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Harold G. Wren
University of Richmond

CHARITABLE REMAINDER TRUSTS: SOME CONSIDERATIONS TO DRAFTMANSHIP†

*Harold G. Wren**

The Tax Reform Act of 1969[1] limited the charitable deduction for remainder interests for the purposes of income, estate and gift taxes to three specific forms: the annuity trust, the unitrust, or a gift to a pooled-income fund. This article will not deal with the details of a pooled-income fund, commonly established by a public charity to make it possible for a donor of a relatively small gift to do what we shall discover the wealthy donor can do by way of a charitable remainder trust. Since estate planners are primarily concerned with the drafting of trusts for donors of larger gifts, it is to charitable remainder trusts that I shall direct my attention. They are known in the statute as annuity trusts[2] and unitrusts.[3]

I. THE GENERAL PROVISIONS

The regulations regarding charitable remainder trusts were originally proposed on September 18, 1971, and finally adopted on August 22, 1972 by T.D. 7202. On September 5, 1972 the Internal Revenue Service issued Revenue Ruling 72-395, which set out some so-called "mandatory" and "optional" provisions for both annuity trusts and unitrusts. The final regulations, along with the revenue ruling, give estate planners the appropriate guidelines for the drafting of these trusts. I propose to make some suggestions as to approaches that may be used in drafting that will incur the optimum estate planning benefit from the final regulations and the ruling.

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† The basis for this article was an address delivered by Dean Wren before the Richmond Estate Planning Council.

* Dean, University of Richmond School of Law. LL.B., Columbia University, 1948; J.S.D. Yale University, 1957. Dean, Northwestern School of Law, Lewis and Clark College, 1969-1972.

1. INT. REV. CODE OF 1954 § 664. Section 664 is located in subpart C of Part I of Subchapter J, dealing with the income taxation of estates, trusts, and beneficiaries. The draftsman is advised to avoid the possible application of Subpart E (Sections 671-678), by inserting provisions negating the possibility that the trust might be construed to be for the grantor's benefit or that the trust income might be attributed to the grantor due to the retention of excessive economic control.

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

3. INT. REV. CODE OF 1954 § 664(d)(2).

There are four pertinent regulations. The first regulation is concerned with charitable remainder trusts in general.[4] The second, third, and fourth deal with annuity trusts,[5] unitrusts,[6] and the calculation of the fair market value of remainder interests.[7] The ruling follows the same pattern as the regulations in that it first gives some general provisions regarding charitable remainder trusts, and then makes suggestions for mandatory and optional provisions which may be inserted into first, annuity trusts, and then unitrusts.[8] We shall consider the rules with respect to both annuity trusts and unitrusts together, for comparative purposes.

There are two important considerations which affect all types of charitable remainder trusts. In order for a trust to be a charitable remainder trust, a deduction must be "allowable" for purposes of one's income, estate or gift taxes.[9] If, for example, an estate failed to claim the deduction within the period of the statute of limitations, or if it compromised its estate tax liability without specifically identifying that a charitable deduction had been allowed, the trust might still qualify as a "charitable remainder trust" under Sections 170 or 2522.

A trust can fail to qualify as a charitable remainder trust if its investment provisions are so restrictive that the trust could not realize "a reasonable amount of income or gain from the sale or disposition of trust assets."[10] We will consider other aspects of the general provisions after we have dealt with the problem of choosing between an annuity trust and an unitrust.

The annuity trust is a trust from which a sum certain, of not less than five per cent of the initial net fair market value of all property that is placed in trust, is to be paid at least annually to one or more persons with the remainder interests passing irrevocably to or for the use of charity, or to be retained by the trust for such use.[11] The

4. Treas. Reg. § 1.664-1 (1972).

5. Treas. Reg. § 1.664-2 (1972).

6. Treas. Reg. § 1.664-3 (1972).

7. Treas. Reg. § 1.664-4 (1972).

8. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36, at 22 and 32.

