
Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Regarding Charitable Remainder Trusts

REG-209823-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed amendments to the regulations under section 664 of the Internal Revenue Code of 1986 relating to charitable remainder trusts and under section 2702 relating to special valuation rules for transfers of interests in trusts. The proposed amendments contain rules on the conditions under which the governing instrument may provide for a change in the method of calculating the unitrust amount, the date by which the annuity amount or the unitrust amount under the fixed percentage method must be paid to the recipient, who is required to value unmarketable assets, and when section 2702 applies to certain charitable remainder unitrusts. The proposed regulations clarify existing law that prohibits allocating pre-contribution capital gain to trust income. The proposed amendments also contain an example illustrating how the ordering rule of section 664(b) applies to distributions from a charitable remainder unitrust using an income exception method to calculate the unitrust amount. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of topics to be discussed at the public hearing scheduled for September 9, 1997, at 10 a.m. must be received by August 19, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209823-96),

room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-209823-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeffrey A. Erickson or Mary Beth Collins, (202) 622-3070; concerning submissions and the hearing, Evangelista Lee, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by July 17, 1997. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through

the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collection of information in this proposed regulation is in § 1.664-1(a)(7). This information is required to allow taxpayers alternative means of valuing a charitable remainder trust's hard-to-value assets. This information will be used to determine if a taxpayer properly claimed a charitable deduction for a contribution to a charitable remainder trust and if assets in the charitable remainder trust are properly valued each year. The collection of information is voluntary. The likely respondents are for-profit entities.

Estimated total annual recordkeeping burden: 75 hours.

Estimated average annual burden hours per respondent: .5 hours.

Estimated number of respondents: 150.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document proposes amendments to 26 CFR parts 1 and 25 to provide additional rules under sections 664 and 2702. Section 664, added to the Internal Revenue Code by section 201 of the Tax Reform Act of 1969 (Public Law 91-172), contains the rules for charitable remainder trusts. In general, a charitable remainder trust provides for a specified periodic distribution to one or more noncharitable beneficiaries for life or for a term of years with an irrevocable remainder interest held for the benefit of charity. Section 664(c) provides that a charitable remainder trust is exempt from all taxes under subtitle A of the Code for any taxable year except a taxable year in which the trust has unrelated business taxable income under section 512.

There are two types of charitable remainder trusts. A charitable remainder annuity trust (a CRAT) pays a sum certain at least annually to one or more noncharitable beneficiaries. A charitable remainder unitrust (a CRUT) pays a unitrust amount at least annually to one or more noncharitable beneficiaries. The unitrust amount is generally a fixed percentage of the net fair market value of the CRUT's assets valued annually (the fixed percentage method). The unitrust amount can instead be the lesser of the fixed percentage amount or the trust's net income (the net income method). Alternatively, the unitrust amount can be the amount determined under the net income method plus any amount of income that exceeds the current year's fixed percentage amount to "make up" for any shortfall in distributions in prior years when the trust income was less than the fixed percentage amount (the NIMCRUT method).

Explanation of

Provisions

I. Flip Unitrusts

A. General Explanation

The governing instrument of a CRUT must specify the method of computing the unitrust payments. Section 664(d)(3) provides that the income exception methods (either the net income method or the NIMCRUT method) may be used to pay the unitrust amount "for any year." The legislative history, however, provides that the method used to determine the unitrust amount may not be discretionary with the trustee. H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 296 (1969), 1969-3 C.B. 644, 655.

Some donors may fund a CRUT with unmarketable assets that produce little or no income. These donors often want the income beneficiary or beneficiaries of the CRUT to receive a steady stream of payments based on the total return available from the value of the assets. The donors recognize, however, that the CRUT cannot make these payments until it can convert the unmarketable assets into liquid assets that can be used to pay the fixed percentage amount. These donors establish CRUTs that use one of the income exception methods to calculate the unitrust amount until the unmarketable assets are sold. Following the sale, the donors may prefer that the CRUT use the fixed percentage method to calculate the unitrust amount. A trust using such a combination of methods would be a "flip unitrust."

