A PRACTICAL LOOK

AT

CHARITABLE LEAD TRUSTS

Jane Peebles, J.D.
Karlin & Peebles, LLP
8383 Wilshire Blvd., Suite 708
Beverly Hills, California 90211
(310) 274-5245
jpeebles@karlinpeebles.com

TABLE OF CONTENTS

Page

I. INTRODUCTION 1
II. WHEN TO CONSIDER A CHARITABLE LEAD TRUST 1
A. Liquidity Event 1
B. IPO 2
C. Desire to Benefit Younger Generations in the Future 2
D. Client Already Maxing Out Charitable Deductions 2
III. BASIC TYPES OF AND REQUIREMENTS FOR THE CLT 2
A. General Description 2
B. Two Types of Lead Interest 2
C. No Term of Years Limitation 4
D. Payment for Life or Lives 4
E. No Minimum or Maximum Distribution Amount 5
F. No Limitation as to Remainderman 5
G. Grantor Versus Nongrantor Trust Status 5
H. The "Super CLT" 9
I. The Charitable Beneficiaries 9
J. Trustees and Trustee Powers 10
K. Application of Private Foundation Rules 11
IV. PRIVATE FOUNDATION AS CHARITABLE LEAD BENEFICIARY 12
V. CONSIDERATIONS IN TRANSFERRING DIFFERENT TYPES OF ASSETS TO A CLT 17
A. Business Transfers 17
B. Transfers of Real Estate 18
C. Bonds/Notes 18
D. Tangibles/Collections 18
E. Intangibles 18
G. Income in Respect of a Decedent 19
VI. GST PLANNING WITH CHARITABLE LEAD TRUSTS 19
A. Designing a CLT for Lower Generations 19
B. GST Tax and the CLUT 20
C. GST Tax and the CLAT 20

TABLE OF CONTENTS
(continued)

Page

D. Allocation of GST Exemption to a CLT 21
VII. CONCLUSION.. 34
EXHIBIT A CLT FILING REQUIREMENTS... 35
EXHIBIT B UNRELATED BUSINESS INCOME AND THE CLT 36

A PRACTICAL LOOK
AT
CHARITABLE LEAD TRUSTS

Jane Peebles, J.D.[1]

I. INTRODUCTION

A charitable lead trust makes payments to charity for a measuring life or a term of years or sanctioned combination thereof and then either reverts to the settlor or passes to or in trust for other individual beneficiaries. Using a charitable lead trust ("CLT"), your client can:

- Obtain an income tax deduction for the charitable interest;
- Leverage his gift to his children or grandchildren and exclude the CLT property from his estate; or
- Achieve all of these goals using a "Super CLT" that is a grantor trust not includible in the client's estate.

CLTs have enjoyed increased popularity in recent years largely as a result of the generation-skipping planning they permit, low applicable federal interest rates under IRC Section 7520 (which make charitable lead annuity trusts more effective for leveraging of gifts), the 10% remainder requirement for charitable remainder trusts (which makes it difficult to structure a CRT to benefit grandchildren or children) and favorable tax treatment when the settlor's private foundation is the CLT's charitable beneficiary.

II. WHEN TO CONSIDER A CHARITABLE LEAD TRUST

Assuming your client is philanthropically inclined, consider a charitable lead trust in the following circumstances:

A. Liquidity Event

Your client is selling her business and will recognize substantial capital gains. She is not willing to part with her sudden riches permanently. A transfer to a CLT that is a grantor trust after any sale of assets, such as closely-held stock, will produce a generous deduction while ensuring the return of the assets ultimately to the donor or her spouse. In cases of reluctance to part with the principal, this technique is very viable. A

---

[1] Jane Peebles, a Law Corporation is a principal in the Beverly Hills law firm of Karlin & Peebles, LLP.

© Jane Peebles, all rights reserved (2012)

grantor CLT will allow her to (i) offset those gains with an income tax deduction in the year of sale and (ii) pay the tax on her gains over several years. This effectively allows income averaging instead of a huge tax bill in the year of sale. She gets the property back when the trust terminates.

B. IPO

Often planners advise clients about to undertake an initial public offering to place some of their shares in a charitable remainder trust. This, however, is anathema to the shareholder who until now has had only paper wealth. Why would he want to give it away? The thought of having only the income and none of the principal is a problem. Some amount of the closely-held stock might be placed in a grantor CLT with a reversion to the donor. This generates a lump sum deduction in the same year that the shareholder had gain on the closely-held stock. Selling some of the new stock may be necessary to meet the payout commitment of the CLT, but ultimately receiving back the remainder interest after a period of years would be the selling point of this strategy.

C. Desire to Benefit Younger Generations in the Future

Your client has young children and wants to provide them with funds when they are in their 20's or 30's. A nongrantor charitable lead annuity trust will allow her to pass assets down a generation at little or no gift tax cost. A nongrantor charitable lead unitrust will also allow her to pass assets down to grandchildren at little generation-skipping transfer tax cost.

D. Client Already Maxing Out Charitable Deductions

If your client contributes substantial amounts to charity and cannot fully deduct his gifts because of the percentage limitations on income tax charitable deductions, consider a CLT that pays to his private foundation or to a donor advised fund that can, in turn, make grants to his favorite charities. These distributions from the CLT are deductible by the CLT and are not subject to the percentage limitation.

III. BASIC TYPES OF AND REQUIREMENTS FOR THE CLT

A. General Description

A CLT provides for a "lead" interest to be paid to a charity or charities at least annually and then a remainder interest to be paid to one or more individuals and/or trusts upon termination of the lead interest. The CLT is sometimes referred to as a "wait a while" trust since the individual heirs must wait a while to enjoy any benefit from the trust.

B. Two Types of Lead Interest

The CLT pays either an annuity amount or a unitrust amount to charity during its term, but not a net income payout.

1. Charitable Lead Unitrust. The charitable lead unitrust (CLUT) pays charity a unitrust amount. A unitrust payment is a fixed percentage of the fair market value of the trust as determined annually. If the value of the CLUT goes up, the unitrust amount increases, and vice versa.

2. Charitable Lead Annuity Trust. The charitable lead annuity trust (CLAT) provides an annuity for charity. An annuity payment is typically a fixed dollar amount each year, expressed as a dollar amount or as a fraction or percentage of the trust's initial value.

(a) A properly designed CLAT can also provide for annuity payments to charity that increase over the years. Unequal annuity payments, such as 2% for the first three years then increasing to 5%, are permissible, as long as the value of the lead interest is ascertainable at the inception of the CLT.[2]

(b) In PLR 201216045, the IRS approved a testamentary CLAT providing for annuity payouts that would increase by 20% for each year of the 10-year CLAT term. The ascending charitable payout allowed the trust to be invested so that the annuity payments could be made for the full 10 years. The percentage payout was by formula designed to result in a zeroed out remainder. The formula was needed because the drafter could not predict what the AFR would be at the client's death.[3]

(c) The validity of so-called "shark-fin" CLATs has been hotly debated in recent years. With a shark-fin CLAT, the payouts to charity are substantially back-loaded. If this works, it permits the transfer of very significant wealth to the next generation with limited estate or gift tax liability. But the IRS has not ruled on whether this works. One version of shark-fin being heavily promoted provides for a very low charitable payout over the life of the settlor, which is also the term of the non-grantor CLAT. Most of the funds in the CLAT are used to buy a single-premium life insurance policy on the settlor. The trustee uses the rest of the funds to buy tax-free municipal bonds to make nominal annual payments to charity during the settlor's life. When the settlor dies and the CLAT terminates, a portion of the life insurance proceeds funds the back-loaded charitable payout, and the remainder of the proceeds, together with any other assets then in the CLAT, passes to the next generation.

---

[2] PLR 9112009.

[3] Annuity amounts ascending in this manner are expressly permitted for GRATs. Treas. Reg. 25-2702-3(b)(1)(ii)(A).

The basis for the back loading is Revenue Procedures 2007-45 and 2007-46[4], which contain sample CLAT forms with annotations indicating that a CLAT may provide for an annuity amount that is initially expressed as a fixed dollar amount "but increases over the annuity period." The shark-fin design would be a very efficient asset transfer vehicle if it worked. However, the fact that de minimis payments to charity are made during the CLAT term and the final, big payment is triggered by the settlor's death may cause the CLAT not to qualify as a CLAT at all because the post-mortem payment is not an annuity payment.

