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New Law Changes Taxation of Charitable Remainder Trusts Earning Unrelated Business Income

Tax Relief and Health Care Act. The Tax Relief and Health Care Act of 2006 (The "Act"), passed by both the Senate and the House in early December, was signed into law by the President on December 20, 2006. Although the Act primarily focuses on the extension and/or modification of many important tax provisions (including key tax breaks that expired at the end of 2005), it also makes a major change to the taxation of charitable remainder trusts ("CRT") that earn unrelated business taxable income ("UBTI") during a given tax year. In certain situations, this change may provide CRTs with more favorable income tax treatment, while still imposing a significant tax bite.

Prior Rule. Prior to the Act, a CRT would lose its federal income tax exemption under Internal Revenue Code §664(c) for the tax year in which it earned *any* UBTI, regardless of the amount. The CRT would thus be taxed as a complex trust for federal income tax purposes. Furthermore, a CRT earning UBTI would be subject to income tax not just on the UBTI, but on *all* the CRT's income for that tax year. This rule produced a particularly severe income tax result, especially for CRTs that earned minimal or incidental UBTI.

New Law. Under the Act, CRTs that earn UBTI will no longer lose their federal income tax exemption for the relevant tax year, but rather will incur a new excise tax equal to 100% of the amount of the UBTI so earned. This change eliminates the harsh tax consequences generally associated with the CRT's loss of its tax exemption for the year it earned UBTI. Note, however, that the new excise tax effectively confiscates any UBTI earned by the trust. Thus, although the new rule provides CRTs with some leniency, such trusts should still avoid, to the greatest extent possible, making investments or engaging in transactions that generate UBTI.

In other situations, this "favorable" change may not necessarily be a panacea. Remember that the UBTI realized by the CRT not only is subject to the 100% excise tax (again, confiscating all return on the investment that generated UBTI) which is charged to the charitable remainder, but also is subject to another level of tax (both federal and state income tax) paid by the distributee (under the CRT tier income tax system) when it receives its distribution from the CRT. Thus, it appears possible that the results in many situations may not be that much different from simply taxing the CRT as a complex trust without the benefit of its tax exempt status. In certain situations, it is possible that third-party trustees of CRTs could be sued for dereliction of duty if they invest in assets that generate UBTI and this adverse tax result. Moreover, it is plausible in certain situations even where the trustees are the charitable remainder beneficiary, that the relevant state attorney general may become involved since the investment may have resulted in an obvious "negative return." Thus, careful monitoring of the investment activities and an understanding of what is treated as UBTI is even more necessary for those involved in the administration of CRTs than in the past.

Effective Date. The new law is effective for tax years beginning after December 31, 2006.

*Cites: Internal Revenue Code §664(c); Tax Relief and Health Care Act of 2006, H.R. 6111; Steve Leimberg's Charitable Newsletter # 114 (December 27, 2006) at <http://www.leimbergservices.com>.



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