income based on the fund's yearly rate of return, and income cannot be accumulated by the trust for any income beneficiary. The fund must be maintained by the recipient charity, and no donor or income beneficiary may serve as trustee. The fund must commingle all property transferred to it under the above circumstances and cannot invest in tax-exempt securities. At the termination of the income interest, the charity has a remainder interest in the property transferred to the fund.

4. *Exceptions.*—Under section 170(f)(3)(B), there are two exceptions to the general rule of section 170(f)(3)(A) that no charitable contribution deduction will be allowed for transfers of less than a taxpayer's entire interest in property, including a remainder interest, unless a charitable deduction would be allowed if the gift had been made in trust. The first exception, and definitely the more important in terms of practical usage, involves a remainder interest in a personal residence or farm. Charitable deductions will be allowed, for example, when an individual transfers his farm to charity and retains the right to live on the farm during his life. There is a provision, however, that aside from the usual factor to be used in discounting the remainder interest by the value of the life estate, straight-line depreciation and depletion for the period of the life interest must be taken into account.[63] The second exception provides for allowance of a charitable deduction for a gift of an undivided portion of a taxpayer's entire interest in property, such as an undivided one-fourth interest in the ownership of an office building.[64]

C. *Potential for Non-Correlation*

Despite the rigid requirements of the tripartite statutory arrangement for charitable remainder trusts, there are some specific situations in which the legislative purpose of a better correlation between the deduction and the true value of the remainder interest apparently has not been achieved. These shortcomings are attributable to several factors. First, the implementation of rigid, unfamiliar forms cannot be expected to be accomplished without difficulties. Moreover, the fact that final Treasury Regulations, which are essential to fill the gaps left by the new statute if practitioners are to understand and comply with

63. INT. REV. CODE OF 1954, § 170(f)(4).
64. *See* text accompanying notes 76-78 *infra*.

the requirements, have not been promulgated—except for the pooled income fund—contributes to the creation of the situations discussed below. Finally, there is the possibility that sufficient thought and attention were not given to structuring the statutory changes before they were enacted, with the result that what were judged to be defects in the old law regarding charitable remainder trusts have not yet been corrected.

1. *Invasion of Corpus.*—Under the proposed regulations for the annuity trust and unitrust, the trust cannot be subject to a power to invade, alter, revoke, or amend for the beneficial use of any person other than a charity.[65] These provisions are designed to eliminate the problems that existed under the old law in valuing the charitable remainder intercst when a trustee was given the power to invade corpus if the trust income was not sufficicnt to meet the needs of the income beneficiary as set forth in the trust instrument. The prohibition against invasion of corpus, however, cannot be reconciled with the annual distribution requirements in the statute[66] or with the actual operation of these trusts, except where there is sufficient trust income to pay both expenses and the required annuity. If the trust does not, in fact, earn net income equal to the designated payout rate, the trustee obviously must utilize corpus to make up the difference. The likelihood of the trust earning less than the five percent minimum required by statute to be paid out to the income beneficiary is reflected by the annual net earnings on invested funds of the life insurance industry. For example, in only two years during the period from January 1, 1931, through December 31, 1970, has that net earnings figure equaled or exceeded five percent.[67] Consequently, except when the alternative provision to pay net income from a unitrust is selected, the erosion of principal before the charity receives its remainder interest is potentially serious. A simple hypothetical illustrates this point.

A unitrust was cstablished on January 1, 1970, and funded with stock that had a fair market value of 50,000 dollars and a basis of 25,000 dollars in the hands of the grantor, who had held the stock for more

65. Proposed Treas. Reg. §§ 1.664-2(a)(4), -3(a)(4), 36 Fed. Reg. 18673, 18675 (1971). While this provision is not justified in light of the mandatory distribution requirements in the statute and the actual operation of a trust, as shown by the ensuing discussion in the text, the requirement of the regulation still must be met. To accomplish this, one writer has suggested a prohibition against invasion of corpus, followed by the words "except such as is required to meet the annual payments to the recipient (annuitant)." Gillon, *In a Strait Jacket on the Bed of Procrustes—Charitable Remainder Trusts Under the Tax Reform Act of 1969*, 32 ALA. LAW. 243, 255 n.39 (1971).

66. INT. REV. CODE OF 1954, §§ 664(d)(1)(A), (2)(A).

67. Gillon, *supra* note 65, at 255 & n.39a.

than six months. During 1970, the trust earns 1,000 dollars of ordinary income. To simplify the factual situation, the valuation date selected is December 31, 1970, and on that date the trust assets are worth 51,000 dollars. Assuming that a five percent payout is required and that no distributions were made during the year, the trustee is then obligated to pay 2,550 dollars to the income beneficiary. Since the income produced by the trust is not sufficient to meet the payout requirement, the trustee sells stock having a fair market value of 1,550 dollars and a basis of 775 dollars, resulting in the trust's realizing a capital gain of 775 dollars. According to the tier-system character of the income rules of section 664(b), the income beneficiary treats the distribution of 2,550 dollars as ordinary income of 1,000 dollars, capital gain of 775 dollars, and the remaining 775 dollars as tax-free return of principal.