If the strategy does not work:

- For a testamentary CLAT, the entire amount transferred is included in the settlor's gross estate;
- For an inter vivos nongrantor CLAT, the entire amount transferred is a taxable gift; and
- No income tax deduction is available for an inter vivos grantor CLAT.

C. No Term of Years Limitation

There is no term of years limitation for the charitable lead trust as for the charitable remainder trust and, therefore, effective planning for grandchildren can be accomplished using terms in excess of 20 years by careful choice of assets that produce enough growth for the preservation of the grandchildren's future interest in the trust assets while meeting the payment obligation to the charity during the trust term.

D. Payment for Life or Lives

The payment to the charity may be structured on the basis of a specified term of years (with no limit to the term) or on the basis of a life or lives in being at the inception of the CLT. Most CLTs are nevertheless structured as term trusts. Regulations limit the measuring lives that can be used to (i) the settlor, (ii) his or her spouse, (iii) descendants of the settlor and (iv) spouses of such descendants.[5] The lead payments may also be over a term of years plus a life or lives in being.[6]

---

[4] Rev. Procs. 2007-45 and 2007-46 contain CLAT forms; Rev. Procs. 2008-45 and 2008-46 contain CLUT forms.

[5] See Treas. Reg. Sections 1.170A-6(c)(2), 1.170A-6(e); 20.2055-2(e); 25.2522(c)-3(c).

[6] Rev. Rul. 85-49, 1985-1C.B. 330, approving a term that ended on the first to occur of 30 years after funding or 21 years after the death of the last to die of a class of lives in being.

E. No Minimum or Maximum Distribution Amount

In contrast to the charitable remainder trust, the CLT can pay any amount to charity and is not subject to a minimum 5% payout. Generally, because family members will receive the remainder interest, the payout is kept within reason so as to preserve the original principal and to achieve some growth of principal. Balancing the tax avoidance goals of the settlor and the desire to have the assets grow sufficiently for the ultimate family remainder beneficiaries is a large part of the planning process.

F. No Limitation as to Remainderman

There is no limitation as to who may receive the remainder interest. Trusts for grandchildren frequently receive the remainder and even a "supplemental needs" trust for a disabled beneficiary could be used. However, keep in mind that if the settlor or spouse of the settlor receives the remainder interest, the CLT is likely to be a grantor trust. This is acceptable only if intended since the planning uses for grantor and nongrantor trusts are vastly different.

G. Grantor Versus Nongrantor Trust Status

Either a CLAT or a CLUT may be deemed a grantor trust or a nongrantor trust.

1. Grantor CLTs. A *grantor* CLT provides the settlor with an immediate charitable income tax deduction for the present value of the annuity or unitrust amounts to be paid to charity. The grantor CLT is not permitted to claim a charitable deduction under IRC Section 642(c) for its distributions to charity.

(a) If the client experiences a large gain such as from the sale of a major asset, the proceeds can be used to fund a grantor CLT in order to create a lump-sum deduction for the settlor in the same year. The price of the income tax deduction at inception is that the settlor of a grantor CLT must report all of the net income realized by the CLT each year on his personal income tax return.[7]

(b) If the settlor dies during the term of the CLT or otherwise ceases to be deemed the owner of the CLT for income tax purposes, all or part of the income tax charitable deduction is recaptured.[8]

---

[7] Section 170(f)(2)(B). Unless otherwise indicated, all references to "Section" are to the Internal Revenue Code of 1986, as amended.

[8] Treas. Reg. Section 1.170A-6(c)(A).

(c) If the settlor or the settlor's spouse retains a reversionary interest, the CLT will generally be a grantor trust. Any retention of a power listed in IRC Sections 671 to 679 will cause the trust to be a grantor trust. For example, reversionary interests, power to control beneficial enjoyment, retention of administrative powers not in a fiduciary capacity, power to revoke, using the income for the benefit of the settlor, or foreign trusts with U.S. beneficiaries are some of the reasons a trust may be deemed a grantor trust. Drafters commonly cause CLT grantor trust status by allowing a non-adverse party, in a non-fiduciary capacity and without the consent of the trustee, to acquire the trust corpus by substituting other assets of equivalent value.[9]

(d) Where the tax rate of the transferor in the year of transfer is expected to be considerably higher than the following years' will be, either by tax law change or by individual circumstance, such as retirement, it may be beneficial to establish a grantor CLT, take a lump-sum deduction and invest the tax savings, recognizing income at a lower taxable rate in subsequent years, when the grantor's marginal income tax bracket is lower.

(e) Private letter rulings have permitted trustees to invest, in trustee discretion, in tax-exempt investments, provided the trustee has total control to "uninvest" in such an asset. Thus, when the grantor trust rules require inclusion on the Form 1040 of the settlor, there is no taxable income, but there was a deduction. Eventually, the settlor receives his assets back (or the value of the trust remainder) at the end of the trust term.

2. Nongrantor CLTs. A *nongrantor* CLT offers no income tax deduction to the settlor but can offer substantial gift or estate tax savings.

(a) Taxable Trust. A nongrantor CLT is a taxable trust. To the extent the CLT realizes income (including capital gains) in the year in excess of the charitable deduction allowed to it for the lead interest distributions for that year, the trust is required to pay income taxes on the excess, computed using standard trust tax rates.

(b) Deduction for Charitable Distributions. The CLT is entitled to an IRC Section 642(c) income tax charitable deduction for the amount it

---

[9] Such a power to acquire trust assets causes the CLT to be a grantor trust notwithstanding the use of the term "reacquire" in Section 675(4). See PLR 9642039. Moreover, the power to "acquire" is the only grantor trust taint included in the Rev. Proc. 2007-45 form of inter vivos grantor CLAT and Rev. Proc. 2008-45 form of inter vivos grantor CLUT.

pays to charity from gross income each year. The trust's charitable deduction is not limited to a percentage of its AGI unless it has unrelated business income. However, the CLT cannot carry forward excess charitable deduction amounts to future years.[10]

- While the charitable lead interests may be satisfied by in kind distributions at date of distribution values,[11] the trust gets no Section 642(c) deduction for such distributions as they are not made from gross income.[12] However, if the CLT realizes capital gains on the in-kind distribution because it is made with appreciated assets, the deduction will be allowed.[13]

(c) Offsetting Income with Future Year's Deduction. If income realized by the CLT is greater than the current year's charitable distributions, IRC Section 642(c)(1) allows the trustee to elect to "borrow" some of the next year's charitable deduction to offset the extra income in the current year. Any amounts so "borrowed" cannot be used by the trust again as a deduction in the subsequent year.

(d) No Four-Tier System. The "four-tier" system applicable to CRTs does not apply to CLTs. Instead, each payment to charity is treated as having been made ratably from ordinary income, long-term capital gains, tax-free income and principal of the CLT. Nevertheless, drafters have made numerous attempts to obtain IRS approval of its application, seeing no valid grounds for the IRS to disallow it. The IRS has consistently taken the position that a CLT's charitable distribution will be treated as coming ratably from each type of trust income.[14] Final Treasury Regulations under IRC Section 642(c) effective April 16, 2012 confirm that Treasury will not respect such income ordering under IRC Sections 642 and 643 unless it has economic substance independent of income tax consequences.[15] Application of a four-tier system would distribute the

---

[10] The payments are considered "for the use of" the lead beneficiary. PLR 8824039.

[11] Treas. Reg. Section 1.664-1(d)(5).

[12] See PLR 8931029.

[13] Rev. Rul. 83075, 1983-1C.B. 114; PLR 9201029.

[14] PLR 9821030, 9808035, PLR 9808031, 9348012, 9233038, 9052013 and 8931029.

[15] 76 F.R. 22483 (April 13, 2012).

highest cost income to the charity (which does not care) and leave the lowest rate income in the trust[16].

(e) Discounted Remainder Interest. The major tax savings offered by a nongrantor CLT is the reduction of estate or gift tax due to the discounted value of the remainder interest. The value of the remainder is computed when the CLT is funded, using IRS tables. The present value of the charitable lead interest is deductible for gift or estate tax purposes, and that of the remainder is subject to gift or estate tax. The value of each is affected by the amount to be paid to charity each year, the term of the trust and the Section 7520 interest rate in effect when the CLT is funded.

(f) Lower Generation Beneficiaries. The simple wealth shift trust is the most common use of the nongrantor CLT. Many individuals would rather pay tax (or utilize gift tax exemption) on the present value of the remainder interest than on the whole value of the asset. The penalty is making the noncharitable recipient wait for the trust to terminate. For that reason, it is best used for children or grandchildren who would have received a delayed gift anyway and therefore would have waited for their trust distribution.