The proposed regulations provide that a donor may establish a flip unitrust that qualifies as a CRUT if the following conditions are satisfied. First, to ensure that the CRUT has substantially all unmarketable assets prior to the switch in methods, at least 90 percent of the fair market value of the assets held in the trust immediately after the initial contribution or any subsequent contribution (prior to the switch in methods) must consist of unmarketable assets. Unmarketable assets are assets that are not cash, cash equivalents, or marketable securities (within the meaning of section 731(c)).

Second, because the legislative history indicates that a trustee should not have discretion to change the method used to calculate the unitrust amount, the governing instrument must provide that the CRUT will use an income exception method until the earlier of (a) the sale of a specified unmarketable asset or group of unmarketable assets contributed at the time the trust was created or (b) the sale of unmarketable assets such that immediately following the sale, any remaining unmarketable assets total 50 percent or less of the fair market value of the trust's assets. For making this determination, the remaining unmarketable assets are valued as of the most recent valuation date.

Third, to ensure that the CRUT will use the fixed percentage method after the unmarketable assets are sold, the CRUT must switch exclusively to the fixed percentage method for calculating all remaining unitrust amounts payable to any income beneficiary at the beginning of the first taxable year following the year in which the earlier of the above events occurs.

Finally, because the fixed percentage method does not provide for a makeup amount, any makeup amount described in section 664(d)(3)(B) is forfeited when the trust switches to the fixed percentage method.

The IRS and Treasury request comments on whether there are additional circumstances under which a combination of methods should be addressed in regulations.

B. Proposed Effective Date and Transitional Rules

The amendments allowing a flip unitrust are proposed to be effective for CRUTs created on or after the date the final regulations are published in the **Federal Register**.

If a trust was created before the effective date of this amendment and its governing instrument contains a flip provision other than the one permitted by the regulations, the trust may be amended or reformed to comply with the final regulations. If a trust is created after the effective date of this amendment and has a flip provision not expressly permitted by the regulations, the trust will qualify as a CRUT if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust. If a qualified CRUT is created before or after the effective date of this amendment and its governing instrument does not contain a flip provision, the trust will not continue to qualify as a CRUT if it is amended or reformed to add a flip provision.

The IRS and Treasury invite comments on the least burdensome methods of changing the terms of a trust's governing instrument.

II. *Time for Paying the Annuity Amount or the Unitrust Amount*

A. General Explanation

The regulatory provisions permitting a trustee of a charitable remainder trust to pay the annuity or unitrust amount within a reasonable period of time following the close of the trust's taxable year were intended as an administrative convenience for trustees. Under the income exception methods, the trustee may not be able to determine the amount of trust income and, thus, the amount to be distributed for a trust's taxable year until after the close of that year. Therefore, a trustee may need the additional time to pay the unitrust amount if a CRUT uses one of the income exception methods.

In contrast, a trustee of a CRAT or a CRUT using the fixed percentage method can easily determine the annuity or unitrust amount and pay it before the close of the taxable year to which it relates. The annuity amount is fixed and determinable as of the date the trust is created. The fixed percentage unitrust amount is fixed and determinable as of the annual valuation date, which is specified in the governing instrument or on the initial Form 5227, Split-Interest Trust Information Return. The valuation date can be set well before the end of the taxable year.

The IRS and Treasury believe that certain trustees of charitable remainder trusts have attempted to abuse the provi-

sions in the current regulations that permit a trustee to pay the annuity or unitrust amount within a reasonable time after the close of the taxable year for which the payment is due. The IRS and Treasury are especially concerned about accelerated charitable remainder trusts described in Notice 94-78 (1994-2 C.B. 555). Therefore, the regulations propose to amend §§ 1.664-2(a)(1)(i) and 1.664-3(a)(1)(i) to provide that the payment of the annuity amount or the unitrust amount determined under the fixed percentage method must be made by the close of the taxable year in which it is due. These proposed amendments should not require the amendment or reformation of governing instruments of existing charitable remainder trusts that allow a trustee to pay the unitrust or annuity amount after the close of the taxable year. The trustees of such trusts can comply with the proposed regulations by actually paying the annuity or unitrust amount within the time permitted by the proposed amendments.