Some commentators have maintained that the noncharitable beneficiary's receipt of capital-gain or tax-free distributions neither lessens the remainder interest nor violates the legislative intent of correlating the deduction with the remainder interest received by charity.[68] This position seems well founded in cases in which the trust instrument has a required payout of more than the six percent rate of return that is assumed for charitable remainder trusts in the regulations.[69] In such cases, the grantor's charitable deduction is computed on the theory that some principal will be repaid to the income beneficiary, because of the difference in the designated payout rate and the assumed rate of return. Under these conditions, the charity admittedly has no reason to expect an amount precisely equal to the amount originally contributed to the charitable remainder trust.[70] Accordingly, the amount of the charitable deduction is reduced proportionately by the amount of principal expected to be repaid, and the desired correlation is maintained. When a unitrust instrument provides for an annual payout of an amount equal to five percent of the trust assets valued annually, as in the above hypothetical, this position seems more vulnerable. The combined distribution of capital gains and trust corpus necessitated by the minimum

68. *E.g.*, Morrison & Marcus, *supra* note 1, at 232.

69. Treas. Reg. § 20.2031-10 (1970) (annuity trust); Proposed Treas. Reg. § 1.664-4(a)(1)(i), 36 Fed. Reg. 18676 (1971) (unitrust). For a pooled income fund, the rate of return used in valuing the remainder interest is a rate equal to the highest yearly rate of return of the fund for the 3 taxable years immediately preceding its taxable year in which the transfer of property to the fund is made. If a pooled income fund has been in existence for less than 3 taxable years, however, the highest yearly rate of return shall be deemed to be 6 percent. Treas. Reg. § 1.642(c)-6(b)(2) (1971).

70. For a hypothetical example illustrating this point see Morrison & Marcus, *supra* note 1, at 232 n.197.

five percent payout provision clearly lessens the charitable remainder interest and violates the desired correlation. There was no reason to assume any repayment of principal in computing the grantor's deduction, since the designated payout rate was only five percent. Moreover, in a unitrust with a five percent or greater payout provision, the possibility of a rapid reduction of corpus is particularly acute when the trust is created during a bear market, and the payout continues after the value of the corpus has increased considerably, from a subsequent rise in the market. If the trust is still earning approximately the same amount of income as when it was first established, the increase in the amount to be paid out to the noncharitable beneficiary, resulting from a higher valued corpus on which the percentage distribution is based, will have to come from corpus.

While the alternative unitrust payout method of distributing only trust income if the income is less than the amount determined under the standard five percent formula[71] preserves corpus, this formula does not give the annuitant a guarantee of sufficient income in years in which the trust has little or no earnings. Corpus can be protected by this method, therefore, only when the settlor is reasonably satisfied that the needs of the noncharitable beneficiary will be met by the expected annual yield of the unitrust. This alternative unitrust payout method also revives another problem that the changes of the 1969 Act were designed to eliminate.

2. *Determination of "Trust Income."*—Because of the valuation problems resulting from a trustee's having the power to allocate items between income and principal under the old law, the 1969 Act undertook to do away with this discretionary accounting power. The solution was to eliminate distinctions between the two accounts by providing that the amounts to be paid out were to be a "sum certain," in the case of an annuity trust,[72] and a "fixed percentage," in the case of a unitrust.[73] The alternative unitrust payout method, however, refers to "trust income" as the amount to be distributed to the income beneficiary. Section 643(b) defines trust income for purposes of the alternative payout method and provides that this item is to be determined under the terms of the governing instrument and applicable local law. It is clear, therefore, that section 643(b) revives the traditional division of principal and income and the traditional problems of balancing the interests of the

71. INT. REV. CODE OF 1954, § 664(d)(3)(A).
72. INT. REV. CODE OF 1954, § 664(d)(1)(A).
73. INT. REV. CODE OF 1954, § 664(d)(2)(A).

beneficiary and the remainderman, which are the very problems that the unitrust was designed to solve.[74]

D. Unresolved Problem Areas

Aside from the instances in which the congressional goal of correlating the amount of the charitable deduction with the value of the remainder interest seemingly has not been reached, specific problems have arisen in drafting and administering charitable remainder trust instruments that are not answered adequately by the 1969 Act or the proposed regulations. The problems in arriving at satisfactory regulations may be seen as a reflection of poor draftsmanship in the Act itself and the intransigent stand being taken by the Treasury Department and the Internal Revenue Service regarding deductions for charitable remainder trusts.[75] Thus, a discussion of these specific problems hopefully will aid in stressing the need for their urgent individual resolution in the regulations or, if that alternative should prove infeasible, perhaps it will further serve to point up the need to reconsider the statutory changes in their entirety.

