

REV. PROC. 2005-24 – WITH SAFE HARBORS LIKE THESE...

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I. REV. PROC. 2005-24 - PURPOSE AND SAFE HARBOR

- A. Safe harbor. Rev. Proc. 2005-24 was issued on March 30, 2005 with the stated goal of providing a “safe harbor procedure under which the Internal Revenue Service will disregard” a surviving spouse’s right to elect to receive a statutory share from the assets of a charitable remainder trust (CRT).
- B. What safe harbor? Although the phrase “safe harbor” is used consistently in the Rev. Proc., it is clear that failure to obtain a valid waiver pursuant to the terms of the Rev. Proc. “will result in the CRAT or CRUT failing to qualify under § 664(d) continuously since its creation, *whether or not [the surviving spouse] exercises the right of election.*”² Section 3.01. (Emphasis added.)³
1. Note that the “safe harbor” was provided by the Service “in the interest of sound tax administration and to reduce the burden on taxpayers....” Section 2.04. The Service estimated, however, that the total annual reporting burden is 150,000 hours. Section 6.
 2. *Query* how the total annual reporting cost (as described below, there may also be annual monitoring costs) and the possible increase in tax revenue for failure to comply with the “safe harbor” compares to the taxes lost by reason

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² A “safe harbor” usually describes a procedure which, if complied with, provides the taxpayer with protection, but which if the taxpayer does not follow, does not necessarily result in automatic disqualification or tax liability with respect to the issue. *Compare* Rev. Proc. 2000-37, 2000-40 I.R.B. 308 (“[N]o inference is intended with respect to the federal income tax treatment of ‘parking’ transactions that do not satisfy the terms of the safe harbor provided in this revenue procedure, whether entered into prior to or after the effective date of this revenue procedure.”) *and* Treas. Reg. § 53.4958-6(c)(2)(ii) (“No inference is intended with respect to whether circumstances falling outside this safe harbor will meet the requirement with respect to the collection of appropriate data.”).

³ Unless otherwise noted, references herein to “Section” are to Rev. Proc. 2005-24.

of the (probably few) instances in which a spousal election has been exercised against a CRT?

II. WHAT CRTs ARE COVERED BY REV. PROC. 2005-24?

A. Effective date? Rev. Proc. 2005-24 is said to apply only to CRTs created on or after **June 28, 2005**. Section 3.01.

1. Rights of election will be disregarded with respect to CRTs created before June 28, 2005 *unless* a surviving spouse exercises a right of election against the CRT.
2. The IRS implicitly encourages practitioners to obtain waivers for *all* CRTs ever created. (“Thus, for all CRATs and CRUTs, regardless of when they were created, a waiver under this revenue procedure of [the surviving spouse’s] right of election will provide certainty that the right of election will not cause the trust to fail to qualify under § 664(d) continuously since its creation.”) Section 3.01.
3. Additional funds cannot be contributed to a CRAT.⁴ Questions have been raised, however, as to how to treat contributions made after June 28, 2005 to CRUTs created before June 28, 2005.⁵
 - (a) It is not clear how such an additional contribution will be treated if a waiver is not obtained pursuant to the Rev. Proc.
 - (b) There is some authority, however, that suggests that additional contributions to a CRUT should be treated as a separate trust, at least in other contexts.⁶ Perhaps only the additional contribution, and not prior fundings, would be at risk if a waiver is not obtained.

B. A specific type of spousal share right.

1. The Rev. Proc. only applies if the surviving spouse of the settlor of a CRT:

⁴ Treas. Reg. § 1.664-2(b).

⁵ See “NYC Bar Association Comments on CRAT, CRUT Safe Harbor Guidance,” 2005 TNT 145-22 (July 15, 2005) (hereinafter the “NYCBA Comments”).

