

Planned Giving News

SECOND QUARTER 2005

MUCH ADO ABOUT NOTHING

Spousal "Right of Election" against CRT Assets

by Ken Dike

MUCH ADO ...

On March 30, 2005 the Internal Revenue Service issued Revenue Procedure 2005-24. This regulation, which many consider unnecessary, significantly increases the burden and complexity of charitable remainder trust (CRT) administration. A spousal waiver of a real or potential "right of election" against CRT assets is now required to protect the tax exempt status of CRTs created on or after June 28, 2005.

THE PROBLEM AS SEEN BY THE IRS

Unlike "community property" states such as California, "common law" jurisdictions recognize the separate ownership of property acquired during marriage and protect the surviving spouse through an "elective share" provision. An elective share provision allows the surviving spouse to demand a statutory percentage of the decedent's estate rather than the amount bequeathed to the surviving spouse by the decedent's will. The Uniform Probate Code allows the surviving spouse to take, through an elective share provision, a percentage of an "augmented estate" that may include not only the assets remaining at death but certain inter vivos (lifetime) transfers by the decedent such as assets transferred to a CRT.

CRTs pay private (non-charity) income beneficiaries an annual amount that is either fixed for the duration of the trust as in a *Charitable Remainder Annuity Trust* (CRAT) or is based on a percentage of the periodic market value of the trust assets as in a *Charitable Remainder Unitrust* (CRUT). When the CRT terminates, its assets are given to a charity. The IRS sees a problem where the ultimate transfer to charity *could* be subverted by a surviving spouse with the ability to take assets from a CRT pursuant to an elective share provision.

THE IRS SOLUTION

If the surviving spouse has the right under applicable state law to receive an elective share that could be satisfied from the assets of a CRT, there is a possibility that the CRT may be invaded for the benefit of the surviving spouse. The *mere existence* of the right, and the related *possibility* that the CRT could be invaded by the surviving spouse, results in the trust's forfeiture of its tax exempt status *continuously from the inception of the trust*.

There are two exceptions to this general rule:

- (1) The CRT was created prior to June 28, 2005 and the surviving spouse does not exercise their right to an elective share that could be satisfied from CRT assets, or
- (2) The surviving spouse irrevocably waives their right to an elective share in a timely manner to the extent that there is no possibility that any CRT asset could be used to satisfy the elective share.

Failure to qualify under either of these two exceptions will result in (1) the loss of any income or gift tax charitable deduction taken by the donor, (2) the trust will be taxed on any income or capital gains not paid to the income beneficiaries, (3) any gift or estate tax marital deduction related to assets transferred to the CRT will be lost if the surviving spouse has an income interest (right to receive beneficiary distributions) in the CRT, and (4) any estate tax charitable deduction could be disallowed.

CRTS CREATED PRIOR TO JUNE 28, 2005

Assuming that an elective share waiver is not obtained, a CRT created prior to June 28, 2005 will fail *only if the surviving spouse exercises their right* to an elective share that could be satisfied by CRT assets. The requirement that the

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"THE IRS SEES A PROBLEM WHERE THE ULTIMATE TRANSFER TO CHARITY COULD BE SUBVERTED BY A SURVIVING SPOUSE WITH THE ABILITY TO TAKE ASSETS FROM A CRT PURSUANT TO AN ELECTIVE SHARE PROVISION."

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surviving spouse actually exercise the right to an elective share is an attempt by the IRS to reduce the impact of the revenue procedure on existing trusts. This contrasts with CRTs created on or after June 28, 2005 where the *mere existence of the right* to elect against CRT assets is enough to disqualify the trust.

CRTS CREATED ON OR AFTER JUNE 28, 2005

A CRT created on or after June 28, 2005 will fail from its inception unless a spousal waiver of elective share is obtained if applicable state law provides for a spousal right to an elective share that *could* be satisfied from the assets of a CRT. The applicable state is the state in which the CRT donor is domiciled in, or is resident of, *at the time of the donor's death*. The following situations require a spousal waiver of elective share assuming the CRT was created on or after June 28, 2005:

- Donor creates a CRT in a community property state such as California that has no elective share provision (no waiver required) then moves to a common law state that provides for an elective share that could be satisfied with CRT assets (waiver required).
- Donor creates a CRT in a common law state where the elective share cannot be satisfied with CRT assets (no waiver required) then moves to another common law state where the elective share could be satisfied with CRT assets (waiver required).
- State law is amended to provide for

an elective share that could be satisfied from CRT assets.

Since it is not unusual for people to move from one state to another, a spousal waiver of elective share should be acquired for all CRTs created after June 28, 2005 if the donor is married or when the donor marries after the CRT is created.

SPOUSAL WAIVER OF ELECTIVE SHARE—TIMELINESS

Assuming the trust's federal Form 5227 Information Return is due on April 15, the spousal waiver of elective share must be obtained by October 15 of the year following the year in which the later of these events occur:

- the creation of the trust;
- the date of donor's marriage;
- the date donor becomes domiciled in or a resident of a jurisdiction whose law provides a right of election that could be satisfied from assets of the CRT; or
- the effective date of an applicable state law creating a right of election.

SPOUSAL WAIVER OF ELECTIVE SHARE—SCOPE

The spouse need not waive the right to an elective share of any non-CRT assets. A partial waiver is only required to the extent that it eliminates any possibility that CRT assets could be used to satisfy the elective share. In addition, the spouse need not waive any right to receive any CRUT or CRAT (income interest) distributions that they may be entitled to receive from the CRT.

SPOUSAL WAIVER OF ELECTIVE SHARE—VALIDITY & SAFEKEEPING

The spousal waiver must be valid under applicable state law. Some states require that the spouse's signature be witnessed and some states require that the signature be notarized. Therefore, a generic waiver should include both witnesses and a notarization to accommodate the possibility that the Donor will move to a state that requires such formalities.

The waiver must be irrevocable, in writing, and signed by the spouse.

Lastly, a copy of the signed waiver must be provided to the trustee of the CRT and the trustee must retain the copy in the official records of the trust.

... ABOUT NOTHING

It is unfortunate that this revenue procedure was never issued in a proposed form allowing for comments given its impact on donors supporting their charities through CRTs, trustees attempting to administer CRTs, tax professionals advising the donors and trustees, and the nonprofit community in general. In a reasonable world, the IRS would realize that a spouse electing against the will and taking from a CRT is highly unusual. Furthermore, if such an election is actually exercised against CRT assets, the deceased donor's final income tax return and estate tax return could accommodate any adjustment to previously taken income tax charitable deduction or revised estate tax charitable deduction. §

“IN A REASONABLE WORLD, THE IRS WOULD REALIZE THAT A SPOUSE ELECTING AGAINST THE WILL AND TAKING FROM A CRT IS HIGHLY UNUSUAL.”

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