1. *Determination of a Taxpayer's "Undivided Interest."*—Under section 170(f)(3)(A), the charitable deduction is denied for certain contributions of partial interests in property. An exception to this general rule is found in section 170(f)(3)(B)(ii), permitting the deduction for the contribution of an undivided portion of the taxpayer's entire interest in property. The distinction between the conveyance of an undivided interest and some other interest that is less than the grantor's entire interest, however, is not always drawn easily.[76] One specific example provided by the congressional conferees is that the gift of an open space easement in gross is a gift of an undivided interest when the easement is in perpetuity.[77] In light of this statement, the suggestion has been made that the principal test for determining a gift of an undivided interest is whether the interests of the contributor and charity, although not required to be identical in all respects, are of the same duration.[78] While such suggestions are helpful in the drafting of instruments, there is a distinct need

74. *See* Morrison & Marcus, *supra* note 1, at 216.

75. *See, e.g.*, Fleming, *Charitable Trusts Under the Tax Reform Act*, 48 TAXES 757, 762 (1970).

76. Sneed, *The Effect of the '69 Revenue Act on Charitable Giving to Educational Institutions: Charitable Remainder Trusts, Pooled Income Funds and Other Problems*, 5 MIAMI INST. ON EST. PLAN. ch. 71-18, ¶ 71.1803.1 (1971).

77. H.R. REP. No. 91-782, 91st Cong., 1st Sess. 294 (1969).

78. Sneed, *supra* note 76.

for a definitive statement on this point in the regulations. An additional problem arises when the taxpayer's entire interest is only a partial interest such as a life estate or a remainder interest. Although the term "entire interest" does not seem to require a fee simple—in which case the taxpayer should be entitled to a deduction even though he contributes only a partial interest—this is another matter that has not yet been addressed directly in the proposed regulations.

2. *Alternative Payout Method of Section 664(d)(3).*—Because of a conflict between the statute and the proposed regulations, there is also some uncertainty regarding the unitrust payout provision in section 664(d)(3). The 1969 Act provides that under this formula the trustee must make up any deficiency between the sum actually paid and the five percent share in later years when the trust income exceeds five percent. For example, if a unitrust earned only three percent in 1970, the trustee, pursuant to the alternative payout method, would be required to distribute only the three percent income actually earned. If the trust were to earn income at a six percent rate in 1971 and 1972, the trustee would be required by the statute to distribute the one percent "surplus" for each of the last two years to make up the two percent deficiency from 1970. Despite this clear statutory provision, the proposed regulations state that such deficiencies do not have to be made up, indicating that the additional make-up provision is optional.[79] This conflict naturally has caused considerable disagreement among writers in this area on how much discretion trustees have in making distributions under the alternative payout method when trust income rises from below to above the five percent level.[80] The importance of resolving this uncertainty can be shown by a trustee's doubt, when the governing intrument is silent regarding this aspect of his duties, whether he is obligated to pay out unitrust income in excess of five percent because income was earned at a lesser percentage in prior years. The trustee presumably could be surcharged for failing to make this distribution if such a duty were found to be imposed by law.

79. Proposed Treas. Reg. § 1.664-3(a)(1)(i)(b), 36 Fed. Reg. 18674 (1971).

80. Several writers have taken the view that a trustee is required to make up any deficiency in later years. *E.g.*, Swados, *Charitable Remainder Trusts—Drafting and Valuation Guidelines*, N.Y.U. 29TH INST. ON FED. TAX. 2023, 2042 (1971); Turley, *Charitable Deductions, Remainders to Charity, and the Tax Reform Act*, 8 HOUSTON L. REV. 411, 427 (1971). Other commentators support the position that such make-up provisions are optional. *E.g.*, *Accumulation Trusts and Charitable Remainder Trusts*, S. CAL. 23RD INST. ON FED. TAX. 501, 550-51 (1971). At least one member of the former group, Robert O. Swados, has recanted his published opinion and adopted the latter position in a recent private conversation. Interview with Robert L. Edwards, Attorney, in Winston-Salem, N.C., Dec. 28, 1971.

IV. ADMINISTRATIVE AND POLICY CONSIDERATIONS

Besides the instances which indicate that the 1969 changes regarding charitable remainder trusts perhaps have not attained their ultimate goal and the specific problems that as yet remain unresolved, there are a number of policy considerations that cast doubt upon the effectiveness of the new law. This discussion is intended to demonstrate the level of dissatisfaction with the recent legislation among those persons who must utilize it daily and to point out the possible need for further revision. While criticisms undoubtedly arise whenever there is a revision of the law as significant as that made by the Tax Reform Act, the points discussed below weigh particularly strongly, not merely because of their number, but also because of their emphasis on establishing a more viable structure to coordinate the needs of society and the governing tax law. In the area of charitable giving, such coordination is essential. Moreover, in achieving this coordination, policy values are as important in deciding upon the applicable law as are the purely technical reasons for change.

