



Charitable Lead Trust Handbook

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Introduction

A charitable lead trust (CLT) combines a donor's philanthropic values with his or her financial values. A CLT is an irrevocable agreement in which a donor transfers assets to a trust that creates a current income, or lead, interest payable to one or more charities. The trust's remainder interest either comes back to the donor or passes to some other non-charitable beneficiary—typically the donor's heirs. The charitable interest can be designated for the benefit of one or more charitable beneficiaries, including public charities, donor-advised funds, supporting organizations and private foundations.

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Greg has helped nonprofit and for profit advisors help their donors and clients commit over \$6 Billion to charity through a variety of giving tools. Greg is recognized as a subject matter expert and speaks regularly at industry conferences.

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Parties to a Charitable Lead Trust

In its most basic form, a charitable lead trust consists of an arrangement between four parties: 1) a donor; 2) a trustee; 3) a charitable income beneficiary; and 4) a non-charitable remainder beneficiary. The donor enters into a trust agreement with the trustee to transfer certain assets to be managed and maintained by the trustee. In accepting the assets, the trustee agrees to pay an income stream to one or

more charitable income beneficiaries for a specified period of time. At the expiration of the trust term, the trustee delivers the remaining trust assets to one or more non-charitable remainder beneficiaries.

The Donor. Any individual, corporation, partnership, LLC, or trust can be a CLT donor; however, the donor is usually an individual because the most significant tax benefit obtained from creating and funding a CLT is a transfer tax charitable deduction. An individual donor can create a CLT during life or at death. Transfers to a CLT may qualify for one or more of the following charitable deductions: 1) income tax; 2) gift tax; 3) estate tax; and/or 4) generation-skipping transfer (GST) tax.

The Trustee. The CLT trustee may be an individual or an institution such as a bank or charity. While the donor may serve as trustee of a grantor CLT, only in rare circumstances should the donor and/or the donor's spouse serve as trustee of a non-grantor or "Super" CLT. When an individual serves as trustee, it is possible to unbundle the traditional trustee services (fiduciary decision-making, investment management and CLT administration), permitting the trustee to hire best-in-class service providers for investment management and CLT administration. Charities and banks can utilize this same outsourcing approach for investment management and CLT administration.

The Charitable Income Beneficiary. The charitable lead interest in a CLT may benefit a public charity (e.g., one's alma mater, a religious institution, the United Way, etc.) or a privately-controlled charity (e.g., a private foundation). A third possibility is to split the income interest among several charities such as "2/3 to my alma mater and 1/3 to my private foundation."

The charitable income beneficiaries of many CLTs are named irrevocably. However, it is not uncommon in grantor CLTs for the donor to retain the power to change the charitable income beneficiaries. For non-grantor and "Super" CLTs, the donor should not have this power due to potential estate tax inclusion

concerns.¹ Nevertheless, granting the power to change the charitable income beneficiaries to the donor's children is often a feature of non-grantor and "Super" CLTs. Naming the initial charitable income beneficiaries and deciding whether to grant some party a power to change the charitable income beneficiaries should be guided by the donor's charitable goals.

The Non-Charitable Remainder Beneficiary. At least one CLT remainder beneficiary must be an individual, corporation, partnership, LLC, or trust. As noted above, the remainder beneficiary of a grantor CLT is typically the donor and/or the donor's spouse. Note that if the donor dies during a grantor CLT's term, then the grantor CLT's assets will be included in the donor's estate and the donor may be required to recapture a portion of the income tax charitable deduction previously claimed.²

In a non-grantor or "Super" CLT, the remainder beneficiaries are usually the donor's children and/or grandchildren. Non-grantor and "Super" CLTs are typically designed to remove all or a portion of the trust assets from the donor's taxable estate. Designing a non-grantor or "Super" CLT creates gift, estate and/or GST tax ramifications that are discussed more fully below.

The donor may elect to include one or more charities as the default remainder beneficiary. For example, if all of the other named remainder beneficiaries die before the end of the CLT term, a charity may be the back-up remainder beneficiary.

It is important to remember that the remainder beneficiaries receive just that—the remainder. It is possible that the combination of the charitable payments and poor investment performance will exhaust the trust. In this situation, the remainder is zero, which means the remainder beneficiaries will receive nothing from the CLT.

