AN UPDATE
ON CHARITABLE LEAD TRUSTS

Presented To

Financial Counseling Services Committee
Morton Plant Mease Foundation

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By

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THE CHARITABLE LEAD TRUST[1]

1 **A. What is a charitable lead trust ("CLT")?**

1. Irrevocable trust.
2. Specified distribution, at least annually, to be paid to one or more charitable beneficiaries.
3. Remainder interest passing either to a non-charitable remainderman or to the grantor.
4. Can be inter vivos trust or a testamentary trust.

B. Benefits of a CLT.

1. Remove appreciated asset from the grantor's gross estate without gift tax on appreciation.
2. Provide for the well being of family members, with a charity receiving income immediately and the trust principal remaining within the family unit.
3. Income, estate or gift tax charitable deduction.

C. Grantor and nongrantor CLTs. The value of the lead interest is fully deductible for estate and gift tax purposes. Differences in income tax consequences:

1. Grantor trust (§671 of the Internal Revenue Code of 1986 (the "Code")).
   - (a) Grantor entitled to an income tax charitable deduction for the present for the actuarial value of future payments made to the charitable beneficiary.
   - (b) Deduction is taken in the year the trust is created for the value of a charitable lead interest.
   - (c) Trusts income taxed to donor as earned.
   - (d) Transfer of property to grantor CLT - contribution to charity, subject to limitations under §170.
   - (e) If trust ceases to be a grantor trust, then benefit of income tax is recaptured.
   - (f) Exchanging benefit of up front deduction (may be high income tax rates) for income in later years.
2. Non-grantor CLT.
   - (a) Grantor receives no income tax deduction for the fair market value of the charitable lead interest.
   - (b) Trust tax rules apply, and the trust is taxed on income earned.

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[1] This outline is edited from the outline provided by Sharon A. Drucher and Phillip A. Baurnam, "Split Interest Trusts", Fla. Bar Seminar, Will and Trust Drafting, Part Deux, September 18, 1997.

(c) Accordingly, the trust may fully deduct payments to charity.

D. Types of CLTs.

1. Charitable lead annuity trust ("CLAT") - the amount paid annually to charity is in the form of an annuity.
2. Charitable lead unitrust ("CLUT") - the amount paid annually to charity is the amount equal to a percentage of the fair market value of the trust determined annually.

E. Common requirements for CLATs and CLUTs.

1. Duration of the CLT is for the life or lives of one or more individuals or for a fixed term, (<u>not</u> limited to 20 years).
2. Term can be a combination of the life or lives of one or more individuals and a specified term of years.
3. Grantor of the inter vivos CLT may not have testamentary power to revoke the lead interest.
4. No termination of a trust upon the happening of a contingency.
5. The charitable lead interest must be either a CLAT or a CLUT.
6. Must have one or more charitable income beneficiaries.
7. Document must provide for an alternate charity if the specified charity does not continue to qualify.
8. Document must contain a provision disallowing prohibited transactions applicable to private foundations.
9. Prohibited from making distributions for a private purpose prior to the expiration of the charitable lead interest.
10. Document <u>may</u> provide excess income earned be distributed to the charitable beneficiary or document may specify that excess income is added to principal.
11. Provision requiring that excess income be distributed in the year earned will not increase charitable deduction available at the creation of the trust.
    (a) Grantor CLT, however, the grantor will be entitled to a charitable deduction in the year the excess income is distributed to the charity.
    (b) Non-grantor CLT the trust will be entitled to an annual deduction for the excess amount under IRC § 642(c).
12. No explicit prohibition against additional contributions to a CLAT. In a CLUT additional contributions are permitted and are highly valuable as they will result in additional charitable deductions.

F. Taxation of CLTs.

1. Estate and gift tax charitable deduction equal to the present value of the lead

interest given to charity.

2. Not a tax exempt trust.
3. Complex trust.
4. Non-grantor CLT.
   (a) The trust will be taxed and grantor is not taxed on income nor entitled to charitable unitrust deduction.
   (b) Usually not subject to estate tax because not a grantor trust.
   (c) Taxed on any income that is not distributed to charity.
   (d) Distributions to charities are deductible by trust only when distributed from gross income.
      (i) No deduction by trust allowed for distributions from tax exempt income.
      (ii) Unrelated business taxable income associated with a non-grantor CLT will also be disallowed as an income tax charitable deduction under IRC § 642(c).
      (iii) Cannot carry over excess charitable deductions.
5. Grantor CLT.
   (a) Grantor is taxed as the owner of the trust.
   (b) If grantor survives the expiration of the lead interest, and the property reverts back to the grantor, the value of the property in the trust includable in the grantor's gross estate.
   (c) If grantor dies before the expiration of the lead interest, only the value of the reversion will be includable in the grantor's gross estate.
   (d) If grantor retains reversionary interest - no gift tax liability.
   (e) If remainder interest passes to a non-charitable beneficiary then grantor subject to gift tax.
6. No gift tax - a testamentary CLT.
7. Charitable and non-charitable beneficiaries of a CLT generally not be taxed.
   (a) Charitable beneficiaries are tax exempt.
   (b) Non-charitable beneficiaries do not receive any distribution until the trust terminates.
8. Gift tax only if completed gift and because gift of future interest, then no annual exclusion.