⁶ See Code § 664(d)(4), which was added at the same time as Code §§ 664(d)(1)(D) and 664(d)(2)(D) (which impose the requirement that, with respect to the contribution of property to a CRAT and CRUT, respectively, the value of such remainder interest in such property must be at least 10 % of the net fair market value of such property as of the date such property is contributed to the CRT). Code § 664(d)(4) sets out special rules for additional contributions of property to an otherwise qualified CRUT. If the “additional contribution” of property to a CRUT would not satisfy the 10% requirement, the CRUT is not disqualified; instead the additional contribution is treated as if made to a separate, non-qualified trust. The related legislative history also consistently describes this special provision as related to an “additional contribution” to a CRUT where the trust would not satisfy the 10% requirement “with respect to the additional contribution.” H.R. CONF. REP. NO. 220, 105th Cong., 1st Sess. 607 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1129, 1419-20.

- (a) has the right, exercisable at the time of the settlor's death,⁷ to an elective or statutory share, and
 - (b) the right can be exercised against, or satisfied out of the assets of, the CRT.
2. If the spouse is not entitled to the right to elect against the CRT, either due to state law or a *valid* waiver, there is no *current* issue with respect to the CRT.

III. WHAT IS REQUIRED FOR A WAIVER?

- A. Form of waiver. If a waiver is required, it must meet certain criteria. Section 3.02.
 1. The waiver must be written.
 2. The waiver must be signed and dated by the settlor's spouse.⁸
 3. The waiver must be irrevocable.
 4. The waiver must at least waive the spouse's right to elect against the CRT assets (but can more broadly waive the right to elect against other or all assets).⁹
 5. The waiver must be valid under applicable state law.
- B. Timing of waiver. The waiver must be obtained on or before the date which is 6 months after the due date (*excluding* extensions) of the Form 5227 for the year in which the latest of the following occurs:
 1. the creation of the CRT;
 2. the date of the settlor's marriage;
 3. the date the settlor becomes a resident of or domiciled in a jurisdiction which provides the requisite right of election; and
 4. the effective date of applicable state law creating the requisite right of election.

⁷ Although some language in the Rev. Proc. might be interpreted to mean that no problem occurs until the death of the settlor and the vesting of the right of election, other language makes it clear that failure to obtain the waiver, even though the "right of election" is still inchoate, will cause the CRT to fail to continuously qualify under Code § 664(d). See text accompanying fn. 2.

⁸ Read literally, the waiver would be invalid if anyone other than the settlor's spouse dated the waiver.

⁹ The procedure states that the spouse "must irrevocably waive the right of election *to whatever extent necessary* to ensure that no part of the trust (other than the annuity or unitrust interest of which [the spouse] is the named recipient under the terms of the trust) may be used to satisfy the elective share."

- C. Delivery and retention of waiver. A copy of the waiver must be provided to the trustee of the CRT, and the trustee must retain the copy in the “official records of the trust” so long as the waiver is material for tax purposes.
1. *Query* when the copy must be delivered to the trustee?¹⁰
 2. *Query*, if the waiver is in the form of a pre-nuptial agreement (see Section 4.05, Example 5), must the trustee receive and retain the entire prenuptial agreement, or just the portion containing the waiver?
 3. *Query* what happens if the trustee cannot prove the apparent requirement of constant retention (especially in the case of successor trustees)?

IV. POTENTIAL PITFALLS POSSIBLY OUTWEIGH “SAFE HARBOR” BENEFITS

- A. You may not be able to rely on your state law. Even if you prepared a CRT under the laws of the state in which either no spousal election is provided, or which does not allow for election against the assets of the CRT, the Rev. Proc. makes clear that the law of the settlor’s domicile at the date of death governs.
1. Therefore, a married settlor who moves to a state which has the requisite right of election will have to obtain a waiver. Section 3.03(3).
 2. Additionally, if the law *changes* to provide a right of election, a waiver will be required for married settlors. Sections 3.03(4) and 4.03, Example 3.
- B. Single settlors might require waivers if they marry. It is also clear that a settlor of a CRT who marries after creating a CRT will need to obtain a waiver if the spouse has the requisite right of election under applicable state law. Sections 3.03(2) and 4.02, Example 2.
- C. What does “valid under applicable state law” mean? A waiver must be valid under applicable state law.
1. Does this mean that the IRS may “step into the shoes” of the spouse and argue that the waiver was not valid, such as because:
 - (a) the spouse was not represented by separate counsel?
 - (b) the waiver was a *post*-nuptial agreement (and void under a state’s law for public policy reasons)?
 - (c) the spouse did not knowingly and voluntarily grant the waiver, including because he or she did not receive full disclosure of the settlor’s assets?