For CRUTs using an income exception method, the regulations continue to provide that if the CRUT pays the unitrust amount within a reasonable time after the close of the trust's taxable year, the trust is not deemed to have engaged in an act of self-dealing, to have unrelated debt-financed income, to have received an additional contribution, or to have failed to function exclusively as a charitable remainder trust.

B. Proposed Effective Date

These amendments are proposed to be effective for taxable years ending after April 18, 1997.

The IRS will continue to challenge the purported tax consequences of accelerated charitable remainder trusts as described in Notice 94-78.

III. *Appraising Unmarketable Assets*

A. General Explanation

Under § 1.664-1(a)(1)(iii)(a), a trust may qualify as a charitable remainder trust only if a deduction is allowable under sections 170, 2055, 2106, or 2522 for transfers to the trust. The legislative history of section 664 indicates that Congress contemplated denying a charitable contribution deduction to a donor who transferred unmarketable assets to a charitable remainder trust unless an independent trustee valued the assets. H.R. Rep. No. 413, 91st Cong., 1st Sess. 60 (1969), 1969-3 C.B. 200, 239. Because the statute does not contain a corre-

sponding provision, many practitioners have asked whether a charitable remainder trust that holds unmarketable assets must have an independent trustee value the assets.

The proposed regulations provide that if a charitable remainder trust holds unmarketable assets and the trustee is the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or the noncharitable beneficiary within the meaning of section 672(c) and the applicable regulations, the trustee must use a current qualified appraisal, as defined in § 1.170A-13(c)(3), from a qualified appraiser, as defined in § 1.170A-13(c)(5), to value those assets. A trustee who is not the grantor, a noncharitable beneficiary, or a related or subordinate party does not have to use a qualified appraisal from a qualified appraiser to value the unmarketable assets. Therefore, the grantor, a noncharitable beneficiary, or a related or subordinate party may be the sole trustee of a charitable remainder trust if the trustee uses a current qualified appraisal from a qualified appraiser to compute the fair market value of the trust's unmarketable assets.

B. Proposed Effective Date

The amendments are proposed to be effective for trusts created on or after the date on which the final regulations are published in the **Federal Register**. If the governing instrument of an existing trust created before the effective date of this amendment already requires an independent trustee to value the trust's unmarketable assets, the governing instrument may be amended or reformed to conform with this provision.

IV. *Application of Section 2702 to Certain Charitable Remainder Unitrusts*

A. General Explanation

Section 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to or for the benefit of a family member and the individual or an applicable family member retains an interest in the trust. Under section 2702(a), the retained interest in these situations is generally valued at zero unless the interest is a qualified interest. Under section 2702(b), a qualified interest includes the right to receive fixed payments at least annually and the right to receive amounts at least annually that are a

fixed percentage of the annual fair market value of the property in the trust.

Section 2702(a)(3)(A)(iii) was added by section 1702(f)(11)(A)(iv) of the Small Business Job Protection Act of 1996 (Public Law 104-188) as a technical correction to the Revenue Reconciliation Act of 1990 (Public Law 101-508). Section 2702(a)(3)(A)(iii) provides that section 2702(a) shall not apply to any transfer to the extent regulations provide that such transfer is not inconsistent with the purposes of the section. According to the legislative history, the regulatory authority could be used to create an exception from the application of section 2702 for a qualified charitable remainder trust that does not otherwise create an opportunity for transferring property to a family member free of transfer tax. H.R. Rep. No. 586, 104th Cong., 2d Sess. 155-56 (1996). Under § 25.2702-1(c)(3) of the Gift Tax Regulations, section 2702 does not apply to CRUTs or CRATs.