A. The Mandatory Distribution Requirement

Congress added a rather illogical quirk to the law by requiring that the sum certain, in the case of an annuity trust, or the fixed percentage, in the case of a unitrust, distributed to the noncharitable beneficiary be not less than five percent of the value of the trust assets.[81] This provision creates the puzzling situation in which a retained five percent interest permits the settlor to obtain a charitable deduction, but a retained four percent income interest produces no charitable deduction. In effect, a donor is penalized for attempting to be beneficient by retaining a smaller interest for himself or his designated income beneficiaries. This result apparently was intended by Congress, as an outgrowth of a belief that charitable remainder trusts and private foundations should be given the same treatment.[82] Admittedly, charitable remainder trusts are subject to many of the requirements and restrictions imposed on private foundations.[83] Therefore, the grantor will be allowed a charitable con-

81. Moore, *Estate Planning Under the Tax Reform Act of 1969: The Uses of Charity*, 56 VA. L. REV. 565, 585 (1970).

82. *Id.* "Sen. Fin. Rpt., H.R. 13270, Charitable Contributions, Item 6: '. . . [T]rusts generally are subject to the same requirements and restrictions imposed on private foundations, since to the extent of the charitable interest, their use achieves the same result.' " Fleming, *supra* note 75, at 757 n.2.

83. INT. REV. CODE OF 1954, § 4947(a)(2). This subsection, however, applies to the charitable remainder trust only during the period the trust is administered for private persons. *See* Treas.

tribution deduction, and the trust will be exempt from the taxes imposed by Subtitle D of Chapter 42 of the Code, only if the trust instrument contains certain express prohibitions.[84] Moreover, Congress seemingly felt that if tax-exempt private foundations are to be required to distribute annually a fixed percentage of their assets or adjusted net income,[85] a like requirement should be imposed on charitable remainder unitrusts and annuity trusts.[86] The imposition of this uniform treatment by Congress has been criticized because it fails to deal with an essential distinction between distributions by private foundations and charitable remainder trusts.[87] Whereas amounts distributed by a private foundation are devoted currently to charitable use, distributions by a charitable remainder unitrust or annuity trust to an income beneficiary probably never

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Reg. § 53.4947-1(c)(1)(i). From the first date upon which one of the provisions of Treas. Reg. § 53.4947(b)(2) is satisfied, INT. REV. CODE OF 1954, § 4947(a)(1) shall apply to the trust. Moreover, under INT. REV. CODE OF 1954, § 4947(a)(2)(A), the requirements of Int. Rev. Code of 1954, § 4947(a)(2) are made "inapplicable to any amounts payable under the terms of a split-interest trust to income beneficiaries, unless a deduction was allowed under section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B) with respect to the income interest of any such beneficiary." Treas. Reg. § 53.4947-1(c)(2). In the case of a charitable remainder trust, in which the trust income is payable to noncharitable beneficiaries, there obviously is no charitable deduction for the distribution of the income interest.

84. "A charitable remainder trust is considered a split-interest trust under § 4947(a)(2), and therefore its governing instrument must contain certain provisions required under § 508(e) as if it were a private foundation. [footnote citation to Proposed Treas. Reg. § 1.664-1(b), 36 Fed. Reg. 18669 (1971)] § 4947(b)(3)(B) states that the § 4943 (excess business holdings) and § 4944 (investments which jeopardize charitable purpose) restrictions shall not apply to a split-interest trust if a charitable deduction is allowed for the gift of the remainder interest . . . . Thus, the trust's governing instrument must only prohibit the trust from engaging in any act of self-dealing (§ 4941) and from making any taxable expenditures (§ 4945)." *Charitable Remainder Trusts—Required Governing Instrument Provisions*, BNA Tax Management Memo. No. 72-04, at 10 (Feb. 21, 1972). "The escape from the full impact of the private foundation rules, however, may be illusory in the case of a charitable remainder trust, for the Senate Committee Report makes the point explicitly that 'in the latter case [the sole charitable interest being that of the remainderman] the stock ownership and speculative investment requirements are to become applicable at the time the remainder interest of charity comes into possession.' [footnote citation to S. REP. No. 91-552, 91st Cong., 1st Ses. 94 (1969)]" Swados, *supra* note 80, at 2059. Moreover, when the noncharitable income expires, and the trust becomes subject to INT. REV. CODE OF 1954, § 4947(a)(1), all of the provisions of § 508(e), as well as the substantive requirements of §§ 4943 and 4944, become applicable. Thus, there must be a ban on accumulation of income by the trustee if the corpus is not distributed upon termination of the noncharitable interest but is retained by the trust for the charitable use, a requirement that does not exist when §§ 664 and 4947(a)(2) are read together. *Id.* at 2059-60 & n.65.

It has been advised that the trust instrument include the restrictions of §§ 4943 and 4944 from the outset, since in the case of a testamentary charitable remainder trust, it would be impossible to insert these provisions at the expiration of the noncharitable income interest. *Id.* at 2060.

85. INT. REV. CODE OF 1954, § 4942(d)(1). *See* H.R. REP. No. 91-782, 91st Cong., 1st Sess. 281 (1969).

86. Moore, *supra* note 81.

87. *Id.*

will be used by or for a charity. This flaw in the apparent reasoning for imposing the particular payout requirements on charitable remainder trusts points up the lack of logic in denying the charitable deduction to a donor who wants to make an increased contribution by retaining an income interest of less than five percent.