¹⁰ See the NYCBA Comments.

- (d) the terms of the waiver or the overall pre-nuptial agreement were “unconscionable” or otherwise “unfair”?
 - (e) the spouse was incapacitated?
2. What state law applies?
- (a) Although the waiver is valid under the applicable state law when given, what if it is not valid under the state law applicable at the settlor’s death, or after the settlor moves to another state?
 - (b) What if the law governing the administration of the CRT would not allow the assets of the CRT to be used to satisfy the right of election granted to a surviving spouse under another state’s law? Delaware has modified its Delaware Qualified Dispositions in Trust Act (specifically, 12 Del. C. Sec. 3573) to provide that a surviving spouse will be considered a creditor for purposes of CRTs which are covered by the Act.¹¹
- D. What about community property states? Rev. Proc. 2005-24 deals only with states which have rights of election. Community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin) do not have the elective share concept, and the IRS states that the “elective share provisions are *generally* unnecessary because [the surviving spouse] *typically* has vested ownership in one-half of the community property.” Section 2.05. (Emphasis added.)
- 1. As mentioned above, a CRT created in a community property state is still at risk if the settlor is married and moves to a state with an elective share right which can be satisfied out of the assets of the CRT.
 - 2. What about quasi-community property? If a settlor creates and funds a CRT in a non-community property state, but the property would have been considered community property if earned in the community property state, will the death of the settlor give the surviving spouse the right to claim against the CRT to the extent of the quasi-community property?
- E. Can the rationale for Rev. Proc. 2005-24 be extended? The Rev. Proc. only applies to surviving spouse’s rights of election. The premise behind the Rev. Proc., however, is that no assets of a CRT, other than the annuity or unitrust interests, should ever be paid (or even potentially be payable) to or for the benefit of any person other than an organization described in Code § 170(c).

¹¹ Will such a law raise the “Full Faith and Credit” issues which are discussed in the debate of whether domestic asset protection trust laws will be honored in other states? See Warnick and Pareja, “Selecting a Trust Situs in the 21st Century,” *Probate & Property* (Mar./Apr. 2002).

1. Is there any risk that a spouse's rights upon divorce, or a claim that separate property contributed to a CRT was really community property, could raise the same issue?
2. There might be other potential recipients of assets held in CRTs under applicable state law. What if creditors (for child support payments or to satisfy judgments of tort creditors, etc.) of the settlor could reach the CRT assets?
3. Will practitioners now be on notice that these sorts of mere possibilities must be taken into consideration?
4. Is this issue limited to CRTs, or can it be extended by analogy to other planning techniques, such as GRATs?¹²

V. WHAT HAPPENS IF A CLIENT DOES NOT SATISFY THE “SAFE HARBOR”?

- A. Not a “safe harbor”. As mentioned above, the Rev. Proc. does not really provide a safe harbor, as failing to obtain a waiver when required *will* result in a CRT being deemed to have failed to qualify continuously under Code § 664(d), at least in the view of the IRS.
- B. What does failure mean? What is not discussed in the Rev. Proc. are the possible remedies available to the IRS for a failure to obtain a waiver. Can the IRS retroactively disallow the charitable deduction(s) taken by the settlor, and impose taxes which would have been due had the CRT not been an exempt trust?
 1. Could the IRS argue that the CRT was retroactively disqualified? The issue of retroactivity has come up in several private letter rulings involving the termination of a trust's status as a charitable remainder trust. *See* PLRs 8221078 (Feb. 25, 1982), 9409017 (Dec. 1, 1993), 7743027 (July 27, 1977), 7949035 (Sept. 5, 1979), 8647007 (Aug. 18, 1996) and 8647008 (Aug. 18, 1996). The IRS did not attempt to revoke charitable remainder trust status retroactively in these rulings, although the rationales for not seeking retroactivity varied.