Some taxpayers have created CRUTs using an income exception method to take advantage of the section 2702 exclusion granted to charitable remainder trusts in the regulations. These taxpayers attempt to use this exclusion and the income exception feature of a CRUT to pass substantial assets to family members with minimal transfer tax consequences.

For example, a donor establishes a NIMCRUT to pay the lesser of trust income or a fixed percentage to the donor for a term of 15 years or his life, whichever is shorter, and then to the donor's daughter for her life. If the tables under section 7520 are used to value the donor's retained interest and the donor's gift to the daughter, the amount of the donor's gift to the daughter is relatively small compared to the amount the daughter may actually receive. To illustrate, the trustee may invest in assets that produce little or no trust income while the donor retains the unitrust interest, creating a substantial makeup amount. At the end of the donor's interest, the trustee alters the NIMCRUT's investments to generate significant amounts of trust income. The trustee then uses the income to pay to the donor's daughter the current fixed percentage amount and the makeup amount, which includes the makeup amount accumulated while the donor was the unitrust recipient.

The use of a CRUT as described in the above example permits the shifting of a beneficial interest in the trust from

the donor to another family member and, thus, creates an opportunity for transferring property to a family member free of transfer tax that is contrary to section 2702(a)(3)(A)(iii). Therefore, the proposed regulations will amend § 25.2702-1(c)(3) to provide that the unitrust interests in a CRUT using an income exception method retained by the donor or any applicable family member will be valued at zero when someone other than (1) the donor, (2) the donor's spouse, or (3) both the donor and the donor's spouse (who is a citizen of the U.S.) is a noncharitable beneficiary of the trust. In these situations, the value of the donor's gift is the fair market value of all the property transferred to the CRUT. The present value of the remainder interest passing to the charitable organization will qualify for the deduction under section 2522. Accordingly, the amount used to calculate the donor's gift tax liability is the value of the property transferred to the trust less the value of the interest passing to charity.

Section 25.2702-1(c)(3) will continue to exclude from the application of section 2702 transfers to pooled income funds described in section 642(c)(5) and to CRATs and CRUTs that pay the unitrust amount under the fixed percentage method.

B. Proposed Effective Date

This amendment is proposed to be effective for transfers in trust made on or after May 19, 1997.

V. Prohibition on Allocating Pre-contribution Gain to Trust Income

A. General Explanation

When assets are transferred to a charitable remainder trust, the amount of the donor's charitable deduction is generally based in part on the fair market value of the property transferred to the trust. Although an income exception CRUT provides a different method for calculating the unitrust amount than a fixed percentage CRUT, any charitable deduction for an income exception CRUT is calculated as if the fixed percentage is distributed each year. Allocating amounts to trust income that are part of the fair market value of the contributed property on which the charitable deduction was based would be inconsistent with Congress's intent to assure that the amount claimed as a charitable deduction for the contribution to the trust relates to the projected growth of the assets contributed less the

expected distributions to the income beneficiaries. H.R. Rep. No. 413, 91st Cong., 1st Sess. 58-59 (1969), 1969-3 C.B. 200, 237-38; S. Rep. No. 552, 91st Cong., 1st Sess. 87 (1969), 1969-3 C.B. 423, 479. Therefore, the regulations clarify that the proceeds from the sale of an income exception CRUT's assets, at least to the extent of the fair market value of the asset when contributed to the trust, must be allocated to principal.

B. Proposed Effective Date

This amendment is proposed to be effective for sales or exchanges after April 18, 1997. For sales or exchanges on or before the effective date of this amendment, the Service will continue to challenge any attempt to allocate pre-contribution gain to trust income as being fundamentally inconsistent with applicable local law and with the amount of the charitable deduction claimed.

