ADVANCED LEGACY PLANNING

Eric S. Ratliff, J.D., LLM
BLUE TRUST
Director of Estate and Philanthropic Planning

I. THE CLIENT

A. All planning begins with understanding the Client, otherwise you are merely selling a product not helping the Client to achieve their objectives in an efficient manner.

B. What are the Client's needs:

1. Standard of living.
2. Familial obligations.
3. Financial commitments.

C. What are the Client's assets and liabilities: obtain net worth statements, cash flow statements; details concerning debts and mortgages;

D. What major transactions are contemplated by the Client such as the sale of a business or of investment assets, or plans for transition of business interests to family members or others?

E. What Legacy does the Client desire to leave?

1. A Legacy is gift which seeks to advance a religious, civic, social, educational, medical, or other charitable purpose.
2. A common denominator of all our clients is gratitude for financial blessings they have received and the desire to leave behind a legacy through the use of some of those financial resources.

II. CHALLENGES IN ESTABLISHING A LEGACY.

A. Taxes.

1. A gift of after tax income, or a gift of property which will produce taxable income to the charity (such as UBTI {unelated business taxable income}) results in funds which might have gone to the charity being diverted to the federal and state governments in the form of taxation, often rendering direct giving an inefficient method of giving.

B. Assignment of income doctrine.

1. When property is given to a charity and soon thereafter the property is sold, then Internal Revenue Service often treats the donor as taxable on the sale proceeds (even though received by the charity) under the Assignment of Income Doctrine.

2. As articulated by the Internal Revenue Service: "In general, under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from it, if the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is practically certain to occur (i e., whether the right basically had become a fixed right), even if the taxpayer transfers the right before receiving the income." Private Letter Rulings, 201232024 and 200445002.

a. This doctrine is based on cases such as*: Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999); *Jones v. United States*, 531 F.2d 1343, 1346 (6th Cir. 1976); *Kinsey v. Commissioner*, 447 F.2d 1058, 1063 (2d Cir. 1973); *Hudspeth v. United States*, 471 F.2d 275, 280 (8th Cir. 1972).

3. In the context of gifts to charity, until 2022 it was generally assumed that as long as the gift to charity was completed before a binding commitment had been consummated to sell the asset, the assignment of income doctrine would not be applied as a result of the Tax Court's decision in *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on another issue*, 523 F.2d 1308 (8th Cir. 975).

4. In Rev. Rul. 78-197, the IRS capitulated to the Tax Court's decision in *Palmer*. "**The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption**."

5. The IRS applied Rev. Rul. 78-197 to a transfer to a unitrust in Rev. Rul. 78-197 and in Private Letter Ruling 20021010.

6. While the IRS attempted to backtrack on its concession in Rev. Rul. 78-197 in subsequent litigation, the Courts continued to apply the "binding commitment test" to find that the assignment of income doctrine did not apply to charitable contributions of property in the absence of a binding commitment. *Rauenhorst v. Commissioner*, 119 T.C. 157 (2002); *Dickinson v. Commissioner,* T.C. Memo. 2020-128.

7. This widely accepted view of the law was upended in 2023 by the Tac Court's decision in *Estate of Hoensheid v. Commissioner*, T.C. Memo. 2023-34

a. The case involved a gift of stock to charity followed by a sale of that stock.

b. Even though the stock was not subject to a binding commitment to sell it at the time of the gift, the Court held that, because the sale was "virtually certain" to occur under the facts of the case, the assignment of income doctrine applied to cause the income from the sale to be taxed to the transferor and not the charity.

c. While the Court declined to apply Rev. Rul. 78-197 because the facts before it were not substantially identical to the facts in *Palmer*, the Court did not articulate what differences existed in the facts before it from the facts in *Palmer*, nor how those differences merited distinguishing the cases from each other.

d. The case is a mess and leaves us with no bright line test to predict when income from a transaction will be taxed to the donor as opposed to the charity.

8. In the absence of a bright line test, and awaiting further clarification from the Courts, the best advice for a Client interested in making a gift to charity of an interest in an asset which the Client anticipates selling in the near future is to make the gift as early as possible to avoid a challenge by the IRS on this basis.

C. Prudent use of funds.

1. Often, upon receipt of a large fund of money, charities will often build a structure and initiate new programs, without an appropriate appreciation for the commitment of future resources needed to maintain the structure and manage the programs on a continuing basis.

2. This consideration suggests making gifts in increments over time to match the prudent needs of the charity for funds rather than making one large scale donation.

D. Control.

1. Donors naturally donate to charities which perform activities of which the donors approve.

2. However, charities change their mission statements over time in ways in which the prior donors would not approve.
3. For example, churches today increasingly "deconstruct" Biblical teachings in novel ways which the original supports find abhorrent
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III. METHODS OF CHARITABLE GIVING.

A. Direct gift

1. This is a gift to charity of an interest in property, such as a gift of stock in a corporation, a limited partnership interest, or a membership interest in a limited liability company.

B. Gift and hold.

1. This is a gift of an interest in an entity, such as a subchapter S Corporation, to a donor advised fund which holds the stock until the entity or its assets are sold.

C. NIMCRUT/LLC structure.

1. Client transfers assets to a limited liability company ("LLC") in exchange for one voting membership unit and 99 non-voting membership units.
   a. Each unit receives 1%/unit of the income of the LLC.
   b. Management control is exclusively in the hands of the one voting unit.
2. Client establishes a 20 year, net income make-up charitable remainder unitrust ("NIMCRUT") meeting the requirements of Section 664(d)(3).
   a. The NIMCRUT pays out each year to the Client (or another named by him) a set percentage of the NIMCRUT assets (currently 11.2%) or trust "income", but if income is less than the set percentage the shortfall is carried forward and can be paid in later years.
   b. Income for these purposes is defined as cash actually received from the LLC and NOT as taxable income.
3. Operationally
   a. 99% of the income generated by the LLC is allocated to the NIMCRUT, which is exempt from tax under Section 664.

b. When the NIMCRUT distributes to the income beneficiary, the income beneficiary will receive taxable income in accordance with the ordering rules of Section 664(b).

c. However, the Client as the owner of the one voting unit can withhold cash payments to the NIMCRUT, depriving it of cash to make distributions, so distributions will accrue each year.

d. This permits accumulation of income within the structure on a tax deferred basis.

e. At the end of 20 years whatever is left in the NIMCRUT belongs to a charity designated by the Client.

f. At the outset of the NIMCRUT the anticipated present value of the trust's charitable remainder interest will be at least 10% of the assets in the NIMCRUT under the government's formula in Treasury Regulation Section .1664-4.

IV. EXAMPLE A: ASSUMPTIONS.

A. Client owns 100% of the stock of a Subchapter S Corporation which owns $50M of assets with a tax basis of $10M.

B. Client wants to sell the assets of the corporation (buyers seldom purchase stock for both tax and non-tax reasons) and would like to give 10% to charity.

C. Assume a 25% State and Federal tax rate on capital gains and 40% on ordinary income.

V. EXAMPLE A: COMPARASON OF GIFTING OPTIONS.

A. Direct Gift.

1. Giving the stock of a Subchapter S Corporation directly to a charity is not practical because it would terminate the Subchapter S election, resulting in a tax at the corporate level when the assets are sold and a second tax to the Client when the corporation distributes the sale proceeds to him. Section 1361.

2. Thus, the shareholder would need to sell the assets inside the company for $50M, pay $10M in tax.

3. The shareholder then gives 10% of the remaining $40M to charity.

a. Thus the charity end up with $4M.

4. The shareholder is left with $36M.

a. Assuming that the Client then invests this $36M for 20 years, at a 10% rate of return, but pays tax at a blended (capital and ordinary income, state and Federal) 30% rate, the Client will be left after 20 years with $139M.

B. Gift and hold.

1. A donor advised fund can be the shareholder of a Subchapter S corporation.

a. Section 1361(c)(6) provides that "an organization which is— … **(B)** exempt from taxation under section 501(a), may be a shareholder in an S corporation."

2. However, the donor advised fund will be taxable on both the income generated by the business of the corporation, and on its share of any gain from the sale of its assets.

a. Section 512(e) characterizes income received by a donor advised fund as Unrelated Business Income taxed at ordinary income tax rates.

B. One author summarized the law as follows "When a charity owns shares of an S corporation, all of the charity's share of the S corporation's income and capital gains and the capital gains on the sale of the S corporation stock will be considered UBTI; therefore, they're taxed at regular tax rates." Liebell & Brunner, *Charitable Planning With Closely Held Businesses*, Journal of Estate & Tac Planning, 11, 13 (June 2014).

