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## now crts can have ubti!

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*MSK Client Alert*

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Tucked into the Tax Relief And Health Care Act of 2006, which became law on December 20, 2006, is a fundamental change to the rules affecting charitable remainder trusts ("CRT") which provides that, starting in 2007, a CRT with unrelated business taxable income ("UBTI") will no longer lose its tax exemption for the year. Instead, an excise tax will be imposed in the amount of the UBTI realized. (You understood that correctly: the tax rate is 100%). While this change is generally good news, it is not universally helpful. Planners need to be aware of those circumstances in which the new rules are less helpful than those they replaced.

### **Background**

Since the introduction of CRTs 38 years ago in the Tax Reform Act of 1969, the normal tax exemption of a CRT could be lost for any year in which the CRT had any UBTI – even a small amount. Because of the potentially disastrous consequences, this rule caused some gift plans to be reconfigured with sometimes awkward complexity and others to be abandoned completely. For these purposes, UBTI might result from the funding of a CRT with an interest in an operating business; for example, a business held in a partnership or other conduit entity like a limited liability company. UBTI can also result from acquisition indebtedness – the classic example is receiving real estate subject to a mortgage or other encumbrance. If this acquisition indebtedness does not qualify for one of the statutory exceptions, the result could be UBTI of the debt-financed variety, causing the trust to lose its tax exemption in the year the property is disposed of by the trust.

### **New Rules**

Under the new law, having a little UBTI will not cause the CRT to lose its tax exemption. Instead, a 100% excise tax will be imposed on the amount of the UBTI, itself. The statutory language is fairly straightforward:

*"In the case of a [CRT] which has UBTI . . . for a taxable year, there is hereby imposed on such [CRT] an excise tax equal to the amount of such UBTI."*

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transactional tax



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### A Blessing Or A Curse?

This is a good thing, right? After all, the gift planning community had been pushing for a number of years for an amendment to Code Section 664 that would allow CRTs to pay tax on UBTI (although, it must be said, at regular rates rather than a confiscatory 100% rate), but otherwise, retain their tax exemption.

The cases where this new rule will really help involve CRTs funded with highly appreciated assets generating a small amount of UBTI.

**Illustration:** The CRT will be funded with a mobile home park with a market value that is \$2,000,000 in excess of its basis, which nets \$50,000 per year from the small convenience store located on the property. Assuming that the property would be in the CRT for 3 months before it is sold, 1/4 of this amount, or \$12,500 would be UBTI. Under the old rules, this small amount of UBTI could strip the CRT of its tax exemption in the year of sale, resulting in federal income tax of at least \$300,000 (15% of \$2,000,000). Under the new rules, the capital gain would be within the general tax exemption of the CRT and only the UBTI from the store would be subject to tax, at 100%, resulting in total tax for the CRT of only \$12,500. Unintended consequences can arise, however, if the UBTI results from debt financed income.

Assume the same facts as the last illustration, and a basis in the mobile home park of \$100,000. To prepare the property for sale, the trustee of the CRT borrows \$100,000 to spruce the place up with new signage, landscaping and a coat of paint. The debt will result in UBTI of the debt-financed variety. Under Code Section 514, the taxable portion of income realized from the investment is based on the ratio of the debt (\$100,000) to the basis in the property (\$100,000) or 100%. This results in the entire gain from sale of the property of \$2,000,000 being UBTI, resulting in tax of \$2,000,000 (and after tax proceeds from the sale of an asset for \$2,100,000 of only \$100,000). Note that under the old rules, the UBTI would have made the trust taxable at normal rates, resulting in tax of, say, \$300,000, and net proceeds of \$1,800,000.

The bottom line is that, generally speaking, the amendment to Section 664(c) allowing CRTs to realize (and pay tax on) UBTI will be helpful to gift planners. But care must be taken, especially with encumbered property, to make sure that we are not making a bad situation worse.

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