¹² *See* Treas. Reg. § 25.2703-3(d)(3) (“The governing instrument must prohibit distributions from the trust to or for the benefit of any person other than the holder of the qualified annuity interest during the term of the qualified interest.”). Note, however, that the restriction in the GRAT regulations speaks specifically to the terms *of the governing instrument*, as compared to the restrictions in Code §§ 664(d)(1)(B) and 664(d)(2)(B), which are not so limited.

2. Statute of limitations. Why would the IRS not be limited by the statute of limitations?¹³
3. Annual accounting period principle. A retroactive disqualification should violate the long standing annual accounting period principle, which states that “income tax laws are administered on the basis of annual accounting periods and the tax is assessed on the basis of events happening in each such period.” *Hugoton Production Co. v. United States*, 349 F.2d 418, 432 (Ct. Cl. 1965) (citation omitted). See also *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), *United States v. Lewis*, 340 U.S. 590, *Healy v. Commissioner*, 345 U.S. 278 (1953), *Exxon Corp. v. United States*, 2000-1 U.S.T.C. 50,116 (Cl. Ct. 1999), *rev'd on other grounds*, 2001-1 U.S.T.C. 50,348 (Fed. Cir. 2001) and *Alderman v. Commissioner*, T.C. Memo. 1988-49.
4. NYCBA proposal. The NYCBA Comments suggest that an alternative to the Rev. Proc. would be to amend the statute of limitations for trusts so that *only* an actual exercise of a right of election would result in the payment of back taxes, plus interest, for the charitable deductions and exclusions of income.¹⁴

C. Who is responsible for getting the waiver?

1. What if the settlor is not the trustee?
 - (a) What steps, if any, should a trustee take to try to obtain a waiver, or to get the settlor to obtain the waiver?
 - (b) If the trustee has any liability exposure, is it limited to potential tax payments if the CRT is found to not qualify continuously under Code § 664(d) (and if so, for how many years), or is there also state law fiduciary risk?¹⁵
2. This question may be less material if the settlor is the trustee of the CRT. (But then the question is whether the settlor, or one of the settlor’s advisors (and if so, which), is responsible for obtaining a waiver?)

¹³ The Service made the following statement in each of PLRs 8647007 (Aug. 18, 1996) and 8647008 (Aug. 18, 1996):

In the present situation, because the grantor’s income tax, gift tax, and estate tax returns have already been filed, the subject matter of the ruling request, pertaining to the retroactive disallowance of an income tax, gift tax, or estate tax deduction, is properly within the jurisdiction of the district director in the district where those tax returns were filed. Therefore, we are unable to issue a ruling concerning the effect of the termination and partition of the trust on the deductions taken on the income tax, gift tax, and estate tax returns.

¹⁴ See NYCBA Comments.

¹⁵ If there is state law fiduciary risk, it is not due to the Rev. Proc., but perhaps just made more evident thereby.

VI. WHAT CAN (OR SHOULD) YOU DO (ASSUMING THE REV. PROC. REMAINS AS IS)?

A. Get a waiver when relevant.

1. If the settlor lives in a state which provides for a right of election, the settlor of a new CRT should obtain a waiver under the Rev. Proc., at least for all CRTs created on or after June 28, 2005.
2. Practitioners should consider obtaining waivers for CRTs created prior to June 28, 2005, at least if the settlor lives in a state which provides the requisite right of election.