VI. Example Illustrating Rule for Characterizing Distributions from CRUTs

Section 664(b) contains the ordering rule used to determine the character of the annuity or unitrust amount in the hands of the recipient. The legislative history states that the ordering rule applies to both CRATs and CRUTs. S. Rep. No. 552, 91st Cong., 1st Sess. 90 (1969), 1969-3 C.B. 423, 481. The ordering rule applies to the unitrust amounts received from all CRUTs regardless of the method used by the CRUT to determine the unitrust amount.

Although the current regulations clearly provide that the ordering rule of section 664(b) and § 1.664-1(d)(1)(i) applies to all unitrust amounts received from CRUTs, some practitioners have asked whether the ordering rule applies to unitrust amounts paid under the income exception methods. To provide taxpayers with additional guidance, the proposed regulations add an example of how the ordering rule operates when the unitrust amount is computed under an income exception method.

VII. Request for Comments on Income Exception CRUTs Holding Certain Investments

The IRS and Treasury are aware that taxpayers are using income exception CRUTs to take advantage of the timing difference between the receipt of trust income (as defined in section 643(b)) and income for federal income tax purposes. For example, an income excep-

tion CRUT may hold an interest in a partnership controlled by a trustee of the trust, a grantor, a beneficiary, or a party related or subordinate to the trustee, the grantor, or a beneficiary. In such a case, an interested party controls when the trust will receive the earnings from its partnership interest and, accordingly, when the unitrust recipient will receive distributions from the trust. Although the income exception CRUT has taxable income on its distributive share of partnership items, the trust does not have trust income until it actually receives a distribution of its share of the partnership's earnings.

The IRS and Treasury are studying whether investing the assets of an income exception CRUT to take advantage of the timing difference between the receipt of trust income and income for federal tax purposes causes the trust to fail to function exclusively as a charitable remainder trust. Therefore, the IRS and Treasury request comments on drafting future guidance on this issue. Revenue Procedure 97-23, to be published on April 28, 1997, in Internal Revenue Bulletin 1997-17, provides that the IRS will not issue letter rulings on whether a trust that will calculate the unitrust amount under section 664(d)(3) qualifies as a section 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under section 643(b) and income for federal income tax purposes for the benefit of the unitrust recipient.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the recordkeeping requirement in these regulations does not affect small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submit-

ted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 9, 1997, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Ave, NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments by August 19, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic by August 19, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these proposed regulations are Mary Beth Collins and Jeffrey A. Erickson, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, personnel from other offices of the IRS and Treasury Department participated in their development.

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26 CFR Part 25

Gift taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, CFR parts 1 and 25 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.664-1, paragraphs (a)(7), (d)(1)(iii), and (f)(4) are added to read as follows (paragraph (f)(4) follows the concluding text of paragraph (f)(3)):

§ 1.664-1 Charitable remainder trusts.

(a) * * *

(7) Valuation of unmarketable assets.

If a trust has assets that are not cash, cash equivalents, or marketable securities (within the meaning of section 731(c) and the applicable regulations) and the trustee is the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or noncharitable beneficiary within the meaning of section 672(c) and the applicable regulations, the trustee must use a current qualified appraisal, as defined in § 1.170A-13(c)(3), from a qualified appraiser, as defined in § 1.170A-13(c)(5), to value those assets. A trustee who is not the grantor of the charitable remainder trust, a noncharitable beneficiary, or a related or subordinate party to the grantor or noncharitable beneficiary does not have to use a current qualified appraisal from a qualified appraiser to value the trust's assets.

* * * * *

(d) * * *

(1) * * *

(iii) *Example.* The following example illustrates the application of this paragraph (d)(1):

Example. (i) X is a charitable remainder unitrust described in sections 664(d)(2) and (3). The annual unitrust amount is the lesser of the amount of trust income, as defined in § 1.664-3(a)(1)(i)(b)(3), or six percent of the net fair market value of the trust assets valued annually. The net fair market value of the trust assets on the valuation date in 1996 is \$150,000. During 1996, X has \$7,500 of income after allocating all expenses. All of X's income for 1996 is tax-exempt income. At the end of 1996, X's ordinary income for the current taxable year and undistributed ordinary income for prior years are both zero; X's capital gain for the current taxable year is zero and undistributed capital gain for prior years is \$30,000; and X's tax-exempt income for the current year is \$7,500 and undistributed tax-exempt income for prior years is \$2,500.

