

Charitable Planning Opportunities

Charitable Lead Trusts Reference Outline

**Deren L. Worrell
Jeffrey N. Myers
Michael V. Bourland**

Bourland, Wall & Wenzel,
A Professional Corporation
Attorneys and Counselors
301 Commerce Street, Suite 1500
Fort Worth, Texas 76102
(817) 877-1088 (Telephone)
(817) 877-1636 (Fax)

www.bwwlaw.com (website)
mbourland@bwwlaw.com (email)

Presented to

San Antonio Estate Planners Council

May 17, 2011

San Antonio, Texas

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Speaker

MICHAEL V. BOURLAND
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

Mr. Bourland is the founding shareholder of Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represent individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Bourland was born in Fort Worth, Texas on October 2, 1943. He earned a B.A. from Baylor University and his J.D. from Baylor University School of Law. He earned his LL.M. in Taxation from University of Miami, Florida. Additionally, he was a Captain in JAGC, USAF, 1970-1975.

Mr. Bourland was admitted to practice law in Texas in 1969 and is Board Certified in Estate Planning and Probate Law (Texas Board of Legal Specialization). He is a member of the American Bar Association; State Bar of Texas and its Real Estate, Probate and Trust Law Section (Real Estate, Probate and Trust Law Council, 1993-1996); Tarrant County Bar Association (Director, 1987-1989); Tarrant County Probate Bar Association; Fort Worth Business and Estate Council (Chair, 1992-1993); and a Fellow of the American College of Trust and Estate Counsel.

Mr. Bourland's practice is directed to business, tax, estate planning, probate, charitable entity and charitable giving law. Mr. Bourland is a guest lecturer in estate planning at Baylor University School of Law, Baylor University School of Business, Southern Methodist University School of Law, University of Texas School of Law and The Center for American and International Law. He speaks regularly throughout the United States on subjects within his practice areas at seminars conducted by, among others, American Bar Association, American Law Institute-American Bar Association, Texas Bar Association, Texas Society of CPAs and Notre Dame, Duke and Tulane Universities.

Additionally, he speaks regularly to churches and church leaders on the creation of church foundations and contributes on subjects within his practice areas to publications including the New York Times, Nation's Business, Business Week and Money magazine. Mr. Bourland is a co-author of [Keeping Your Church Out of Court](#), first, second and third editions. Mr. Bourland is adjunct professor of law, co-teaching the Nonprofit Organizations course of the Baylor University School of Law.

Author

Jeffrey N. Myers
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

EDUCATION

B.A., University of Texas
J.D., California Western School of Law
LL.M. – Taxation, University of San Diego School of Law

PROFESSIONAL ACTIVITIES, ACADEMIC APPOINTMENTS AND HONORS

Shareholder - Bourland, Wall & Wenzel, P.C.
Fellow of The American College of Trust and Estate Counsel
Board Certified (Estate Planning and Probate Law) – Texas Board of Legal Specialization

GUEST LECTURER IN ESTATE PLANNING

Texas Society of CPAs – Fort Worth Chapter (2000-2007)
Brazos Valley Estate and Financial Planning Council (2001-2003)
State Bar of Texas Advanced Estate Planning and Probate (2001, 2002, 2004-2007)
State Bar of Texas Advanced Drafting – Estate Planning (2002, 2008, 2009)
State Bar of Texas Advanced Estate Planning Strategies (2009, 2010)
State Bar of Texas Charitable Giving Program (2004)
Center for American and International Law - 42nd Annual Program on Wills & Probate Law (2003)
Texas Bankers Association Trust School II (2003-2007)
State Bar of Texas - State Bar College Summer School (2006)
Smith County Bar Association (2006)
Second Annual Tax and Financial Planning Institute - McLennan Community College (2006-2008)
University of Texas – 54th Annual Taxation Conference (2006)
Family Wealth Advisory Council Meeting (2007)
Estate Planning and Community Property Law Journal – Texas Tech (2009)
Adjunct Instructor 1998-1999 – University of Texas at Arlington, Continuing Legal Education

Author

DEREN L. WORRELL
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

Deren L. Worrell joined the law firm of Bourland, Wall & Wenzel as an associate in 2007. Originally from Florence, Kentucky, Mrs. Worrell graduated summa cum laude in 2004 from the University of Kentucky in Lexington, KY with a Bachelor of Arts in Political Science. She earned her J.D. in July 2007 from Baylor Law School in Waco, TX, where she was a member of the Order of the Barristers, National Champion of the 2006 American Bankruptcy Institute National Moot Court Competition in New York, NY, and the winner of the 2006 Professor Larry T. Bates Excellence in Advocacy Award.

Mrs. Worrell's practice focuses primarily on tax, estate planning, probate, charitable entity and charitable giving law. She represents numerous professionals, charitable entities, families, and family and closely held businesses within her and the firm's areas of expertise, including gift and estate planning, employee benefit planning, personal and business planning for family businesses and professions, probate, fiduciary representation, and charitable giving, particularly the establishment and governance of public charities and private foundations.

Mrs. Worrell is the co-author of "Governance in the World of Family Foundations", presented to the Non-profit Organizations Section of the State Bar of Texas in August 2008.

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The authors gratefully acknowledge Shannon G. Guthrie for her contribution to this outline.

CHARITABLE LEAD TRUSTS

I. ATTRIBUTES OF CHARITABLE LEAD TRUST (“CLT”)

A. Payment – Charitable Lead Interest

Annual (or more often) payments to charitable beneficiary for a number of years or for a life or lives in being at the trust’s creation. But see subparagraph C below regarding proposed regulations limiting permissible term.

1. ANNUITY TRUST

Payment is a fixed dollar amount or a fixed percentage of the initial net fair market value of the trust assets. IRC §§ 2522(c)(2), 2055(e)(2) and 170(c); Treas. Reg. §§ 25.2522(c)(3) and 1.170A-6(c).

2. UNITRUST

Payment is a fixed percentage of the net fair market value of the trust assets determined annually. IRC §§ 2522(c)(2), 2055(e)(2) and 170(c); Treas. Reg. §§ 25.2522(c)(3) and 1.170A-6(c).

The Annuity Trust has traditionally been the preferred form of a CLT because remaindermen benefit from appreciation of the trust assets without gift or estate taxation (but with potential generation-skipping transfer taxation) and the assets do not need to be revalued each year for determining the charitable payment. However, the IRC now requires the Annuity Trust (but not the Unitrust) to be valued at the end of the charitable term for Generation-Skipping Transfer Tax (“GST”) purposes using the interest rate used for valuing the charitable interest at the time of funding the trust and applying it to the value of the remainder interest at the time of funding, compounded annually. IRC § 2642(e). (See GST paragraph below.)

Formula Clauses: The use of a formula clause has been allowed by the Service as long as the gift is determinable at the time of the transfer. *Planning idea:* make the formula have one variable (either the term or the payment amount) calculated to result in a certain gift amount.

B. Distributions in Satisfaction of Annuity or Unitrust Payment

The CLT instrument may provide for the payment of the annuity or unitrust interest to be made in cash or in kind. If the trust distributes appreciated property in satisfaction of the annuity trust or unitrust payment, the trust will realize capital gains on the assets distributed in kind to satisfy the annuity or unitrust payment. Rev. Rul. 83-75, 1983-1 C.B. 114. See also, P.L.R. 9201029 (Oct. 7, 1991) applying Rev. Rul. 83-75 to the income tax treatment of distributions of appreciated stock in satisfaction of a lead unitrust payment.

Planning Opportunity: Establish the trust with appreciated stock and distribute stock to satisfy the annuity or unitrust payment. The CLT will recognize the gain and the CLT will receive an income tax charitable deduction for the amounts paid to charity resulting from the realization of the capital gain. (See discussion of income tax treatment of the non-grantor and grantor charitable lead trusts below.)

C. Term

Payments can continue for the life or lives of one or more individuals, all of whom must be living when the trust is created or for a term of years (limited only by the applicable rule against perpetuities). Treas. Reg. §§ 1.170A-6(c)(2)(i)(A) and (ii)(A); Treas. Reg. §§ 20.2055-2(e)(2)(v)(a) and (vi)(a); Treas. Reg. §§ 25.2522(c)-3(c)(2)(v)(a) and (vi)(a). However, the Service issued proposed regulations on April 5, 2000, (Proposed Reg. 100291-00, 65 Fed. Reg. 17835 (4/5/00) and Final Regulations, effective January 5, 2001, whereby the permissible term for charitable lead trusts is defined so as to prevent abuse in obtaining inflated charitable deductions.