3. As another author has said: "[A]ll income of the S Corporation attributable to a charity shareholder and all capital gain that a charity recognizes from the sale of appreciated S Corporation stock is automatically taxable as unrelated business income (UBI), resulting in the imposition of unrelated business income tax (UBIT), which is imposed at the applicable income tax rate. … As noted above, S Corporation stock is not generally a good asset for a charitable organization to hold due to the continuing UBIT exposure." Megan Okun, *Did you know that charitable gifts of S Corp stock have many traps for the unwary*?"

4. It has been suggested that the donor advised fund can make a contribution to charities of the income thus generated each year and deduct up to 60% of the contribution as a charitable contribution tax deduction. This would reduce the Federal tax rate on ordinary income from 27% (ignoring for the moment the investment tax and any state tax)

to 14.8% and the Federal tax rate on capital gains from 20% to 8%. *See*: https://charitablesolutionsllc.com/2019/06/an-s-corp-gift/

5. However, Section 512(e) (quoted above) specifically defines Subchapter S Corporation income allocated to a charity as "unrelated business taxable income", whether or not otherwise related to the conduct of a trade or business.

a. "Section 512(b)(10) provides that in calculating UBTI, the charitable contribution deduction allowed by section 170 is allowed whether or not directly connected with the carrying on of the trade or business, **but shall not exceed 10 percent of UBTI**." IRS Office of Chief Counsel, ILM 202027003, published in Tax Notes (June 4, 2020) [https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/charitable-contribution-deduction-not-disallowed-for-ubti-calculation/2cp9l].

b. More specifically, in computing the tax on unrelated business taxable income, Section 512(b)(10) provides that: "… the deduction allowed by section 170 (relating to charitable contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 10 percent of the unrelated business taxable income computed without the benefit of this paragraph."

c. Thus, "nonprofits are allowed to deduct charitable contributions to a maximum limit of 10 percent of UBTI." Gregg Bossen, *Taxing Nonprofits* [https://proconnect.intuit.com/taxprocenter/tax-law-and-news/taxing-nonprofits-changes-in-unrelated-business-income/].

d. " A tax-exempt corporation was allowed a deduction for charitable contributions up to 10 percent of its unrelated business taxable income computed without regard to the deduction for contributions." Internal Revenue Service, *SOI Tax Stats - Exempt Organizations' Unrelated Business Income (UBI) Tax Study Terms and Concepts* [https://www.irs.gov/statistics/soi-tax-stats-exempt-organizations-unrelated-business-income-ubi-tax-study-terms-and-concepts#:~:text=A%20tax%2Dexempt%20corporation%20was,to%20the%20deduction%20for%20contributions.].

e. " A tax-exempt nonprofit organization is allowed a deduction for charitable contributions. This deduction is limited to 10 percent of its

unrelated business taxable income computed without regard to the deduction for contributions." *Unrelated Business Income Tax (UBTI) For 501c3 Nonprofits* [https://form1023.org/unrelated-business-income-tax-ubit-for-501c3-nonprofits].

e. Please note that this is actually more liberal than the Section 642(c) rule applicable to trusts which provides that "No charitable contributions deduction is allowable to a trust under section 642(c) for any taxable year for amounts allocable to the trust's unrelated business income for the taxable year" Treasury Regulation Section 1.681(a)-(2).

6. Thus, if the S Corporation sold its assets for $50M, $40M would constitute capital gains

7. The donor advised fund would receive $5M, including $4M gain which is taxed at ordinary income tax rates of 40%, leaving it with 3.4M.

8. If the donor advised fund distributed the entire $4M gain in the year of receipt it could decrease its taxable income to $3.56M resulting in $3.56M after tax to the charity.

9. The Client would receive $45M, pay $11.25 in tax, and have $33.75 remaining after tax.

a. Assuming that the Client then invests this $33.75M for 20 years, at a 10% rate of return but pays tax at a blended (capital and ordinary income, state and Federal) 30% rate, the Client will be left after 20 years with $131M

C. NIMCRUT/LLC structure.

1. Because a NIMCRUT cannot be a shareholder of an S Corporation, the S Corporation establishes a NIMCRUT/LLC structure, transferring the corporate assets to the LLC where they are temporarily leased back to the corporation until they are eventually sold. This often includes and is in large part the intellectual property of the business, while recognizing the limitations of Section 338.

2. The LLC has $50M of assets and, except for the 1% voting interest, none of the gain is currently taxed.

3. Assuming that these funds are invested at an annual compounded rate of return of 10% (the annual rate of return for the S&P 500 over the past 100 years has been 10.56%) at the end of 20 years this would have grown to $336,000,000.

a. Based upon the government's projections in Treasury Regulation Section 1.664-4, !0% of this amount would be payable to charity.
b. The Client would receive the remaining $302.4M, and after paying tax at the blended 30% rate described above, the Client would be left with $211.68M.

VI. EXAMPLE B: ASSUMPTIONS.

A. Client owns 100% of the stock of a C Corporation which owns $50M of assets with a tax basis of $10M.
B. Client wants to sell the assets of the corporation (buyers seldom purchase stock for both tax and non-tax reasons) and would like to give 10% to charity.
C. Assume a 25% State and Federal tax rate on capital gains and 40% on ordinary income.

VII. EXAMPLE B: COMPARASON OF GIFTING OPTIONS.

A. Direct Gift.
1. Client gives 10% of the stock of the C Corporation directly to a charity.
2. Then, the corporation sells the assets for $50M, pays $8,400,000 in tax (@ 21%), and distributes the remainder ($41.6M) to the shareholders.
3. The charity receives 10% leaving it with $4.16M.
4. The Client receives 90% ($37.44M) and would pay tax on the distribution ($9.36M), leaving him with $28.08M.
a. Assuming that the Client then invests this $28.08M for 20 years, at a 10% rate of return but pays tax at a blended (capital and ordinary income, state and Federal) 30% rate, the Client will be left after 20 years with $109M
B. Gift and hold.
1. The results are essentially identical to the results of a direct gift as described above.
C. NIMCRUT/LLC structure.

1. While a NIMCRUT can be a shareholder of a C Corporation, the transfer of stock to our structure would not defer the gain at the shareholder level upon the sale of assets by the Corporation.
2. The more tax efficient option is for the C Corporation to establish a NIMCRUT/LLC structure, transferring the corporate assets to the LLC where they are temporarily leased back to the corporation until they are eventually sold.
3. The LLC has $50M of assets and, except for the 1% voting interest, none of the gain on their sale is not currently taxed.
4. Assuming that these funds are invested at an annual compounded rate of return of 10% (the annual rate of return for the S&P 500 over the past 100 years has been 10.56%) at the end of 20 years this would have grown to $336,000,000.
a. Based upon the government's projections in Treasury Regulation Section 1.664-1, !0% of this amount would ($33.6M) be payable to charity.
b. The Client would receive the remaining $302.4M, and after paying tax at the blended 30% rate described above, the Client would be left with $211.68M.

VIIII. EXAMPLE C: ASSUMPTIONS.

A. Client owns an interest in assets (such as real estate), or investments (such as limited partnership interests or LLC membership interests) worth $50M of assets with a tax basis of $10M.
B. Client wants to sell theses and would like to give 10% to charity.
C. Assume a 25% State and Federal tax rate on capital gains and 40% on ordinary income.

IX. EXAMPLE C: COMPARASON OF GIFTING OPTIONS.

A. Direct Gift.

1. Client gives 10% of the assets or entity interests directly to a charity.
2. Then, the Client or the entity sells the assets for $50M.
3. The charity receives 10% leaving it with $5.0M.

4. The Client receives 90% ($45MM) and would pay tax on the gain ($11.25 M), leaving him with $33.75M

a. Assuming that the Client then invests this $33.75M for 20 years, at a 10% rate of return but pays tax at a blended (capital and ordinary income, state and Federal) 30% rate, the Client will be left after 20 years with $139M.

B. Gift and hold.

1. The results are essentially identical to the results of a direct gift as described above.

C. NIMCRUT/LLC structure.

1. The assets are transferred to a NIMCRUT/LLC structure, where they are eventually sold.

2. The LLC has $50M of assets and, except for the 1% voting interest, none of the gain is not currently taxed.

3. Assuming that these funds are invested at an annual compounded rate of return of 10% (the annual rate of return for the S&P 500 over the past 100 years has been 10.56%) at the end of 20 years this would have grown to $336,000,000.

a. Based upon the government's projections in Treasury Regulation Section 1.664-1, !0% of this amount ($33.6M) would be payable to charity.

b. The Client would receive the remaining $302.4M, and after paying tax at the blended 30% rate described above, the Client would be left with $211.68M.

X. EXAMPLE D: ASSUMPTIONS.

A. Client owns a business, with his child/children owning a small percentage, with a low tax basis in its assets producing little in depreciation deductions.