(ii) Because the trust income of \$7,500 is less than the fixed percentage amount of \$9,000, the unitrust amount for 1996 is \$7,500. The character of that amount in the hands of the recipient of the unitrust amount is determined under section 664(b). Because the unitrust amount is less than X's undistributed capital gain income, the recipient of the unitrust amount treats the distribution of \$7,500 as capital gain. At the beginning of 1997, X's undistributed capital gain for prior years is reduced to \$22,500, and X's undistributed tax-exempt income is increased to \$10,000.

* * * * *

(f) * * *

(4) *Valuation of unmarketable assets.* The rules contained in paragraph (a)(7) of this section are effective for trusts created on or after the date the final regulations are published in the **Federal Register**. A trust whose governing instrument requires that an independent trustee value the trust's unmarketable assets may be amended or reformed to permit any trustee to value those assets if the trustee uses a current qualified appraisal, as defined in § 1.170A-13(c)(3), from a qualified appraiser, as defined in § 1.170A-13(c)(5), in the taxable years beginning on or after the date the final regulations are published in the **Federal Register**.

* * * * *

Par. 3. In § 1.664-2, paragraph (a)(1)(i) is revised to read as follows:

§ 1.664-2 *Charitable remainder annuity trust.*

(a) * * *

(1) * * * (i) *Payment of sum certain at least annually.* The governing instrument provides that the trust will pay a sum certain not less often than annually to a person or persons described in paragraph (a)(3) of this section for each taxable year of the period specified in paragraph (a)(5) of this section. The annuity amount must be paid to the recipient no later than the close of the taxable year for which the payment is due. The rules contained in this paragraph (a)(1)(i) are effective for taxable years ending after April 18, 1997.

* * * * *

Par. 4. Section 1.664-3 is amended as follows:

1. Paragraphs (a)(1)(i)(a), (a)(1)(i)(b)(1), and (a)(1)(i)(b)(2) are revised.

2. Paragraphs (a)(1)(i)(b)(3), (a)(1)(i)(c), (a)(1)(i)(d), (a)(1)(i)(e), and (a)(1)(i)(f) are added.

3. The third sentence of paragraph (a)(1)(iv) is revised.

4. Paragraph (a)(1)(vi) is added.

The added and revised provisions read as follows:

§ 1.664-3 *Charitable remainder unitrust.*

(a) * * *

(1) * * *

(i) * * * (a) *General rule.* The governing instrument provides that the trust will pay not less often than annually a fixed percentage of the net fair market value of the trust assets determined annually to a person or persons described in paragraph (a)(3) of this sec-

tion for each taxable year of the period specified in paragraph (a)(5) of this section.

(b) * * *

(1) The amount of trust income for a taxable year to the extent that such amount is not more than the amount required to be distributed under paragraph (a)(1)(i)(a) of this section.

(2) An amount of trust income for a taxable year that is in excess of the amount required to be distributed under (a)(1)(i)(a) of this section for such year to the extent that (by reason of paragraph (a)(1)(i)(b)(1) of this section) the aggregate of the amounts paid in prior years was less than the aggregate of such required amounts.

(3) For this paragraph (a)(1)(i)(b), trust income means income as defined under section 643(b) and the applicable regulations. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of contribution.