The problem: taxpayers have been using an unrelated individual’s measuring life as the term of the charitable lead trust where that unrelated individual is seriously ill, but not “terminally ill” as defined under I.R.C. § 7520 and the Regulations thereunder. (See, for example, Treas. Regs. § 20.7520-3(b)(3)). The value of the charitable interest is calculated under the applicable actuarial tables, which are based upon the average life expectancies of individuals of the same age as the measuring life. However, the life expectancy of the measuring life involved is, in fact, much shorter than the life expectancy of individuals set forth in the actuarial tables. If the individual

dies prematurely (which is expected), the charity's interest is terminated resulting in the remainder beneficiaries receiving their interest sooner than anticipated by the tables at a reduced gift or estate tax of that based upon the lives of those provided in the tables. The measuring life individual is paid a fee for allowing the trust creator to use such individual as the measuring life. The Service believes that this type of charitable lead trust is abusive and frustrates the Congressional intent of allowing deductions for certain split-interest trusts and further that the marketing of such is against public policy. *The Service's Solution:* the final regulations limit the permissible term for a guaranteed annuity interest and unitrust interest to a specified term of years, or the life of certain individuals living at the date of the transfer, such individuals being limited to one or more of the donor, the donor's spouse, or a lineal ancestor or spouse of a lineal ancestor of all of the remainder beneficiaries. Additionally, an interest payable for a specified term of years will also qualify where the governing instrument contains a "savings clause" that is intended to qualify with the rule against perpetuities. A trust will satisfy the requirement that all of the noncharitable remainder beneficiaries are lineal descendants of the measuring life individual (or the spouse of the measuring life individual), if there is less than a 15% probability (computed based upon the current applicable Life Table under Treas. Reg. § 20.2031-7 at the time the property is transferred to the trust, taking into account interest of all primary and contingent remainder beneficiaries living at that time) that individuals who are not lineal descendants will receive any trust corpus. Treas. Dec. 8923.

If a transfer is made to a trust on or after April 4, 2000 that uses an individual other than a permitted measuring life individual, the trust may be reformed to satisfy the rule or may be rescinded for a transfer made on or before March 6, 2001. See Treas. Reg. § 25.2522(c)-3(e). The final regulations apply to transfers to inter vivos charitable lead trusts made on or after April 4, 2000 and to testamentary type transfers where the creator dies on or after such date.

Although comments to the proposed regulations pointed out that the limitations on the measuring lives, although not a bad thing, were too narrow and precluded many situations where the beneficiaries are not related to the creators of the charitable lead trust, the Service did not adopt any of such suggestions, except as they further broadened the class of the measuring lives as described above.

D. Remainder Interest

The remainder interest, after payment of the charitable lead amount, is distributed to the noncharitable beneficiary or beneficiaries, which may include (but is not limited to) the donor, donor's estate, children, grandchildren or other trust or trusts for children or grandchildren.

E. Testamentary and Inter Vivos CLTs

The charitable lead trust may be established as an inter vivos trust (during life) or as a testamentary trust (at death).

F. No Minimum Distribution

Unlike a Charitable Remainder Trust and a Private Foundation, there is no minimum percentage or amount that must be distributed annually and, therefore, the Charitable Lead Trust ("CLT") is not subject to the Annual Minimum Distribution Amount, which is 5% of the initial fair market value of the trust assets (with a charitable remainder annuity trust) and 5% of the annual fair market value of the trust assets (with a charitable remainder unitrust), or 5% of the annual fair market value of the assets of the private foundation. Compare IRC §§ 664(d)(1)(A) and 664(d)(2)(A).

G. Private Foundation Rules

CLT is a split-interest trust under IRC § 4947(a)(2). As such, it is subject to the following private foundation rules:

1. *Self-Dealing:* Trust must not be involved in self-dealing whether direct or indirect with disqualified persons as precluded by IRC § 4941(d). Includes any direct or indirect: a) sale or exchange or leasing of property between trust and a disqualified person; b) lending of money or extension of credit between a trust and a disqualified person; c) furnishing of goods, services, or facilities between a trust and a disqualified person, unless such goods, services or facilities are made available to the general public on at

least as favorable a basis as they are made to the disqualified person, Treas. Reg. § 53.4941(d)(3)(b)(1); d) payment of compensation (or payment or reimbursement of expenses) by a trust to a disqualified person, unless it is for personal services and such compensation is reasonable and necessary to carry out the exempt purpose and is not excessive, Treas. Reg. § 53.4941(d)(3)(c)(1); e) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and, f) agreement by a private foundation to make any payment of money or other property to a government official [as defined in § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. IRC § 4941(d).

Treas. Reg. § 53.4941(d)-1(b)(3) provides an exception to the prohibitions against self-dealing in a transaction involving the administration of an estate or revocable trust if the administrator or executor or trustee either possesses a power of sale with regard to the property, has the power to reallocate the property to another beneficiary, or is required to sell the property under the terms of a preexisting option, such transaction is approved by the probate court having jurisdiction over the estate, the transaction occurs before the estate is considered terminated under Treas. Reg. Sec. 1.641(b)-3(a), the estate or trust receives an amount which equals or exceeds the fair market value of the foundation's (CLT's) interest or expectancy in the property at the time of the transaction taking into account the terms of any options subject to which the property was acquired by the estate and (with respect to transactions occurring after 4/16/73) the transaction either resulted in the foundation receiving an interest or expectancy at least as liquid as the one it gave up, resulted in the foundation (CLT) receiving an asset related to the activity carrying out its exempt purposes or is required under the terms of any option which is binding on the estate or revocable trust.

A “disqualified person” is a substantial contributor to the CLT (an individual, trust, estate, corporation or partnership who or which contributes an aggregate amount in excess of \$5,000 to the CLT, if his or her total contributions are more than 2% of the total contributions received), or a family member of a substantial contributor (spouse, descendants and spouses of descendants), or persons owning more than 20% of an entity which is a substantial contributor to the CLT (includes an entity in which a disqualified person [considering the attribution rules of I.R.C. § 4946(a)(4)] owns more than 35%.)

Reimbursement for Expenses: Reimbursement to disqualified persons for travel expenses cause the CLT and the disqualified person's spouse to be potentially liable for penalty taxes for self-dealing, for making non-charitable expenditures, or possibly both. Such reimbursement of expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the CLT and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is “reasonable and necessary.” Treas. Reg. § 53.3941(d)-3(c)(1). Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. § 1.162-2(a). The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is “excessive.” Under Treas. Reg. § 1.162-7, an amount spent on director's services will not be deemed “excessive” if it is only such as would be paid “for like services by like enterprises under like circumstances.” Treas. Reg. § 1.162-7 (i.e. As the organization would pay to someone independent of the CLT).

A grant by one private foundation (a CLT in this case) to another private foundation does not constitute self-dealing within the meaning of I.R.C. § 4941 even when one entity serves as Trustee of both foundations. Rev. Rul. 82-136 (1982-2 C.B. 300). See also Treas. Regs. Examples 53.4941(d)-2(f)(2).

Excise Tax on Acts of Self-Dealing: Any disqualified person who engages in an act of self-dealing is assessed an excise tax of 10% of that amount involved in the transaction for each year that the transaction is uncorrected. Additionally, a foundation manager who knows the act is prohibited but approves it may also be subject to a tax of 5% of the amount involved (up to \$20,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected and the 5% was

initially assessed, the disqualified person is subject to being assessed an additional tax of 200% of the amount involved. Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to \$20,000 for each such act.)

2. Excess Business Holdings: Trust must not retain excess business holdings as restricted by IRC § 4943(c). To apply, the entity in which an interest is held must be engaged in a business enterprise. IRC § 4943(a)(1). A business enterprise includes the active conduct of a trade or business and also includes any activity which is regularly carried on for the production of income from the sale of goods or the performance of services and that constitutes an unrelated trade or business. Treas. Reg. § 53.4943-10(a)(1). Production of a profit is not required. *Id.* An entity is not engaged in a business enterprise if 95% or more of gross income is from passive activity, IRC § 4943(d)(3), or if the business is a functionally related business defined in IRC § 4942(j)(4). A functionally related business is one which is either (1) a trade or business which is a related trade or business (as defined under I.R.C. § 513), or (2) an activity which is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which is related to the exempt purposes of the organization. I.R.C. § 4943(d)(3)(A); I.R.C. § 4942(j)(4). (*See* Exception subsequent to #6 below.)

If a CLT holds business holdings, it must be determined whether the business holdings are excess business holdings, meaning that they are in excess of permitted holdings. I.R.C. § 4943(c)(1). Three rules apply as to permitted holdings:

- 1) General Rule as to Permitted Holdings: the CLT's holdings in a corporation's voting stock is 20% of the voting stock reduced by the percentage of the voting stock actually or constructively owned by all disqualified persons, I.R.C. § 4943(c)(2)(A);
- 2) The 35% Rule: Where the CLT and all disqualified persons together do not own more than 35% of the voting stock of a corporation and it is established to the satisfaction of the Secretary that effective control is in one or more persons who are not disqualified persons with respect to the CLT, then the 20% General Rule becomes a 35% rule, I.R.C. § 4943(c)(2)(B)-I; and,
- 3) 2% De Minimus Rule: The CLT is not treated as having excess business holdings in any corporation in which it, together with all other private foundations, owns not more than 2% of the voting stock and not more than 2% in value of all outstanding shares of all classes of stock, I.R.C. § 4943(c)(2)(C).