B. The business is producing $5,000,000/year in profits (including salary paid to Client).

C. Client wants to pass on the business to his child/children for $50M and would also like to give 10% to charity.

D. Assume a 25% State and Federal tax rate on capital gains and 40% on ordinary income, and a 21% tax rate on corporations.

XI. EXAMPLE B: COMPARASON OF GIFTING OPTIONS.

A. Direct Gift.

1. If a 10% interest in the business is given to charity and then redeemed the IRS will almost certainly argue that the redemption proceeds represent capital gain to the Client under the assignment of income doctrine.

a. If the Client receives the $50M and pays tax, the charity would receive $4M as the after tax 10% on the sale of the business.

2. Even if that could be avoided, the business ends up paying tax on its earnings and then using the after tax income to redeem the shares.

a. For a corporation, it would need to earn about $63,500,000 to generate $50,000,000 after tax to fund the redemption.

b. For a pass through entity it would need to generate over $83,000,000 to fund the redemption.

C. The Client would pay tax at a 25% rate.

B. Gift and Hold.

1. If a 10% interest in a Subchapter S corporation is given to charity and then redeemed, even if we avoid the assignment of income issues, the gain on the redemption ($4M) will be subject to tax at ordinary income tax rates.

a. As described in connection with Example A above, that will leave the charity with between $3.4M and $3.56M after tax.

C. NIMCRUT/LLC Structure.

1. Rather than paying the entire $50M for the business, it may be possible to allocate some of the value of the business to the intellectual property (good will, trade secrets, personal contacts, ect) which belong to the Client personally even though used in the business.

a. For example, in *Bross Trucking Co. v. Commissioner*, TC Memo 2014-107, the Tax Court held that a dissolved corporation's intellectual property belonged to the shareholders personally and not to the corporation.

b. Martin Ice Cream Co. v. Commissioner, 10 T.C. 189 (1998) ("… a corporation cannot distribute intellectual assets that are individually owned by its shareholders.").

c. Intellectual property rights were also found to be owned by the shareholder even though used in the business in *Norwalk v. Commissioner*, T. C. Memo. 1998-279.

2. These rights are transferred to a NIMCRUT/LLC structure.

a. Payments for the use of those rights are deductible by the business under Section 162, thus eliminating that level of taxation entirely.

b. Distributions from the structure are made directly to the Client, and income inside the structure can remain tax deferred,
accumulating additional investment income, until distributed.

c. The charity receives the benefit of the remainder interest in the NIMCRUT.

XII. EXAMPLE E: ASSUMPTIONS

A. Client wants to pass along valuable assets worth $100x to his children/grandchildren.

B. A direct gift would generate a huge gift tax liability if given to his children.

C. A gift to grandchildren would alo generate generation skipping tax consequences making the cost obscene.

XIII. SOLUTION

A. Client transfers assets to an LLC for one voting and 99 non-voting u nits.

B. Client transfers the 99 non-voting units to a 20 year NIMCRUT.

C. After more than a year passes a trust is established by client or client's children.

1. Beneficiaries re the children and/or grandchildren.

2. Client has not control which would bring the assets into Client's estate.

3. Assume we fund the trust with $1x in assets.

D. At this time the charity's charitable remainder interest is $12X using the Treasury Regulation Section 1.664-4 formula.

E. The charity agrees to sell to the trust the 99 non-voting membership units.

1. Charity receives $12x immediately.

2. When Charity receives the 99 non-voting units it is obligated to deliver those units to the trust, at which time the trust pays an additional $0.5x plus interest.

F. Trust funds the purchase with its $1x and obtains an $11x loan form the LLC.

G. Trust terminates:

1. Client can surrender his income interest in the NIMCRUT causing it to prematurely terminate (generating a charitable contribution tax deduction for the Client).

2. Or Client can provide in his will that his estate surrenderes this income interest at his death, thereby terminating the NIMCRUT.

a. The entire value of the interest in the NIMCRUT is in Client's gross estate, and is deducted as a charitable contribution because 100% of the NIMCRUT belongs to the charity.

3. Or the trust term expires.

H. At the termination of the NIMCRUT the Charity receives the 99 no n-voting units.

I. Charity transfers the 99 non-voting u nits to the trust for $0.5M plus interest.

J. the Trust borrows another $0.5M to pay the final installment to the Charity.

K. Trust's tax basis is the $12.5M it paid for the units.

1. It takes a distribution from the LLC of $11.5M to repay the loans it used to buy the 99 non-voting units.

2. The distribution is a return of capital (no tax implications).

L. The trust now has a 99% interest in an LLC.

1. Trust can simply retain the LLC and distribute the income its assets generate each year to the trust beneficiaries.

2. Alternatively Trust can liquidate the LLC after the capital gains holding period is passed and recognize capital gains.

XII. FLEXIBILITY

A. As described above, the NIMCRUT/LLC structure avoids the immediate imposition of tax on the gain from the sale of assets by an S or a C corporation, which cannot be otherwise avoided.

B. In all events, the structure enables the growth of funds inside the structure on a tax deferred basis, providing superior long tern returns to both the Client and the charity.

1. This does not mean that the charity must wait for 20 years before receiving cash.

2. One option is for the LLC to make a non-recourse loan to the charity at a low interest rate.

a. Because the loan is non-recourse it is repayable only out of the NIMCRUT interest of the charity, which is never personally liable on the debt.

b. Because the interest rate can be low, the charity still benefits form the growth inside the LLC in excess of the interest rate on the loan.

3. The LLC can, with the Client's consent make a charitable contribution to the charity.

4. The Client can agree to a partial termination of the structure which would provide an immediate benefit to the charity.

C. Because the Client retains the one voting membership unit in the LLC the Client can control the timing of the flow of funds to the charity.

D. Because the Client retins the right to change the charitable remainder beneficiary, the Client can re-direct charitable benefits to other charities is the originally designated charity adopts new objectives inconsistent with the Client's beliefs and intentions.

XIV. COMMONLY ASKED QUESTIONS CONCERNING THE LLC/NIMCRUT STRUCTURE.

A. HOW DO WE KNOW THE NIMCRUT WILL QUALIFY UNDER SECTION 664?

The Internal Revenue Service has ruled that if the trust document contains terms and conditions substantially similar to those contained in the Internal Revenue Service's form documents (Rev. Proc. 2005-53 through

2005-59), then the Internal Revenue Service will recognize the trust as a NIMCRUT qualified under Section 664(d), provided that the trust continues to operate in a manner consistent with the terms of the trust document, and the NIMCRUT is a valid trust for state law purposes. The trust documents we use reflect the language in the previously described revenue procedures. Assets are being transferred to a trustee vested with fiduciary duties in favor of current and remainder beneficiaries, and the CRUTs will otherwise meet the requirements of trusts under state law. Restatement (Third) of the Law of Trusts, Section 3 (2003).

B. WILL THE ALLOCATION OF99% OF THE TAXABLE INCOME TO THE NIMCRUT BE RESPECTED?

The Internal Revenue Code provides that: "A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement." Section 704(a). (For these purposes, the LLC's Operating Agreement is the relevant "partnership agreement".) Our form of Operating Agreement provides that profits and losses are to be divided proportionately among the 100 membership units (voting and non-voting) with each unit receiving 1% of the profits and losses. Further said allocations are applied to each member's capital account, and distributions, including but not limited to liquidating distributions, are made in accordance with the members' capital accounts.

The primary limitation on the ability of partners to allocate income and losses by agreement among the partners is the "*substantial economic effect*" Regulations. Although analysis of provisions under this rule can be complex, the essential objective of the Regulations can be understood as follows:

Partners are not able to allocate tax benefits among themselves in a manner that is divorced from their allocation of economic profit or loss. A partner who is economically enriched by an item of partnership income or gain is required to shoulder the associated tax burden. Similarly, a partner who is economically hurt by an item of partnership loss will be allocated the tax benefit of the loss. The tax

allocations must ultimately conform to the economics of the partnership's transactions.

Chapter 6, IRS Partnership Audit Guidelines (12-2007).

Another author expresses this even more simply:

At the heart of this complexity is the requirement that the tax consequences of a partnership's operations inure to the benefit or detriment of those partners who are economically at risk—a union of tax consequences and economic consequences. Historically, drafters of partnership agreements guaranteed this union by requiring that (1) the partnership maintain a separate capital account for each partner that tracked each partner's economic rights in the partnership and (2) the partnership liquidate in accordance with those capital accounts.