(c) *Combination of methods.* Instead of the amount described in paragraph (a)(1)(i)(a) or (b) of this section, the governing instrument may provide that the trust will pay the amount described in paragraph (a)(1)(i)(b) of this section for an initial period and then pay the amount described in paragraph (a)(1)(i)(a) of this section (calculated using the same fixed percentage) for the remaining years of the trust if—

(1) At least 90 percent of the fair market value of the assets held in the trust immediately after either the initial contribution or any subsequent contribution (prior to the change in methods) to the trust consists of unmarketable assets;

(2) The governing instrument provides that the change of method described in this paragraph (a)(1)(i)(c) will be triggered by the earlier of—

(i) The sale or exchange of a specified asset or group of assets that was contributed to the trust on its creation; or

(ii) The sale or exchange of unmarketable assets if immediately following the sale or exchange, the fair market value of any remaining unmarketable assets total 50 percent or less of the total fair market value of the trust's assets. For making this determination, the remaining unmarketable assets must be valued as of the most recent valuation date;

(3) The change of method described

in this paragraph (a)(1)(i)(c) takes effect at the beginning of the first taxable year following the year in which the earlier of paragraph (a)(1)(i)(c)(2)(i) or (ii) of this section occurs; and

(4) Following the trust's conversion to the method described in paragraph (a)(1)(i)(a) of this section, the trust will pay at least annually to the permissible recipients the amount described only in paragraph (a)(1)(i)(a) of this section and not any amount described in paragraph (a)(1)(i)(b) of this section.

(5) For this paragraph (a)(1)(i)(c), unmarketable assets are assets that are not cash, cash equivalents, or marketable securities as defined in section 731(c) and the applicable regulations.

(d) *Example.* The following example illustrates the rules in paragraph (a)(1)(i)(c) of this section:

Example. (i) On the creation of charitable remainder unitrust Y, S contributes four assets—A, B, C, and D. A is a marketable security under section 731(c) and the applicable regulations. B, C, and D are unmarketable assets. The fair market value of B, C, and D is at least 90 percent of the fair market value of all four assets at the time of contribution.

(ii) The governing instrument of Y provides for calculating the unitrust amount under the combination of methods described in paragraph (a)(1)(i)(c) of this section. The initial method for calculating the unitrust amount is the lesser of the amount of trust income, as defined in paragraph (a)(1)(i)(b)(3) of this section, or six percent of the net fair market value of the trust assets valued annually. The unitrust amount also includes any amount of trust income for any taxable year that exceeds six percent of the net fair market value of the trust's assets valued annually to the extent the total of the amounts paid in prior years was less than the total of the amounts computed as six percent of the net fair market value of Y's assets on the valuation dates. After the change in method, the unitrust amount will equal six percent of the net fair market value of Y's assets on the valuation dates.

(iii) The governing instrument provides that the change in method will occur for the first taxable year beginning after both B and C are sold or the year in which the trust has sold or exchanged enough unmarketable assets so that the remaining unmarketable assets total 50 percent or less of the fair market value of the trust's assets, whichever occurs first.

(iv) In Year 3, the trustee of Y sells B, one of the three unmarketable assets. After the sale of B, the fair market value of all of Y's unmarketable assets is greater than 50 percent of the fair market value of Y's assets. Therefore, in Year 3, the method used to calculate the unitrust amount remains the initial method.

(v) In Year 4, the trustee sells D. After the sale of both B and D, the fair market value of Y's unmarketable assets is 50 percent or less of the fair market value of Y's assets. In Year 4, however, the method used to calculate the unitrust amount remains the initial method.

(vi) In Year 5 and for all subsequent years, the trust must pay a unitrust amount equal only to six percent of the net fair market value of Y's assets determined annually. The change in method occurs

in Year 5 because the fair market value of Y's unmarketable assets totaled 50 percent or less of the fair market value of Y's assets after the sale of both B and D. The change in method occurs even though Y still owns C, the other unmarketable asset specified in the governing instrument.

(vii) By the end of Year 4, Y's total trust income had been less than the sum of the unitrust amounts based on six percent of the net fair market value of Y's assets determined annually, leaving a balance of \$1,000. The \$1,000 balance can never be distributed to the unitrust recipient after the change to the fixed percentage method.