B. Depreciation Factor for Personal Residences and Farms

Another provision that is difficult to understand in the context of a tax law presumably designed to promote charitable contributions as well as equity among taxpayers relates to gifts of remainder interests in personal residences and farms. In section 170(f)(3)(B)(ii), Congress acceded to the requests of charities—educational institutions in particular[88]—and retained this popular form of giving without imposing the rigorous requirements of a charitable remainder trust. This beneficence is not as generous as it may first appear, however, because of the factors that must be considered in valuing the remainder interest. First, there is a requirement that straight-line depreciation and depletion, computed for the period of the retained life estate, be taken into account in determining the value of the remainder.[89] That value then must be discounted at the usual rate of six percent per annum, again for the number of years attributable to the life estate as determined by the annuity tables.[90]

The fundamental assumption of the requirement to consider depreciation in valuing the remainder interest, and accordingly the charitable deduction, is that the value of the residence or farm when received by charity will be less than at the time the deduction is taken. The fallacy in this assumption is the impossibility of predicting future events. Moreover, it should be remembered that making a depreciation adjustment is strictly an accounting technique, to be used for the purpose of amortizing the cost of an asset, and is not recognized as a means of determining the actual future market value of the asset being depreciated. Depending of course on the location and particular physical characteristics of the residence or farm, there is the possibility of an actual increase in value, perhaps considerable, by the time the charity receives its remainder. Thus, the point to be made is that, while depreciation perhaps is a factor to be taken into account, it is not the only factor that should be recognized. If an expert appraisal of the potential increase in the value of the property during the period of the life interest is not deemed

88. *See Hearings on H.R. 13270 Before the Senate Finance Comm.*, 91st Cong., 1st Sess., pt. 3, at 2185-257 (1969).

89. INT. REV. CODE OF 1954, § 170(f)(4).

90. *Id.*

feasible—for example, because of the anticipated length of the life estate in a particular case—then consideration should be given to some alternative fairer than merely discounting the value of the remainder interest by two factors for purposes of the charitable deduction.

C. *Lack of Flexibility*

1. *Use of Multiple Trusts.*—A common criticism of the 1969 Act involves the overall lack of flexibility in the requirements for charitable remainder trusts. Estate planners maintain that too often a multiplicity of trusts is now necessary to carry out the grantor's wishes, whereas a single, more familiar, and simpler form of trust was available prior to 1969.[91] An illustration of the apparently increased need to use multiple trusts, and the accompanying necessity of additional expense, is shown by a difference in the requirements for the charitable remainder unitrust and the annuity trust. The proposed regulations permit additional contributions to a unitrust, if the governing instrument includes provisions designating a valuation date for the added property and an adjustment to the payout rate that takes the additional contributions into account.[92] In the case of an annuity trust, however, the governing instrument must include a specific provision that no future contributions may be made to the trust after it is established.[93] A donor utilizing the annuity trust format, therefore, must form additional trusts whenever he wishes to increase his gift to a particular charity. This need for other trusts could have the effect of discouraging charitable contributions after the donor weighs the expense and trouble of establishing a separate trust arrangement against the value, in philanthropic and economic terms, of making the charitable gift.

Another example of the rigid structure of the 1969 requirements and the increased need for a multiplicity of trusts is the exclusion of noncharitable beneficiaries from sharing in the remainder interest.[94] The rationale of Congress for eliminating noncharitable beneficiaries as discretionary or contingent beneficiaries of corpus is clear, since an accurate valuation of the charity's interest would be impossible if such contingencies existed. The suggestion has been made, however, that it

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91. *See, e.g.*, Peter, *An Analytical Comparison of the Three Split-Interest Charitable Trust Vehicles*, 35 J. TAX. 240, 242 (1971).

92. Proposed Treas. Reg. § 1.664-3(b), 36 Fed. Reg. 18675 (1971).

93. Proposed Treas. Reg. § 1.664-2(b), 36 Fed. Reg. 18673 (1971).

94. INT. REV. CODE OF 1954, §§ 642(c)(5)(A), 664(d)(1)(C), (2)(C). Treas. Reg. § 1.642(c)-5(b)(8); Proposed Treas. Reg. § 1.664-2(a)(6), 36 Fed. Reg. 18673 (1971); Proposed Treas. Reg. § 1.664-3(a)(6), 36 Fed. Reg. 18675 (1971).

probably was not necessary to preclude the noncharitable beneficiaries from sharing a vested remainder with charity on a fractional basis, in which case the charitable and noncharitable interests still could be defined.[95] Nevertheless, the requirement remains that, at the termination of all income interests, the entire corpus must be irrevocably transferred to or for the use of a charitable organization.[96] There is therefore a need to create separate inter vivos or testamentary trusts, with the remainder interest in one trust designated solely for charity, whenever a donor desires to divide what would otherwise be a single remainder interest between private beneficiaries, and a charity. Moreover, the rather common practice of directing gifts to third parties following the death of the testator and his spouse prior to the passing of a remainder to charity is no longer possible unless multiple trusts are used.[97] It again seems that a less rigorous requirement, permitting fractional sharing in a vested remainder, for example, might have been used without sacrificing the desired objective of eliminating uncertainty generated by contingent transfers.