(g) Zeroing Out the Remainder. When the AFR is low, it is fairly easy to "zero out" the remainder of a CLAT. The CLAT term and payout are set so that the gift tax charitable deduction fully offsets the value of the gift to the CLAT on funding. Therefore, for a testamentary CLAT, there is no inclusion in the gross estate, and for an inter vivos CLAT, there is no taxable gift. PLR 9631021 allowed a decedent's daughter to choose, during the disclaimer period, between a CLAT paying the AFR plus 1% or one paying the AFR plus 2%, in each case with a term just long enough to zero out the value of the remainder. The funding of a zeroed out testamentary CLAT may also be set by formula.[17]

(h) Double Discounts. The nongrantor CLT offers double discounts when funded with interests in the family business. The transfer tax is imposed on the wealth shift of the remainder interest, which is already only a portion of the total asset value of the lead trust. When this is combined with minority and lack of marketability discounts, an enormous amount of wealth can be transferred at very small tax cost.

---

[16] PLR 9233038; PLR 8727072.

[17] PLR 9128051; PLR 9118040; PLR 9631021; PLR 9840036.

(i) CLUT for GSTT Planning. The CLUT allows the settlor to leverage his GST exemption highly effectively. Often, those who can wait for the distribution are the grandchildren due to their younger ages. Because only the value of the remainder must be covered by the client's GST exemption, the value of the CLT itself can be significantly higher.

H. The "Super CLT"

The IRS has approved a CLT design which offers grantor trust status and exclusion of the CLT assets from the grantor's gross estate. The trick is to use a grantor trust taint (such as giving a non-adverse person other than the settlor hold the IRC Section 675(4)(c) ability in a non-fiduciary capacity to acquire the corpus by substituting assets of equivalent value) that does not cause inclusion in the gross estate.[18]

I. The Charitable Beneficiaries

1. Types of Charities that can Benefit. Private foundations, support foundations, community foundations and other charitable receptacles such as donor advised funds can receive the CLT distributions.

2. Power to Change the Charities. The charities to receive the lead interest may be named irrevocably in the trust document or may be amendable by the settlor, the trustee or another.[19]

(a) A power in the settlor to change the charitable beneficiaries of a *nongrantor* CLT should fall within the exception of IRC section 674(b)(2) for naming charities without risk of a nongrantor CLT being deemed to be a grantor trust.

(b) If the settlor retains this power, however, the gift of the lead interest is incomplete for gift tax purposes,[20] and IRC Section 2036(a)(2) will cause inclusion of the remaining lead interest in the settlor's estate if she dies during the term of the CLT. In other words, the transfer tax benefits of the CLT are lost. This power could be given to an independent special trustee trusted by the settlor.

---

[18] See PLRs 9810019, 9642039, 9407014, 9247024 and 9224029.

[19] PLR 9331015.

[20] Rev. Rul. 77-32, 1977-2 C.B. 353.

J. Trustees and Trustee Powers

1. Grantor as Trustee

(a) The grantor can act as trustee of *a nongrantor* CLT without causing inclusion of the corpus in his gross estate as long as the grantor holds only routine administrative powers. However, the corpus will be includible in the gross estate under IRC Section 2036 or 2038 if the grantor retains the power to designate the income or remainder beneficiaries.

(b) The grantor can act as trustee with the power to designate the income or remainder beneficiaries if the trust is a *grantor* CLT and the corpus will be includible in his gross estate in any event, such as due to a retained reversionary interest.

2. Grantor's Family Member as Trustee

(a) A member of the grantor's family other than the grantor's spouse can act as trustee of a *nongrantor* CLT. The spouse can act as long as not granted any power that would cause grantor trust status due to IRC Section 672(e).

(b) Family members may act even where the trustees otherwise control the assets which are held in the trust, such as closely held stock.

(c) Any compensation paid to a family member trustee should not exceed reasonable compensation, or such excess compensation might be deemed a current noncharitable distribution and thus disqualify the CLT.

3. Trustee's Sprinkle Power

(a) An independent trustee of a CLT may safely have the power to sprinkle the annuity or unitrust payment among qualifying charitable beneficiaries. It should also be safe to allow an independent trustee to sprinkle the remainder among a class of individual beneficiaries upon termination of the lead interest.

(b) If the grantor or the grantor's spouse held the power to sprinkle *corpus*, the grantor would be treated as the owner for income tax purposes under IRC Section 674(a). Moreover, a sprinkle power held by the grantor (but not his or her spouse) will cause inclusion of the corpus in the grantor's gross estate under IRC Sections 2036(a)(2) and 2038(a)(1).

(c) A sprinkle power retained by the grantor or his or her spouse with respect to the *annuity or unitrust payments* will not cause the grantor to be treated as the owner for income tax purposes,[21] but the retention of this power by the grantor (but not his or her spouse) will cause inclusion in the gross estate under IRC Sections 2036(a)(2) and 2038(a)(1).

(d) Even if the grantor is not the trustee, if the trustee holds sprinkle powers and the grantor can freely discharge the trustee and appoint another, including the grantor or any trustee that is related or subordinate to the grantor, the corpus will be includible in the grantor's estate under IRC Section 2036.

K. Application of Private Foundation Rules

1. Excise Tax Provisions. The excise tax provisions applicable to private foundations under IRC Sections 4941 to 4945 also apply to CLTs. Therefore, the trust document should include specific prohibitions against their violation as required by IRC Sections 4947(a)(c) and 508(e).

2. Excess Business Holdings. If the value of the charitable interest exceeds 60% of the value of the trust at inception, IRC Sections 4943 (excess business holdings) and 4944 (jeopardizing investments) may apply.[22]

(a) If the CLT holds more than a 20% voting interest in a business entity, there are excess business holdings. If the excess business holding rules of IRC Section 4943 do apply, the trust is allowed a maximum of five years to divest itself of the "excess" received at funding.

- In PLR 9819031, the IRS approved issuance of a new class of nonvoting stock of a closely held C corporation, with a fixed rate dividend for 15 years, to fund CLTs. After 15 years, the stock was to revert to voting stock. This avoided the excess business holdings problem and provided cash flow for the charitable lead distributions.

(b) The 60% rule is obviously to avoid "packing" the value into the charitable income interest and zeroing out the remainder where family business interests are passed down to lower generations at little or no transfer tax cost. A formula clause may set the payment rate for a

---

[21] Section 674(b)(4).

[22] Sections 4947(a)(2) and 494(b)(3)(A).

testamentary CLT so the charitable interest does not exceed 60% of the CLT's total value, and excess business holdings are avoided.[23]

(c) If the jeopardizing investment rules of IRC Section 4944 apply, the exception for assets that are "gratuitously transferred" to the trust, e.g. at funding, does not apply. The CLT may not either acquire or retain such assets.[24]

IV. PRIVATE FOUNDATION AS CHARITABLE LEAD BENEFICIARY

1. Benefits of Private Foundation as Lead Beneficiary. If your client regularly contributes substantial amounts to charity and the percentage limitations on charitable deductions result in her being unable to fully deduct her gifts, she should consider setting up a CLT that pays to a private foundation that, in turn, makes grants to her favorite charities.

(a) The value of lead distributions from a CLT of which a private foundation is the charitable beneficiary need not be included when calculating the foundation's 5% minimum distribution.[25] Prior to the 1994 Ann Jackson case, in order for the private foundation to meet the 5% payout requirement, it had to distribute a substantial portion of the CLT payments per Treasury Regulation Section 53.4942(a)-2. In the Ann Jackson case, the 9th Circuit ruled this regulation, and its rule that the value of the lead distributions had to be included for purposes of computing the 5% payout amount, to be invalid. This permits a significantly greater benefit to the foundation and provides a method to build the value of the foundation in order to meet a client's philanthropic goals.

(b) If the charitable beneficiary is a private foundation, the IRS has ruled that amounts distributed to it by a CLT will be subject to the 2% excise tax on private foundation net investment income only if they are "gross investment income," i.e., dividends, interest, rents and royalties. Capital gains distributed by a CLT will apparently not be taxed to a private foundation which holds the lead interest.[26]

---

[23] PLR 9128051, PLR 9118040.

[24] Treas. Reg. Section 20.22055-2(e)(vi)(e).

[25] The Ann Jackson Family Foundation v. Comm'r, 97 T.C. #35 (1991), 15 F.3d 917 (9th Cir. 1994). See PLR 9633027.

