

# PROFESSIONAL TAX & ESTATE PLANNING NOTES

October 2008

## Charitable <sup>3</sup>Lead Trusts

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The last two issues of *Professional Notes* explored charitable remainder trusts (CRTs), popular planning giving vehicles that allow people and businesses to transfer property to charity after paying income to non-charitable beneficiaries for a period of time. We noted that The New York Community Trust had many years of experience as a remainderman of CRTs, distributing the money to effective non-profits according to the donor's wishes, be they broad or narrow.

This issue discusses another planning giving vehicle, for which The Trust is also an ideal beneficiary—the charitable lead trust (CLT). Often described as a reverse CRT, it also is an irrevocable trust with both charitable and non-charitable beneficiaries. Like the CRT, the

charitable lead trust can be structured to pay either an annuity interest or a unitrust interest to one or more interim beneficiaries for a specified term, before the assets are disbursed to the remainder beneficiary. But unlike the CRT, the charitable lead trust makes the initial or “lead” payments to one or more charities for a period of time, and distributes the remainder of trust property to one or more non-charitable beneficiaries after the lead interest expires.

While the CLT is not as well-known as the CRT, it is an excellent financial and estate planning tool with particular utility for donors seeking to reduce estate and gift taxes in a low interest rate environment.

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Written by Amarah Sedreddine, associate general counsel, The New York Community Trust. We wish to acknowledge, with gratitude, Jonathan G. Blattmachr and John Sare, the authors of the October 1998 issue of *Professional Notes*, upon which this column is based.

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## Basic Requirements

Contributions to and from qualified charitable lead trusts may be eligible for various income, gift, and estate tax deductions. To constitute a qualified CLT, the trust must meet the statutory requirements of the Internal Revenue Code and Treasury Regulations.<sup>1</sup>

The key elements are highlighted below:

- A CLT may be structured either as a charitable lead annuity trust (CLAT), in which the lead interest takes the form of a guaranteed annuity payment, defined as a fixed amount to be distributed at least annually; or as a charitable lead unitrust (CLUT) in which the lead interest takes the form of an annual distribution of a fixed percentage of the fair market value of the trust's assets, revalued each year. With a CLAT, the trust instrument may provide that the amount of the annuity interest will change after a specified period of time, provided that the exact amount that will be paid can be ascertained when the CLAT is created. In either case, any income accrued to the trust that exceeds the lead interest distribution must either be paid to or for the use of the charitable recipient(s) or added to trust corpus; as a general rule, it may not be paid currently to the non-charitable remaindermen.
- The term of the lead interest may be a term of years, for the life or lives of certain individuals who are living as of the date of the trust's formation, or for the lives of certain individuals living as of the date of the trust's formation *plus* a term of years. The IRS has indicated that the term of the lead interest may also be the lesser of a term of years or a period of lives in being plus a term of years. If the lead interest is

defined in terms of measuring lives, the measuring lives may only be that of the grantor, the grantor's spouse, and/or a lineal ancestor of the remainder beneficiary or the spouse of such ancestor.

- One or more charitable recipients may be designated when the trust is created or the trust instrument may specify that the payments may be made to one or more charitable organizations as described in Code Sections 170(c), 2055(a) and 2522(a), and vest the trustee with sole discretion to select such recipient(s) from time to time. If the grantor chooses to designate one or more charitable recipients at the time of the trust's formation, the instrument must authorize the trustee to select an alternate recipient should any designated recipient have ceased to qualify at the time any payment is to be made to it.

Charitable lead trusts, unlike charitable remainder trusts, are not subject to statutory requirements imposing a minimum threshold for the remainder interest or limitations with respect to the payout rate.

The Internal Revenue Service has published model forms of qualified CLATs, both *inter vivos* and testamentary, in Revenue Procedures 2007-45 and 2007-46, respectively, and model forms of CLUTs, both *inter vivos* and testamentary, in Revenue Procedures 2008-45 and 2008-46, respectively.

## Benefits of Qualified Charitable Lead Trusts *Gift and Estate Taxes*

The gift and estate tax law allows a deduction for the actuarial value of the leading interest in the trust committed to charity. As a result, an individual who

<sup>1</sup> All "Code" references are to Sections of the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. Section" references are to regulations thereunder.

creates a charitable lead trust will be deemed to have made a taxable gift or bequest equal only to the present value of the remainder that will pass to the non-charitable beneficiaries. The value of the remainder is the difference between the actuarial value of the annuity or unitrust amount committed to charity and the fair market value of the property transferred to the trust. The actuarial value of the annuity or unitrust interest depends upon several factors, such as the length of time the charitable interest is to last and the percentage payout to charity.