2. *Inapplicability of Alternative Payout Method to the Annuity Trust.*—Although uncertainties regarding the alternative payout provision for the charitable remainder unitrust[98] already have been discussed to some extent,[99] there is the further question of why this provision was not extended to apply to the annuity trust. The Senate did, in fact, relax the nearly "debt" character of the income interest by permitting the alternative payout arrangement in both the unitrust and the annuity trust and providing that deficiencies resulting from a drop in trust income below the stated amount payable could be made up in later years when income exceeded this amount.[100] The Senate noted that, by allowing the income payout alternative, there could be greater flexibility in the making of charitable gifts while still protecting against abuse of the charitable deduction.[101] In light of this purpose, it is not surprising that the logic behind the congressional conference committee's decision to make this flexibility applicable only to unitrusts has been attacked. The point has been made that, since in both types of trust the remainder must be valued on the assumption that at least a five percent interest is to be distributed annually, an investment policy reducing the trust in-

95. Sneed, *supra* note 76, at ¶ 71.1803.1.
96. *See* note 94 *supra*.
97. Haberman, *Trusts and the Tax Reform Act*, 54 MARQ. L. REV. 117, 120 (1971).
98. INT. REV. CODE OF 1954, § 664(d)(3).
99. *See* notes 79-80 *supra* and accompanying text.
100. S. REP. NO. 91-552, 91st Cong., 1st Sess. 89 (1969).
101. *Id.* at 90.

come and accordingly the annuitant's return to below five percent would not seem to be detrimental to the interests of the remainderman or the Government.[102] Moreover, invasions of corpus would not be necessary since payouts would be limited to actual income of the annuity trust if less than the designated dollar annuity. These observations, in addition to the need for greater flexibility under the new law, support an extension of the alternative payout method to the annuity trust.

D. *Overall Complexity of the Statute*

The examples of decreased flexibility and the accompanying need to use multiple trusts reflect the rigidity and complexity that pervade the charitable remainder provisions of the 1969 Act. There are more than fifteen statutory provisions that must be considered in deciding the type and form of gift and the amount of charitable contribution deduction that is available.[103] The basic inquiry of persons attempting to utilize these provisions as donors, attorneys, or charitable donees is why such strictures were thought necessary to achieve reform.[104] Critics who were comfortable in the ways of the old law are disappointd with the movement away from the traditional and well understood concept of dividing a trust into income and remainder interests. While changes almost certainly were needed to obtain a better correlation between the charitable deduction and the value of the remainder interest actually received by charity, the desired result could have been reached more easily through the adoption of much simpler statutory changes.

The complexities of the recent legislation and particularly the response of practitioners point up the need for a sample document that satisfies the requirements of the statute and the Treasury Department. While the Treasury reportedly has stated that a revenue ruling or procedure containing such a document is being developed, the ruling has not yet been published and should be given a high priority.[105] The need for such a document is further accentuated by the allegation that some of the governing instrument requirements in the proposed regulations find no support in the statute.[106] Thus, aside from the problems created by the statute itself, critics can point out that final regulations still have not been promulgated to implement the statute, and that current proposed

102. Sneed, *supra* note 76, at ¶ 71.1801.2.

103. Swados, *supra* note 80, at 2025-26 n.1 (excellent summary of provisions).

104. *E.g.*, Fleming, *supra* note 75.

105. Covey, *Estate, Gift and Income Taxation—1970 Developments*, 5 MIAMI INST. ON EST. PLAN ch. 71-1, ¶ 71,100, at ¶ 71.122.7 (1971).

106. *Id.*

regulations definitely are not adequate.

Another argument directed against the complexities of the new law is the doubt that the increased assurance of correlation, aside from being less than complete in light of the problems already discussed, is worth the increased cost and inconvenience.[107] While the magnitude of these costs is not yet ascertained, they nevertheless are a concern of both donors and donees. For the donors, there are increased expenses in structuring their gifts to meet the needs of their chosen charitable and noncharitable beneficiaries in accordance with the new law. For charitable donees, the technicalities of the new rules, especially those governing the pooled income fund, have increased the costs of obtaining and administering contributions. Consequently, in addition to the potentially negative reaction by contributors to the stringencies of the 1969 Act and the indirect effect of that reaction on charities, charitable organizations themselves are suffering directly from increased expenses made necessary by the new law.

V. Proposed Changes

A. *Changes Within the Framework of the 1969 Act*

1. *Alternative Payout Method for Annuity Trust.*—Within the context of the tripartite arrangements for charitable remainder trusts in the 1969 Act, one possible change would be to extend the alternative payout provision of distributing only trust income, if less than the designated payout,[108] to the annuity trust. This change would allow some flexibility in the distribution requirements for the annuity trust and, at the same time, serve the additional function of preserving corpus for charity.