Exception For Gratuitous Transfer: If the CLT is determined to have excess business holdings and the receipt of the assets constituting excess business holdings is by gratuitous transfer, then the assets received are treated as being held by a disqualified person for 5 years after the gratuitous acquisition. I.R.C. § 4943(c)(6). The CLT must dispose of the excess business holdings within the 5 year period. An additional 5 year extension may be granted to the CLT in order to provide additional time for the CLT to dispose of the excess business holding received by gratuitous transfer. The discretion is given to the Secretary to extend the period of disposition in the case of unusually large gifts or bequests of diverse holdings with complex corporate structures. I.R.C. § 4943(c)(7). The extension may be given provided that the following requirements are met:

- 1) the CLT establishes that it has made diligent efforts to dispose of the excess business holdings within the initial 5 year period;
- 2) disposition of the excess business holdings within the initial 5 year period has not been possible (except at a price substantially below fair market value) by reason of such size and complexity or diversity of the excess business holdings;
- 3) before the end of the initial 5 year period, the CLT a) submits to the Secretary a plan for disposing of all of the excess business holdings involved; b) the CLT submits such plan to the Attorney General (or other appropriate State official) having administrative or supervisory authority or responsibility with respect to the CLT's disposition of the excess business holdings and submits to the Secretary any response received by the CLT from the Attorney General (or

- other appropriate State official) to the plan within the 5 year period; and,
- 4) the Secretary determines that such plan can reasonably be expected to be carried out before the close of the extension period.

Corporate Redemption: One way to dispose of the excess business holding is to have the corporation redeem the excess business holding of the CLT. This includes holdings of a partnership in a corporation since the CLT is attributed with owning the shares of the corporation. However, in redeeming the stock, care must be taken not to violate the rules against self-dealing. (*See generally*, the discussion above regarding self-dealing.) In the case of a corporate redemption, the involved act of self-dealing is the direct or indirect sale or exchange of property between a disqualified person and a private foundation. I.R.C. § 4941(d)(1)(A). The CLT is treated as a private foundation for these purposes. However, as to acts which would be an act of self-dealing, an exception is provided where liquidation or redemption of stock held in a private foundation (or CLT) is to a disqualified person which is the corporation if:

- 1) the corporation makes a bona fide offer of liquidation or redemption on a uniform basis to the private foundation (or CLT) and to every other person who holds stock in the corporation; and,
- 2) the liquidation terms provide for the liquidation at a price which is no less than fair market value. Further, the corporation cannot use a note to redeem its stock from the private foundation (or CLT). Treas. Reg. § 53.4941(d)-2(c)(1); Treas. Reg. § 53.4941(d)-3(d). The exception for redemption on a uniform basis exception has been applied to partnerships in P.L.R. 9237032.

Excise Tax on Excess Business Holdings: the CLT is taxed on its excess business holdings in the amount of 10% of the value of the excess business holding. A penalty of 200% is imposed on the CLT if the initial penalty is assessed and the excess business holding is not timely corrected. I.R.C. § 4943(b). Although the CLT has a 5 year time period to dispose of the excess business holding, the disposition of such holding is subject to the restrictions against acts of self-dealing.

3. Jeopardizing Investments: Trust must not make investments which would jeopardize the carrying out of the exempt purpose as prohibited by IRC § 4944. (*See* Exception subsequent to #6 below.) Although no investment is a *per se* violation, this rule requires close scrutiny of the standard of care in investment of the assets of the CLT when the trustees have invested in speculative investments such as working interests in oil and gas, trading on margin, trading in commodity futures, purchase of “puts” and “calls” and “straddles”, warrants and selling short. This restriction addresses actions of investing and does not cover assets received by a CLT by gift or bequest.

Excise Tax on Jeopardizing Investments: The CLT is not allowed to invest its funds in investments which could jeopardize the CLT’s ability to carry on its exempt purpose. If it does, it is taxed 10% of the amount of the improperly invested assets (not to exceed \$10,000). Additionally, each trustee who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the CLT’s exempt purposes may be subject to being assessed a tax of 5% of the amount of the improperly invested assets. If the investment is not disposed of within 90 days after imposition of the initial tax, the CLT is liable for an additional tax of 25% of the amount improperly invested and each trustee who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the exempt purposes may be subject to being assessed an additional tax of 5% of the amount of the improperly invested assets (up to \$20,000).

4. Taxable Expenditures: Trust must not make taxable expenditures as governed by IRC § 4945(d). This covers amounts paid for propaganda or to attempt to influence legislation or the outcome of a public election, amounts paid to carry on any voter registration drive, or amounts paid as certain grants. IRC § 4945(d). The excise tax imposed on taxable expenditures is 20% of the amount involved. The tax imposed on trustees who knowingly participate in or approve the foundation’s taxable expenditure is 5% (not to exceed \$10,000). If the taxable expenditure is not corrected, there is an additional tax of 100% of the amount of the expenditure. If the additional tax is imposed and the trustees

refuse to agree to the correction of the taxable expenditure, the trustees could face an additional 50% penalty on the amount of the taxable expenditure (up to \$20,000).

5. Termination Tax: Trust is subject to “termination of private foundation status” of IRC § 507. The tax is the lower of the aggregate tax benefit resulting from status as a private foundation or the fair market value of its net assets. IRC § 507(c).
6. Governing Instrument Requirements: Trust must meet “governing instrument language” of IRC 508(e). This includes provisions, the effects of which are to require income to be distributed so as to not subject the foundation to tax under IRC § 4942 and to prohibit foundation from engaging in self-dealing, retaining any excess business holdings, making jeopardizing investments and making taxable expenditures.

Exception:

Under IRC § 4947(b)(3)(A), the excess business holdings and jeopardy investment restrictions are not applicable if the charitable interest of the CLT at inception does not exceed 60% of the aggregate fair market value of the trust assets at inception and the CLT income interest (and none of the remainder interest) is devoted to specified charitable purposes. This exception allows the qualified CLT to hold closely-held stock if the value of the charitable interest does not exceed 60% of the value of the trust assets at inception of the trust.

Planning Opportunity:

By using a testamentary CLT that satisfies the exception described above, a decedent may retain control of a family corporation while reducing the estate tax on transfer of the stock to children or other beneficiaries and receive an income tax basis adjustment on the family corporation stock at death.

II. BASIC DIFFERENCES BETWEEN GRANTOR CHARITABLE LEAD TRUST AND NON-GRANTOR CHARITABLE LEAD TRUST

A. Non-Grantor Charitable Lead Trust

1. Grantor (donor) will not receive an income tax charitable deduction upon contribution to the trust. IRC § 170(f).
2. Grantor (donor) will receive a gift tax charitable deduction upon contribution to the trust based upon the present value of the stream of payments to be made to the charity.
3. Income of the trust is not taxed to grantor. IRC § 641.
4. This trust is most often used as transfer tax reduction technique.
5. The trust receives an unlimited income tax charitable deduction for payments to charitable organizations from gross income. IRC § 642(c). Excess income is taxed at compressed trust income tax rate.

B. Grantor Charitable Lead Trust

1. Grantor (donor) receives an income tax and gift tax charitable deduction upon contribution to the trust. IRC § 170(f)(2)(B). The income tax deduction is the present value of the charitable interest in the charitable lead trust. Treas. Reg. § 1.170A-6(c)(3). The income tax charitable deduction is subject to the limitations on charitable deductions made by individuals under IRC § 170(b).
2. Grantor (donor) is taxed on the income from the trust as it is earned without a corresponding annual income tax charitable deduction. IRC § 671-679.
3. Effect is to convert future charitable contributions into a present income tax deduction and is useful when the donor has an unusually large income in a particular tax year.
4. Must be created as an inter vivos trust.

III. TAXATION OF NON-GRANTOR AND GRANTOR CHARITABLE LEAD TRUSTS

A. Non-Grantor CLT

1. INCOME TAXATION OF TRUST

- a. Non-grantor CLT is a complex trust for income tax purposes under § 641 and as such, is fully taxable as a separate entity for income tax purposes.