N. P. Brock, *Targeted Partnership Allocations: Part I,* The Tax Advisor (June 1, 2013).

Because LLCs' profits and losses will be shared among the members proportionately based upon their ownership interests as of the end of each year for purposes of determining how much they each are entitled to receive from the entity, and because their capital accounts (which are relevant in determining, *inter alia*, their distributions upon liquidation) are likewise adjusted based on their interests in the entity as of the end of each year, the allocations will have substantial economic effect, and the allocations will be respected for tax purposes as well

C. CAN THE BUILT IN GAIN BE ALLOCTED TO THE NIMCRUT?

The difference between the fair market value of the property contributed to a partnership (the LLC will be treated as a partnership for Federal income tax purposes) and its tax basis is treated as "built in gain". *See, Santa Monica Pictures, LLC v. Commissioner*, T.C.Memo. 2005-104; Treasury Regulation Section 1.704-3(a)(3)(ii). Under Section 704(c)(1), and Treasury Regulation Section 1.704-3(a), the built in gain from the sale of the contributed property must be allocated to the ownership interest of the contributing partner. *See generally*, Andrea M. Whiteway, *Property and Liability Transfers to Partnerships: Built In Gain or Loss, Boot and Disguised Sales*, William & Mary Annual Tax Conference (2006).

Because the built in gain will initially be allocated proportionately to each of the 100 membership units received in exchange for this property, the allocation of built in gain provisions in Section 704(c) will be satisfied upon formation of Investment LLC. When the 99 non-voting membership units are transferred to the NIMCRUT, the NIMCRUT inherits responsibility for the built in gain attributable to the 99 non-voting membership units. "If the contributing partner transfers his interest, built in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner." *Santa Monica Pictures, LLC v. Commissioner*, T.C.Memo. 2005-104. *See also, The Markell Co., Inc. v. Commissioner*, T.C.Memo. 2014-86. This means that upon the transfer of the 99 non-voting membership units to the NIMCRUT, the NIMCRUT **must** be allocated 99% of the built in gain attributable to the property originally transferred to the Investment LLC. Treasury Regulation Section 1.704-3(a)(7) dictates this result by providing that:

If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.

Thus, when the property with built in gain is sold by the LLC, the NIMCRUT, as the owner of the 99 non-voting membership units, must recognize 99% of the gain generated by that sale.

D. HOW CAN THE NIMCRUT HAVE INCOME FOR TAX PURPOSES BUT NOT FOR DISTRIBUTION PURPOSES?

Our NIMCRUT document provides that the trust shall make distributions each year equal to the lesser of a set percentage of trust assets or "income", but if "income" in a year is less than the amount which would be distributable under the fixed percentage formula, the difference is carried over into future years and may be distributed in later years if "income" is sufficient for this purpose. This distribution provision is authorized by Section 664(d)(3). It also follows the language of Rev. Proc 2005-54, Section 6.08(3)(b).

As the years pass during which full distributions are not made, the accumulated "distribution deficiency" is reported on the Form 5227, part VI, Line 6b, and is available for distribution during any year in which trust "income" is sufficient to permit such distributions.

It is important to note that the "income" which the NIMCRUT may distribute refers to *trust accounting income*, rather than *taxable income*. Ellen K. Harrison, *Selected Planning Techniques* (ACTEC regional Meeting Annapolis, Maryland, September 11 - 12, 2004). Treasury Regulation Section 1.664-3(a)(i)(b)(3), provides in relevant part that, for purposes of Section 664, "trust income generally means income as defined under section 643(b) and the applicable regulations." This is echoed by Rev. Proc. 2005-54, which notes, "the trust income for the taxable year" is the income of the trust "as defined in § 643(b) of the Code and the applicable regulations."

Treasury Regulation Section 1.643-1 unequivocally states that: ""income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." Thus, for purposes of Section 664 distributions, it is the trust document and applicable state trust law which defines income, not tax law concepts. Ellen K. Harrison, *Selected Planning Techniques* (ACTEC regional Meeting Annapolis, Maryland, September 11 - 12, 2004). http://www.pillsburylaw.com/siteFiles/Publications/F6A9253F3D71D9481F278E1355C70A17.pdf.

It is not unusual for the term "income" to have different meanings in different contexts such as this. For example, in *Thor Power* Tool v. Commissioner, 439 U.S. 522 (1979) the Supreme Court specifically held that taxable income and income for generally accepted accounting principles were different concepts derives from the application of distinctly different standards for different purposes. "The amount of accounting "income" under a will or trust instrument, … may differ

considerably from taxable income." Blattmachr on Income Taxation of Estates and Trusts (Sixteenth Edition), page 3-73.

Turning to "the governing instrument and applicable [state] law" of the trust in question (as required by Treasury Regulation Section 1.643-1), the definition in our form of NIMCRUT document of trust accounting income as cash actually received from an LLC.

For all purposes of this Trust Agreement "trust accounting income" as that term relates to income from any annuity contract, insurance contract, zero coupon bonds, partnership interest, or LLC interest owned by the Trust shall be the actual cash received by the Trust as a distribution from such annuity contract, insurance contract, zero coupon bonds, partnership, or LLC during each calendar year.

This definition of trust income is consistent with general state trust law defining income for distribution purposes. "[T]rust income is a cash concept. That is, the trust will not have trust accounting income if it does not have a cash receipt." *Dusting Off the Old Charitable Remainder Trust and Advanced Structures* [http://rhcclaw.com/wp-content/uploads/2015/02/Dusting-Off-Charitable-Trust.pdf]. Section 401(b) of the Uniform Principal and Income Act (which has been widely adopted by the states) provides that "a trustee shall allocate to income money received from an entity." "The general rule found in the Act at section 401(b) [of the Uniform Act] is simple enough: Except as otherwise provided, money received from an entity is allocated to income." David Wheeler Newman, *Advanced NIMCRUT Design*, http://www.pgdc.com/pgdc/advanced-nimcrut-design. And the commentators are in accord that this means that a NIMCRUT will have trust income, which it must distribute to its income beneficiary, *if but only* if it actually receives cash from the LLC/partnership in which it owns an interest.

- “The underlying concept, now codified in the revised Uniform Principal and Income Act, is that the NIMCRUT will not have fiduciary accounting income except, and only to the extent that, the trust receives distributions from the partnership.” *Id*.
- “A trustee shall allocate to income money received from an entity.” Section 401(b) of the Uniform Principal and Income Act.
- “Trust income is defined by reference to state principal and income acts, which generally limit trust income to interest and dividends. Furthermore, under these laws, trust income is a cash concept—a trust will not have trust accounting income if it does not have a cash receipt.” Gona, Moran, and Church, *Controlling Capital Gains Deferral with a Spigot Net Income Make-up Charitable remainder Unitrust* (August 2, 2021) [https://news.bloombergtax.com/daily-tax-report-state/controlling-capital-gains-deferral-with-a-spigot-net-income-charitable-remainder-unitrust].
- *“* If the partnership distributes cash, the distribution will be treated as income by the trustee who will distribute it to the income beneficiary.” And if no such distribution is made there is no trust income to be distributed. MSK, *Uniform Principal and Income Act* (2000) [https://www.msk.com/newsroom-alerts-1];
- “When a distribution is made from the ... partnership to the NIMCRUT. That distribution is characterized as income and distributed to the beneficiary.’’ Conversely, if no distribution is made there is no trust income to distribute. “[T]he trust will not have trust accounting income if it does not have a cash receipt.” *Dusting Off the Old Charitable Remainder Trust and Advanced Structures* [http://rhcclaw.com/wp-content/uploads/2015/02/Dusting-Off-Charitable-Trust.pdf].

In short, our definition of accounting income as cash actually received by the NIMCRUT is consistent with generally accepted principles of state trust law. Further, "several private letter rulings concerning the determination of trust accounting income of a net income charitable remainder trust conclude that governing document provisions of a trust will not be regarded as fundamentally departing from local law if local law rules apply in determining income and corpus only in default of explicit provisions in the governing instrument." Blattmachr, *supra*.

Our structure permits the owner of the one voting LLC unit to withhold or make distributions from the LLC to the NIMCRUT. Until such distributions are made, the NIMCRUT has no trust accounting income to distribute.

- "[B]ecause the NIMCRUT only receives income actually paid from your LLC, the NIMCRUT will no longer have to make payouts to the receiver of the trust income as long as you do not distribute income to the NIMCRUT. As such, we can use the "make-up" provision to shift taxable income forward to future years when your income tax bracket is lower by distributing income from the LLC to the NIMCRUT in those future years." Dahl, *Using a Spigot Charitable Remainder Trust to Reduce Income Taxes* (September 13, 2022) [https://tqdlaw.com/using-a-spigot-charitable-remainder-trust-to-reduce-income-taxes/].
- "Until a distribution is made from the LLC, the NIMCRUT would not have any trust accounting income and would not have an obligation to make a distribution to the beneficiary" even if the LLC had trust income for tax purposes. *Using Single Member LLCs In Net Income Charitable Remainder Unitrusts* [http://www.pgdc.com/pgdc/using-single-member-llcs-income-charitable-remainder-unitrusts]
- "An alternative to permit discretionary distribution of capital gain is to place the unitrust assets in a partnership or single-member LLC. When a trust payout is desired, recognized

capital gains are distributed from the partnership or LLC to the unitrust, and then to the income recipients. The NIMCRUT defines income as a cash distribution from the LLC or partnership and there is no obligation to make the trust income payments until receipt of the LLC or partnership distribution. *Unitrusts II: Payouts and Trustees*, UC Riverside (March 6, 2024) [https://planmygift.ucr.edu/?pageID=41&docID=303].

