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Through a regulation issued in December 1998, the Internal Revenue Service (IRS) officially gave its blessing to a type of charitable remainder trust (CRT) known as the “flip trust.” As anticipated, this now well-accepted planned giving vehicle has proven to be quite versatile.

Flip Trust Basics

As its name suggests, a flip trust starts out as a charitable remainder unitrust (CRUT) having one kind of structure, but then “flips” to have a different structure during the rest of the trust term. In particular, a flip trust must begin with a net-income limitation, meaning it will be either be:

- a net-income CRUT (NICRUT) or
- a net-income with make-up CRUT (NIMCRUT)

initially and then will be transformed into a standard CRUT (SCRUT). It is not possible to have a flip trust that begins as a CRUT and then becomes a charitable remainder annuity trust (CRAT), nor is the opposite possible.

The flip occurs in connection with what the IRS refers to as a “triggering event,” about which more will be said momentarily. At the start of the taxable year of the trust (which, in the case of a CRT, is the same as the calendar year), after the taxable year in which the triggering event has occurred, the trust commences its existence as a SCRUT going forward. It cannot become a NICRUT or a NIMCRUT again.

Example

If a CRUT is funded with assets worth $500,000 and has a payout rate of five percent, to what extent does the trust’s structure affect how it will perform over time based on certain assumptions? Specifically, it is assumed that during each of the trust’s first five years, its assets appreciate in value at a rate of six percent although its net income is only one percent. This means that if the trust has a net-income limitation during those years (either because it is structured as a NICRUT or a NIMCRUT or because it is structured as a flip trust that has not yet flipped), only

the one-percent amount can be paid out. By contrast, a SCRUT pays out five percent of its value every year throughout its existence, regardless of net income.

It is further assumed that each year starting in the sixth year and continuing for the balance of the trust's existence, its assets appreciate in value at a rate of five percent and it earns net income of three percent. If the trust is structured as a NICRUT or a NIMCRUT, only the three-percent amount will be paid each year going forward. In the case of a flip trust that becomes a SCRUT at the beginning of year six, however, five percent of its value will be paid annually henceforth.

Here are the results generated using PG Calc's *Planned Giving Manager*:flip

The Art and Science of the Triggering Event

The triggering event must be defined in the document by which the trust is established. This means not only that settling on the definition cannot be postponed, but also that the drafter of the document needs to get it right the first time (recognizing that there can sometimes be a limited ability to amend a document used to create a CRT). Furthermore, the event must be either a specific date set forth in the trust document, or a single event described in the document whose occurrence is not discretionary with, or within the control of, any trustee or any other person.

Fortunately, in Treasury Regulation Sec. 1.664-3(a)(1)(i)(d) and (e), the IRS provides fairly helpful guidance as to what a permissible triggering event can be. Among the specific possibilities listed are "the sale of unmarketable assets as defined in § 1.664-1(a)(7)(ii), or the marriage, divorce, death, or birth of a child with respect to any individual." The regulation goes on to provide a total of 10 examples of triggering events that are and are not permissible. Together they offer an overview of what sorts of assets are and are not unmarketable, along with what sorts of developments in the lives individuals do and do not constitute sufficient triggering events.

Over the years, PG Calc clients have brought to our attention all sorts of interesting triggering event scenarios. While we admire the imagination of the donors, charities, advisors, and trustees in question, we are ultimately not in a position to provide guidance to anyone beyond pointing them to the applicable regulation. Indeed, even though the examples presented in the regulation should not be viewed as exhaustive of what is possible, anything that differs from those examples should be

approved by legal counsel for all concerned.

Practical Applications of the Flip Trust

When Real Estate Is Involved

Many gift planners have come to regard the flip trust as the CRT of choice when the funding asset is real estate. Using a CRAT is, and always has been, relatively risky. A CRAT is realistic only if 1) the real estate can definitely be sold by the trust for an adequate price no later than the end of the trust's first taxable year, 2) if retained by the trust, the real estate will reliably produce each year rental income comfortably in excess of the annuity amount combined with all trust expenses, or 3) on the day the trust was funded, it received not only the real estate, but also ample cash or liquid assets. If the trust still owns the real estate at the end of any year but does not have enough cash or liquid assets to make its payments and cover its costs, it will need to begin deeding away undivided fractional shares of the property. Such would not be a desirable state of affairs.