9. Treas. Reg. § 1.664-1(a)(1)(iii)(a) (1972).

10. Treas. Reg. § 1.664-1(a)(3) (1972).

11. Treas. Reg. § 1.664-2(a)(1)(i) (1972); Treas. Reg. § 1.664-2(a)(2) (1972). It should be noted that if the remainder interest is to be retained in trust for charitable purposes at the

important consideration is that it is the initial net fair market value that is used in the annuity trust. By contrast, the unitrust requires the payment of a "fixed percentage" of not less than five per cent of the net fair market value of the trust assets, valued annually, to one or more persons, at least one of which is not a charity.[12]

When the major objective is to give the non-charitable beneficiary security and certainty, the annuity trust should be selected. By so doing, the planner does not have to concern himself with annual revaluations in a fluctuating market. The annuity trust would be the best vehicle to receive bonds, since the trustee can tie the annual payment to the present interest rate on the bonds. If the bonds are tax-free municipals, the annuity payments will be received tax-free by the beneficiary. It has been argued that the annuity trust may also be more useful in the case of the closely held corporation where the *res* of the trust consists primarily of the stock of such a corporation.[13] Annual valuation of such stock may cause serious problems, and it might well be possible to establish the valuation of the stock at the outset and not have to be concerned about it in later years.

On the other hand, the unitrust provides greater flexibility and a better hedge against inflation. In a rising market asset values would normally increase with the inflationary trend, increasing the amount of the annual payments. Conversely, in a downward economy, the beneficiary's dollar payments might be reduced, but he would theoretically be able to purchase more with the amounts that he receives.

One of the major advantages of the unitrust is the availability of the income option. The draftsman may provide in the instrument that if the actual amount of trust income is less than the specified fixed percentage of assets, the lesser amount may be paid.[14] The ruling goes on to provide that it is optional whether this deficit is to be subsequently made up.[15] Thus, the draftsman may provide

end of the annuity period, then the trust at that point will likely be a private foundation and subject to all of the rules and restrictions imposed by the Tax Reform Act of 1969 (including perhaps a reduced charitable deduction).

12. Treas. Reg. § 1.664-3 (1972).

13. Olsen and Ledwith, *Final Regulations Point the Way to Effectively Use Charitable Remainder Trusts*, 37 J. TAX. 368 (1972).

14. Rev. Rul. 72-395, 1972 INT. REV. BULL No. 36, at 29.

15. Id. Comment (1).

that the deficit is to be made up by payments in later years, when and if, the trust income exceeds the percentage otherwise required to be distributed.

This option would be particularly useful in the situation where the income beneficiary is one who has built up an estate where the bulk of his wealth is in the stock of a closely held corporation. During the earlier years of the trust's existence, trust income would normally be below the fixed percentage since the stock of the closely held company would be typically growth, rather than dividend paying, stock. As the trustee would begin to convert the *res* so as to make the income higher than the fixed percentage, this additional income would be paid to the non-charitable beneficiary to make up any deficiencies owed him for the prior years. Since the charitable remainder trust is usually established when the non-charitable beneficiary is in a high tax bracket, he would welcome the lesser income in the earlier years. As he begins to reduce his income from other sources, his bracket falls and he is then put into a position where he receives more income from the charitable remainder trust.

II. THE MANDATORY PROVISIONS

The ruling of the Internal Revenue Service has classified its provisions as either mandatory or optional. While there is no requirement that one follow the precise wording of these provisions, the draftsman will obviously include all provisions, whether mandatory or optional, so long as they do not violate local law or are not inherently inconsistent. The mandatory provisions for annuity trusts and unitrusts are roughly parallel. The first mandatory provision provides for a sum certain in the case of the annuity trust, and for a fixed percentage in the case of unitrust.[16] The payments, in both cases, must be made at least annually to the income beneficiary or beneficiaries, for his life or for their lives, or for a fixed term, not exceeding twenty years.[17] The second mandatory provision provides for the turning over of any principal and accumulated income to the charity upon the termination of the trust.[18] The third mandatory provision is certainly wise, and is a good illustration of how the Internal Reve-

16. Rev. Rule. 72-395, 1972 INT. REV. BULL. No. 36, at 22 and 27.
17. *Id.* at 22 and 27.
18. *Id.* at 23 and 27.

nue Service apparently seeks to aid the draftsman. If the particular charity involved should not qualify, the draftsman may either insert a provision naming an alternative charity, or provide that the trustee in his discretion may select an alternate remainderman.[19]