- "Fiduciary accounting income for a partnership/LLC is the actual cash received from the partnership or LLC not the reported Form K-1 income. Therefore, unless the partnership/LLC makes a cash distribution to the CRT there is no requirement to make a payment to the individual beneficiary during that year. The payment amount does not vanish because it was not paid during a given year. Rather, any unpaid amounts are accumulated for future year when actual cash is distributed from the partnership/LLC to the CRT. This is referred to as a "net income make-up" provision." Michael Kirkman & Tyler Wilson, *Controlling Income Recognition Using a Charitable Trust* (August 12, 2021) [https://www.cbh.com/guide/articles/controlling-income-recognition-using-a-charitable-trust/].

As the above authorities evidence, the use of an LLC to own the NIMCRUT's assets, and the definition of trust income as cash received from the LLC, are accepted planning mechanisms among those engaged in highly sophisticated planning.

In TAM 982500 the Internal Revenue Service effectively recognized that the investment of NIMCRUT assets so as to defer the receipt of cash within the NIMCRUT and the corresponding duty of the NIMCRUT to make distributions, neither disqualifies the NIMCRUT under Section 644 nor results in a prohibited self-dealing transaction. While a TAM is not binding authority, "Under *Skidmore v. Swift & Co.,* 323 U.S. 134, 140 (1944), we determine whether the Commissioner's rulings and pronouncements may have the "power to persuade" by looking to "the thoroughness evident in its consideration, the validity of its reasoning, [and] its consistency with earlier and later pronouncements"." Estate of

Schaeffer v. Commissioner, 145 T.C. #4 (2015). This is especially the case here where decades have passed with no further authority of any relevance. Further, the Tax Court, in *Estate of Schaefer v. Commissioner of Internal Revenue,* 145 T.C. No. 134 (2015), relied extensively upon the IRS's administrative interpretation of Section 664 in interpreting the Regulations thereunder.

The facts of Technical Advice Memorandum 9825001 are essentially these. An individual established a NIMCRUT for himself and his wife for their joint and survivor lives. The NIMCRUT owned the vast majority of the stock of a corporation which was sold under an agreement by which the grantor/beneficiary of the NIMCRUT was given a 5 year contract, meaning that he would not need NIMCRUT distributions for at least 5 years. The NIMCRUT's independent trustee purchased two deferred annuities by which the NIMCRUT could take withdrawals at any time, change the maturity date, and make other changes, but if the grantor and his wife lived to age 80 and the annuities were not otherwise changed the annuities would mature and be paid to them, not the NIMCRUT.

The first question addressed was whether the possible payments of the annuities upon maturity to the grantor and his wife conferred a right upon a disqualified person for self-dealing purposes. The IRS concluded that it did not because the right to receive the annuity amounts upon maturity conferred no present benefit to the disqualified persons.

The Service has found an act of self-dealing under section 4941(d)(1)(E) only in the case where the disqualified person has received a current benefit. In Rev. Rul. 74-600, 1974-2 C.B. 385, the Service held that self-dealing occurred under section 4941(d)(1)(E) when paintings owned by a private foundation were allowed to be placed in the residence of a disqualified person. In Rev. Rul. 77-160, 1977-1 C.B. 351, the Service held that the dues paid to a church on behalf of a disqualified person in order to allow such person to retain his membership in the church was an act self-dealing.

In summary, it is our position that the donor receives no present value from the contract right to receive annuity payments. We do not believe that the annuity right could be currently assigned by the donor and his wife to a third party for any significant value. The donor and his wife have recently assigned their interest in the policy as named annuitants to X. Thus, the problem is resolved for future years.

The second question addressed was whether the entire transaction taken as a whole; the purchase of a deferred annuity, the failure to make withdrawals from the annuity policies, and the intention to subsequently make unitrust payments to the beneficiary/grantor under the "make-up" provision of the NIMCRUT; could be construed as an act of self-dealing under section 4941(d)(1)(E) of the Code by virtue of the authority provided by Section 53.4941(d)-2(f)(1) of the Treasury Regulations. The IRS acknowledged that it was faced with a conundrum. Any benefit to a disqualified person was an act of self-dealing, but "any investment decision regarding trust assets that results in an increase or decrease in the unitrust amount will inescapably constitute an attempted use for the benefit of the disqualified person." Here is how the IRS resolved this problem. "Therefore, rather than focusing on whether the deferral of income is a use of trust assets, the relevant question is whether the deferral of income is a permitted use. Since charitable remainder trusts by their intrinsic nature provide for a continuous use by the disqualified person of the entire trust corpus, we conclude that the presence of an unreasonable affect on the charitable remainder interest distinguishes a permissible use of trust assets from an impermissible use." The deferred annuity in question was found not to result in an unreasonable affect on the charitable remainder beneficiary.

The third question addressed was whether the mere right to withdraw funds each year from the annuities resulted in the NIMCRUT receiving "income" for distribution purposes. The IRS concluded that it did not.

The applicable state law, the Uniform Principal and Income Act of Tennessee, appears ambiguous on whether a trust's right to receive money is income to the trust, whether characterized as principal or income. The implication from the sections that define income and principal, however, is that a trust does not realize either until the trust actually receives possession of money or other property. See Tenn. Code Ann. section 35-6-102 and section 35-6-104 (1991). Therefore, the Trust's right to receive either the cash value or the surrender value of the contracts does not create trust accounting income under section 643(b) of the Code. On this last issue, *see also*, Letter Ruling 9009047.

An excellent analysis of the impact of this ruling on NIMCRUT investments which result in the deferral of income for distribution purposes is Ron Shoemaker and Bill Brockner, *THIRTY YEARS AFTER THE 1969 TRA – RECENT DEVELOPMENTS UNDER CHAPTER 42*, 1999 EO CPE Text [https://www.irs.gov/pub/irs-tege/eotopicp99.pdf]. Marty McKeever, *IRS Approves Income Deferral CRUT Funded with Deferred Annuities* (1999) [https://www.pgdc.com/pgdc/irs-approves-income-deferral-crt-funded-tax-deferred-annuities], stated that "The TAM also suggests that even if the trust instrument has not anticipated income deferral arrangements, they may be permissible provided they are compatible with state law."

Justin Ransome and Eileen Sherr, *Patenting Tax Ideas,* The Tax Advisor (January 2018) [https://www.thetaxadviser.com/issues/2007/aug/patentingtaxideas.html], state that in "TAM 9825001 … the IRS permitted a net-income charitable remainder unitrust to invest in a tax-deferred annuity contract for the purposes of controlling the timing and amount of income distributions and to otherwise provide a guaranteed death benefit payable to the charitable remainder interest holder." Similar conclusions h ve ben expressed by: Jerome M. Hesch, Stephen M. Breitstone, and David C. Jacobson, *Statutory Clarity for Early Termination of NICRUTs and NIMCRUTs*, Tax Notes 1717, 1720 note 27 (June 19, 2017); J. Ackerman, *The CRT Stock Redemption Strategy for Philanthropic and Business Succession Planning*, *Partnership for Philanthropic Planning*, 5 at page 8; David Wheeler Newman, *The Income Control Unitrust* (2010).

Please note that several of these authors advocate for the NIMCRUT owning 100% of the LLC. Our concern is that such a structure would give the trustee of the NIMCRUT control over the timing of distributions from the LLC, raising constructive receipt issues which are avoided by having control over distributions in the hand of the Lient through ownership of the one voting membership unit.

E. CAN WE PLACE PROPERTY WHICH HAS OUTSTANDING DEBT INTO THE LLC/NIMCRUT STRUCTURE?

If property which is subject to an "acquisition indebtedness" is contributed to a NIMCRUT (or is owned by an LLC which is partially or wholly owned by a NIMCRUT), a portion of the income from that property (including but not limited to income from its sale) is treated as UBTI. Section 514. UBTI income should not be allocated to the NIMCRUT because it would be subject to a 100% excise tax under Section 664. For these purposes, "acquisition indebtedness" is debt secured by the property in question, and any debt which would not have been incurred but for the acquisition of the property. Section 514.

Our form of LLC Operating Agreement specially allocates UBTI to the taxable, voting member's interest, as described earlier in this White Paper. This mitigates the effect of UBTI on our planning, although the presents of UBTI can still reduce the benefits available from our strategy.