- b. It is allowed, under IRC § 642(c), an unlimited income tax charitable deduction for payments of gross income that are, pursuant to the governing instrument, paid for charitable purposes outlined in IRC § 170(c). The grantor of the CLT is entitled to an *income tax* charitable deduction only if the grantor is considered the owner of the income of the trust under the grantor trust rules. *See* discussion of Grantor CLT under B below.
- c. Distributions to charity made in succeeding taxable year according to the governing instrument may be treated as made in the prior taxable year. IRC § 642(c). To do so, the Trustee must make an election on the income tax return (as amended) for the year in which the payment is treated as made, and include a statement that:
- 1) States the name and address of the fiduciary;
 - 2) Identifies the trust for which the fiduciary is acting;
 - 3) Indicates that the Trustee is making an election under I.R.C. § 642(c)(1) in respect of contributions treated as paid during such taxable year;
 - 4) Gives the name and address of each organization to which such contribution is paid; and,
 - 5) States the amount of each contribution and date of actual payment, or, if applicable, the total amount of contributions paid to each organization during the succeeding taxable year, to be treated as paid in the preceding taxable year. Treas. Reg. § 1.642(c)-1.
- If the trust is a testamentary trust, then the obligation to pay the guaranteed payment may commence with the Grantor's death, but may be deferred from the Grantor's death until the end of the year when the funding of the charitable trust occurs. P.L.R. 9047053.
- d. To the extent the lead payments are from unrelated business taxable income ("UBTI"), the IRC § 642(c) charitable deduction is disallowed. (*See* UBTI discussion below.) Notwithstanding, the CLT is allowed an income tax charitable deduction for actual payments allocable to UBTI which are made to charities, subject to the deduction percentage limitations applicable to contributions by individuals, but is not subject to the itemized deduction limitation reduction.
- e. Excess income (after payment of charitable distributions) will be taxed to the CLT at compressed trust tax rates. IRC § 1(e); IRC § 641. However, care must be taken in drafting to assure the desired tax consequence. Income in excess of the required charitable payment may be required to be distributed according to the governing instrument, or required to be held in the CLT according to the governing instrument. If the excess is required to be distributed to charity, then the CLT will receive a full income tax charitable deduction for the amounts paid to charity from the income. I.R.C. § 642(c). If the excess income is held in the CLT, then the CLT will have taxable income that will be taxed at the trust compressed tax rates. I.R.C. § 641. If the governing instrument gives the Trustee the discretion as to whether to accumulate or distribute the excess income, then other tax implications may arise depending upon who is serving as Trustee. (*See also* discussion of Independent Trustee below.)
- I.R.C. §§ 671-678 provide the situations in which a trust can be considered a grantor trust thereby taxing the grantor on the income of the trust. These provisions set forth the means by which a trust becomes a grantor trust resulting in the grantor being taxed for income tax purposes on the portion of the trust over which the grantor has specified powers. If a grantor or non-adverse party has the power to effect the beneficial enjoyment of the corpus or income of a trust because of a power of disposition, exercisable by the grantor alone or in conjunction with others, the grantor is treated as the owner of the portion of the trust over which the power exists. I.R.C. § 674(a).

An adverse party is any person having substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. I.R.C. § 672(a). The power to allocate or distribute income is a power to direct the enjoyment of trust income and, therefore, I.R.C. § 674(a) would apply unless the Trustee is an adverse party or one of the exceptions applies. If the Trustee has the discretion to accumulate or distribute excess income, this discretion directly affects what the charity and the remainder beneficiaries receive. If the Trustee is not a beneficiary, or is one of several beneficiaries, then he is a non-adverse party as to the trust interest being held for the benefit of beneficiaries other than himself. Alternatively, he is an adverse party only as to his own interest and, therefore, the excess income (or the portion which is not subject to his adverse interest) will be income taxable to the grantor. This discretionary power would not, as a result, create a pure grantor trust whereby the grantor would be taxed on all income of the trust but would tax the grantor only on that portion of the trust over which the grantor or non-adverse party has the power to distribute or accumulate income in excess of the annuity or unitrust payment. See Jennifer I. Last, Is it a Grantor Charitable Lead Trust or Not? – How the Grantor Trust Rules Interact with the Charitable Lead Trust, 30 J.P. Marshall L. Rev. 1023 (Sum. 1997). Other powers, such as a power to revoke, would create a purely “grantor” trust thereby taxing the grantor on all income of the CLT. I.R.C. § 676(a).

2. UNRELATED BUSINESS TAXABLE INCOME (“UBTI”)

a. UBTI, In General

UBTI generally arises in two situations: 1) when the CLT has income from an unrelated trade or business; or, 2) when the CLT has income incurred with respect to debt-financed property. IRC § 512(a)(1); § 514(a)(1); and § 514(a)(2).

1) INCOME FROM AN UNRELATED TRADE OR BUSINESS

A CLT must include in its unrelated business income the gross income from any regularly conducted trade or business which is not substantially related to the performance of the organization’s exempt function. Treas. Reg. § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105, (1986). This includes income when an exempt organization is a partner, limited or general, in a partnership which carries on a trade or business wholly unrelated to the exempt organization’s purposes, regardless of whether or not the income from the trade or business is actually distributed. See IRC § 512(c)(1); Treas. Reg. § 1.681(a)-2(a). See also, *Service Bolt & Nut Co. Profit Sharing Trust v. Comr.*, 78 T.C. 812 (1982). “Unrelated trade or business” does not include: 1) any trade or business in which substantially all the work in carrying on the trade or business is performed for the exempt organization without compensation; 2) any trade or business carried on by an IRC § 501(c)(3) organization or by an IRC § 511(a)(2)(B) governmental college or university, primarily for the convenience of its members, students, patients, officers or employees; or 3) any trade or business which consists of selling merchandise, substantially all of which is received by the organization as gifts or contributions. IRC § 513(a). The income and deductions are subject to the modifications under § 512(b).

2) EXCLUSION OF ITEMS FROM UBTI

Some items excluded from UBTI are dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, income from research for the U.S., income of a college, university or hospital, or income for fundamental research. IRC § 512(b). (See also PLR 200147058 and PLR 200148074 where

the Service mentions many types of services that would be excluded where a landlord charity receives income (fixed fee or based upon percentage of third party's revenue [or both] from telecommunications agreements) in exchange for exclusive right to market such services, including multi-channel television, video-on-demand, Internet access and data transmission services, video services, telephone services, radio services, ancillary security services, ancillary medical services and other information retrieval services.)

(a) Example 1

If the CLT holds a pass-through interest (for income tax purposes) in a factory, which is an operating business, the CLT will have UBTI to the extent it has income from the operation of the factory.

(b) Example 2

If the CLT holds an interest in a partnership which owns rental real property, exclusively, and there is no debt related to the property, the CLT will not have UBTI because the income is from passive rental real property.

3) INCOME OR DEDUCTIONS INCURRED WITH RESPECT TO "DEBT-FINANCED PROPERTY"

Except for limited exclusions, a CLT has unrelated business income if it has income incurred with respect to debt-financed property. IRC § 512(a)(1), § 514(a)(2). "Debt-financed property" includes any property held to produce income (including gains from disposition of property) and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property or the property secures the debt) at any time during the taxable year. IRC § 514(b)(1); Treas. Reg. § 1.514(b)-1.

"Acquisition indebtedness" is generally the indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of the acquisition. See IRC § 514(c)(1); Treas. Reg. § 1.514(c)-1. If proceeds from the debt financed property are used to acquire or improve property, the debt is considered to be "acquisition indebtedness" related to "debt financed property" even if the debt is not secured by the property. Deeds of trust, conditional sales contracts, chattel mortgages, security interests under the Uniform Commercial Code, pledges, agreements to hold title in escrow and tax liens not subject to IRC § 514(c)(2) are all treated as similar to mortgages for purposes of applying IRC § 514(c)(2)(A).

b. Effect of UBTI on Non-Grantor CLT

The Non-Grantor CLT, like an exempt organization, is subject to the rules regarding UBTI. IRC § 501(a), § 501(c)(3); § 511(a)(2)(A), § 511(b)(2). See Treas. Reg. § 1.501(c)(3)-1(e)(2); § 1.511-2(a)(1)(i), and § 1.511-2(b)(1). As a result of the application of these rules, to the extent the CLT has unrelated business taxable income that is paid to a charity, the charitable income tax deduction under IRC § 642(c) is disallowed because the unrelated business income is subject to taxation under the rules governing UBTI. Notwithstanding, the CLT is allowed a deduction for actual payments allocable to UBTI made to charity, subject to the adjusted gross income percentage limitations applicable to charitable contributions made by individuals. IRC § 681(a). The CLT is not subject to the reduction in the income tax charitable deduction applicable to individuals under the itemized deduction limitation.

c. Examples of Application of UBTI Rules to Non-Grantor CLT

A CLT owns an interest in a real estate limited partnership. The partnership will be required to incur indebtedness to complete construction and finishing of certain rental units before tenants take possession of the lease premises. Since the CLT will hold an interest in the partnership and does not qualify under any exclusion or definition of a “qualified organization”, the indebtedness is subject to IRC § 514 and, therefore, the CLT has UBTI to the extent income arises from the debt-financed property.

3. ALTERNATIVE MINIMUM TAX (“AMT”)

Alternative minimum tax is applicable to a charitable lead trust only to the extent the alternative minimum tax exceeds the trust’s regular tax. IRC § 55(a). If the trust’s regular tax is lower than the AMT, it is subject to AMT. IRC § 55 et seq. The income subject to AMT is equal to the excess of the trust’s “tentative minimum tax” for the tax year over the trust’s “regular tax” for the tax year. IRC § 55(a). The tentative minimum tax is 26% of the AMT base not exceeding \$175,000 plus 28% of the excess, reduced by the AMT foreign tax credit. IRC § 55(b)(1). The AMT base is the alternative minimum taxable income less the exemption amount. IRC § 55(b)(1). (After 1993, exemption is \$22,500 for trusts which is phased out for high income taxpayers. IRC § 55(d).) However, in 1982, adjusted itemized deductions were eliminated as an item of tax preference for irrevocable inter vivos charitable lead trusts. *See* T.M. Portfolio 866: Charitable Income Trusts. *See also* Treas. Reg. § 1.58-3T. Temporary regulations provided that itemized deductions, which are not alternative minimum tax itemized deductions, are treated as tax preference items for former IRC § 58(c) and should be apportioned between the trust and beneficiaries. *Id.* The effect of this change was that, subsequent to this change, the only item of tax preference of consequence to a charitable lead trust was the capital gains preference, which was eventually eliminated. *See* T.M. Portfolio 866: Charitable Income Trusts.