B. Should you get the waiver?

1. Depending upon state law, separate counsel may be required (or at least prudent) for obtaining a waiver.
2. Even if separate counsel is not required, conflict of interest issues may arise for those representing both spouses. (*Query* how a surviving spouse will react if the decedent dies penniless and the surviving spouse has waived a right of election - to save taxes?)¹⁶

C. What if your state does not have a right of election?

1. Advisors should monitor the law in their own states, and advise current (and depending upon obligations to past clients, possibly past) clients of any such pending change and the steps they should take in order to comply with the Rev. Proc. - if possible.
2. Can you waive rights that do not exist – to protect against a change in the law or a move to another state?
 - (a) It is not clear if a spouse can waive what he or she does not yet have under applicable state law.
 - (b) On the other hand, is there a harm in attempting to waive in advance such future rights? (But see VI.B.2., above.)

D. Warnings to clients. Practitioners may wish to warn clients with CRTs of the issues raised by the Rev. Proc., even if they do not yet fit within the scope of the Rev. Proc.

1. Warn single settlors regarding a future marriage.
2. Warn married settlors (even those with waivers) regarding subsequent marriages.

¹⁶ The issue of the IRS' potential remedies may be relevant to a determination of whether a spouse should provide a waiver.

3. Warn settlors regarding a move to another state.
4. Warn settlors regarding a change in the law of their current state.
5. Warn settlors of the risk that the incapacity of the settlor's spouse could prevent (or at least hinder) obtaining a future waiver, if needed.

E. What about the return preparer?

1. Should the person preparing the settlor's income and gift tax returns which report the creation and funding of the CRT do any due diligence in light of the Rev. Proc.? What about the Forms 5227 in the first and subsequent years?
2. Should the return preparer ask you, as the drafter of the CRT, for an opinion as to the validity of the CRT, either upon creation or in subsequent years?

F. Can you (or should you) revise how you draft CRTs?

1. Addressing the issue of the waiver within the document seems prudent, at least for those states which provide a right of election. Doing so, if valid and done properly, may satisfy all of the requirements for the contents, timing, delivery and retention of the waiver. (See III.A., B. and C., above.)
2. Could a CRT be drafted to take into consideration a future right of election – without violating the CRT requirements?
 - (a) Assume that a surviving spouse has a right of election and did not grant a waiver. If the entire CRT is subject to taxes (at least estate taxes), should the governing terms of the document remain unchanged - so that all assets eventually go to charity? (Remember, the Rev. Proc. provides that *any* right to elect against a CRT, even if only for the last dollar necessary to satisfy the election share, means the entire CRT has not continuously met the requirements of Code § 664(d), and the CRT will therefore at least be subject to estate taxes.¹⁷) Should the CRT provide for the contingency, perhaps to distribute all of the assets to the surviving spouse (instead of just what could be recovered by the surviving spouse under state law)?
 - (b) Assume instead that the surviving spouse does not have a right of election at the settlor's death, but the surviving spouse *used* to have the right of election (either because the settlor lived in another state which granted the right of election, or a prior law gave the right of

¹⁷ Note that the Tax Court, in *Estate of Atkinson v. Commissioner*, 115 T.C. 26 (2000), found that the Trustee failed to pay the annuity amount during the *life* of the settlor/annuitant and thus violated the 5% minimum payment requirement. This violation during the life of the grantor was one of several grounds for the Tax Court's holding that the CRAT in question had not continuously met the requirements of Code § 664, and as a result, the federal *estate* tax deduction was denied.

election). If the IRS successfully argues that the prior existence of the right causes the CRT to not have continuously met the requirements of Code § 664(d), should the dispositive provisions take this into consideration?

VII. SUMMARY

The IRS has a legitimate concern that property set aside for charity in a CRT may instead be paid to a surviving spouse who exercises his or her right of election against the assets in the CRT. It is not clear, however, whether this concern has resulted in abuses, or if so, how widespread and material the cost to the government. It is also not clear whether the “safe harbor” in Rev. Proc. 2005-24 is the best solution to address the concern.

The extent of the potential problems posed by Rev. Proc. 2005-24, including the additional costs placed upon taxpayers, is not yet known. Those taxpayers who are represented by less capable tax practitioners, and those who are no longer represented by anyone, will be more likely to suffer negative consequences from Rev. Proc. 2005-24, despite the legitimate intentions of the IRS.