[26] PLR 9724005.

2. Settlor and Private Foundation Grantmaking Decisions. If the income beneficiary of the CLT is a private foundation established by the settlor, and if the CLT is not intended to be includable in the settlor's estate for estate tax purposes, the settlor should not participate in grantmaking decisions of the foundation's board with respect to amounts received from the CLT. The IRS takes the position that this results in inclusion of the CLT in the settlor's estate under Section 2036(a) if he dies during the term of the trust.[27]

(a) The simplest solution is to block the settlor from sitting on the foundation's board.

(b) It seems, however, that the settlor of a CLT can name his private foundation as the lead beneficiary and remain a trustee or director of the foundation if he can be insulated from making grant decisions regarding the funds received from the CLT.

(c) In PLRs 199908002 and 200138018, the IRS ruled that no part of a CLT would be includible in the settlor's gross estate, even though he was an officer of the private foundation that was the lead beneficiary, where the funds received by the foundation from the CLT had to be held in a segregated fund as to which he had no vote. This ruling did not state whether the settlor was also a founder of the foundation. One also finds analogous strategies in the context of qualified disclaimers of property which then passes to a foundation. One requirement for a valid disclaimer under IRC Section 2518(b) is that the disclaimant may not retain any benefits from the property. If disclaimed property passes to a private foundation, the disclaimer will be ineffective if the disclaimant is a director, trustee or other disqualified person with respect to the foundation and has the power to name charitable recipients.[28] Treas. Reg. Section 25.2518-2(e)(1)(i). Private letter rulings have approved creative strategies which allow the disclaimant to continue to be actively involved with the foundation without tainting the disclaimer.

- PLR 9319022: Separate the foundation into two distinct entities, with the disclaimant prohibited from serving in any capacity on the board of the foundation which receives the disclaimed property.

- PLRs 9317039 and 9320008: Create a separate and segregated fund within the foundation, to be the recipient of the

[27] Revson Estate v. United States, 51 C1. Ct. 362 (1984).

[28] Treas. Reg. Section 25.2518-2(e)(1)(i).

disclaimed property, with the disclaimant prohibited by the bylaws from participating in grantmaking decisions as to those funds.

- PLR 9532027: Create a donor advised fund equivalent within the foundation, to receive the disclaimed property. The disclaimant may make recommendations regarding charitable grants from this fund; however, his recommendations may be accepted or rejected by the other directors.

3. An alternative to paying the CLT lead interest to a family foundation is to set up a donor advised fund at a community foundation and designate that fund as the charitable beneficiary. The settlor's family may then act as the advisory board without anyone's running afoul of IRC Section 2036. This allows more flexibility in the timing of distributions to charities. It also allows accumulation of distributions for several years in order to facilitate a large grant.

EXAMPLE 1: *Hank Hystok, age 40, with children ages 8 and 10, wants to establish his own private foundation with an initial funding of $1 million. His assets consist largely of low basis, low yielding stock, which he regularly gives to his alma mater and other favorite charities - a practice he would like to continue in addition to funding the foundation. Hank's annual income (before gains) is $500,000, and his gifts of stock to public charities typically use up most of his 30% contribution limit for such gifts. Thus, a contribution to a private foundation would give rise to little or no deduction except if Hank stopped making his other charitable gifts. A contribution of appreciated publicly traded securities to a private foundation gives rise to a deduction based on the fair market value of the securities, but still subject to the lower percentage limitations.*

Hank establishes a 5.768% 20-year nongrantor CLAT and funds it with $1 million of low basis stock when the AFR is 1.4%. At the end of the 20 years, the trust terminates in favor of the children. Stock will be sold off as needed to fund the annuity payout, or distribution will be made in kind to the extent income is not available. By the end of the 20 year lead term, the foundation will have the desired funding. If the stock grows by at least 5% per year, as it has historically, $947,760 or more will be available for the children at the end of the ten years. If the stock does not meet this growth target, the children will take correspondingly less, which is alright with Hank since the primary purpose of the trust is to fund the foundation in an income tax efficient manner. Hank is confident the stock will grow at least 1.4% - the rate assumed by the IRS in determining the gift tax consequences of the gift.

None of the trust will be treated as a taxable gift as the remainder is zeroed out on these numbers. If it were not, there would still be no gift tax assuming Hank had enough lifetime gift tax exemption available to shield the initial value of the remainder interest. GST exemption should not be allocated to the trust, and the trust should be drafted in such a way as to ensure that it will not give rise to any generation-skipping transfers, since the children will be the remainder beneficiaries. A CLAT is used since the dividends are low, and ability to pay a unitrust amount would become a problem as a CLUT increased in value.

The funding of the CLAT with low basis stock will result in a reduction of Hank's annual income. Hank can continue to claim deductions for gifts of stock directly to his favorite public charities, up to 30% of his adjusted gross income per year, while funding his foundation through the lead trust.

EXAMPLE 1: HANK HYSTOK

Charitable Lead Annuity Trust 5/11/2012

Trust Type:	Term
Transfer Date:	5/2012
§7520 Rate:	1.40%
FMV of Trust:	$1,000,000.00
Growth of Trust:	5.00%
Percentage Payout:	5.768%
Payment Period:	Annual
Payment Timing:	End
Term:	20
Total Number of Payments:	20
Exhaustion Method:	IRS
Vary Annuity Payments?	No

Annual Payout:	$57,680.00
Annual Payment:	$57,680.00
Term Certain Annuity Factor:	17.3391
Payout Frequency Factor:	1.0000
Present Value of Annuity Limited by §7520 Regs:	$1,000,000.00
Remainder Interest = FMV of Trust less PV of Annuity:	$0.00
Charitable Deduction for Income Interest:	$1,000,000.00
Donor's Deduction as Percentage of Amount Transferred:	100.000%

Year	Beginning Principal	5.00% Growth	Payment	Remainder
1	$1,000,000.00	$50,000.00	$57,680.00	$992,320.00
2	$992,320.00	$49,616.00	$57,680.00	$984,256.00
3	$984,256.00	$49,212.80	$57,680.00	$975,788.80
4	$975,788.80	$48,789.44	$57,680.00	$966,898.24
5	$966,898.24	$48,344.91	$57,680.00	$957,563.15
6	$957,563.15	$47,878.16	$57,680.00	$947,761.31
7	$947,761.31	$47,388.07	$57,680.00	$937,469.38
8	$937,469.38	$46,873.47	$57,680.00	$926,662.85
9	$926,662.85	$46,333.14	$57,680.00	$915,315.99
10	$915,315.99	$45,765.80	$57,680.00	$903,401.79
11	$903,401.79	$45,170.09	$57,680.00	$890,891.88
12	$890,891.88	$44,544.59	$57,680.00	$877,756.47
13	$877,756.47	$43,887.82	$57,680.00	$863,964.29
14	$863,964.29	$43,198.21	$57,680.00	$849,482.50
15	$849,482.50	$42,474.13	$57,680.00	$834,276.63
16	$834,276.63	$41,713.83	$57,680.00	$818,310.46
17	$818,310.46	$40,915.52	$57,680.00	$801,545.98
18	$801,545.98	$40,077.30	$57,680.00	$783,943.28
19	$783,943.28	$39,197.16	$57,680.00	$765,460.44
20	$765,460.44	$38,273.02	$57,680.00	$746,053.46
Summary:	$1,000,000.00	$899,653.46	$1,153,600.00	$746,053.46

V. CONSIDERATIONS IN TRANSFERRING DIFFERENT TYPES OF ASSETS TO A CLT

A. Business Transfers

1. Business to Children: Declaring Dividends to Pay CLT Payout to Foundation or Charity as CLT Recipient. If a business interest such as closely-held C corporation stock is transferred to a CLT, it will be necessary to declare dividends to fund the payout to the charitable recipient(s). This must be analyzed from the point of view of the ongoing (for the term of the trust) cost of the nondeductible dividends to the corporation plus the tax, if any, on the transfer of the value of the remainder interest to the children versus the cost of the estate or gift tax if the stock is gifted directly to the children at a later date, plus the potential estate tax (or gift tax) on projected appreciation in the value of the stock.

2. Sale or Redemption of Stock held by the CLT. If no dividends are to be declared for some reason, such as too many other shareholders who may also have to receive dividends, then the CLT may be able to redeem some of the shares of the corporation for cash or notes in order to meet the required payout. An installment note for a stock redemption should be acceptable as within the IRC Section 4941(d) exception from self-dealing for corporate redemptions. A recent position of the IRS is that the one exemption from self-dealing does not cover both acts. This is a dubious position under the IRC Section 4941(d) exceptions, but the IRS ruling office is on a self-dealing binge lately.