4. CAPITAL GAINS TAX

Gains may be allocated to corpus or income as governed by the trust instrument. When the instrument is silent on capital gains, local law applies, generally allocating gains to corpus. If gains are allocated to corpus, they will not be income tax deductible even if distributed to a charity as part of a lead trust payment. *See* Rev. Rul. 83-75, 1983-1 C.B. 114.

5. TIER SYSTEM OF ALLOCATION

If neither local law nor the trust instrument dictates the nature of payment made to charitable beneficiaries, the amounts may be deemed to be pro rata distributions of the income of the trust. Treas. Reg. 1.643(a)-5(b) and § 1.662(b)-2; Rev. Rul. 71-285, 1971 - 12 C.B. 248. *But see* PLR 8727072. In PLR 9233038, the Service stated that the tiered allocation of income in the trust would not be given effect for federal income tax purposes and that trust income would be deemed to come proportionately from each class of income. That case involved a 6% charitable lead unitrust which paid the unitrust amount to the grantor’s family foundation. The governing instrument provided that if ordinary income was not sufficient to pay the unitrust amount, the lead amount would be considered as taken first from long term capital gains, then out of tax exempt income, and finally out of principal. This was an attempt to impose on the charitable lead trust a tier system of taxation which applies to remainder trusts. Despite the Service’s ruling to allocate the income pro rata, the trust was, nevertheless, approved.

6. ESTATE/GIFT TAX

Grantor contributes property to the trust (CLT) and pays tax only on the value of the remainder interest. Treas. Reg. § 1.170A-6(c)(3). The appreciation in a lead trust of trust assets escapes transfer tax. It is possible to achieve a charitable contribution deduction of close to 100% of the trust assets by use of certain discount rates.

7. GENERATION SKIPPING TAX (“GST”)

Whether or not GST applies depends upon the status of the remainder beneficiaries and whether CLUT or CLAT.

- a. Where income or corpus is transferred to a skip person (certain relatives two or more generations below grantor's generation or, absent such relationship, any individual born more than 37 ½ years after grantor), GST applies. IRC § 2601; § 2611; and § 2611. Under IRC § 2651(e)(3), a charity is considered to be in the same generation as the grantor of the CLT and, therefore, no GST is due upon the initial transfer of property to the trust due to the trust providing for the payments to charity.
- b. Generation skipping transfers include: 1) taxable distributions, IRC § 2612(b); 2) taxable terminations, IRC § 2612(b); and, 3) direct skips, IRC § 2612(c). Unless governed by the trust instrument, tax on the transfer is charged to the property constituting the transfer property.
- c. Tax is highest estate and gift tax rate. IRC § 2641.
- d. Tax is in addition to any estate or gift tax.
- e. GST is determined by multiplying the taxable amount (GST transfer) times the applicable rate under IRC §§ 2602 & 2641. The applicable rate is the inclusion ratio times the maximum federal estate tax rate. IRC § 2641. The inclusion ratio is determined by subtracting the applicable fraction from 1, IRC § 2642, and takes into account the amount of property transferred, the amount of GST exemption allocated to the transfer, death taxes paid, and any estate or gift tax charitable deduction allowed. IRC § 2642(a). *See* PLR 8729051. Specifically, the applicable fraction is determined by dividing the amount of GST exemption allocated to the transfer by the value of the property transferred to the trust, reduced by the sum of the property's Federal Estate Tax or State Death Tax, if any, allocable to recovery from the trust and any charitable deduction allowed as to the property under IRC § 2055 or § 2522. IRC § 2642(a). For GST exemption allocation on transfers to a charitable lead unitrust, the value of the property transferred to the trust is determined on the date of funding or transfer (like for the gift and estate tax). IRC § 2642(a). However, the GST exemption allocation at date of transfer or funding in PLR 8729051 is no longer available to charitable lead annuity trusts as a result of IRC § 2642(e). Under that section, the applicable fraction is redefined for transfers to charitable lead annuity trusts after October 13, 1987, the numerator being the allocated portion of the exemption at the date of funding or transfer increased by the interest determined at the rate used for valuing the charitable interest, compounded annually for the term of the charitable interest, and the denominator being the value of the property in the trust immediately after the termination of the charitable lead annuity trust charitable interest. The amount of the exemption allocated may not be reduced even though it is ultimately determined that the allocation of a lesser amount to the charitable lead annuity trust would have resulted in an inclusion ratio of zero (as where the trust property does not appreciate to the extent expected). This means that the GST exemption cannot be leveraged as to the charitable lead annuity trust but can be leveraged as to the charitable lead unitrust. *See* H.R. Rep. No 795, 100th Cong. Second Sess., at 347.

B. Grantor CLT

1. INCOME TAXATION OF TRUST

Grantor remains taxable on income earned by the trust (i.e. the initial deduction is recaptured over the term of the trust as the trust's income is taxed to grantor) IRC § 671, *et seq.*

Planning Opportunity:

However, the grantor may alleviate the effect of being taxed on the income by having the Trustee invest in tax exempt investments. *See* PLR 8427022 regarding approval of municipal bonds for assets of lead investment trusts.

- a. Grantor receives an income tax charitable deduction for value of lead interest passing to charity. This contribution is subject to the 30% limitations under IRC § 170(b)(1)(B) because the gift is deemed to be "for the use of" rather than "to"

charity. Treas. Reg. § 1.170A-8(a)(2). This limitation is imposed regardless of whether the charitable beneficiary is a public or private charity. If the contributed property is appreciated capital gain property, the limitation is 20%. IRC § 170(b)(1)(D). Because grantor receives an immediate income tax charitable deduction in the year of the transfer to the trust, no further charitable deductions are allowed to either grantor or the trust (unless in any year the payment to charity exceeds the required annuity or unitrust amount). Treas. Reg. §§ 1.170A-6(c) and 1.170A-6(d)(2)(ii); IRC § 170(f)(2)(B).

- b. If the grantor dies or relinquishes certain trust powers and, therefore, is not taxed on the income of the trust prior to full recapture of the charitable deduction, the unrecaptured portion remaining is accelerated and taxed as ordinary income. The taxable portion is the value of the initial charitable deduction less the discounted value of all amounts which were actually paid to the charitable organization before cessation of tax to the grantor. IRC § 170(f)(2)(b); Treas. Reg. § 1.170A-6(c)(4). This acceleration provision is not to be construed to disallow a deduction to the trust for amounts paid by the trust to charitable organizations subsequent to the cessation of grantor being taxed as the owner of the trust. Treas. Reg. § 1.170A-6(c)(4).

2. ALTERNATIVE MINIMUM TAX

A grantor of a charitable lead trust is subject to AMT on the same basis as an individual taxpayer. *See* discussion above. For a grantor of a grantor trust, items of income and deductions and preference items are included in the grantor's income.

3. CAPITAL GAINS TAX

- a. The extent to which a grantor is taxed on the income and capital gains of the CLT depends on the grantor's power over the trust. A grantor is taxed on the portion of income to which such grantor is considered to be the owner. *See* Treas. Reg. § 1.671-3(a)(3). If a grantor has a reversionary power which extends only to ordinary income, then the grantor will be taxed only on those items included in ordinary income and not those allocated to corpus. Treas. Reg. § 1.671-3(b)(1). If the grantor is considered the owner of the entire trust, then the grantor is taxed on all ordinary income and capital gains of the trust.
- b. The IRS stated in PLR 200920031 that the CLAT grantor was taxable on the appreciation in securities distributed to a charity in satisfaction of the annuity obligation of the trust. The CLAT was obligated to make a set annuity payment to a private foundation for twenty years. The Trustee sought to disburse directly to the private foundation appreciated securities rather than disbursing from income. The IRS held that the distribution is a taxable event and the grantor would recognize gain. The IRS treated an annuity payment under a CLAT as a debt – not a satisfaction of a mere pledge to a charity.
- c. Rev. Proc. 2007-45, section 8.02(2): If the trustee distributes appreciated property in satisfaction of the required annuity payment, the donor will realize capital gain on the assets distributed to satisfy part or all of the annuity payment.

4. TIER SYSTEM OF ALLOCATION

A tier system of allocation of income described in the previous section applicable to non-grantor CLTs would only be applicable where a grantor is not taxed on the entire income of the trust. Where a grantor is taxed on all of the income of the CLT, a tier system of allocation of income would serve no purpose.