For a charitable lead *annuity* trust, another important factor is the assumed IRS interest rate (referred to as the Section 7520 rate). The taxpayer may choose to value the interest in the trust based on either the Section 7520 rate for the month in which the trust was created *or* either of the two preceding months. Because it will result in a larger charitable deduction, the lowest of these rates should be used.

It is possible that the charitable deduction for a transfer to an annuity trust will equal the entire value of the property transferred, but only if the annuity payment is sufficiently high for a long enough period of time. The taxable gift or bequest will then be zero, and no estate or gift tax will be payable.

Significantly, if the trust grows at a rate higher than the Section 7520 rate, non-charitable beneficiaries may actually wind up receiving more property than they would by certain other forms of property trans-

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fer, since the excess amount will pass tax-free to beneficiaries when the trust terminates. Given the current, low interest rates, and with the Section 7520 rate at a near-historic low (the August 2008 rate is 4.2 percent), it may be a particularly opportune time to create a CLAT. Donors should consider providing low initial annuity payments, to be increased after a specified term or terms, so that trust corpus is not excessively or prematurely expended.

Although it is not possible to reduce the taxable gift or bequest to zero with a *unitrust*, the taxable gift or bequest can be reduced to a small portion of the value of the property transferred to the unitrust. (See chart on page 4.)

### ***Income Tax***

Individuals usually are entitled to an income tax deduction for the value of property contributed to charity during their lifetimes. However, no income tax deduction is permitted for a transfer to a charitable lead trust unless it is structured as a “grantor trust” under Code Section 671 *et seq.* (A grantor trust is one from which the income, deductions, and credits are attributed directly to the grantor.) In effect, a person who creates a CLT that is a grantor trust trades a current income tax deduction for the future imputation of income from the trust.

Most charitable lead trusts created during the grantor’s lifetime are not structured as grantor trusts because avoiding grantor trust status may provide

## CHARITABLE LEAD TRUSTS

### Charitable Lead ANNUITY Trust

\$5,000,000 Contribution in 2008

| Length of Term (Years) | Annuity Percentage | Size of Taxable Gift or Bequest | Potential GST Protection   |
|------------------------|--------------------|---------------------------------|--|
| 10                     | 8.00%              | \$ 1,787,720                    | Depends upon amount of GST exemption increased by Code §7520 interest rate compared to size of fund when charitable term ends. |
| 20                     | 8.00               | 0                               |  |
| 30                     | 8.00               | 0                               |  |
| 10                     | 6.00               | 2,590,790                       |  |
| 20                     | 6.00               | 994,160                         |  |
| 30                     | 6.00               | 0                               |  |
| 40                     | 6.00               | 0                               |  |
| 10                     | 12.45              | 0                               |  |
| 20                     | 7.49               | 0                               |  |
| 30                     | 5.92               | 0                               |  |
| 40                     | 5.20               | 0                               |  |

Calculated using the August 2008 Code §7520 Interest Rate of 4.2%

### Charitable Lead UNITRUST

\$5,000,000 Contribution in 2008

| Length of Term (Years) | Annuity Percentage | Size of Taxable Gift or Bequest | Potential GST Protection |
|------------------------|--------------------|---------------------------------|--------------------------|
| 10                     | 14.86%             | \$ 1,000,000                    | Total                    |
| 20                     | 7.73               | 1,000,000                       | Total                    |
| 30                     | 5.22               | 1,000,000                       | Total                    |
| 40                     | 3.94               | 1,000,000                       | Total                    |
| 10                     | 4.00               | 3,324,165                       | Reduces GST*             |
| 20                     | 4.00               | 2,210,010                       | Reduces GST*             |
| 30                     | 4.00               | 1,469,290                       | Reduces GST*             |
| 40                     | 3.00               | 1,469,290                       | Reduces GST*             |

\*But not to zero

For a unitrust, the results are the same regardless of Code §7520 Interest Rate.

greater tax benefits for the grantor. For example, the non-grantor charitable lead trust avoids the percentage of income limitations imposed on individuals under Code Section 170, except to the extent the trust has unrelated business taxable income. It also avoids the reduction in the charitable deduction that can occur under Code Section 68.

This flexibility can be very helpful. For a donor who has already exceeded his or her charitable deduction limitations (under the 20 percent, 30 percent, and 50 percent deductibility rules) or wishes to avoid sacrificing part of his or her charitable deduction because of the cut-back rules under Code Section 68, the creation of a non-grantor CLT effectively allows assets (and the income earned on them) to be shifted from the donor's balance sheet to the trust's. Instead of earning income from assets and paying tax on the income before making an otherwise non-deductible charitable contribution, the donor is able to fund his or her contribution through the trust, wholly or in part, with trust income that has not been taxed.