This is an issue which we have repeatedly run across in connection with our planning, and, fortunately, we have strategies for addressing the issue. First, we check the age of the debt. Section 514(c)(2)(B) permits liens realted to debt which is more than five years old on property transferred to a NIMCRUT owned LLC without being treated as debt financed property. *See*, Laura Peebles, *Contributing Mortgaged Property to Charity* (updated September 16, 2012) [https://www.pgdc.com/pgdc/contributing-mortgaged-property-charity].

Second, if the five year rule is unavailable to provide relief, we may be able to pay off the debt.

Third. we can fund the LLC with a modest amount of cash which the LLC uses to buy an option on the property with the option pricde equal to the nproperty's tax basis. The property can be sold to a third party for the difference between the fair market value of the property and its tax basis, with the third party then buying the poroperty bey exercising the option. The taxable gain is trapped inside the LLC/NIMCRUT structure. Using this option is rare however due to its complexity and reliance on third-parties to value the option.

In Private Letter Ruling 9240017 the IRS approved of the transfer of an option to acquire property to a unitrust, even though the tax deduction for the contribution would be delayed until the option was exercised per Rev. Rul. 82-197. Some authors suggested that this approach could be used to transfer all sorts of assets which otherwise would be unsuitable for direct transfer to a unitrust, like Sub S stock. *See*, Tax Management Portfolio 865, at A-9; Hollis F. Russell, Matthew E. Brady, and Colette K. Meyer, *Practical Guidance for Charitable Remainder Trust Planning for Residential Property Real Property* BNA Estate, Gifts and Trusts Journal (March 1996) [http://www.ackermanlevine.com/wp-content/uploads/2014/05/practical-guidance.pdf]; Teitell, *Funding Charitable Remainder Trusts with Innovative Assets*, 132 Tr. & Est. No. 1, 53 (Jan. 1993). "As the implications of this technique became better understood, the IRS, in PLR 9417005, withdrew PLR 9240017 for further consideration. Then, in PLR 9501004 the IRS announced a new position on the issue, ruling that a transfer of an option to a unitrust ... would disqualify the trust." Tax Management Portfolio 865 at page A-9. *See also,* Michael V. Bourland, Jeffrey Myers, *The Charitable Remainder Unitrust*, 6th Annual Advanced Estate Planning strategies Course (1999); Bryle Abbin, *Significant Recent Developments in Estate Planning,* The Tax Advisor (December 1995.*)* In this ruling, the IRS began by noting that Treasury Regulation Section 1.6641(a)(1) and (4) require a unitrust to qualify as such from the date of its beginning. It then stated that any transfer to a unitrust must qualify for a charitable deduction from the date of the contribution for the trust to qualify as a unitrust under Section 664. The IRS then reasoned that: "The requirements of being a charitable remainder trust in every respect and functioning exclusively as a

charitable remainder trust from its creation cannot be met unless each transfer to the trust during its life qualifies for a charitable deduction under one of the applicable sections (section 170, 2055, 2106, or 2522)." Private Letter Ruling 9501004. The IRS repeated that position in a private letter ruling not involving an option, Private Letter Ruling 9532006, and other authorities appear to accept this logic. Thomas J. Ray, Charitable Gift Planning: a Practical Guide for the Estate Planner 315.

Thus, under the current IRS logic, because an option contributed to a charity is deductible for Federal income tax purposes when the option is exercised and not when made (Rev. Rul. 82-197), the transfer of an option to a unitrust would not generate a tax deduction upon contribution and, hence the contribution of an option would disqualify the unitrust. *Tax Management Portfolio 865* at page A-9. The IRS position appears inconsistent with its position as articulated in other rulings. In PLR 9452026, the taxpayer proposed funding a charitable remainder unitrust with tangible personal property--in this case a violin. There were no other strings attached (if you will forgive the pun). The Service ruled that the deduction would be allowable at the time the property is sold and that the trust qualifies as a charitable remainder trust. … This seems to fly in the face of PLR 9501004. Katzenstein, Lawrence P., *Charitable Planning Through Deferred Giving Vehicle,* William & Mary Annual Tax Conference. 327 (1996) https://scholarship.law.wm.edu/tax/327

The IRS has also pointed to the gratuitous nature of an option transferred to a trust as a factor in its conclusion that an option funded trust cannot qualify as a unitrust under Section 664. "Rev. Rul. 80-186, 1980-2 C.B. 280, concludes that the transfer of an option to purchase real property for a specified period is a completed gift under section 2511 of the Code on the date the option is transferred, if, under state law, the option is binding and enforceable on the date of the transfer." PLR 9501004. "Because a gratuitous option is not enforceable under applicable state law, the transfer to the trust is not a completed gift." Marty McKeever, *Funding A Charitable Remainder Trust With Encumbered Property Crunching The Numbers* [https://www.pgdc.com/pgdc/funding-charitable-remainder-trust-encumbered-property].

This is a highly suspect conclusion as to the application of state law. "The Service's analysis suggests that local law involving grants of options may affect the determination whether use of an option is appropriate. Specifically, if under local law a grant of an option with no consideration imposes a binding obligation on the settlor. PLR 9501004 implies that the grant of an option may satisfy the requirements of §2522" Hollis F. Russell, Matthew E. Brady, and Colette K. Meyer, *supra*. For example, in some cases, statutory provisions require that a written offer may be irrevocable for a stated duration, notwithstanding lack of consideration. 17A Amer. Jur. 2d §119. See N.Y. Gen. Obl. L. §5-1109. *See also*, Conrad Tietell, *Charitable Remainder Trusts—Recent Scarlet Letter Rulings*, ASTEC Notes 199 (1995) [http://www.actec.org/assets/1/6/Notes_V21_N3_Winter95.pdf].

In our planning, interests in a limited liability company (an "LLC") are transferred to a NIMCRUT, not an option. The Options are owned by the LLC, not by the NIMCRUT. A unitrust may own an interest in an LLC. *See, e.g.*, Private Letter Ruling 200043047, in which the Service held that a charitable remainder unitrust's participation in a family LLC's investment fund and the reimbursement of certain investment expenses would not be self-dealing. [https://www.pgdc.com/pgdc/crut-participation-llc-approved]. *See also*, Claudia B. Sangster and Stephanie C. Buckley, *Gifts of LLC Interests* [https://www.pgrtsc.org/assets/documents/Claudia_Sangster_Handout_1.pdf]. Moreover, the Option is not gratuitous, it is bargained for, albeit, at a bargain price. Bargain sales are recognized as immediate charitable contributions for tax purposes. *See*, Treasury Regulation Section 1.1011-2; IRS Publication 526 (2019). Further, options given for consideration are enforceable under state law, as the IRS has acknowledged in Rev. Rul. 82-197. Our actual planning, involving the transfer of funds to an LLC giving it positive value, and then buying an enforceable Option, also with real value, removes our planning from even the outer ambit of the IRS's current ruling positions.

Fourth, we have LLC Operating Agreement language by which the 1% voting unit owner assumes exclusive responsibility for the debt, and holds harmless the 99% non-voting unit owner for the debt. The 1% owner

obtains an interest in the LLC burdened by debt while the NIMCRUT obtains an interest in the LLC free of debt, which is allocated 100% to the voting unit. Notwithstanding anything to the contrary herein or elsewhere, if any property is contributed to the capital of this Company on which there is an indebtedness, such indebtedness shall be allocated to the voting membership interest(s) exclusively, and shall be treated as an indebtedness of the owner of the voting membership interest(s) rather than an indebtedness of the Company, and any payment of said indebtedness out of Company assets shall be treated as a distribution to or on behalf of the owner of the voting membership interest(s), and capital accounts shall reflect the foregoing provisions.

Here is an explanation as to how this resolves the debt financed property issues. We rely primarily upon authorities in which liabilities on property for which both (a) the exempt organization is not liable and (b) in which the organization has obtained protection against such debt, are treated as not rendering the property "debt financed property" for Section 514 purposes.

In TAM 9651001, an exempt organization was a member of a joint venture which secured a promissory note by a lien on its property. Because the exempt entity was not personally liable and because a fully funded independent escrow account was contractually liable to pay principal and interest on the debt, the IRS rules that the debt would not constitute an acquisition indebtedness. Tax Management Portfolio 875 at A-21. The guarantee of the owner of the one voting unit in our situation functions in a manner similar to that of the escrow in the TAM.