G. Advantages of a CLT.

1. Personal satisfaction of charitable objectives in lifetime.
2. Educate family in making decisions in philanthropy.
3. Can designate private foundation.
4. Income and estate tax advantages.

H. Disadvantages of a CLT.

1. Loss of control of the asset.
2. Loss of benefit of substantial income produced by the asset.
3. Grantor may also incur gift tax liability on the remainder reducing the unified credit.
4. Not suitable in the case of needy family members because as remainderman it may be some time before the remaining interest is transferred to them.
5. CLT is complicated to draft and understand. A private letter ruling should be obtained.

I. Generation-skipping transfer ("GST") tax consequences.

1. If remainder to "skip" person then GST consequences.
2. If GST exemption allocated to CLUT then trust will be exempt even though grows to 2 million dollars and distributed to grandchildren.
3. Section 2642(e) of the Code requires in a CLAT the determination of the applicable fraction is not made until the <u>end</u> of charitable term because as the annuity is fixed the remainderman benefit from principal appreciation. In a CLUT as principal increases so do payments to charity.
4. Generally, because of the problem with allocating the GST exemption to a CLAT, the CLUT is the trust to use if GST consequences.
5. Section added to prevent leverage of GST exemption.
6. Avoid inadvertent GST transfers.

J. Comparison of Charitable Remainder Trust ("CRT") and CLT.

	CRT	CLT
Income Interest	Individual	Charity
Remainder	Charity	Individual
Term of Trust	Lifetime or period not exceeding 20 years	Unlimited number of years or lifetime
Minimum Rate	5%	No minimum rate
Capital Gains Tax	Avoided	Not avoided
Income Tax	Grantor's tax reduced None on trust income	Grantor's tax payable; Trust income taxable as complex trust

K. Impact of the Taxpayer Relief Act of 1997.[2]

1. If CLT is created with remainder paid to a "skip" generation, but the remainder beneficiary's parent (the intervening generation) was deceased at the time the trust was created, no generation-skipping tax will be due when the trust ends. Effective for transfers occurring after December 31, 1997 the predeceased parent (orphan's) exception has been extended to charitable trusts.
2. The throwback rules for domestic trusts have been repealed effective to distributions made in tax years beginning after August 5, 1997 and with respect to sales or exchanges occurring after August 5, 1997.
3. The rule that gain on the sale of appreciated property contributed to a lead trust be taxed at the contributor's marginal tax rates if sold within two years of the date of contribution has been repealed.

L. IRS Rulings Which Seem to Allow Greater Flexibility in Non-Reversionary Charitable Lead Trusts (Gift/Estate Tax Savings).[2]

1. Revenue Ruling 95-98, grantor's power to replace independent Trustee did not result in a "grantor" trust.
2. Ltr. Rul. 9304020, request that Trustee "consult" with the grantor's children regarding selection of the annual charitable beneficiaries did not result in a "grantor" trust.
3. Ltr. Rul. 9512002, the purchase of the remainder interest by the son of the majority owners of a Sub-S corporation was approved where the Sub-S corporation established the lead trust and was the remainder beneficiary.
4. Ltr. Rul. 9532007 (referring to the Rev. Rul. 78-101), independent Trustee's power to replace the charitable beneficiaries did not result in a "grantor" trust.
5. Ltr. Rul. 9610014, allowed allocation of the GST exemption.
6. Ltr. Rul. 9631021, a will included alternative lead annuity trusts and gave the decedent's daughter the right to determine, within the 9 month disclaimer period, which trust to create and fund based on a formula clause.
7. Ltr. Rul. 9633027, allowed distributions from a lead unitrust to be made to a donor-advised fund at a foundation, with the independent Trustee of the lead trust the donor advisor, and did not result in a "grantor" trust.

M. Recent Letter Rulings affecting Charitable Lead Trusts.

1. PLR 9713017. Foundation is recipient of charitable lead interest. Donor not

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[2] This portion of the outline has been edited from an outline written by Laura Hanson Dean, Esquire who spoke to the Tampa Bay Area Planned Giving Council on December 3, 1997.

member of Board. Assets includable in estate.

2. PLR 9716023. Unitrust lead interest deduction for estate tax purposes.
3. PLR 9718025. Court ordered modifications of lead trust (administrative) which will not cause loss of grandfather status of GST exempt trust.
4. PLR 9718032. No GST tax upon transfer but taxable termination upon distributions to grandchildren.
5. PLR 9721106. Annuity interest qualifies as estate tax charitable deduction.
6. PLR 9725012. Irrevocable charitable lead trusts <u>not</u> includable in gross estate and trusts are not grantor trusts.
7. PLR 9737023. Charitable unitrust - gift tax deduction.

Application for Lecture Credit for "An Update on Charitable Lead Trusts"
Presented on February 19, 1998

To prepare for this lecture I had to research extensively the statutes, regulations and case law regarding charitable lead trusts, including private letter rulings, and thus such research greatly increased my proficiency in the area of charitable lead trusts.

Application for lecture credit for "Disclaimers"
Presented to the Florida Bar on February 26 and 27, 1998

To prepare for this lecture I researched extensively for fifteen hours the statute, regulations and case law regarding disclaimers, including private letter rulings, and thus my knowledge of disclaimers and related planning has greatly increased.