(e) *Payment under general rule.* When the unitrust amount is computed under paragraph (a)(1)(i)(a) of this section, the unitrust amount must be paid to the recipient no later than the close of the taxable year of the trust for which the payment is due.

(f) *Payment under income exception.* When the unitrust amount is computed under paragraph (a)(1)(i)(b) of this section, the unitrust amount may be paid to the recipient after the close of the taxable year of the trust for which the payment is due if paid within a reasonable time after the close of such taxable year. The trust will not be deemed to have engaged in an act of self-dealing (within the meaning of section 4941), to have unrelated debt-financed income (within the meaning of section 514), to have received an additional contribution (within the meaning of paragraph (b) of this section), or to have failed to function exclusively as a charitable remainder trust (within the meaning of paragraph (a)(4) of this section) merely because payment of the unitrust amount is made after the close of the taxable year if such payment is made within a reasonable time after the close of such taxable year. For this paragraph (a)(1)(i)(f), a reasonable time will not ordinarily extend beyond the date by which the trustee is required to file Form 5227, Split-Interest Trust Information Return, (including extensions) for the taxable year.

(iv) * * * If the governing instrument does not specify the valuation date or dates, the trustee must select such date or dates and indicate the selection on the first return on Form 5227, Split-Interest Trust Information Return, that the trust must file. * * *

(vi) *Effective date and reformations.* (a) The rules in paragraph (a)(1)(i)(a) of this section are effective for taxable years ending after April 18, 1997.

(b) The rules in paragraphs (a)(1)(i)(c) and (d) of this section are effective for charitable remainder

unitrusts created on or after the date the final regulations are published in the **Federal Register**. If a trust was created before the effective date of paragraph (a)(1)(i)(c) of this section and contains a provision allowing a change in calculating the unitrust method, the trust may be amended or reformed to comply with the provisions of paragraph (a)(1)(i)(c) of this section. If a trust is created after the effective date of paragraph (a)(1)(i)(c) of this section and contains a provision allowing a change in calculating the unitrust method that does not comply with the provisions of paragraph (a)(1)(i)(c) of this section, the trust will continue to qualify as a charitable remainder unitrust if it is amended or reformed to use the initial method for computing the unitrust amount throughout the term of the trust. A qualified charitable remainder unitrust created before or after the effective date of paragraph (a)(1)(i)(c) of this section will not continue to qualify as a charitable remainder unitrust if its governing instrument is amended or reformed to add a provision allowing a change in the method for calculating the unitrust amount.

(c) The rules in paragraphs (a)(1)(i)(b)(1), (2), and (3) of this section are effective for taxable years ending after April 18, 1997, and for sales or exchanges described in paragraph (a)(1)(i)(b)(3) of this section that occur after April 18, 1997.

(d) The rules in paragraphs (a)(1)(i)(e) and (f) of this section are effective for taxable years ending after April 18, 1997.

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 5. The authority for part 25 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 6. In § 25.2702-1, paragraph (c)(3) is revised to read as follows:

§ 25.2702-1 *Special valuation rules in the case of transfers of interests in trust.*

(c) * * *

(3) *Charitable remainder trust.* (i) For transfers made on or after May 19, 1997, a transfer to a pooled income fund described in section 642(c)(5); a transfer to a charitable remainder annuity trust described in section 664(d)(1); a transfer to a charitable remainder unitrust described in section 664(d)(2) if under the terms of the governing instrument the

unitrust amount is computed only under section 664(d)(2)(A); and a transfer to a charitable remainder unitrust described in sections 664(d)(2) and (3) if the only permitted recipients of the unitrust amount are the donor, the donor's spouse, or both the donor and the donor's spouse who is a citizen of the United States.

(ii) For transfers made before May 19, 1997, a transfer in trust if the remainder interest in the trust qualifies for a deduction under section 2522.

* * * * *
Margaret Milner Richardson,
Commissioner of Internal Revenue.

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