A fourth mandatory provision provides for adjustments in the event of incorrect valuations.[20] This is the only mandatory provision that is peculiar to unitrusts, as distinct from annuity trusts. In the case of the unitrust, the assets are revalued annually,[21] whereas, in the case of the annuity trust, the only valuation is at the time of the establishment of the trust.[22] Under the unitrusts, the amount payable to the non-charitable beneficiary is a fixed percentage.[23] Hence, if there is an undervaluation of the net fair market value of the assets, the trust must make certain additional payments to the income beneficiary. If there is an overvaluation, the reverse is true. The payments or repayments must be made within a reasonable time after the determination of value.[24] The regulations contain a similar provision for annuity trusts where the sum certain is stated as a fraction or percentage of the initial net fair market value. Such an adjustment, however, would only be made once in the case of the annuity trust.[25]

The fifth mandatory provision in the case of unitrusts and the fourth in the case of annuity trusts,[26] provides for pro-rated distribution of an annual payment in the event of a short tax year, or the last tax year of a non-charitable beneficiary. Typically, a charitable remainder trust will have a short tax year at the time it is established, and in the year of the non-charitable beneficiary's death. In determining the amount to be paid to the beneficiary, the instrument should provide that the trustee should pro-rate the annual payment on the ratio of the number of days in the short or last year to 365 (or 366, if February 29 is included in the short or last year.)[27]

19. *Id.* at 23 and 28.
20. *Id.* at 28.
21. Treas. Reg. § 664-3(a)(1) (1972).
22. Treas. Reg. § 664-2(a)(1)(iii) (1972).
23. *See* note 21 *supra*.
24. *See* note 20 *supra*.
25. Treas. Reg. § 1.664-2(a)(1)(iii) (1972).
26. Rev. Rul. 72 and 395, 1972 INT. REV. BULL. No. 36, at 23 and 28.
27. Treas. Reg. §§ 1.664-2(a)(1)(iv) and 1.664-3(a)(1)(v) (1972).

A major difference between the annuity trust and the unitrust is that the annuity trust does not permit additional contributions.[28] Indeed, the Service requires that a provision be inserted prohibiting additional contributions in the case of the annuity trust.[29] By contrast, in the case of the unitrust, additional contributions are permitted.[30] The recommendation of the Service is to include a provision allowing for a valuation of additional contributions by prorating in accordance with the number of days in the short year in which the additional contribution is made.[31]

The restriction against additional contributions in the case of the annuity trust is necessary in view of the requirement that the "sum certain" be based on five percent of the initial net fair market value.[32] But there is no reason why one could not establish a new separate annuity trust with a new sum certain and new initial net fair market value. Indeed, even in the case of the unitrust, the draftsman may prefer to create a separate trust rather than make additional contributions. This attitude could stem from the nature of the assets or from the desire to take advantage of the opportunity to draft a new trust instrument with new provisions.

The last mandatory provision to both unitrusts and annuity trusts is a provision which requires that the trustee of the trust be prohibited from engaging in any self-dealing, or from making any taxable expenditures.[33] This inhibition is in accordance with the restrictions placed on private foundations, and is probably a wise provision even from the point of view of local law. It certainly provides no serious problem for the draftsman.

In sum, all of the mandatory provisions which the Service has recommended for inclusion in annuity trusts and unitrusts seem quite appropriate, and in no way can be deemed to be unduly restrictive on the draftsman. If the planner has decided to establish an annuity trust, he must be sure that the "sum certain" is not less than five per cent of the initial net fair market value of the assets

28. Treas. Reg. § 1.664-2(6) (1972).
29. Treas. Reg. § 1.664-2(6) (1972); Rev. Rul. 72-396, 1972 INT. REV. BULL. No. 36, at 24.
30. Treas. Reg. § 1.664-3 (1972).
31. Treas. Reg. §§ 1.664-3(6)(1) and 1.664-3(6)(2) (1972).
32. *See* note 5 *supra*.
33. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36, at 24 and 29. The restriction is in accordance with the requirements of INT. REV. CODE OF 1954 §§ 508 and 4947(a).

placed in trust. The planner cannot afford to make an error as to the initial valuation. In the case of the unitrust, error poses no problem by reason of the provision that allows adjustments for incorrect valuations.[34] As for the problem of additional contributions,[35] the draftsman can avoid this prohibition in the case of the annuity trust by establishing another annuity trust. In the case of the unitrust, he should insert a provision allowing for additional contributions in the event the grantor should later decide to make them.