Unlike a charitable remainder trust, a lead trust is not exempt from income tax, although its income escapes taxation to the extent it is paid over to charitable beneficiaries. To ensure that no income tax is imposed on a non-grantor charitable lead annuity trust, it may be structured as an "income-only" trust so that it is impossible for the trust's income to exceed its annual charitable payout.

### ***Generation-Skipping Transfer Tax***

When property skips a generation and passes to the next one, usually grandchildren, a generation-skipping transfer tax (GST) is imposed in addition to

estate or gift taxes, and is often a relevant consideration in structuring a CLT. A property owner's GST exemption may be allocated to reduce the GST otherwise applicable, although the application is different for each kind of lead trust.

For a charitable lead *annuity* trust, the GST exemption initially is allocated to the trust; the amount of the exemption is increased by the Section 7520 rate until the end of the charitable term. At that time, the adjusted GST exemption is applied. Because it will generally be impossible to forecast the growth of the trust during the charitable term, it is not possible to forecast whether the adjusted GST will fully protect the property in the charitable lead annuity trust from generation-skipping tax.

For a charitable lead *unitrust*, however, the GST exemption is applied immediately. If the amount of the exemption allocated to the trust is equal to the taxable gift or bequest made by creating the unitrust, when the property in the trust passes to grandchildren, it will be entirely protected from the generation-skipping transfer tax. See the chart page 4 for examples of how the exemption may be applied.

## **Additional Considerations**

### ***Income Ordering Provisions***

As noted, non-grantor CLTs are taxed on income earned and receive an unlimited charitable deduction for any amount of gross income that is paid for charitable purposes specified in Code Section 170(c). Under Code Sections 681 and 512(b)(11), however, this charitable deduction is reduced by any amounts of such payments that are allocable to the unrelated business taxable income (UBI) of the CLT, to the

extent that the UBI exceeds the percentage limitations applicable to individuals under Code Section 170(b)(1)(A). (A trust may deduct distributions allocable to UBI up to 50% of the trust's contribution base if made to a public charity, such as The New York Community Trust, or up to 30% if made to a private non-operating foundation.) As a result, practitioners have commonly structured governing instruments to provide for charitable distributions from, in sequence, ordinary income, short-term capital gains, long-term capital gains, unrelated business income, tax-exempt income and, last, trust corpus.

Proposed regulations issued by the Treasury Department and guidance issued concurrently from the IRS, however, will likely put an end to this practice. In July of this year, the Treasury Department announced its proposal to amend Code Section 642 to clarify that an ordering provision will *not* be honored unless it has an economic effect independent of income tax consequences. (The Department maintains that existing regulations incorporate the economic effect requirement by reference to other regulation provisions, and that the proposed amendment only makes this requirement explicit.) As an example, it notes that an ordering provision in the governing document of a CLT does not have economic effect because the amount paid to the charitable beneficiary "is not dependent upon the type of income it is allocated [and] is the same regardless of the source of income." Revenue Procedures 2008-45 and 2008-46, issued later the same month, reinforce this analysis, stating specifically that ordering provisions in a CLT "will not be respected because such a provision does not have economic effect independent of the income tax consequences of the payment."

### ***Inclusion of Assets in Grantor's Estate***

Assets of a CLT established upon the grantor's death will be included in the grantor's estate. An estate tax deduction is allowable for the value of the charitable interest determined as of the date of the grantor's death, with the value of the noncharitable remainder subject to the estate tax. Also, if a grantor CLT ceases to be a grantor trust before the expiration of the lead term due to the grantor's death, a portion of the charitable income tax deduction the grantor previously obtained will be recaptured and included in the grantor's estate as income.

### ***Excise Taxes Applicable to Private Foundations***

Like charitable remainder trusts, charitable lead trusts are subject to many of the private foundation rules, including the prohibition on self-dealing contained in Section 4941. Section 4941 imposes a punitive excise tax on the amount involved in certain acts of self-dealing between the private foundation (in this case, the CLT) and disqualified persons, who would include the trustees, the donor, and certain family members. The tax is payable by the disqualified person who engages in the act of self-dealing and, in some cases, by the participating foundation managers (i.e., the trustees, in the case of a CLT). The tax on the disqualified person is 10 percent of the amount, but if the act of self-dealing is not corrected, there is a second tax of 200 percent of the amount involved. The tax on the foundation manager is 5 percent of the amount involved and 50 percent if not corrected, capped at \$20,000.

With certain exceptions, acts of self-dealing may include: (1) the sale, exchange, or lease of property between a CLT and a disqualified person; (2) the lending of money or other extension of credit

between a CLT and a disqualified person; (3) the furnishing of goods, services, or facilities between a CLT and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a CLT to a disqualified person (other than reasonable compensation for necessary services); and (5) the transfer to, or for the benefit of, or use by, a disqualified person of the income or assets of a CLT.