A SCRUT represents a somewhat more promising option, mostly because – unlike a CRAT – a CRUT (regardless of how it is structured) can receive additional assets at any time. Thus, if the SCRUT faces a cash crunch, *and if the donor can afford to do so*, the donor can contribute cash or liquid assets worth enough to save the day. Here again, such would not be a very appealing development. Of course, once a SCRUT (or, for that matter, a CRAT) does sell the real estate, it will have cash that will afford the trustee the flexibility of investing trust assets with an objective of maximizing total return.

In light of these considerations, before flip trusts came along CRTs funded with real estate were usually structured as NIMCRUTs, although occasionally the NICRUT structure was chosen. The major benefit of a CRUT subject to a net-income limitation is that it does not need to make any unitrust payments in a given year if it does not earn any net income that year. If it does have some net income, then it needs to pay out only the lesser of that amount or the amount determined by use of the unitrust percentage (plus any make-up amount, if the trust is a NIMCRUT and if the make-up provision comes into play). The drawback is that especially in the current financial environment, once the trust has sold the real estate the trustee will find it difficult or impossible to invest with an objective of maximizing net income yet still actually earn anything equivalent to even the minimum unitrust percentage (5.0%).

Investing to maximize total return would result in still lower net income.

The beauty of a flip trust is that it combines the advantages of both a SCRUT and a trust subject to a net-income limitation without taking on any of the disadvantages. If real estate used to fund a trust initially is to be sold, the trustee can spend whatever time is needed to market the property and secure an acceptable offer yet not be under pressure to make trust payments in the absence of cash or liquid investments. Once the property has been sold (which triggers the flip), the trustee can invest the proceeds to maximize total return without compromising the amounts distributed to the income beneficiaries, an investment approach that will likely aid both the income beneficiaries and the charitable remainder beneficiaries in the long run.

As a Charitable Retirement Plan

In the days before flip trusts, donors would often fund a NIMCRUT with cash or long-term, appreciated publicly-traded securities that the trustee would sell to produce cash. The trust’s assets would then be reinvested in stocks selected to maximize growth in value. Once the income beneficiary reached retirement age, the trustee would sell the stocks and reinvest the proceeds in a portfolio designed to maximize net income, ideally earning enough to capitalize at least partially on the make-up provision.

An alternative was for the trustee to acquire a commercial deferred variable annuity contract shortly after the trust was established. Ideally, the value of the contract would increase significantly over the years (as a result of the investment account linked to the contract having experienced success with a growth objective). When the income beneficiary began to need retirement cash flow, the value of the annuity contract would be tapped by the trustee in order to produce net income that could be paid to the income beneficiary.

As discussed already, the problem with the first approach has been the difficulty in earning a decent level of net income during the last many years. The problem with the second approach is that all unitrust payments derived from a commercial annuity owned by a CRT are taxed to the income beneficiary at his or her highest marginal rate. In addition, an annuity contract sometimes features hefty fees in connection with money drawn out of the contract.

With the understanding that investing for growth – whether directly or through an account linked to an annuity contract – is by no means guaranteed to produce the desired results, if a flip trust is structured so that the triggering date is a point in the future when the income beneficiary thinks he or she will begin to want extra cash to finance his or her retirement, then the ability of the trustee to invest for growth until the flip occurs and then for total return from that point on gives a retirement flip trust an edge over a retirement NIMCRUT.

Of course, the triggering date has to be settled upon when the trust is established, and as the years go by, the income beneficiary might wish a different date had been identified. In view of the fact that two of the examples in the Treasury Regulation discussed earlier appear to be aimed at preventing retirement flip trusts from having impermissible triggering events, it is fair to say the IRS is on the lookout for clever attempts to disguise what would amount to someone’s exercise of discretion.