III. The Optional Provisions

Apart from the warning that one must be careful to avoid inherent inconsistencies or violations of local law, there is no apparent reason why the optional provisions should not also be inserted in all charitable remainder trusts. Of the nine optional provisions available for annuity trusts and unitrusts, eight are completely parallel. The ninth provision, though parallel in language, is different in its operative effect when applied to the two trusts. This is due to the fact that the assets in the unitrust are revalued annually while valuation in the annuity trust occurs only once.

The first optional provision listed for annuity trusts permits the draftsman to use a fixed percent (not less than five per cent) in lieu of a dollar amount,[36] as provided in the first mandatory provision.[37] These two provisions are meant to be mutually exclusive. The draftsman should use the fixed percentage of the initial net fair market value where he is not certain of the precise value. He might then calculate what this value would be as finally determined for federal tax purposes, with an appropriate adjustment within a reasonable period after such final determination.[38]

Typically, the draftsman establishing an annuity trust would use mandatory provision number one in the case of assets which can be readily valued, such as listed securities, and optional provision number one where the gift consists of property which is difficult to value, such as the stock of a closely held corporation.

34. *See* note 20 *supra*.
35. *See* note 32 *supra*.
36. Rev. Rul. 72-395, 1972 Int. Rev. Bull. No. 36 at 24.
37. *See* note 16 *supra*.
38. Treas. Reg. § 1.664-2(a)(1)(iii) (1972).

The first optional provision for a charitable remainder unitrust allows for the payment of an amount less than the fixed percentage where the actual trust income for the particular year was less than five per cent.[39] As has been discussed, this particular optional provision is especially desirable for the donor in a high income bracket, who is anticipating retirement when he will have substantially less income from other sources.

The next seven optional provisions are parallel for both annuity trusts and unitrusts. Optional provision number two[40] is to be used in the case of both annuity trusts and unitrusts where the trust is to be established at the time of the grantor's death, but the precise amount that is to pass into the trust is unknown. Under the recommended provision, the planner may defer the requirement to pay the first annual amount to the non-charitable beneficiary until the end of the tax year in which the complete funding of the trust occurred.[41] Optional provision number two would not be inserted in the case of the *inter vivos* charitable remainder trusts since there would be no delay for purposes of the administration of the estate.

Optional provision number three[42] allows the draftsman to insert a spray power permitting the trustee to distribute the annuity or unitrust payment among several members of a class of non-charitable beneficiaries, all of whom must be living as of the time of the creation of the trust. In describing such a class gift, the draftsman should use the names of the beneficiaries where they are all known. This, however, might not be possible where the draftsman is drafting a will or revocable *inter vivos* trust, and is attempting to describe a class in existence as of the time of the testator's death. In such case, he would have to be certain to limit the class (for example, "to such of my grandchildren living at my death") to those non-charitable beneficiaries who would be certain to be alive as of the date of his death, the time of the creation of the trust.

An important change occurred in the final regulations in connection with the description of the class of persons who would qualify for a charitable remainder trust. The first set of proposed regula-

39. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36, at 29.
40. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36 at 25 and 30.
41. Treas. Reg. § 1.664-1(a)(5)(i) (1972).
42. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36 at 25 and 30.

tions provided only for the payment to a named person or persons. The question arose whether the regulations would be violated if the governing instrument contained the usual provision for payment to a guardian of a beneficiary in the case of incapacity. The final regulations used the languge "to or for the use of" a named person or persons,[43] thereby indicating that the payment to a guardian of a beneficiary in the case of incapacity would be appropriate.

One question that remains unanswered with respect to who would qualify as a recipient during the payment period is whether the language "to or for the use of a named person or persons" is broad enough to include another trust. This might be appropriate if the beneficiary of such other trust was in being at the time of the creation of the annuity trust or unitrust. The better practice is to avoid using other trusts as recipients of the payments.

In drafting the terms of the trust for the non-charitable beneficiaries, the draftsman should use either a life or lives in being at the time of the creation of the trust or a term of years, not to exceed twenty, and normally should not mix the two.[44] If the term of years is used, the draftsman may describe a class in which some of the members may not be living or ascertainable at the time of the creation of the trust.[45]

Optional provision number four[46] provides for the reduction of the payment of an annuity or unitrust amount at the death of a recipient or on the expiration of a term of years provided:

> (1) the reduced percentage is the same either as to each recipient or as to the total percentage payable each year for the balance of the period;
> (2) there is a distribution to a charity at such time; and
> (3) the total of the percentages payable thereafter is not less than five per cent.[47]

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43. Treas. Reg. §§ 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i) (1972).