(a) The redemption will result in a "phantom shift" to children in total percentage ownership because the denominator has decreased in size relative to their holdings.

(b) The redemption must be offered to all shareholders owning the same class of stock, however. This may call for a recapitalization in certain instances where there are dissident shareholders who may find this an opportunity to cash in their stock, or if too many shareholders cash in for the cash flow of the company.

(c) Perhaps the ESOP could purchase stock from the CLT if the ESOP is not a disqualified person with respect to the trust and if the CLT is not a disqualified person with respect to the plan, and provided that the stock is qualifying employer securities under ERISA rules. The rules of both sides of the transaction, the ESOP and the CLT, must be reviewed.

3. Shifting Appreciation to Lower Generations Who Intend to Own/Run the Business. Either of the two above techniques will help to accomplish the shift, not only of the underlying stock at its reduced remainder (and perhaps minority) value at the time of the creation of the CLT, but also the future value of the stock held by the CLT to be distributed later to the children.

B. Transfers of Real Estate

1. Personal. The self-dealing rules apply and therefore the donor(s) would not be able to live in the property. However, if the house were no longer to be occupied by the donors and if it were to be rented at a rate sufficient to maintain the CLT payout, this asset may be suitable to use and then distribute out to the children, similar to a qualified personal residence trust.

2. Investment. Passive investment property such as apartment buildings or office buildings that have adequate yield may also be suitable for a CLT. Keep in mind that if the property is sold, the CLT pays tax on the gain, or the grantor does if it is a grantor trust.

3. Commercial. The same concerns as for CRTs exist here -- possible unrelated business income as a result of the operation of the property, such as farmland or other business, or leases that appear to share the burdens of ownership on a percentage of net rentals. A CLT's deduction for lead distributions of UBI is subject to the charitable deduction percentage limitations.

4. Encumbered Real Estate. In PLR 9241064, the IRS addressed the question of the transfer of encumbered real estate to a CLT. It held that because the transfer was "subject to" debt which was more than five years old on property held at least five years and not assumed by the CLT, no UBI would result from debt-financed income. It also stated that no self-dealing occurred because the debt was 10 years old and thus came within an exception in IRC Section 4941(d)(2)(A).

C. Bonds/Notes

Bonds and notes that are producing sufficient income to meet the payout requirement are acceptable transfers unless the donor is the maker of the note. This would likely be self-dealing.

D. Tangibles/Collections

This non-income producing property is an unlikely candidate for a transfer to the CLT (either grantor or nongrantor) unless the grantor understands that the sale of such an asset will cause the recognition of gain by either the trust or the grantor, as the case may be. If an undivided interest in the item is transferred in satisfaction of the payout requirement, this is deemed to be a sale by the trust and gain will be recognized.

E. Intangibles

1. Partnership Interests and LLC Memberships. Because these properties are pass-through entities, any income, whether or not distributed, is part of the income of the CLT. While there is some discussion of using a partnership to control the timing of income in combination with a re-definition of income in the trust agreement, the partnership tax laws cause recognition of income to the partner whether or not the income or gain is distributed, so a clause as is used for deferred annuities alone may

not work. In addition, the nature of the income may be unrelated business income and may limit the trust's ability to claim the IRC Section 642(c) trust charitable deduction for meeting its payout in accordance with IRC Section 681. See, though, PLR 9810019, approving a CLAT funded with LP units, where all partnership income was passive income. Also see PLR 9402026.

2. Life Insurance/Annuities. The redefinition of income as used in the CRT (an exempt entity) arena to include income earned within a commercial annuity in fiduciary income only when the trustee actually takes a withdrawal of income used to characterize the income received as income that is not available for distribution under state law does not work for nongrantor CLTs. Because the CLT is a taxable entity, it will be deemed to have income on the annuity under IRC Section 72(u) because it is a nonnatural entity holding the annuity. Certain types of life insurance may have a different result.

3. Intellectual Property -- Copyrights, Trademarks, Patents. Intellectual property is an asset capable of being transferred and valued. This property may also generate sufficient income in the form of royalties to sustain the required payout of a CLT. Thus, this type of asset should be considered. However, if the owner of the intellectual property is the transferor, it is not deemed to be a capital asset generating capital gain on its transfer, but rather ordinary income. If the creator of the asset transfers it, any income tax deduction (grantor trust version) would be necessarily reduced to basis under Section 170(e)(1)(A) (one of the "reduction rules").

G. Income in Respect of a Decedent

IRD that will be paid out over a number of years after death (such as the remaining years of a 20-year lottery payout) and subject to tax at ordinary income rates could be assigned to a testamentary CLT. The IRD would be offset by the CLT's charitable deduction to the extent it were distributed to charity. Other CLT assets could be held in tax-free investments.

VI. GST PLANNING WITH CHARITABLE LEAD TRUSTS

A. Designing a CLT for Lower Generations

Many clients do not want their children or grandchildren to have a current gift, but would like it deferred for a number of years. A CLT for such a client to last for the desired deferral period (which may be the rest of the client's life), may be ideal. During the lead term, the CLT may be used to implement charitable gifts which the client would otherwise make in any event from his own funds. For the client who routinely exceeds his percentage AGI limits for charitable gifts, the lead trust can effectively increase those limits. Charitable distributions from the lead trust are 100% deductible by the CLT (up to the gross income of the trust) and are not taken into account in the client's own contribution limits.

B. GST Tax and the CLUT

A CLT can be used as a creative vehicle to "leverage" the client's generation-skipping transfer ("GST") tax exemption and ultimately pass greater assets to future generations. A CLUT which provides for the remainder to pass to a skip person will not pay an additional GST tax if the present value of the remainder interest when the trust is funded is less than or equal to the settlor's available GST tax exemption amount and sufficient GST tax exemption is timely allocated to the CLUT at inception to fully exempt the remainder.

1. For example, a CLUT is funded with $20 million, either during the settlor's lifetime or on her death. The remainder is to be paid (either outright or in further trust) to the settlor's grandchildren. Under the terms of the trust, the present value of the remainder interest is 20%. Therefore, the value of the remainder interest is $4 million ($20,000,000 x 20%).

2. If the settlor has not previously utilized her GST tax exemption, the entire trust will pass to the grandchildren at the end of the charitable term without the imposition of a GST tax. Therefore, if the investment performance of the trust assets (after taxes) is greater than the IRC Section 7520 rate on the date the trust was funded (or on the decedent's date of death), the grandchildren will receive more than $4 million. The charities receiving payments during the lead term will also benefit since the unitrust amount computed each year will increase.

3. The IRS has approved the use of a formula funding clause for a testamentary CLUT, designed to ensure the value of the remainder interest is equal to the settlor's available GST exemption.[29]

C. GST Tax and the CLAT

A CLAT requires a more complicated computation. The determination of the amount of the transfer subject to GST tax is not ascertainable until the termination of the lead interest. At that time, the value of the trust passing to the skip persons is compared to the amount of the "adjusted GST exemption amount." This is the amount allocated by the settlor to the trust at the time of funding, increased by the assumed appreciation in the assets at the IRC Section 7520 rate during the charitable lead period. Therefore, if the trust assets outperform the IRC Section 7520 rate, the CLAT will be required to pay a GST tax at the termination of the charitable lead interest. Although there is the potential for the payment of a GST tax at the termination of the lead interest, there also are potentially more benefits to the remainder interests. Since the amount of the annuity payments to charity is fixed at the beginning of the trust, all appreciation during the charitable term will benefit the remainder.

---

[29] PLR 9532007.

D. Allocation of GST Exemption to a CLT

1. Allocation to CLUT. A CLUT may be entirely exempted from the GST by allocating exemption to the noncharitable interest only. For this purpose, the noncharitable interest is valued as of the date of transfer if allocation is timely, or as of the date of the allocation if allocation is late.