The IRS has ruled that when a tax exempt organization acquires an interest in property subject to a mortgage, and either pays off (or satisfies by an independently trusted and fully funded escrow) its share of the obligation and receives releases from its share of the debt from both the lender and the co-owners, it does not have acquisition indebtedness for Section 514 purposes. Rev. Rul. 76-95, 1976-1 C.B. 172:

In our structures, even though the entire property is still encumbered by the lien of the mortgagee, the organization has taken steps necessary to release itself from all indebtedness under the mortgage. By liquidating its proportionate share of the outstanding indebtedness and by securing

releases of its financial obligations under the mortgage from the mortgagee and the other co-owners, the organization has satisfied the full amount of its indebtedness. Accordingly, the organization has no acquisition indebtedness within the meaning of section 514(c)(1) of the Code with respect to its undivided interest in the property.

In our situation, the NIMCRUT obtains an interest in the LLC and obtains from the owner of the one voting unit a release from having any portion of the indebtedness in question paid from funds which would otherwise belong to the NIMCRUT. *See also*, Private Letter Ruling 9723025; Private Letter Ruling 9651001 (June 27, 1996); RIA, *Federal Tax Coordinator*, paragraph D-7043; Bruce R. Hopkins, The Law of Unrelated Business for Nonprofit Organizations, pages 116-117 (2005).

This is not the first time it has been suggested that the retention of personal liability by a transferor of property to an exempt organization would prevent the income from the property from constituting debt financed property income.

Fifth, yet another alternative would be to structure the transaction so that: 1) the transferor gives an undivided fractional interest in the property, equivalent to her unencumbered equity, to the trust, retaining the balance; 2) the trustee does not assume the indebtedness; 3) the transferor agrees to remain liable for and to hold the trustee harmless from liability on the debt; and 4) the transferor gives the trustee authority to market the entire property, including the retained interest. Marty McKeever, *Funding A Charitable Remainder Trust With Encumbered Property: Crunching The Numbers* (updated 2012) [http://www.pgdc.com/pgdc/funding-charitable-remainder-trust-encumbered-property]. "The … strategy is for the donor to issue a personal guarantee that the debt will be paid out of retained assets. This strategy has not been formally approved by Treasury, but has been used by individuals…." Gift Law Pro. *5.1.3 Unitrust Debt Solutions* [https://giftlawpro.giftlegacy.com/glawpro_subsection.jsp?WebID=GL1999-0001&CC=5&SS=1&SS2=3].

Moreover, our reasoning is consistent with the way debt on partnership property is treated for other purposes by the IRS. A debt of the partnership

as to which no partner is personally liable is allocated to each partner for basis purposes in accordance with their partnership interests. Treasury Regulation Section 1.752-3(a). But if one partner only is personally liable the indebtedness is allocable to that partner only. "A partner is allocated recourse liabilities if that partner bears the economic risk of loss for those liabilities, meaning that the partner would have to pay a creditor upon a constructive liquidation of the partnership (Regs. Sec. 1.752-2(b)(1))" Mark S. Heroux and Colin J. Walsh, *Debt and Providing Basis in Flowthrough Entities*, The Tax Advisor (October 1, 2013) [https://www.thetaxadviser.com/issues/2013/oct/clinic-story-08.html].

In our planning, the LLC's indebtedness is a liability of the one voting membership member only, and the basis attributable to that liability is allocated elusively to him, not to the NIMCRUT. Consequently, if the indebtedness is allocated to the one voting member exclusively, and not to the NIMCRUT, for basis purposes, it appears reasonable to allocate indebtedness to the one voting member, and not to the NIMCRUT, for other purposes such as for Section 514 purposes

In Private Letter Ruling 9533014 [http://www.pgdc.com/pgdc/story/ltr-rul-9533014] the IRS addressed the issue as to whether the receipt by a charitable remainder trust of an interest in a partnership owning mortgaged property would result in the violation of Treasury Regulation Section 1.664-3(a)(4), which prohibits amounts from a unitrust paid out to a non-charitable person other than the periodic required distributions.. The IRS first noted that the grantor of the charitable remainder trust has agreed to retain any liability for the mortgage for which the trust might become liable. For this reason, the IRS then concluded that the transfer would not violate the restrictions contained in Treasury Regulation Section 1.664-3(a)(4). "Because [the grantor] will remain primarily liable for any obligation arising under the partnership agreement for which [the charitable remainder trust] might otherwise be liable, we conclude that the proposed gift will not result in a violation of section 1.664-3(a)(4) of the regulations. See further the discussion in, R. A. Willis, *Funding A Charitable Remainder Trust with Encumbered Property* (2012) [http://www.pgdc.com/pgdc/funding-charitable-remainder-trust-encumbered-property]; Janet A. Meade, *Tax-Effective Charitable*

Donations of Debt-Encumbered Real Estate, Taxes, 17, 20 (November 2006).

F. CAN THE NIMCRUT BE TERMINATED BEFORE THE END OF THE 20TH YEAR?

Our NIMCRUTs are designed to automatically terminate after 20 years, at which time all remaining assets (i.e., the non-voting membership units in the LLC) will belong to the designated charity. However, the NIMCRUT can be terminated prematurely with the consent of all the parties. Numerous private letter rulings have held that the sale of a CRUT interest by a non-charitable beneficiary (typically to the charitable beneficiary or to the CRUT itself in a CRUT termination) generated capital gain to the non-charitable beneficiary. *See, for example*, Private Letter Rulings 20012703 and 200152018.

The present value of the charitable remainder interest computed in accordance with Treasury Regulation Section 1,664-4 must be paid to the charitable beneficiary. Note that the IRS once took the position in private letter rulings that the formula had to be applied by using the lower of the specified minimum distribution percentage in the trust document or the applicable federal rate when the charitable remainder interest of NIMCUTs was being valued. However Congress rejected that interpretation by enacting Section 664(e). *See*, Jerome M. Hesch, Stephen M. Breitstone, and David C. Jacobson, *Statutory Clarity for Early Termination of NICRUTs and NIMCRUTs*, Tax Notes 1717 (June 19, 2017).

The IRS also takes the position that the entire proceeds received constitute the measure of the capital gain with no offset for the basis of the selling non–charitable beneficiary. The authority for the IRS's position is Section 1001(e)(1), which disregards basis in the case of a sale of a term interest in a trust. "Under section 1001(e), if a taxpayer disposes of an income interest (for example, an annuity or unitrust interest) in a trust, any adjusted basis the taxpayer may have in such interest is disregarded in determining the gain or loss from the disposition of the interest." Justin Ransome & Vitu Satchit, *IRS Keeping Watch on Popular Estate Planning Tool*, Journal of Accountancy (October 2009)

[https://www.journalofaccountancy.com/issues/2009/oct/20091726.html]; Notice 2008-99, 2008-47 IRB 1194.

Some taxpayers have attempted to circumvent this rule. We advise against any such attempt. The attempt to avoid these rules begins with the creation of a CRUT, funded with appreciated assets, and the trustee sold all of the assets inside the CRUT. The non-charitable and the charitable beneficiaries have sold their interests in the CRUT to a third party. The non-charitable beneficiary takes the position that the entire interest in the trust has been sold, triggering Section 1001(e)(3), rather than Section 1001(e)(1). In Notice 2008-99, 2008-47 IRB 1194, the IRS has taken the position that treatment of transactions in this manner constitute "transactions of interest" under Sections 611 and 6112, which are required to be disclosed by the taxpayer. See also,Notice 2009-55, and Publication 550. This position was further cemented in subsequent Treasury Regulation Section 1.643(a)-8. Fox & Blattchmer, *Proposed Regulations Apply Special Basis Rules to Combined Sales of Interests in Charitable Remainder Trusts*, Journal of Taxation, 100 (September 2014); **Sally P. Schreiber**, *Final Regulations Prevent Manipulation of Trust Uniform Basis Rules to Avoid Gain*, Tax Advisor (August, 2015).

G. HOW CAN THE LLC LEASE PROPERTY TO A RELATED PERSON WITHOUT VIOLATING THE SELF-DEALING RULE

Investment activities regarding the LLCs, in which the NIMCRUT owns a 99% non-voting membership interest, and the Grantor of the NIMCRUT, does not constitute an act of self-dealing under Section 4941. The simple explanation is that there is no direct act of self-dealing because the Grantor is not a disqualified person with respect to the LLC. Further, the way the entities are structured and related, there is no indirect act of self-dealing because the NIMCRUT lacks the requisite "control" over the LLC, as defined in and required by Treasury Regulation Section 53.4941.

Section 4941(a)(1) imposes taxes upon "each act of self-dealing between a disqualified person and a private foundation." Section 4947 extends the provisions of Sections 4941 and 507 to "split interest trusts," such as a

NIMCRUT, by stating that "such a trust shall be treated as" if it were a private foundation for these purposes. Consequently, a NIMCRUT may not engage in a "self-dealing" transaction as defined under Section 4941, or it may be subject to the taxes imposed by Section 4941. Section 4941 defines term "self-dealing" as "any direct or indirect---Sale or exchange of property, Leases, Loans, Furnishing goods, services, or facilities, payment of compensation between a NIMCRUT and a disqualified person, and any transfers to, or use by or to the benefit of, a disqualified person of the income or assets of a NIMCRUT.