44. Treas. Reg. §§ 1.664-2(a)(5) and 1.664-3(a)(5) (1972). The instrument could provide for payment:

> "to A for his life and then to B for his life or for a term of years (not to exceed 20), whichever is shorter (but not longer), if both A and B are in being at the time of creation of the trust because it is not possible for a period to last longer than the lives of recipients in being at the creation of the trust." *Id.*

45. Treas. Reg. §§ 1.664-2(a)(3)(i) and 1.664-3(a)(3)(i) (1972).

46. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36 at 25 and 30.

47. Treas. Reg. §§ 1.664-2(a)(2)(ii) and 1.664-3(a)(2)(ii) (1972).

Optional provision number five[48] deals with the problem that arises when trust income in excess of the amount required to be paid to the non-charitable beneficiary is paid to the charity. If such a distribution is in kind, the basis of the property distributed must be fairly representative of the basis of the property available for payment as of the date of the payment.[49] If the trust instrument permits or requires distributions to charity prior to the termination of all non-charitable interests, this provision becomes mandatory rather than optional.[50]

Optional provision number six permits the trustee to terminate the regular periodic payments with the last payment prior to the death of the non-charitable beneficiary, or the expiration of a fixed term of years.[51] This provision is a convenience for the draftsman and simply means that the next payment, which would have normally been paid had the trust continued, will be added to the principal and turned over to the charity. The computation of the present value of the remainder interest is not affected by the fact that the income beneficiary may not receive the last payment.[52]

Optional provision number seven allows the grantor to retain the power, exercisable only by will, to revoke or terminate the interest of any non-charitable income beneficiary.[53] This particular provision in the final regulations is so unusual that it requires some extended comment with regard to the interrelationship of income, estate, and gift taxes. Prior to the Tax Reform Act of 1969, if a grantor made a transfer in trust to a trustee to pay the income to himself for life, remainder to the *X* charity, the gift was deemed incomplete. Accordingly, the grantor was taxed on the income from the trust under Section 677, but was entitled to an income tax deduction for the irrevocable gift of the remainder interest to the charity. The entire *corpus* of the trust was included in his gross estate, but it was fully deductible as a charitable deduction. By the same token, the remainder interest was theoretically a taxable gift, but since it was fully deductible for gift tax purposes, no gift tax resulted.

48. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36 at 26 and 31.
49. Treas. Reg. §§ 1.664-2(a)(4) and 1.664-3(a)(4) (1972).
50. Rev. Rul. 72-495, 1972 INT. REV. BULL. No. 36 at 26 and 31.
51. *Id.*
52. Treas. Reg. §§ 1.664-2(a)(5)(i) and 1.664-3(a)(5)(i) (1972).
53. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36 at 26 and 31.

Under the Tax Reform Act of 1969, if a transferor makes a transfer in trust to pay the income to someone other than himself for life, remainder to a charity, the transfer is deemed complete for income, estate, and gift tax purposes.[54] If, however, he made the income payable to himself, he would be taxed under Section 664 on the amounts distributed to him by the charitable remainder trust, rather than under Section 677. While the grantor may be the income beneficiary of a charitable remainder trust, he cannot retain a power to invade, alter, amend, or revoke for the beneficial use of a person other than a charity.[55] Notwithstanding this prohibition, however, the regulation specifically provides that he may nonetheless retain a power, exercisable only by will, to revoke or terminate the interest of a non-charitable beneficiary.[56] This raises the interesting question as to whether or not the retention of such a power would cause the charitable remainder trust to be includable in the gross estate for estate tax purposes of the decedent under Section 2036(a)(2) or 2038, with a corresponding deduction under Section 2055.

Optional provision number eight is designed to make certain that the trustee is not restricted from investing in a manner which would result in the annual realization of a reasonable amount of income, or gain from the sale or disposition of trust assets.[57] The provision is phrased so as to use what is in essence a double negative. The language of the provision provides that the trustee shall not be restricted. Better draftsmanship would state the basic proposition positively, that is, that the trustee endeavor to obtain a "reasonable amount of annual income or gain from the sale or disposition of trust assets."[58] This, after all, is the trustee's unquestioned duty.