5. ESTATE TAXES

In most cases, because of the grantor's or the grantor's spouse's retention of certain powers necessary to make the trust a grantor trust for income tax purposes, corpus is included in grantor's estate for federal estate tax purposes. *See* IRC §§ 2036, 2038, and 2035. If grantor desires to avoid inclusion of the assets in the gross estate in the event he or she dies during the trust term (sometimes called the "Super" Grantor CLT), extra care should be taken in drafting to assure that the circumstances which make the trust a

grantor trust for income tax purposes under the grantor trust rules of IRC § 671 *et seq.* do not cause the assets to be included in the grantor's estate or constitute an act of prohibited self-dealing. There are several private letter rulings dealing with the Super Grantor CLT. From those PLRs, it is apparent that the most favorable way to obtain Grantor Trust status is to use the "SWAP" power which is the power, exercisable in a non-fiduciary capacity to exchange the assets for assets of equal value. It is an issue of fact, determinable at the time the grantor files his Tax Return as to whether the power is exercisable in a non-fiduciary capacity, but if it is, then the CLT would be a Grantor CLT and the grantor taxable on the income. In order to avoid the potential self-dealing prohibited transaction of exchanging the CLT assets with a disqualified person, the CLT should be drafted so that a non-disqualified person has the SWAP power. *See also* above discussion regarding income tax acceleration upon death of grantor.

6. GIFT TAX

The transfer is subject to gift taxes where a taxable gift is made. The value of the taxable gift is the value of the remainder interest. If the gift tax charitable deduction is not obtained, the entire corpus will be subject to gift tax. To prevent this, the trust must be in the form of a charitable lead annuity trust or charitable lead unitrust. No distinction is made between gifts "for the use of" and "to" charity.

7. GENERATION SKIPPING TAX

If a CLT is considered to be a grantor CLT for income tax purposes only, then the discussion in the previous section applicable to non-grantor CLTs is fully applicable. *See* discussion pertaining to non-grantor CLTs above.

8. UNRELATED BUSINESS TAXABLE INCOME

UBTI concerns are not an issue because the grantor is taxed on the income and the trust is not limited by IRC § 681 concerning limitation of a trust's IRC § 642(c) income tax charitable deduction.

IV. SPECIAL CONSIDERATIONS

A. Trustee

The creator of a CLT must be cautious in choosing a trustee so as to fall within the desired tax rules.

1. INDEPENDENT TRUSTEE OR QUALIFIED APPRAISER FOR VALUATION OF ASSETS

Although the governing instrument of an *intervivos* or testamentary CLT is not required to provide for the appointment of an independent trustee or qualified appraiser for the valuation of those assets that are not readily ascertainable, the initial valuation of those assets must actually be determined by an independent trustee or qualified appraiser according to the income tax substantiation requirements. *See* Treas. Reg. § 1.664-1(a)(7) and H.R. Rep. No. 413, 91st Cong. 1st Sess. 60 (1969), 1969-3 C.B. 200, 239, 423, 644 (discussing need for independent trustee in valuing assets of charitable remainder trusts at the time of the initial valuation [for a charitable remainder annuity trust] or each year [for the charitable remainder unitrust] and Treas. Regs. § 1.664-1(a)(7). *See also* P.L.R. 9623018 (Mar. 5, 1996) applicable to charitable remainder trusts. *But see*, Rev. Rul. 80-83, 1980-1 C.B. 210, (qualifying a trust as a charitable remainder trust where the creator of such trust was serving as Co-Trustee and was a director on the board of a publicly held corporation whose stock was owned by the charitable remainder trust and holding that the Co-Trustee/director was bound by a fiduciary duty in his capacity as Co-Trustee and as director to exercise independent judgment on behalf of the trust and the corporation and that the Service is not bound by the valuation in determining the charitable deduction.) The Final Regulations pertaining to Charitable Remainder Trusts changed the rule regarding the need to have an independent trustee to allow for valuation by an independent trustee or a qualified appraiser. Treas. Reg. § 1.664-1(a)(7). Although an income tax charitable deduction may not be sought, (i.e., as with a non-grantor CLT), the substantiation requirements for income tax charitable deductions pertaining to CRTs give guidance as to what the Service requires for the valuation of assets for estate and gift tax

purposes and, therefore, the cautious creator of a CLT will follow such substantiation requirements. See Treas. Reg. §. 1.170A-13(c)(5).

History: Before the new Final Regulations were passed in 1998, in determining whether or not an independent trustee was required, guidance could be found in the legislative history of the rules governing charitable remainder trusts as discussed above. H.R. Rep. No. 413 (Pt. 1), 91st Cong., 1st Sess. 50 (1969). The legislative history of section 664 indicates that Congress contemplated denying the charitable deduction when a grantor of a CRT, who was also Trustee, transferred hard-to-value assets (i.e. all assets other than cash, cash equivalents and marketable securities) to a CRT unless an independent trustee valued the hard to value assets. H.R. Rep. No. 413, 91st Cong., 1st Sess. 60 (1969), 1969-3 C.B. 200, 239. Thus, if the grantor was the trustee of a CRT, the governing instrument had to provide that the annual valuation of the hard to value assets be prepared by an independent valuation trustee. The December 10, 1998 Final Regulations changed this requirement. Under the Final Regulations, a trust's unmarketable assets must either be valued by an independent trustee or by a qualified appraiser. Treas. Regs. 1.664-1(a)(7).

Independent Trustee/Qualified Appraiser: An independent trustee is a person other than the grantor, or the grantor's spouse, a noncharitable beneficiary or a party related or subordinate to either of them. Treas. Regs. 1.664-1(a)(7)(iii). A co-trustee who is independent may value the trust's unmarketable assets. The Pension Protection Act of 2006 redefined a "qualified appraiser" as someone who has met certain educational or certification requirements and regularly performs appraisals for which he or she receives compensation. Such individual must also demonstrate verifiable education and experience in valuing the particular type of property that is the subject of the appraisal and he or she must not be prohibited from practicing before the IRS within a 3 year period. For further information regarding the changes concerning qualified appraisers and qualified appraisals under the Pension Protection Act of 2006, see Notice 2006-96, 2006-46 I.R.B. 902. Even though the legislative history addresses only charitable remainder unitrusts, the conservative view is that the Service may require an independent valuation trustee or qualified appraiser in regards to a charitable lead trust as well. Because of this legislative history, it is common practice in drafting charitable remainder trusts to provide for the appointment of an independent valuation trustee or qualified appraiser if either of the following circumstances is present:

- (a) the trustee of the unitrust is the donor or a party related or subordinate to the donor; or,
- (b) one of the charitable remaindermen of the unitrust is or may be a private foundation with respect to which the donor is a "disqualified person,"

Related or Subordinate Party: A party is a related or subordinate party if the party is a non-adverse party and is also the donor's (a) spouse (if living with the donor); (b) parent, (c) issue, or (d) brother or sister. I.R.C. § 672(c). Brothers and sisters of the halfblood are considered related or subordinate parties for these purposes. Rev. Rul. 58-19, 1958-1 C.B. 251. Additionally, an employee of the donor or of a corporation in which the holdings of the donor and/or the unitrust are significant with respect to control, or in which the donor is an executive, also is a related or subordinate party. I.R.C. § 672(c)(2).

A non-adverse party is any party who is not an adverse party, I.R.C. § 672(b), including any party who has a substantial beneficial interest in the trust (including a general power of appointment over the trust) which would be adversely affected by the exercise or non-exercise of the power over the trust. A beneficial interest includes the right to share in trust income or corpus (either at present or in the future) and also includes a general power of appointment over the trust. Treas. Reg. § 1.6720-1(a)(b). An interest need only be "not insignificant" to be a substantial interest. Treas. Reg. § 1.672(a)-1(a). Clearly, a remainder beneficiary or income beneficiary of a trust, contingent or otherwise, would have more than an insignificant interest in the trust and, therefore, would have a "substantial interest." A party's interest is adverse to the exercise or nonexercise of any power over the trust if, and to the extent that, such exercise or non-

exercise of any power will affect the amount of income or principal received by the other party. Treas. Reg. § 1.672(a)-1(a)-(d).

Disqualified Person: The following are disqualified persons with respect to the CLT for valuation purposes:

- (a) A settlor of or substantial contributor to the CLT;
- (b) A trustee of the CLT;
- (c) An owner of more than 20% of the equity interest in a partnership or corporation or beneficial interest of a trust or unincorporated enterprise that is a substantial contributor to the CLT;
- (d) A member of the family of any of the three preceding categories of persons (family members including: spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren);
- (e) A corporation in which the four preceding categories of persons own, directly or indirectly, more than 35% of the total combined voting power;
- (f) A partnership in which the first four categories of persons own, directly or indirectly, more than 35% of the profits interest; and,
- (g) A trust or estate in which the first four categories of persons hold, directly or indirectly, more than 35% of the beneficial interest.

I.R.C. § 4946(a)(1). Although a Trustee of the CLT is a disqualified person, if such Trustee would not be a disqualified person but for the party's service as Trustee and is not a related or subordinate party, such Trustee may serve as an independent valuation trustee because such party meets the qualification for an independent trustee discussed in the legislative history to the charitable remainder unitrust rules.