Types of Charitable Lead Trusts

To qualify for the charitable deduction, a CLT must specify that the income interest will be paid as a fixed amount (a Charitable Lead Annuity Trust, or CLAT) or paid as a fixed percentage of the trust's assets revalued annually (a Charitable Lead Unitrust, or CLUT). Note that neither a "net income" nor a "make-

up" option is allowed. See Appendix A for a summary of IRS statistics on CLTs.

A second method of classifying charitable lead trusts is how they are taxed for income and transfer tax purposes. Unlike a CRT, a CLT is a taxable entity taxed under subchapter J. The type of CLT determines which party takes into account the CLT's items of income, deduction and credit.

Grantor CLT. In the grantor format CLT, the donor is treated as the owner of the trust by operation of one or more of the grantor trust rules (IRC §§671-679). As a result, the donor to a grantor CLT can claim an income tax charitable deduction at inception for the present value of the charitable interest.³ However, the donor must include all items of income, deduction and credit belonging to the trust in his or her personal income tax return (sometimes referred to as "phantom income" because the donor is not allowed to use the trust's assets to pay the tax liability created by the trust's income). No additional income tax deduction is allowed as the grantor CLT makes payments to the charitable income beneficiary.⁴ The most common method of ensuring a CLT is a grantor CLT is for the donor to retain a greater than 5% reversionary interest (IRC §673(a)).

Non-Grantor CLT. In the non-grantor format CLT, the CLT's items of income, deduction and credit are taken into account by the trust as they occur each year. Therefore the donor is not permitted an income tax deduction. However, the trust is permitted the unlimited income tax charitable deduction provided by IRC §642(c).⁵ Because the remainder beneficiary is almost always someone other than the donor, a transfer tax deduction is allowed for the charitable interest. As a result, the non-grantor CLT is commonly used to reduce or eliminate the transfer tax on a transfer to the donor's heirs.

Super CLT. The third (less common) format of CLT, sometimes referred to as the "Super" CLT, or grantor defective CLT, combines elements of both the grantor and non-grantor CLT format. Like the grantor CLT, the "Super" CLT's items of income, deduction and credit are included in the donor's gross income; and therefore, the donor may claim an income tax deduction for the charitable interest. Like the non-grantor CLT, the "Super" CLT's remainder beneficiary

¹ See IRC §§2036(a) and 2038(a).

² See IRC §170(f)(2)(B) and Treas. Reg. §1.170A-6(c)(4).

³ See IRC §§170(f)(2)(B), 2055(e)(2)(B) and 2522(c)(2)(B).

⁴ See Treas. Reg. §1.170A-6(d).

⁵ The unlimited charitable deduction for CLTs is limited for each year in which the CLT has UBTI. See IRC §681.

is typically the donor's heirs, therefore the donor may claim a transfer tax deduction for the charitable interest.⁶ Great care must be exercised in drafting and administering a "Super" CLT to ensure the donor realizes the expected tax benefits.

Designing the CLT

Select the Appropriate Payout Rate. When selecting the payout rate for a CLT, it is important to keep several key points in mind. First, CLTs have no minimum or maximum payout rate. Second, the payout rate is an integral part of the calculation of the actuarial present value of the charitable interest (APVCI).⁷ Third, CLTs have no payout rate test that is comparable to the 10% tests applicable to CRTs and CGAs. Fourth, the higher the payout rate, the higher the APVCI. Fifth, the payout rate can be variable for CLATs so long as the annuity interest is determinable when the CLT is funded.

The payout rate selected should coordinate with the donor's need for a charitable deduction, the charitable beneficiary's current and future cash flow requirements and the hoped-for value of the noncharitable remainder interest. For CLATs, a payout rate greater than the actual investment return will reduce the remainder interest. For CLUTs, a payout rate greater than the actual investment return will reduce the remainder interest and reduce the payments to the charitable income beneficiary. If the payout rate is greater than the applicable federal rate (AFR)⁸ and all other factors remain constant, the APVCI for a CLAT is greater than the APVCI for a CLUT.

As noted earlier, the payout rate for a CLAT can vary from year to year so long as the variance is clearly defined and can be ascertained when the CLAT is created.⁹ For example, a CLAT could have a payout

structure that pays \$10,000 to charity in the first year and increases that payment by 7% each subsequent year of the charitable term. By starting with a lower payout rate and increasing the payout rate in later years, there is a greater possibility of having a remainder amount to distribute at the end of the charitable term. Variable payouts in a CLAT add to its complexity during the design and operation stages.