Significantly, charitable lead trusts may be structured to avoid the private foundation excise taxes in Code Sections 4943 and 4944, relating to excess business holdings and jeopardy investments. These sections of the Code prohibit a CLT from owning, together with all disqualified persons in the aggregate, more than 20 percent of a business enterprise, and to make any investment that jeopardizes its exempt purposes.

Under Section 4947(b)(3)(A), the Code exempts CLTs from the restrictions on these activities if the value of the charitable income interest is less than or equal to 60 percent of the value of the assets transferred to the CLT. This is an important consideration for a donor who owns a highly valued business enterprise that he or she intends to keep in the family through the CLT.

### ***Non-qualified Charitable Lead Trusts***

A donor may choose to establish a non-qualified charitable lead trust. An in-depth discussion of non-qualified CLTs is outside the scope of this article, but the reader should be aware that while a donor who makes a completed gift to a non-qualified CLT is not

To qualify for the income tax deductions and to avoid inclusion of the trust property in the grantor's estate, the grantor must name a charity at the time the trust is created or grant the power to decide which charities receive the property to others, including his or her spouse or another family member.

entitled to an income or gift tax charitable contribution deduction for the present value of the lead interest, non-qualified CLTs are not subject to the private foundation rules and the value of the completed gift will generally be excluded from the donor's estate.

### ***Selecting the Charitable Beneficiary***

To qualify for the income tax deductions and to avoid inclusion of the trust property in the grantor's estate, the grantor must name a charity at the time the trust is created or grant the power to decide which charities receive the property to others, including his or her spouse or another family member (provided that person is not an actual or deemed contributor to the trust). In any event, even if the charity is specifically and irrevocably designated in the trust instrument, the grantor should not be in a position to control the property received from the CLT he or she created.

The flexibility of The New York Community Trust makes it an ideal lead beneficiary. The Trust offers four types of charitable funds. For people who want to contribute to the vitality of their communities, an unrestricted fund provides maximum flexibility. For those with a particular area of concern, such as education or health, a field-of-interest fund may be the perfect vehicle. And designated funds allow a donor to specify one or more institutions to benefit, subject to The Trust's variance power. Through a donor-advised fund, the grantor of a charitable lead trust may be an advisor, recommending grants, but because he or she does not retain control over the charitable funds, the charitable lead trust should not run afoul of the governing Code provisions.

*If you are interested in creating a charitable lead trust with The New York Community Trust as the lead beneficiary, please contact us.*

**For further reference, see:**

Code Section 68: Cut-back rules on charitable and other itemized deductions.

Code Section 170(b): Percentage limitations on income tax charitable deduction.

Code Section 170(f)(2)(B): Gifts of split interests in property.

Treasury Reg. Sec. 1.170A-6(c)(2)(i) and (ii): Charitable contribution of an income interest in trust.

Code Section 642(c): Deduction for amounts paid by a trust to charity.

Proposed Treasury Reg. Sec. 1.642(c)-3, 2008-28 I.R.B. 111.

Code Section 671 *et seq.*: Grantor-owned trusts.

Code Section 681(a): Limitation on charitable deduction.

Code Section 2055(e)(2)(B): Estate tax charitable deduction.

Treasury Reg. Sec. 20.2055-2(e)(2)(vi) and (vii): Estate tax deduction of transfers not exclusively for charitable purposes.

Code Section 2522(c)(2)(B): Gift tax charitable deduction.

Treasury Reg. Sec. 25.2522(c)(3)(c)(2)(vi) and (vii): Gift tax deduction of transfers not exclusively for charitable purposes.

Code Section 4947: Applicability of private foundation rules to charitable lead trusts.

Code Section 7520: Valuation tables.

Revenue Ruling 78-101; 1978-1 C.B. 301.

Revenue Ruling 85-49; 1985-1 C.B. 330.

Revenue Ruling 88-82; 1988-2 C.B. 336.

Revenue Procedures 2007-45, 2007-29 I.R.B. 89; 2007-46, 2007-29 I.R.B. 102.

Revenue Procedures 2008-45, 2008-30 I.R.B. 224; 2008-46, 2008-30 I.R.B. 238.

Private Letter Ruling 19742006: Non-grantor charitable lead trusts.

Private Letter Ruling 198146072: Charitable lead trust with donor-advised fund as beneficiary.

Private Letter Ruling 199908002: Tax consequences related to charitable lead trusts.

Private Letter Ruling 200043029: Designation of beneficiaries under charitable lead trust.

General Counsel Memorandum 39161.

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## About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of \$2 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee; investments fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

### OUR SUBURBAN DIVISIONS

#### Long Island Community Foundation

Nassau Hall  
1864 Muttontown Road  
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#### Westchester Community Foundation

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