Grantors of NIMCRUTs, are each a "disqualified person" with respect to the NIMCRUT they form, and, therefore, may not engage, directly or indirectly, with the NIMCRUT in any of the types of transactions described in the previous paragraph. The founder (grantor) of the NIMCRUT is a disqualified person with respect to that NIMCRUT under Section 4946(a)(1)(A), because he is a "substantial contributor" to the NIMCRUT. Also, under 4946(a)(2) and Section 507(d)(2)(A), the founder (grantor) of a trust is *per se* a substantial contributor and, hence, a disqualified person with respect to the NIMCRUT. Further, Grantor's beneficial interest in the NIMCRUT renders Grantor a disqualified person with respect to the NIMCRUT.

However, THE LLCs is NOT a foundation for purposes of Section 4941, nor is the Grantor of a NIMCRUT a disqualified person with respect to the LLC. Because transaction the LLC and the Client or an entity controlled by the Client is not a transaction between a disqualified person and a NIMCRUT, the transaction does not constitute a *direct* act of self-dealing.

Nor does such a transaction constitute an indirect act of self-dealing. An indirect self-dealing transaction is a transactions described n Section 4941 which is engaged in between a disqualified person and a person controlled by the NIMCRUT. "An indirect act of self-dealing is also prohibited. Indirect self-dealing includes any transaction between the disqualified person and an organization controlled by a private foundation. See Reg. 53.4941(d)-1(b)(1); 1995 CPE, supra, at 279-287 (discussing indirect acts of self-dealing, and providing examples illustrating such acts)." Michael Seto & David Jones, *Self-Dealing and Other Tax Issues Involving*

Charitable Remainder Unitrusts, 1996 EO CPE Text. Section 4941 and the Regulations thereunder prohibit both direct and indirect self-dealing transactions. Neither Section 4941 nor the regulations thereunder explicitly define "indirect" self-dealing. 879-2nd Tax Management Portfolio, at A-35; Kurz, *The Private Foundation Provisions,* 31 N. Y. U. Inst. on Fed. Tax, 1311, 1317-1320 (1973). But, while the Treasury Regulations do not *explicitly* define indirect self-dealing, they do provide useful guidance. More specifically, Treasury Regulation, Section 53.4941(d)-1(b)(1), provides that certain transactions between a person controlled by a CRUT and a disqualified person will **not** be considered indirect prohibited transactions if certain requirements are satisfied. By inference, transactions between a person controlled by a CRUT and a disqualified person must normally constitute acts of self-dealing, or else there would be no need to establish exceptional circumstances in which such transactions are not acts of self-dealing. This appears consistent with the interpretation of this regulation adopted by the IRS. *See,* Private Letter Ruling 201407021. In Private Letter Ruling 9040063, for example, the IRS stated that the term indirect self-dealing transactions "includes a transaction between a disqualified person and an organization controlled by a private foundation where such transaction, if entered into directly by the private foundation and the disqualified person, would be direct self-dealing." *Accord,* Private Letter Ruling 9222057. In prior instances in which transactions similar in material respects to that proposed for the Grantor herein were audited by the IRS, no self-dealing issue was raised, and no relevant audit changes were proposed. Therefore it is reasonable to conclude that, absent control by a CRUT of an entity engaging in a transaction with a disqualified person, the issue of self-dealing does not arise. To argue to the contrary would require an extension of existing law beyond anything for which there is authority.

A NIMCRUT is in control over another entity with respect to a transaction, if, but only if, the NIMCRUT or persons *acting on behalf* of the NIMCRUT, either (a) requires the entity to engage in that transaction (either alone or with the assistance of others who need the support of the NIMCRUT for this purpose), or (b) possesses the ability to prevent the entity from engaging in the transaction in question. In determining

whether the LLC is "controlled" by the NIMCRUT for these purposes, "control" is defined by Treasury Regulation, Section 53.4941(d)-1(b)(5), as follows:

For purposes of this paragraph, an organization is controlled by a private foundation if the foundation or one of more of its foundation managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction which if engaged in with the private foundation would constitute an act of self-dealing. Similarly, for purposes of this paragraph, an organization is controlled by a private foundation in the case of such a transaction between the organization and a disqualified person, if such disqualified person, together with one or more persons who are disqualified persons by reason of such a person's relationship (within the meaning of Section 4946(a)(1)(c) through (G)) to such disqualified person, may, only by aggregating their votes or position of authority with that of the foundation, require the organization to engage in such a transaction. The "controlled" organization need not be a private foundation; for example, it may be any type of exempt or nonexempt organization including a school, hospital, operating foundation, or social welfare organization. For purposes of this paragraph, an organization will be considered to be controlled by a private foundation or by a private foundation and disqualified persons referred to in the second sentence of this subparagraph if such persons are able, in fact, to control the organization (even if their aggregate voting power is less than 50 percent of the total voting power of the organization's governing body) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing. A private foundation shall not be regarded as having control over an organization merely because it exercises expenditure responsibility (as defined in section 4945(d)(4) and (h)) with respect to contributions to such organization See example (6) of subparagraph (8) of this paragraph.

Applying this Regulation to our facts, the NIMCRUT is deemed in control of the LLC if the NIMCRUT or one or more of the persons having a position similar to the manager of a private foundation, *acting only in such capacity* [Rev. Rul. 76-158, 1976-1 C.B. 354; Private Letter Ruling

201407021], may require the LLC to engage in the transactions in question.[1] The manager of the LLC in question does not operate in any capacity relative to the NIMCRUT. Consequently, the manager's conduct is not attributed as an act of control by the NIMCRUT. Alternatively, the NIMCRUT will be treated as in control if the NIMCRUT can combine with persons who are disqualified persons with respect to the NIMCRUT to force LLC to engage in the transactions in question. Once again, the Manager of LLC does not act with any person acting on behalf of the CRUT in consummating the transactions in question, nor is the concurrence of any person representing the NIMCRUT required. As a matter of fact, the NIMCRUT has an independent Trustee, and there is no authority in the NIMCRUT for a disqualified person to demand an act or omission from it (including, of course, that the NIMCRUT <u>cannot</u> have any grantor trust properties). If the persons named in the Regulation have the power to prevent the act of self-dealing but not to require it, and do not use that power to prevent it, that may be sufficient to satisfy the control requirement. The CRUT does not possess any authority to block or to prevent the transactions in question. Thus, the CRUT fails all three tests of control contained in the Treasury Regulations. *See, Moody v. Commissioner*, T.C.Memo. 1995-195 (In determining whether an organization is in *de facto* control over another, a private foundation, although possessing 50% of the stock of a corporation, was held not to be in control of the corporation.). The NIMCRUT does not and will not control LLC in connection with its decisions to engage in non-voting ownership of the entity.

Private Letter Ruling 201407021 presented a situation remarkably similar to a type of transaction in which our LLC's frequently engage, in which a loan is extended from Investment LLC to the LLC's grantor. The IRS held that, if a private foundation held a non-voting membership interest in an LLC, and the LLC owned a promissory note from a person who was a disqualified person with respect to the foundation, no Section 4941

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[1] This is a critical distinction. Even if an individual who is in control of a CRUT is also in control over another entity, that does not result in the entity being in control of the CRUT if the individual acts with respect to the entity in his individual capacity, rather than as a representative of the CRUT. The IRS has taken pains in both its Regulations and rulings to emphasize this distinction.

prohibited transaction would have occurred because the loan was not from the foundation and because the foundation did not control the LLC (under the Regulations under Section 4941). In other words, a loan by an LLC which is partially owned by a NIMCRUT/private foundation, to a person who is a disqualified person with respect to the NIMCRUT/private foundation, does not constitute self-dealing unless the NIMCRUT is in control of the LLC under the control standards in Treasury Regulation Section 53.4941(d)-1(b).

Because the NIMCRUT IS not in control of the LLC under the control standards articulated in Treasury Regulation Section 153.4941(d)-1(b), the activities of the LLC in question involving the LLC, which are beyond the control of the NIMCRUT to facilitate or to prevent, should not constitute an indirect act of self-dealing. Because the decisions as to whether or not to engage in the transaction in question are *exclusively* in the hands of persons who are not acting for or on behalf of the NIMCRUT, and because the NIMCRUT cannot facilitate or prevent such transactions, the transactions do not constitute acts of indirect self-dealing under Treasury Regulation, Section 53.4941(d)-1(b). As described in the previous paragraph, an indirect act of self-dealing occurs only when a disqualified person engages in a transaction with a person which is controlled by the NIMCRUT, and, as explained above, LLC will not be under the control of the NIMCRUT when it engages in activities suggested herein.