Besides supporting the extension of the alternative payout method to the annuity trust, the Senate, in its deliberations on the 1969 Tax Reform Act, adopted a provision to permit deficiencies resulting from a decline in trust income below the required annual distribution to be made up in later years in which there is a surplus of trust income over the required distribution.[109] This procedure would tend to equate total distributions over several years under the alternative method with the results that would have been reached if the sum certain specified in the

107. *E.g.*, Sneed, *supra* note 76, at ¶ 71.1801.1.

108. The alternative payout method for the unitrust is found in INT. REV. CODE OF 1954, § 664(d)(3).

109. S. REP. No. 91-552, 91st Cong., 1st Sess. 89 (1969). *See* text accompanying notes 100-02 *supra*.

annuity trust instrument had, in fact, been distributed each year. Moreover, the increased correlation between the deduction allowed and the actual value of the remainder implicit in this procedure would achieve a more equitable result for the taxpayer. The theory underlying the alternative payout provision is the protection of charity; the addition of a "make-up" provision secures this objective, and additionally, ensures that the income beneficiary will not receive less than the designated payout if there is surplus income from which payment may be made without reducing the charitable remainder. Whether or not the trustee is allowed to make up deficiencies in this manner, the important point is that he would never have to invade corpus. Thus, the donor who is interested primarily in assuring that his selected charity receives an undepleted remainder interest likely would be attracted to the alternative payout method. Unfortunately, under the current law, such donors have this alternative only with respect to the unitrust. For these reasons, a provision similar to that found in section 664(d)(3) should be extended to apply to the annuity trust.

2. *Fractional Division of Remainder Interests*.—Another change that might be effected within the charitable remainder trust framework of the 1969 Act would be permitting noncharitable beneficiaries to share in the remainder interest. Under current law, the entire corpus must be irrevocably transferred to or for the use of a charitable organization at the termination of all income interests.[110] A donor, therefore, is denied the flexibility of designating members of his family or other specified noncharitable beneficiaries to share the remainder with charity. It seems feasible, however, to permit the charitable and noncharitable beneficiaries to share the remainder on a fractional basis. The donor, of course, would receive no charitable deduction for the portion of the remainder to be taken by the noncharitable beneficiary. The charitable deduction thus might first be computed as if a charity were to receive the entire remainder, as is the case under current law. The amount of this deduction then could be reduced proportionately by the fractional share of the remainder that the donor had designated for a noncharitable beneficiary. For example, if under a typical unitrust arrangement, it were shown that the donor would receive a forty thousand dollar charitable deduction but for the fact that he had granted a one-fourth interest in the remainder to his son, this deduction simply could be reduced to thirty thousand dollars. Then, at the conclusion of the distributions to the income beneficiaries, the son would receive a one-fourth interest in the

110. INT. REV. CODE OF 1954, §§ 642(c)(5), 664(d)(1)(c), (2)(c).

remainder, whatever its value actually might be at that time. This type of provision, permitting fractional sharing in the remainder, would allow the donor flexibility in the use of the charitable remainder trust, instead of requiring him to set up two separate trusts—one in the usual charitable remainder form and the other for the benefit of those persons who would be permitted to receive a fractional share of the charitable remainder if the aforementioned changes were implemented.

B. Modification of the Pre-1969 Charitable Remainder Trust

1. *Rationale.*—In expressing the general reasons for changes in the law applicable to charitable remainder trusts, the House Ways and Means Committee stated that the pre-1969 law for determining charitable deductions for gifts of remainder interests does "not necessarily have any relation to the value of the benefit which charity receives . . . because the trust assets may be invested in a manner so as to maximize the income interest . . . ."[111] The committee thus felt that there was a possibility that a charity may ultimately receive a remainder interest of a value less than that used by the donor to determine the amount of his deduction. The supposition inherent in these statements of the committee, however, is that the trustee will follow an investment policy that discriminates in favor of the income beneficiary of a charitable remainder trust. This assumption violates the prudent man rule of basic trust law that a trustee must make only those investments that are consistent with his dual obligation to produce income and preserve capital.[112] Moreover, if a trustee violates this duty, those persons whose interests are violated have a remedy against the trustee in the state courts.

A further indication that this part of the rationale supporting the 1969 changes is based more on hypothesis than on fact is found in the Tax Reform Study prepared by the Treasury Department. This study recommended changes involving "generally available abuse situations."[113] The mere opportunity for abuse, however, does not mean that abuse actually will occur, especially in light of the effective remedy available under state trust law. Moreover, the study went on the note that "it is impossible accurately to calculate the extent of [actual abuse in these situations]. It is unlikely that the correction of these abuses will have a significant revenue effect."[114] This statement strongly intimates

111. H.R. REP. No. 91-41e, 91st Cong., 1st Sess., pt. 1, at 58-59 (1969).

112. *Hearings on H.R. 13270 Before the Senate Finance Comm.*, 91st Cong., 1st Sess., pt. 3, at 2245 (1969).

113. TREAS. DEP'T, TAX REFORM STUDIES AND PROPOSALS 185 (1969).

114. *Id.*

that improper use of charitable remainder trusts was not in fact widespread and, therefore, that the postulate underlying this portion of the House committee report was not supported by actual evidence.