***EXAMPLE 2**: David Doting creates a 6%, 20-year nongrantor inter vivos CLUT terminating in favor of his granddaughter. The CLUT is funded with $1 million when the 7520 rate is 1.4%. If GST exemption equal to the present value of the remainder interest as of the time of transfer is timely allocated to the CLUT, it will be fully exempt from GST. If the internal rate of return is 6%, the value of the remainder at inception is $295,334. David allocates that much GST exemption to the CLUT. At the end of 20 years, charity has received $1.2 million and his granddaughter receives $1 million.*

(a) For instance, take Example 2 above (6%, 20-year CLUT funded with $1 million) and assume the CLUT terminated in favor of a long-term trust for David's granddaughter (with or without his daughter also as a beneficiary). If $295,334 of GST exemption were timely allocated, and the CLUT had a total return of at least 6%, a minimum of $1 million would pass to the lower generation beneficiaries at the end of the lead term.

(b) Note that inherent in the unitrust structure is the fact that any increase in the value of the trust will inure to the benefit of charity as well as family. Thus the CLUT does not present the opportunity for leveraging the family gift that the CLAT, with a fixed payout, presents if the trust grows at a rate faster than the IRC Section 7520 rate assumed at the time of the gift.

(c) In Example 2 above, the highly discounted gift to family for both gift and GST tax purposes does not mean that value has passed to the family outside the transfer tax system (as is the object of the exercise with a GRAT and, to a lesser extent, with a CLAT), but rather that the untaxed value has gone to charity. Family would have had a great deal more at the end of the 20 years if the $1 million had simply been contributed to a family trust rather than to a CLUT.

EXAMPLE 2: DAVID DOTING

Charitable Lead Unitrust 5/11/2012

Trust Type:	Term
Transfer Date:	5/2012
§7520 Rate:	1.40%
FMV of Trust:	$1,000,000
Growth of Trust:	6.00%
Percentage Payout:	6.000%
Payment Period:	Annual
Months Valuation Precedes Payout:	12
Term:	20

Payout Sequence Factor:	0.986193
Adjusted Payout Rate:	5.917%
Interpolation:	
Factor at 5.8%:	0.302704
Factor at 6.0%:	0.290106
Difference:	0.012598
(5.917% - 5.8%) / 0.2% = X / 0.012598; Therefore X = 0.007370	
Term Remainder Factor = Factor at 5.8% Less X:	0.295334
Remainder Interest:	$295,334.00
Charitable Deduction for Income Interest:	$704,666.00
Donor's Deduction as Percentage of Amount Transferred:	70.467%

Year	Beginning Principal	6.00% Growth	Payment	Remainder
1	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
2	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
3	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
4	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
5	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
6	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
7	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
8	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
9	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
10	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
11	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
12	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
13	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
14	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
15	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
16	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
17	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
18	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
19	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
20	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
Summary:	$1,000,000.00	$1,200,000.00	$1,200,000.00	$1,000,000.00

2. Allocation to CLAT. Although GST exemption may be allocated to a CLAT as of the time of the transfer, per IRC Section 2642(e) the inclusion ratio will be determined on the basis of the ratio of the value of the GST exemption allocated, increased by the IRC section 7520 rate used to determine the gift or estate tax charitable deduction from the effective date of the allocation to the end of the lead term, compounded annually (the "adjusted GST exemption amount"), to the value of the trust at the end of the lead term. In order to ensure a zero inclusion ratio for a CLAT, one can wait until the end of the lead term to allocate GST exemption. Otherwise, to try to ensure that the CLAT will have an inclusion ratio of zero, and thus be fully exempt from GST, one must make one's best guess as to what the value of the remainder will be at the termination of the CLAT and then allocate to the trust that amount of GST exemption which, at a growth rate equal to the applicable IRC Section 7520 rate from the effective date of the allocation, will give rise to the predicted value of the CLAT at the end of the lead term.

(a) Combining a CLAT with generation-skipping is more problematic because of the likelihood one will have a fractional inclusion ratio at the end of the term, contrary to one of the fundamental precepts of GST planning. However, the CLAT has the potential for leveraging the family gift for gift tax purposes, which will appeal to some donors.

(b) If a CLAT is to be used and it is contemplated that additional GST exemption will not be allocated after the initial allocation, the damage from the fractional inclusion ratio will be minimized if all remaindermen at the end of the lead term are skip persons (i.e., grandchildren or lower generations), as opposed to a multigenerational trust which includes children as beneficiaries. In that way, if insufficient GST exemption is allocated to fully exempt the trust at the end of the lead term, there will be a one-time GST tax hit at the end of the lead term, which will be a taxable termination, as opposed to a GST tax every time a distribution is made to a skip person.

EXAMPLE 3: *Gerry Generous establishes a 5% 20-year nongrantor CLAT funded with $1 million when IRC Section 7520 rate is 1.4%. At inception, the remainder is valued at $133,045 and $133,045 of GST exemption is allocated to it. This will give rise to an adjusted GST exemption amount at the end of the lead term ($133,045 at 1.4% for 20 years) of $175,694. Assume the actual value of the trust at the end of the lead term is $1,367,855. No GST exemption has been allocated to 87.16%, and the trust terminates in favor of a trust for Gerry's grandchildren for life. There will be a taxable termination at the end of the lead term, and the trust will be subject to GST tax at an effective rate of 30.5% (87.16% x 35%) at that time, but all future distributions to the grandchild will be free of GST tax (or any other transfer tax).*

(c) By contrast, if the CLAT had terminated in favor of a trust for the settlor's child and grandchild, no GST tax would be due at the end of the lead term, but all distributions to grandchildren would be subject to GST tax (at 30.5%) as taxable distributions. In addition, there would be a taxable termination at the child's death, when the entire trust would be subject to GST tax at 30.5%. Thereafter, future distributions to the grandchildren from the trust would not be subject to GST tax.

(d) If it is realistic to expect that any shortfall between the adjusted GST exemption and the actual value of the CLAT at the end of the lead term will be covered by an additional allocation of GST exemption, a multigenerational trust including the child as beneficiary should be used, because a late allocation at the end of the lead term or at any time prior to the first distribution to the grandchild will be effective to make the trust fully GST-exempt. For instance, in Example 3 above, if the CLAT terminated in favor of a long-term trust for the settlor's child and grandchild, a late allocation of $1,192,161 ($1,367,855 [the value of the remainder when the CLAT ends] - $175,694 [the present value of the remainder on funding]) at the end of the lead term would fully exempt the trust. However, if the CLAT terminated in favor of skip person trusts or of grandchildren directly, allocation of GST exemption would have to occur before the termination of the lead interest, which makes it more difficult to achieve the desired result.

(e) If the predeceased child exception is available (because a child has died leaving children either before or after the trust is established), the GST tax drops out entirely as a planning constraint. A CLAT or CLUT can terminate in favor of such a grandchild (or a trust for such a grandchild), and no GST tax will be due either on termination of the lead term or on any subsequent distributions to the grandchild. (Distributions to great-grandchildren, however, would continue to be subject to tax absent an allocation of GST exemption.) The recent expansion of the predeceased child exception to apply to taxable terminations and taxable terminations as well as direct skips has added this feature for CLTs.

(f) The key point to remember, if you know at the inception of the CLT that the predeceased child exception is available and there are also living children, is to isolate the share of the grandchild eligible for the exception in a separate trust, with another trust providing for any other grandchildren. For instance, suppose a client has three grandchildren, GC-1, GC-2, and GC-3, with only GC-3 eligible for the predeceased child exception. If the client establishes a CLUT terminating in favor of his grandchildren in equal shares, in order to exempt the property passing to GC-1 and GC-2 from GST tax, he will have to allocate enough GST exemption to exempt the entire trust, even though the portion so allocated to GC-3's share would be wasted. By contrast, if he set up two CLUTs,

one terminating in favor of GC-1 and GC2 and the other terminating in favor of GC-3, he would have to allocate GST exemption only to the trust for GC-1 and GC-2.