The last optional provision corrects what would otherwise present a difficult problem in the case of pour-over wills. The charitable remainder trust is valid only if it functions "exclusively" as a charitable remainder trust from its creation.[59] Thus, a charitable remainder trust cannot be used as a receptacle for a pour-over will. On the other hand, a revocable living trust, which has been established to

54. *See* note 1 *supra*.
55. INT. REV. CODE OF 1954 § 664(a).
56. Treas. Reg. 1.664-2(a)(4) and 1.664-3(a)(4) (1972).
57. Rev. Rul. 72-395, 1972 INT. REV. BULL. No. 36 at 26 and 31.
58. Treas. Reg. 1.664-1(a)(3) (1972).
59. Treas. Reg. 1.664-1(a)(4) (1972).

receive the assets from an estate, may distribute its assets to a charitable remainder trust. The same governing instrument may provide for both a revocable living trust and a charitable remainder trust, and both trusts may have the same trustee. In the case of the annuity trust, such a revocable *inter vivos* trust would not violate the prohibition against additional contributions, since the trust would not be deemed established until after the settlement of the settlor's estate.

IV. Using Charitable Trusts as an Estate Planning Vehicle

To fully appreciate the value of charitable remainder trusts in estate planning, the planner must consider all aspects of income, estate, and gift taxes. Prior to the Tax Reform Act of 1969, a grantor who retained the income from a charitable remainder trust would be taxed on the income of the trust (whether or not it was distributed to him), and the trust assets would be included in his gross estate. He would receive an income tax deduction for the present value of the remainder interest contributed to the charity. This remainder interest would be a completed gift, which would be fully deductible for gift tax purposes. On his death, the full value of the trust would be included in his gross estate under Section 2036(a)(1), and he would receive a corresponding charitable deduction under Section 2055.

With the enactment of Section 664, a number of the basic rules regarding charitable remainder trusts have been changed. First of all, since the benefit to be obtained by the taxpayer is dependent upon the proper handling of annuity trusts and unitrusts, it is essential that the draftsman comply strictly with the regulations issued under Section 664. Most of these regulations are in accord with fundamental principles governing the question of whether or not a transfer is complete for income, estate, and gift tax purposes. The principal exception to this is where the grantor solely retains the income from the trust. Prior to the Tax Reform Act of 1969, he would have been taxed on the income of the trust because of his retention of economic control, under Section 677. Since the Act, the taxation to the grantor is based upon the later statute, namely, Section 664. If, however, the trust instrument should retain a power to alter, amend, or revoke, the grantor would continue to be taxed under Section 677, rather than Section 664. Treasury Regulations, Sections 1.664-2(a)(4) and 1.664-3(a)(4), specifically provide:

> The trust may not be subject to a power to invade, alter, amend, or revoke for the beneficial use of a person other than an organization described in Section 170(c).

Under these regulations, it is immaterial whether or not the grantor can only exercise his power in conjunction with an adverse party. At this point the regulations would appear to follow the fundamental philosophy of the estate tax rather than the income tax. However, this is not in accord with Regulations, Section 1.664-1(a)(4), which states that the trust will be deemed to be created at the earliest time so that neither the grantor nor any other person is treated as the owner of the entire trust under the income tax law. Thus, if the power was retained, exercisable by the grantor only in conjunction with an adverse party, it would be deemed to be created at the time of the transfer, rather than at some later time when the grantor released the power.

Having stated that the trust shall not be deemed to be created until the time the grantor has released economic control for income tax purposes, the regulations then provide:

> For purposes of the preceding sentence, neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E, merely because the grantor or his spouse is named as a recipient.[60]

The authority for this regulation stems from the fact that Section 664 specifically provides that the recipient shall be taxed in a particular fashion, whether or not the beneficiary is the settlor or another. All of this would be completely understandable were it not for the fact that in Regulations, Section 1.664-2(a)(4) and 1.664-3(a)(4) the Internal Revenue Service has inserted a further provision allowing the settlor to retain a power of revocation exercisable by will.