Because of the apparently scant evidence of abuse in this area, the 1969 Act often has been termed an excessive response to whatever inequities existed under the old law. Moreover, one article has suggested that the favored tax status of charitable remainder trusts prior to the 1969 Act was more apparent than real because charitable trusts were questioned and attacked continually by the Treasury Department.[115] In light of these comments, it appears that a return to some form of the familiar arrangement of a gift to charity as trustee to pay the income to the donors for life, with a legal remainder to the charity, might be feasible.

2. *Elimination of Contingent Remainders and Powers To Invade Corpus.*—The purpose of any modifications in the traditional trust concept would be to eliminate the possibility of a charitable deduction that is substantially in excess of the amount charity may ultimately receive and, at the same time, to avoid the rigid and rather arbitrary forms of a unitrust or dollar annuity trust. This purpose could be accomplished by first expressly disallowing a deduction for the gift of a contingent remainder interest. This provision would apply whenever there is a possibility that all or part of the remainder interest will not vest in the designated charity. A second modification, still within the familiar framework of the pre-1969 law, would be to prohibit a deduction for a charitable remainder trust that is subject to any power to invade corpus for any purpose.[116] This change would compel the donor to fund the charitable remainder trust on the basis of his careful prior evaluation of the needs of the income beneficiary, instead of leaving that evaluation to the discretion of the trustee. This requirement does not seem unduly harsh or difficult since the donor would have several planning alternatives available, such as increasing the amount of trust corpus in order to provide greater income for the beneficiary or making additional arrangements for the benefit of the income beneficiary that would satisfy his needs by supplementing the income from the charitable remainder trust. The simplicity of this change is particularly appealing. It would eliminate the sort of litigation that is still continuing under the pre-1969 law on whether the trustee's power of invasion is limited by a "presently ascertainable" standard. Perhaps the most favorable aspect of all is that

115. Morrison & Marcus, *supra* note 1, at 233.

116. *See Hearings on H.R. 13270 Before the Senate Finance Comm.*, 91st Cong., 1st Sess., pt. 3, at 2236, 2245 (1969).

the familiar arrangement of income to the donor for life, remainder to charity, would be preserved; this plan, together with the fiduciary obligations imposed by state trust law, would correlate the amount of charitable deduction with the value of the charitable remainder.

3. *Charitable Donee As the Only Permissible Trustee.*—A second means of preserving the familiar trust concept as it existed prior to the 1969 Act would be to require that gifts of remainder interests in trust be made only to the charity itself as trustee.[117] While the charity was typically the trustee of a charitable remainder trust created under the old law, this change would rule out the possibility of designating other trustees. The details of this requirement would be similar to the limitations found in section 642(c)(5)(E) and the regulations thereunder, regarding persons eligible to serve as a trustee of a pooled income fund. The purpose of this requirement is to respond to the reasons for change expressed by Congress in 1969[118] by ensuring an investment policy that does not favor the donor at the expense of the charitable remainder. The underlying assumption of this solution is, of course, that a charity would not advocate an investment policy that is detrimental to its own self-interest. This solution would also preserve the availability of a flexible investment policy to take advantage of fluctuating interest rates and varying investment opportunities. While it is obvious that this arrangement would protect the charitable remainderman, there is the possibility of discrimination against the income beneficiary. This potential for "reverse discrimination," which could result in the donor's obtaining a deduction that is less than the value of the remainder received by charity, does not receive the attention in the legislative history of the 1969 Act that its counterpart does. If a charity follows an investment policy that accentuates the remainder at the expense of the income interest, however, the income beneficiary would have a remedy under state trust law.

Although it would protect the interest of the charitable remainderman, this modification of the pre-1969 law might not be sufficient alone to permit an accurate valuation of the remainder interest for purposes of the charitable deduction. It may be necessary, therefore, to combine the proposal to have the charitable donee as the only possible trustee with the aforementioned recommendation to deny powers of invasion in charitable remainder trusts.

117. *Id.* at 2068.

118. *See* note 111 *supra.*

VI. Conclusion

The proposals offered in this Note are meant to suggest that a return to some form of the flexible, well understood charitable remainder trust of pre-1969 days would prove most satisfactory to the needs of donors, charities, and attorneys. With modifications similar to those recommended above, the familiar concept of traditional income and remainder interests could be reinstated, with its weaknesses eliminated. If reversion to an improved form of the old law is deemed unacceptable, it nevertheless appears that a revision of the tripartite structure of the 1969 Act is mandatory. The complexity and lack of flexibility inherent in the new requirements, together with the several instances in which the desired correlation between deduction and actual remainder value has not been attained, illustrate the necessity for technical improvements in the statute. The effectiveness of any legislation that contains the potential for restricting charitable contributions and thereby making the support of charitable organizations a governmental, rather than a private, function must be reappraised constantly. For these reasons, it is hoped that relief from the mechanical strictures governing charitable remainder trusts under the Tax Reform Act of 1969 soon will be forthcoming.

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