EXAMPLE 3: GERRY GENEROUS

Charitable Lead Annuity Trust 5/11/2012

Trust Type:	Term
Transfer Date:	5/2012
§7520 Rate:	1.40%
FMV of Trust:	$1,000,000.00
Growth of Trust:	6.00%
Percentage Payout:	5.000%
Payment Period:	Annual
Payment Timing:	End
Term:	20
Total Number of Payments:	20
Exhaustion Method:	IRS
Vary Annuity Payments?	No

Annual Payout:	$50,000.00
Annual Payment:	$50,000.00
Term Certain Annuity Factor:	17.3391
Payout Frequency Factor:	1.0000
Present Value of Annuity Limited by §7520 Regs:	$866,955.00
Remainder Interest = FMV of Trust less PV of Annuity:	$133,045.00
Charitable Deduction for Income Interest:	$866,955.00
Donor's Deduction as Percentage of Amount Transferred:	86.696%

Year	Beginning Principal	6.00% Growth	Payment	Remainder
1	$1,000,000.00	$60,000.00	$50,000.00	$1,010,000.00
2	$1,010,000.00	$60,600.00	$50,000.00	$1,020,600.00
3	$1,020,600.00	$61,236.00	$50,000.00	$1,031,836.00
4	$1,031,836.00	$61,910.16	$50,000.00	$1,043,746.16
5	$1,043,746.16	$62,624.77	$50,000.00	$1,056,370.93
6	$1,056,370.93	$63,382.26	$50,000.00	$1,069,753.19
7	$1,069,753.19	$64,185.19	$50,000.00	$1,083,938.38
8	$1,083,938.38	$65,036.30	$50,000.00	$1,098,974.68
9	$1,098,974.68	$65,938.48	$50,000.00	$1,114,913.16
10	$1,114,913.16	$66,894.79	$50,000.00	$1,131,807.95
11	$1,131,807.95	$67,908.48	$50,000.00	$1,149,716.43
12	$1,149,716.43	$68,982.99	$50,000.00	$1,168,699.42
13	$1,168,699.42	$70,121.97	$50,000.00	$1,188,821.39
14	$1,188,821.39	$71,329.28	$50,000.00	$1,210,150.67
15	$1,210,150.67	$72,609.04	$50,000.00	$1,232,759.71
16	$1,232,759.71	$73,965.58	$50,000.00	$1,256,725.29
17	$1,256,725.29	$75,403.52	$50,000.00	$1,282,128.81
18	$1,282,128.81	$76,927.73	$50,000.00	$1,309,056.54
19	$1,309,056.54	$78,543.39	$50,000.00	$1,337,599.93
20	$1,337,599.93	$80,256.00	$50,000.00	$1,367,855.93
Summary:	$1,000,000.00	$1,367,855.93	$1,000,000.00	$1,367,855.93

3. A CLT for the life of a client whose actual life expectancy is less than his life expectancy under the IRS tables used for this purpose can be a highly advantageous (i.e., leveraged) vehicle for family giving, with or without a GST component.

EXAMPLE 4: *6% nongrantor CLUT for life of Marty Party, age 60, terminating in favor of grandchildren, funded with $1 million. The value of nondeductible remainder is $322,170. The CLUT can be fully exempted from GST tax by allocation of $322,170 of GST exemption. If the client dies after five years and the CLUT in the interim has had a total return of 6%, the grandchildren will receive $1 million only five years later. By comparison, the value of the nondeductible remainder for a 6%, five-year CLUT funded with $1 million, which is what the trust turned out to be, would be $1 million. Either way, charity receives $1 million.*

EXAMPLE 4: MARTY PARTY

Charitable Lead Unitrust 5/11/2012

Trust Type:	Life
Transfer Date:	5/2012
§7520 Rate:	1.40%
FMV of Trust:	$1,000,000
Growth of Trust:	6.00%
Percentage Payout:	6.000%
Payment Period:	Annual
Months Valuation Precedes Payout:	12
Lives:	1
Ages:	60

Payout Sequence Factor:	0.986193
Adjusted Payout Rate:	5.917%
Interpolation:	
Factor at 5.8%:	0.32846
Factor at 6.0%:	0.31770
Difference:	0.01076
(5.917% - 5.8%) / 0.2% = X / 0.01076; Therefore X = 0.00629	
Life Remainder Factor = Factor at 5.8% Less X:	0.32217
Remainder Interest:	$322,170.00
Charitable Deduction for Income Interest:	$677,830.00
Donor's Deduction as Percentage of Amount Transferred:	67.783%

Year	Beginning Principal	6.00% Growth	Payment	Remainder
1	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
2	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
3	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
4	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
5	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
6	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
7	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
8	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
9	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
10	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
11	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
12	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
13	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
14	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
15	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
16	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
17	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
18	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
19	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
20	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
21	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
Summary:	$1,000,000.00	$1,260,000.00	$1,260,000.00	$1,000,000.00

Trust Type:	Term
Transfer Date:	5/2012
§7520 Rate:	1.40%
FMV of Trust:	$1,000,000
Growth of Trust:	6.00%
Percentage Payout:	6.000%
Payment Period:	Annual
Months Valuation Precedes Payout:	12
Term:	5

Payout Sequence Factor:	0.986193
Adjusted Payout Rate:	5.917%
Interpolation:	
Factor at 5.8%:	0.741745
Factor at 6.0%:	0.733904
Difference:	0.007841
(5.917% - 5.8%) / 0.2% = X / 0.007841; Therefore X = 0.004587	
Term Remainder Factor = Factor at 5.8% Less X:	0.737158
Remainder Interest:	$737,158.00
Charitable Deduction for Income Interest:	$262,842.00
Donor's Deduction as Percentage of Amount Transferred:	26.284%

Year	Beginning Principal	6.00% Growth	Payment	Remainder
1	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
2	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
3	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
4	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
5	$1,000,000.00	$60,000.00	$60,000.00	$1,000,000.00
Summary:	$1,000,000.00	$300,000.00	$300,000.00	$1,000,000.00

- The IRS actuarial tables cannot be used if the measuring life for the CLT is "terminally ill," i.e., is known to have an incurable illness or other deteriorating physical condition and there is at least a 50% probability of death within one year. However, if the individual survives for at least 18 months, the individual will be presumed not to have been terminally ill unless the contrary is established by clear and convincing evidence.[30]

- Where a CLT has a term based on a measuring life, the person whose measuring life is used must be either a lineal ancestor or spouse of a lineal ancestor of the individual remainder beneficiaries, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus, as computed on the date of transfer to the trust.[31]

4. Where there are concerns of an entirely different nature, such as generation skipping tax for the grandchildren but not for children, consider two CLTs. In addition to the need to consider the tax issues, the need for different timing of distributions of the remainder (i.e., for younger and older remaindermen) should also be taken into account. Some practitioners recommend using separate shares in one CLT as opposed to two CLTs. This is not a tax question as the regulations seem to specifically permit separate shares; thus, it is a question of style and of trust administration convenience.

5. The choice of the form of the CLT, annuity or unitrust, may be influenced by the application of the GST tax considerations. See discussion above regarding application problems of using the annuity form for grandchildren, due to the recalculation for GST purposes at the end of the CLT term. This may cause additional tax to be assessed at the end of the trust term. Thus, for the grandchildren, a unitrust version may be better. However, the choice must be made in light of the earnings of the asset in relation to its probable increase in value over the trust term. If the asset used will produce a fixed income over time but increase in value, the payout to the charitable beneficiaries may become impossible to meet. All the nice paper planning in the world will not help a poorly-designed investment in the trust. Thus, while considering the unitrust for the grandchildren for tax concerns, keep in mind the practical requirements of trust administration, such as the values, and if the values become truly out of sync, the taxation to the trust entity on the gain if the trust must sell to generate more income to meet the payout.

(a) The trust could, with the right asset, liquidate only enough to meet the current payment, paying tax only on that small piece.

---

[30] Treas. Reg. Section 25.7520-3(b)(3).

[31] Treas. Reg. Sections 1.170A-6, 20.2055-2 and 25.2522(c)-3.

(b) Or it could distribute some portion or all of some asset to meet its distribution requirement, understanding that to do so causes taxation just as if it had sold the asset and distributed the proceeds.

EXAMPLE 5*: Penny Provider, age 60, has three children, ages 25, 28 and 32. All are "getting started"; one child, the middle one, is married, two are not. Penny is ambivalent about the married child's spouse, and concerned about whom the other two might marry. Due to prior gifts to custodial accounts, each child received about $500,000 upon reaching age 21, and Penny does not want her children to have anything more for now. She wants to be sure funds are available to educate her future grandchildren, but she does not want them "spoiled," as she thinks her own children arguably were by reason of the funds that they received at age 21. During Penny's lifetime, she can pay for her grandchildren's education directly without gift tax consequences, but she wants to be sure that funds continue to be available for this purpose after her death. In addition, ultimately she wants to pass her wealth on to her children; she just doesn't want to do so in a way that she feels will be contrary to their own best interests.*

Penny has income of $500,000 per year and gives on average $50,000 per year to charity. She contemplates continuing this level of regular charitable giving, and she will probably also want to make larger, one-time gifts to her favorite charities over time.