2. INDEPENDENT TRUSTEE AND GRANTOR TRUST RULES

The grantor of a CLT is treated as the owner of any portion of the CLT that the beneficial enjoyment of the corpus or the income is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party. I.R.C. § 674(a). An exception is provided if the determination of the beneficial enjoyment of the corpus or income is irrevocably payable for charitable purposes, I.R.C. § 674(b)(4). This includes the power to choose among charitable beneficiaries or to affect the manner of their enjoyment of a beneficial interest. Treas. Regs. § 1.674(a)-1(b)(1)(iii); § 1.674(b)-1(b)(4). An additional exception is provided if the power is exercisable by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. I.R.C. § 674(c); Treas. Regs. § 1.674(c)-1. (See above discussion of related or subordinate parties).

3. RELATED PARTY AS TRUSTEE

Child's Discretion to Pay to Charity, Including Charity Controlled by Child: In P.L.R. 9331015, a child of the Grantor of a CLT was named to serve as Trustee of the CLT. The CLT did not specifically identify the charitable recipients of the CLT payments. The child, serving as Trustee, was to choose the charitable recipients of the CLT payments but the charitable recipients had to be charitable organizations other than those controlled by the child. The Service ruled that the CLT was not disqualified because a child of the Grantor was serving as Trustee. Their reasoning was that "there is no provision in § 2522 of the Code or the corresponding regulations that prohibits a relative of the Grantor from serving as Trustee of a charitable lead trust." P.L.R. 9331015 (May 6, 1993).

The ruling does not turn on the fact that the Trustee cannot pay the lead payments to charitable organizations that are controlled by the Trustee, rather such is merely a fact in the case. The conservative position in this situation would be to draft the CLT to fall within the limits of P.L.R. 9331015 and to not allow the child, as Trustee, to choose to pay the lead payment to charitable organizations controlled by the child. Alternatively, the CLT instrument could require the lead payment to be paid to the charitable organization controlled by the child, thereby removing the discretion of the child in the payment and thereby avoiding the factual scenario set forth in P.L.R.

9331015.

General Power of Appointment: The ability of related parties, serving as Trustees, to choose the charitable recipients of the lead payments, does not cause any estate inclusion under I.R.C. § 2041 as such power does not encompass the power to appoint the assets to the trustee, himself, the trustee’s creditors, the trustee’s estate or the creditors of the trustee’s estate. P.L.R. 9532007, P.L.R. 9331005. *But see* P.L.R. 9304020 where independent trustee was requested to consult with Grantor’s children on selection of charitable recipients of lead payments and Service ruling that mere consultation does not rise to level of general power of appointment.

I.R.C. § 2036 Inclusion in Grantor’s Estate: If a grantor creates a CLT and the charitable lead payment is required to be paid to the Grantor’s private foundation of which the Grantor is an officer and director, then the Grantor has retained the right to designate the enjoyment of the property sufficient to cause the assets to be included in the Grantor’s estate. Rifkind v. United States, 5 Cl. Ct. 362 (1984) This reasoning stems from Rev. Rul. 72-552, 1972-2 C.B. 525, where a Grantor made inter vivos gifts to a charitable corporation of which the donor was president and, in serving as president, had the ability to direct the disposition of the charitable corporation’s funds. The Service ruled that the value of the inter vivos gifts was includible in the gross estate of the donor because of the retained power of disposition. The cases addressing this issue track the following progression:

P.L.R. 9534004 (May 16, 1995) provides that where the donor was neither the Trustee of the CLT nor the director of the private foundation to which the lead payment was required to be paid, the trust corpus was not included in the donor’s estate under I.R.C. § 2036. In P.L.R. 9539009 (June 29, 1995), the Grantor created a charitable lead trust of which his children were the trustees and also created a private foundation of which his children and his spouse were Co-Trustees but of which he could appoint himself as trustee. The charitable lead trust was required to pay the lead payment to Grantor’s private foundation; however, the governing instrument of the private foundation was to be amended to provide that Grantor could never participate, as Trustee or otherwise, in decisions regarding the distribution of the assets of the private foundation. The Service ruled that because the Grantor could never participate in the ultimate disposition of the funds of the private foundation, that the gift was complete and that the Grantor did not retain any powers that would cause the assets of the private foundation to be included in his estate for federal estate tax purposes. *Id.* (See also PLR 20010832 for similar treatment for payments received from CLT.)

Generally, in planning, the Grantor will want to have the CLT pay to his or her private foundation without resulting in any estate inclusion. Thus, the following conclusions may be arrived at in analyzing the situation in which a Grantor creates a CLT and the lead payment is either required to be paid to Grantor’s private foundation or the lead payment may be, in the discretion of the Trustee, paid to Grantor’s private foundation.

Donor → CLT → Private Foundation

1. Donor Not Trustee Donor is director/officer
Mandatory payment to → Private foundation

Nexus
(§ 2036 inclusion)

2. Donor’s Children Trustees Donor cannot participate in decisions
as to distribution of unitrust amount

paid by Private Foundation

Mandatory payment to → → / Private Foundation

Nexus Broken
(No § 2036 inclusion)

3. 3rd party Trustee Donor is director/officer
Discretionary payment to → → / private foundation

Nexus Broken
(No § 2036 inclusion)

But see P.L.R. 9331015 (May 6, 1993) where Grantor created charitable lead trust, children of Grantor served as Co-Trustees and Co-Trustees had ability to choose charitable beneficiaries and where Service held that the fact that the designation will be made by the Co-Trustees will not in and of itself lead to a conclusion that the gift is incomplete under the rationale of Rev. Rul. 77-275, assuming that the Grantor does not control the designation through influence over the Co-Trustees. An interesting fact also mentioned by the Service was that the trust prohibited the Trustees from making unitrust distributions to organizations in which the Grantor occupied a fiduciary office although the Service's decision did not turn on such fact.

B. Disqualified Person As General Partner Of Partnership/Avoidance Of Self-Dealing

A transaction between a partnership which has a partnership interest owned by a CLT and a disqualified person is not a direct act of self-dealing because the CLT is not directly involved in such transaction. However, a transaction between such partnership and a disqualified person may be an indirect act of self-dealing. In that situation, because the partnership is controlled by the CLT, it is as though the disqualified person is acting with the CLT itself. (*See* description of Self-dealing above for general rules against self-dealing.) An act of indirect self-dealing may arise:

- 1) Where there is a transaction between a disqualified person and an organization "controlled" by a private foundation;
- 2) Where a disqualified person transacts with respect to a private foundation's interest or expectancy in property held by an estate or revocable trust. Treas. Reg. § 53.4941(d)-1(b)(3); and,
- 3) Where a grant is made to an intermediary organization, which intermediary organization uses the grant to benefit a government official.

The mere voting of stock held in a partnership is not a violation of any direct act of self-dealing. However, each act must be reviewed on a case by case basis to determine whether a prohibited act of direct or indirect self-dealing has occurred. Where a partnership interest is owned by a CLT, an indirect act of self-dealing may arise most likely under the first situation listed above. Control may arise under two tests set forth in Treas. Regs. § 53.4941(d)-1(b)(5) and set forth below:

- 1) If the private foundation (CLT) or one or more of its managers (acting only in such capacity) may, only by aggregating their votes or positions of authority, require the organization to engage in a transaction that if a disqualified person engaged in with the private foundation (CLT), would constitute self-dealing; or,
- 2) If a disqualified person (together with one or more persons who are disqualified persons because of their relationship) may, only by aggregating their votes or positions of authority with that of the private foundation (CLT), require the organization to engage in such a transaction.

Additionally, an organization will be considered to be controlled by a private foundation (CLT) or by a private foundation (CLT) and disqualified persons if such persons are, in fact, able

to control the organization (even if aggregate voting power is less than 50%) or if one or more of such persons has the right to exercise veto power over the actions of such organization relevant to any potential acts of self-dealing. *Id.*

If the Trustee of the CLT, in his or her capacity as Trustee has no ability to control the partnership or to cooperate with any other person or persons to collectively control the partnership and cannot exercise veto power over any actions of the partnership, no indirect act of self-dealing should arise. The actions of the Trustee acting not as Trustee, but as general partner of the partnership are not imputed to the CLT sufficient to establish “control” within the meaning of Treas. Regs. § 53.4941(d)-1(b)(5). *See also* Rev. Rul. 76-158, 1976-1 C.B. 354. Therefore, the partnership would not be “controlled” by the CLT and no act of indirect self-dealing should arise. *See examples under* Treas. Regs. § 53.4941(d)-1(b).

However, if additional capital contributions may be made to a partnership that would alter the capital make-up of the partnership and therefore affect future distributions, an act of self-dealing may arise because the disqualified person has exchanged the subsequent capital contribution to the partnership for a larger partnership interest. *See* P.L.R. 9705013 (Oct. 31, 1996); *But see*, P.L.R. 200053047 where additional contributions by family members to an LLC were not considered self-dealing.

As a result of the foregoing, it is important to construct the partnership agreement where an interest is to be held by a CLT to provide for appropriate restrictions so as to not violate any act of self-dealing, direct or indirect. The partnership agreement should also provide that if the voting procedure of an act of the partnership is violative of an act of self-dealing, that the general partner has the ability to modify the procedure so as to not violate any prohibition against acts of self-dealing.