This bit of largesse of the Internal Revenue Service should have important estate planning consequences for revocable trusts. We may assume that for purposes of local law, one could insert a provision in a trust instrument to allow for revocation by the settlor's will.[61]

60. *See* note 42 *supra*.
61. *Cf.* Cohen v. Cent. Nat'l. Bank 191 Va. 12, 60 S.E. 2d 30 (1950).

When the power to revoke or terminate by will is combined with the trustee's power to spray or sprinkle among the non-charitable beneficiaries during the lifetime of the settlor, it becomes apparent that the charitable remainder trust provides a vehicle, whereby the grantor can retain a remarkable amount of economic control and still obtain all the benefits of the charitable deduction, including the most important benefit of an immediate tax deduction at the time the charitable remainder trust is established.

To appreciate how this affects estate planning, let us imagine a typical hypothetical situation, and see how the planner might use charitable remainder trusts. *H* and *W* are a childless couple, and they have one nephew, *N*, who is the natural object of their bounty. In addition, they would like to benefit the University of Richmond. *H* has devoted his life to building up a successful business, known as Widgets, Inc. He is President and Chairman of the Board, and owns all of the 10,000 shares of stock, presently valued at $50 per share. He would like for the University of Richmond to acquire all of the stock of his company, and gradually convert the portfolio to listed securities. Accordingly, he establishes a charitable remainder trust under the following principles:

1. The trust will be a unitrust, but he will exercise the option to take only the income that the trust actually realizes in the event that his income should be less than five per cent of the fair market value of the trust valued annually.

2. After his death *W* and *N*, or the survivor, will continue to draw the income during their joint lives, or the life of he survivor.

3. The trustee shall have the power throughout the term of the trust to spray income to *H*, *W* and *N* in its sole discretion, in accordance with the beneficiaries needs.

4. *H* retains no power to alter, amend, or revoke, either alone, or in conjunction with any person.

5. *H* does retain the power to revoke or terminate the interest of *W* or *N*, but this power can only be exercised by his will.

From all of the above, it will be seen that *H* obtains substantial tax advantages, but at the same time is able to retain control over the trust during his lifetime. The tax advantages are as follows:

H receives a substantial income tax deduction in the year of the establishment of the unitrust. The amount of the deduction will be the value of the assets transferred, less the prior interest of *H*, *W*, and *N*. For example, if *H* transfers 1,000 shares, the value of the remainder interest deduction would be approximately 30% of $50,000 or $6,000. If *H* is in a 60% tax bracket (annual income of $88,000 to $100,000), he would save $3,600 in taxes (60% of $6,000). In other words, the net tax cost for purposes of income tax for the establishment of the $50,000 remainder trust would be $3,400 or $900 more than what he would receive as income from the charitable remainder trust during its first year. *H* would specifically provide in his trust instrument that he would not retain any power to alter, amend, or revoke, either alone or in conjunction with any person, except that he would retain the power to revoke or terminate exercisable solely by his will.

At *H*'s death, the trust would be includable in his gross estate under either Section 2036(a)(2) or 2038, by reason of the retained power. Since he retained a power to revoke or terminate which was not exercisable in conjunction with any person having a substantial adverse interest, the gift would be incomplete for gift tax purposes, and there would be no gift tax by virtue of the transfer of the income interest to *W* or *N*.

The regulations have achieved something for the taxpayer which is far beyond anything that he could have hoped for apart from the charitable remainder trust approach. *H* has transferred a trust of a value of $50,000 at a net cost of $3,400 from which he will receive $2,500 of income in the first year. Indeed, he may well be able to increase his spendable income by making a gift to a charitable remainder trust. In the example we have given, *H* has achieved the following results: 1. He has established a charitable remainder trust for the benefit of his favorite charity in the amount of $50,000. 2. He increases his additional, spendable income in the year of the establishment of the charitable remainder trust by $4,600. 3. He pays no gift tax, although he makes present transfers to his wife and his nephew of income interests. 4. He makes a transfer which is includable in his gross estate for estate tax purpose, and which is fully deductible to the extent that any interest passes by charitable remainder at the date of his death. 5. He balloons the marital deduction at the date of his death by increasing the charitable deduction. 6. He retains complete control to change the non-charitable beneficiaries through a reserve provision in his will. All these advantages would seem to indicate that the charitable remainder trust, like the marital deduction in 1948, has brought a whole new dimension into the art of estate planning.