Penny establishes a 5% nongrantor CLUT and funds it with $1 million. Distribution of the unitrust amount will be made annually to charities selected by the trustees (which do not include Penny). The term of the trust is the rest of Penny's life, after which the trust will terminate in favor of three separate, discretionary trusts -- one for each child and that child's children.

During Penny's lifetime, the trust will be the vehicle through which Penny's regular charitable gifts may be made. Since the income of the CLUT and the charitable distributions made by the CLUT will be removed from Penny's contribution base, with the CLUT she can make larger deductible contributions than would be possible without it. At Penny's death, the trust becomes a flexible vehicle for children and grandchildren, to be sure the grandchildren's educational costs are met and to dispense funds to or for the children as appropriate. Assuming the trust has a total return (after tax) of 7% per year, and Penny lives for another 20 years, at Penny's death there will be over $1.5 million available for the children and grandchildren, and almost $1.3 million will have been distributed to charity.

If Penny is married and gift splits with her husband, no gift tax will be payable assuming each has enough available lifetime gift tax exemption available. GST exemption can (and should) be allocated to the trust in a timely manner.

EXAMPLE 5: PENNY PROVIDER

Charitable Lead Unitrust 5/11/2012

Trust Type:	Life
Transfer Date:	5/2012
§7520 Rate:	1.40%
FMV of Trust:	$1,000,000
Growth of Trust:	7.00%
Percentage Payout:	5.000%
Payment Period:	Annual
Months Valuation Precedes Payout:	12
Lives:	1
Ages:	60

Payout Sequence Factor:	0.986193
Adjusted Payout Rate:	4.931%
Interpolation:	
Factor at 4.8%:	0.38999
Factor at 5.0%:	0.37656
Difference:	0.01343
(4.931% - 4.8%) / 0.2% = X / 0.01343; Therefore X = 0.00880	
Life Remainder Factor = Factor at 4.8% Less X:	0.38119
Remainder Interest:	$381,190.00
Charitable Deduction for Income Interest:	$618,810.00
Donor's Deduction as Percentage of Amount Transferred:	61.881%

Year	Beginning Principal	7.00% Growth	Payment	Remainder
1	$1,000,000.00	$69,999.96	$50,000.00	$1,019,999.96
2	$1,019,999.96	$71,400.00	$51,000.00	$1,040,399.96
3	$1,040,399.96	$72,828.00	$52,020.00	$1,061,207.96
4	$1,061,207.96	$74,284.56	$53,060.40	$1,082,432.12
5	$1,082,432.12	$75,770.28	$54,121.61	$1,104,080.79
6	$1,104,080.79	$77,285.64	$55,204.04	$1,126,162.39
7	$1,126,162.39	$78,831.36	$56,308.12	$1,148,685.63
8	$1,148,685.63	$80,408.04	$57,434.28	$1,171,659.39
9	$1,171,659.39	$82,016.16	$58,582.97	$1,195,092.58
10	$1,195,092.58	$83,656.44	$59,754.63	$1,218,994.39
11	$1,218,994.39	$85,329.60	$60,949.72	$1,243,374.27
12	$1,243,374.27	$87,036.24	$62,168.71	$1,268,241.80
13	$1,268,241.80	$88,776.96	$63,412.09	$1,293,606.67
14	$1,293,606.67	$90,552.48	$64,680.33	$1,319,478.82
15	$1,319,478.82	$92,363.52	$65,973.94	$1,345,868.40
16	$1,345,868.40	$94,210.80	$67,293.42	$1,372,785.78
17	$1,372,785.78	$96,095.04	$68,639.29	$1,400,241.53
18	$1,400,241.53	$98,016.96	$70,012.08	$1,428,246.41
19	$1,428,246.41	$99,977.28	$71,412.32	$1,456,811.37
20	$1,456,811.37	$101,976.84	$72,840.57	$1,485,947.64
21	$1,485,947.64	$104,016.36	$74,297.38	$1,515,666.62
Summary:	$1,000,000.00	$1,804,832.52	$1,289,165.90	$1,515,666.62

EXAMPLE 6*: Charlie Charitable, age 70, has a net worth of roughly $20 million, of which $5 million is liquid. The balance is illiquid assets consisting primarily of partnership interests, an art collection and real estate. Indeed, because of the nature of his assets, Charlie can never do more than roughly estimate his net worth. Charlie is concerned about how his estate could raise the cash necessary to pay the estate tax at his death (at 35% when the planning was done), since his estate would not be eligible for the various relief options available for closely held businesses.*

Charlie has one living child, age 42, with two children, and one deceased child who left three children, all of whom are still living. His living child is a successful lawyer and able to provide well for his own family. The children of the deceased child are likewise well provided for by their surviving parent. Charlie wants his family to inherit the wealth that he has accumulated, but he is comfortable with their waiting to receive their inheritance. Charlie has always been a generous donor to charity. Charlie feels that his estate could comfortably afford to pay an estate tax of $2.1 million, and he also feels that his illiquid assets will grow overall at a rate of greater than 6% per year. Charlie's full GST exemption is available.

Charlie provides under his estate plan for the residue of his estate to go into a 6% CLAT, with a term determined by a formula. The term is the number of years required in order to give rise to a taxable estate, taking into account all other taxable dispositions, the estate tax on which will be $2.5 million. Suppose the testamentary CLAT were the only taxable disposition under the estate plan. This formula would call for a taxable estate (assuming a 35% tax rate) of $6,000,000. Of this amount $2.1 million would go for estate taxes, and the balance ($3.9 million) would be the present value of the remainder interest in the CLAT.

The CLAT permits Charlie to preserve his estate for the eventual use of his family while keeping his estate taxes manageable. In addition, since because of the formula his taxable estate will be a constant regardless of the value of his assets, the IRS has little incentive to challenge the values used for federal estate tax purposes.

GST implications of the CLAT must be carefully considered and taken into account in the planning process. The CLAT should be subdivided per the estate plan into two separate trusts, one for the children of the deceased child and the other for the living child and that child's issue. GST exemption would be allocated solely to the trust terminating in favor of the family of the living child since the children of Charlie's deceased child enjoy the benefit of the "predeceased child rule."

> NOTE: If the plan is to fund a testamentary CLT by formula, growth in value of the settlor's assets must be monitored so that the CLT does not end up running for a term too long to be acceptable in light of when the settlor wants the family to receive the property.

VII. CONCLUSION

For a client who makes regular charitable contributions and has unneeded income, exploring the idea of a CLT has merit because a CLT provides the opportunity to improve the economic benefits for the client while preserving assets for the family. Careful consideration of the GST implications must be factored in if grandchildren or lower generation beneficiaries are to benefit. If the client's private foundation is to be the lead beneficiary, and the CLT is intended to be a nongrantor trust, the client must be adequately insulated from grantmaking decisions but may still fund the foundation in a tax efficient manner and remain actively involved in its operations.

United States Internal Revenue Service (IRS) Circular 230 disclosure:

To ensure compliance with requirements imposed by the IRS, we inform you that, unless and to the extent we otherwise state, any U.S. federal tax advice contained in this outline (including any attachments) is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

EXHIBIT A

CLT FILING REQUIREMENTS

1. Charitable lead trusts are calendar year taxpayers.

2. A nongrantor CLT must file federal Forms 1041 and 5227 by April 15 of the following year. A Form 1041-A may also be required for amounts accumulated for charitable purposes.

3. State requirements vary. Some states require that a CLT be registered with the Attorney General. In California, no registration with the Attorney General is required, but the CLT must file Forms 541, 541A and 541B.

EXHIBIT B

UNRELATED BUSINESS INCOME AND THE CLT

In addition to being taxable, a CLT is also subject to rules regarding unrelated business income (UBI). This includes both the operational form of UBI from having carried on a trade or business and the form arising from holding or selling debt-financed property. Debt-financed income requires that the property be income producing, and that the debt be "acquisition indebtedness". Acquisition indebtedness is debt incurred for the acquisition or improvement of the trust property.

The reason this is important is that another Section, IRC Section 681, limits the CLT's charitable deduction under 642(c) where the trust has unrelated business income. The limitation is that the percentage limitations of IRC Section 170(b) apply to the trust as if the trust were an individual. As a result, the trust's charitable deduction will be limited to a percentage of its AGI rather than permitted for the full value of the year's charitable distributions. The effect of this is to make the trust pay tax out of its resources even though most or all of its current income was required to be distributed to the charity (depending upon the annuity or unitrust payout rate versus the trust earnings). Clearly, this could cause an incursion on principal and be disadvantageous to the remainder beneficiaries.