The (Some Low Number)-Percent Solution

Whether in connection with a retirement CRUT or with some other set of goals to be accomplished with a CRUT, it would in fact be wonderful if discretion over when a flip trust changes its structure could be exercised in a legally acceptable manner. As it turns out, the aforementioned Treasury Regulation supplies the answer. By way of example, a trust could be funded predominantly with liquid assets but also with an illiquid asset (specifically, one that meets Treasury Regulation 1.664-1(a)(7)(ii)’s definition of an “unmarketable asset”) having a relatively modest value. Although it might take the trustee a period of months to sell the illiquid asset for an acceptable price, the trust can then flip at the start of the year following the sale. So long as the trust continues to own the asset, however, it exists as a sort of built-in trigger mechanism the trustee can make use of more or less at will.

Ways to Avoid Flippin’ Out

Regardless of who is wearing which hat or hats, so long as the donor, the trustee, and the income beneficiary understand how net-income limitation CRUTs work and how SCRUTs work, the transition should go smoothly. That being said, it is helpful to keep a few points in mind.

First, thanks to various template agreements contained in a series of Revenue Procedures issued by the IRS in 2005, drafting a properly worded flip trust instrument is a fairly simple matter, so long as care is used in defining the triggering

event. What this implies, however, is that before the Revenue Procedures were issued, drafters of such instruments faced a somewhat greater challenge in getting things right. Thus, if an existing flip CRUT is governed by such an instrument, then the document should be reviewed for ways in which it may differ materially from the approach in the IRS templates (which ultimately represent simply a “safe harbor,” rather than the one and only way a trust instrument must be worded). Oh, and some trusts flipped not because their trust instruments provided for it initially but because there was a “window” of about 18 months from late 1998 until the middle of 2000 when a flip could be accomplished by following applicable state law procedures for revising trust instruments.

Next, when the trust tax return is filed for the final year the trust was subject to a net-income limitation, the trustee must inform the IRS that the trust has been flipped. This entails describing the triggering event, as well as the date it occurred, and indicating whether the trust began as a NICRUT or a NIMCRUT. If it was a NIMCRUT, then the make-up provision ceases to be effective as of the first day the trust begins to operate as a SCRUT.

Finally, the time between the date of the triggering event and the end of the last taxable year the trust was subject to a net-income limitation is a bit of an interim period. Accordingly, if the trustee decides to begin investing for total return during this period, that should be fine. By contrast, the trustee might want to make one last push to earn net income that can be paid out to the income beneficiary by virtue of the make-up provision if the trust started out as a NIMCRUT. That, too, should be fine, although expectations of actually achieving that objective in a matter of at most a little less than 12 months should be tempered by reality. And if perhaps the life income beneficiary decides during the interim period to terminate the trust (whether by contributing his or her income interest to the charitable beneficiary or by entering into a “cash out” arrangement with the charity), he or she needs to be aware that the trust will still be treated as one subject to a net-income limitation. In light of a couple of private letter rulings issued by the IRS in 2007, the income beneficiary might well end up deriving less economic benefit from a termination than if he or she were to wait until the trust begins to operate as a SCRUT.

Conclusion

On the one hand, there continue to be a number of situations that are best addressed by CRTs that are not flip trusts. On the other hand, in certain circumstances a flip trust is the number one choice. However a CRT is structured, it

remains important for all parties with an interest in the trust to make sure it is serving its intended purposes as well as possible. This means making sure trust assets are invested suitably, trust accounting is handled correctly, and other aspects of trust administration are receiving necessary attention. Furthermore, if the donor has retained the right to change charitable remainder beneficiaries from time to time, he or she should make sure that the current beneficiaries are the right ones and that they are designated to receive the right shares of the remainder. And if a CRT is not functioning as it should and things can’t be improved, that might be the occasion for assessing whether it should be terminated or perhaps transformed into a charitable gift annuity. In short, making a wise choice about how a CRT should be structured is simply one important detail among many.

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