C. Treatment of CLT Payment Received By Private Foundation

Treas. Reg. § 53.4942(a)-2 provides that the undistributed income of a private foundation of which the mandatory payout is determined is increased by the income portion of distributions from charitable lead trust described in I.R.C. § 4947(a)(2) and includes the greater of: (a) the amount of such distribution which is treated as income (within the meaning of section 643(b)), or (b) the guaranteed annuity, or fixed percentage of the fair market value of the trust property (determined annually), which the private foundation is entitled to receive for such year, regardless of whether such amount is actually received in such year or in any prior or subsequent year. If this provision is held valid, a private foundation would be required to include in its distributable amount, the amounts of income (or the guaranteed annuity or unitrust payment) from a CLT. However, the Tax Court and the Ninth Circuit Court of Appeals invalidated the Regulation, determining that the Regulation was not amended at the time the underlying statute was amended and that the Regulation was an unwarranted extension of the statute. *See Jackson v. Commissioner*, 97 T.C. 35 (1991), *aff'd*. 15 F.3d 917 (9th Cir. 1994).

D. Sale of Remainder Interest

It is unclear as to how the Service will address the sale of a remainder interest in a CLAT to a GSTT trust, especially in light of the recent Private Letter Ruling 200107015. In that Ruling, the Service stated that the remainder beneficiary in a CLAT would be treated as the “transferor” for GSTT purposes when the remainder beneficiary assigns his remainder interest to a GSTT trust, but that the Service might collapse the entire transaction as a disregarded transaction and treat the CLAT creator as the “transferor”, thereby resulting in GSTT being applied at the end of the CLAT term. However, if the remainder interest is sold, rather than gifted, it is arguable that the GSTT trust has paid fair-market value for what it received and it is merely an asset of the trust. If a sale is anticipated, the CLT document should modify a spendthrift provision to allow the transfer.

V. ADVANTAGES OF CHARITABLE LEAD TRUST

- A. Generally used by wealthy individuals with sufficient current assets to provide current benefits to charity with later return to the donor or donor's non-charitable beneficiaries, normally family members. If the property is transferred at the end of the charitable term to donor's named beneficiaries, it can be at a value less than the value at the time the trust was funded and less than the value of the property at the time it is received by donor's named non-charitable beneficiaries, i.e. children, grandchildren or trusts for their benefit.
- B. Used in conjunction with the Charitable Remainder Trust, can provide significant estate and gift tax reduction to enhance property going to donor's named non-charitable beneficiaries.
- C. Can remove an appreciating asset from grantor's estate (whether grantor [Super] CLT or non-grantor CLT).
- D. Can avoid the percentage limitations on an income tax charitable deduction imposed on individuals if the trust is a non-grantor CLT. If the trust is a non-grantor testamentary CLT, the beneficiary receives a step-up in basis (subject to new basis rules beginning in 2010) as to assets passing to the non-grantor testamentary CLT.
- E. Is not subject to the special valuation rules of IRC § 2702. *See* Treas. Reg. § 25.2702-(1)(c)(3), (4) and (5) excepting charitable remainder trusts, pooled income funds and charitable lead trusts from IRC § 2702.

VI. DISADVANTAGES/LIMITATIONS OF CHARITABLE LEAD TRUST

- A. If CLT income is insufficient to fund the payment to charity, the Trustee must make distribution from corpus (in kind or cash from sale of corpus), or by borrowing (with UBTI ramifications – debt financial income), or possibly from additional contributions (if unitrust version).
- B. Income of Non-Grantor CLT in excess of guaranteed payment may be retained by the trust (and trust income tax paid) or distributed to charity (and additional trust income tax charitable deduction taken). Treas. Reg. § 1.170A-6(c)(2)(i)(C). No additional income tax charitable deduction is allowed to an individual under IRC § 170(f)(2)(B) for payment of excess income of non-grantor CLT to charity. Treas. Reg. § 1.170A-6(c). However, this does not disallow an income tax charitable deduction to a grantor of a grantor charitable lead trust under IRC § 671 and Treas. Reg. § 1.671-2(c) for a charitable contribution made by the trust in excess of the guaranteed payment required to be made by the trust. Treas. Reg. § 1.170A-6(d)(2). A non-grantor charitable lead trust is allowed a charitable deduction for any excess payments paid from gross income, which pursuant to the governing instrument, is paid for an exempt purpose or a set-aside income tax deduction under IRC § 642(c).
- C. No payment may be made to noncharitable beneficiaries during the charitable term of the trust. Treas. Reg. §§ 1.170-6(c)(2)(i)(E) and (ii)(d).
- D. Section 642(c) full income tax charitable deduction disallowed for any taxable year to the extent such deduction is allocable to the CLT's UBTI for that year. Notwithstanding, the CLT is allowed a deduction for actual payments allocable to UBTI made to charities, subject to the percentage limitations applicable to contributions by individuals, but not subject to the itemized deduction limitation reduction applicable to contributions by individuals.
- E. It is questionable whether a trust with a prepayment clause qualifies as CLT because prepayment and commutation is inconsistent with the regulatory requirements for charitable lead interests and the allowance of a charitable deduction for the charitable interest. *See* Rev. Rul. 88-27, 1988-1 C.B. 331; IRC § 2522(c)(2) and P.L.R. 9734057. *But see* PLR 19952093 where the CLT was allowed to pay off the charitable interest, without discount.
- F. If the Grantor dies or relinquishes certain Grantor trust powers and, as a result ceases to be taxed on the income of the trust prior to full recapture of the previously allowed income tax charitable deduction, the remaining unrecaptured portion of the charitable deduction is accelerated and taxed as ordinary income. The amount recapture is equal to the initial charitable deduction less discounted value of all amounts actually paid to charitable organizations before the time when the Grantor ceased to be taxed on the income of the trust.

VII. DRAFTING CONSIDERATIONS/FILING REQUIREMENTS

- A. Make election by attaching information to first return on which take a charitable deduction.

- B. Trustee should have power to name successor charitable organization in case the current organization loses its charitable qualification.
- C. Set forth a tier system, not contrary to state law, for allocation of payments to charitable beneficiaries; otherwise local law may characterize (but will be ignored unless there is a non-tax reason for the tier system).
- D. Allocate trustee fees to income so they may be deducted by the trust.
- E. File Form 1041 and Schedule K-1, possibly Form 1041-A, and Form 5227. Possibly use Form 4720, Breach of Excise Tax, if a violation of the private foundation rules occurs.
- F. Instrument should expressly negate any local statutory power of invasion if allowed under state law.
- G. Must make quarterly payments of taxes resulting from UBTI. (Form 990W).
- H. To minimize CLT income tax as to the non-grantor CLT, the trust instrument should allow for a reserve for depreciation, and depletion deductions. Otherwise, these items will be allocated pro rata between the CLT and charity based on income retained/received by each. IRC §§ 642(c), 611(b)(3) and 167(d); Treas. Reg. §§ 1.642(e)(i), 1.611-1(c)(4) and 1.167(h)-1(b). It is also appropriate to give the Trustee the power to allocate capital gains between income and corpus so a charitable income tax deduction can be achieved if it is necessary to distribute gain to charity as part of a lead trust payment.
- I. The trust instrument should preclude payment of estate taxes from the trust and, regarding a testamentary lead trust, should state specifically that the trust will not be funded until all estate taxes are paid. *See* PLR 7914008. *See also*, Rev. Rul. 82-128, 1982-2 C.B. 71.
- J. The trust instrument should contain a provision covering the lead trust payment of a short taxable year.
- K. The trust instrument should give the Trustee the power to amend the trust for the purpose of maintaining the trust's tax qualified status as a qualified guaranteed annuity interest or guaranteed unitrust interest.
- L. The charitable lead annuity trust instrument should prohibit additional contributions. *See* PLR 8034093 and 802195.
- M. The CLT instrument should provide for an independent valuation trustee.
- N. The CLT instrument should set forth how to distribute or accumulate excess income, after considering the tax implications resulting from each alternative.
- O. Consider whether to include a spendthrift provision based upon whether or not the remainder interest in the trust will be sold.
- P. Consider final regulations applicable to measuring lives for determining appropriate term and any necessary reformations.

VII. FORMS

- A. Prescribed Forms
The IRS has issued sample forms, along with annotations and alternative provisions, for testamentary Charitable Lead Unitrusts, as well as inter vivos grantor and non-grantor Charitable Lead Unitrusts. *See* Rev. Rul. 2008-45, 2008-30 I.R.B. 224 (July 28, 2008) [inter vivos] and Rev. Rul. 2008-46, 2008-30 I.R.B. 238 (July 28, 2008) [testamentary]
- B. Sample Forms from Bourland, Wall & Wenzel, P.C.

(NOT PROVIDED IN THIS OUTLINE)

If you desire a copy of this attachment please contact Stacie Silver at the following:

Phone: (817) 877-1088

Fax: (817) 877-1636

Email: ssilver@bwwlaw.com

If you have email, these documents can be provided to you free of charge. The documents can be mailed to you for the cost of postage and our firm's copying cost. A statement will be included when you receive the materials.