Match the CLT Format to the Donor's Goals. The donor to a Grantor or "Super" CLT is allowed an income tax charitable deduction. The donor to a non-grantor or "Super" CLT is allowed a transfer tax charitable deduction. The proper CLT format must be used to obtain the deduction the donor desires. Given the appropriate combination of charitable term, payout rate and AFR, a CLAT can produce a 100% charitable deduction. The same result is only achievable for a CLUT with a lengthy charitable term and a double-digit payout rate. In the author's experience, a significant majority of CLTs use the non-grantor, CLAT format.

Select the Appropriate Charitable Term. The term for a CLT may be for any fixed period of time without being limited to the 20-year rule applicable to CRTs.¹⁰ Alternatively, the CLT term may continue for the life of one or more persons. Permissible measuring lives include the donor, the donor's spouse, a lineal ancestor of all of the noncharitable remainder beneficiaries, or the spouse of a lineal ancestor of all of the noncharitable remainder beneficiaries.¹¹ For example, the measuring life could be the parent of the remainder beneficiaries. On the other hand, if the donor or donor's spouse is the measuring life, then the remainder beneficiaries do not have to be their lineal descendants. Note that where the CLT term is measured solely by a fixed period of time, there is no

⁶ The "Super" CLT requires both expert drafting and a commitment to operate the trust in accordance with the governing instrument. To date the authority for a "Super" CLT is limited to private letter rulings that cannot be relied upon by anyone other than the taxpayer that requested the ruling. See for example PLR 9224029, PLR 9247024, PLR 9407014, PLR 9810019, PLR 199922007 and PLR 199936031.

⁷ The actuarial present value of the charitable interest is the amount that may be deducted for income tax purposes, transfer tax purposes, or both. It is discussed more fully below.

⁸ See IRC §7520. The AFR is published monthly by the IRS in a Revenue Procedure issued on or about the seventeenth of each month. The historically low AFRs of past decade are one reason why CLTs are enjoying a renaissance in philanthropic planning.

⁹ See IRC §§2055(e)(2)(B) & 2522(c)(2)(B) and Treas. Reg. §§1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

¹⁰ Note that in some states the rule against perpetuities will limit the length of the trust term.

¹¹ See Treas. Reg. §1.170A-6(c)(2)(i)(A) for CLATs and Treas. Reg. §1.170A-6(c)(2)(ii)(A) for CLUTs. There is a minor exception that permits persons who are not lineal descendants of the measuring life as remainder beneficiaries in a CLT if the probability that such non-lineal descendants will receive any CLT distributions does not exceed 15%.

relational limitation on the identity of the noncharitable remainder beneficiaries.

Along with the payout rate and AFR, the CLT's charitable term is one of the most significant factors in determining the APVCI. The shorter the charitable term, the smaller the APVCI. Conversely, the longer the charitable term, the greater the APVCI. The amount of the APVCI is a primary CLT design consideration. Because the length of the term is one of the controllable inputs in the APVCI computation (along with the payout rate), the great majority of CLTs are designed to make the charitable payout for a term of years instead of for the lives of the donors (or another authorized measuring life).

Table 1 below illustrates the impact of various payout rates and charitable terms assuming a 1.0% AFR.

Table 1. Charitable Deduction for CLATs at 1.0% AFR.

Level Payout Rate	Length of Charitable Term				
	5 years	10 years	15 years	20 years	30 years
4.00%	19.49%	38.03%	55.67%	72.45%	100.00%
5.00%	24.36%	47.53%	69.58%	90.56%	100.00%
6.00%	29.23%	57.04%	83.50%	100.00%	100.00%
7.00%	34.10%	66.54%	97.41%	100.00%	100.00%
8.00%	38.97%	76.05%	100.00%	100.00%	100.00%

Table 2 below depicts the impact of various payout rates and charitable terms assuming a 3.0% AFR.

Table 2. Charitable Deduction for CLATs at 3.0% AFR.

Level Payout Rate	Length of Charitable Term				
	5 years	10 years	15 years	20 years	30 years
4.00%	18.52%	34.50%	78.29%	60.18%	79.28%
5.00%	23.15%	43.13%	60.36%	75.22%	99.10%
6.00%	27.79%	51.75%	72.43%	90.26%	100.00%
7.00%	32.42%	60.38%	84.50%	100.00%	100.00%
8.00%	37.05%	69.01%	96.57%	100.00%	100.00%

Table 3 below depicts the impact of various payout rates and charitable terms assuming a 6.0% AFR.

Table 3. Charitable Deduction for CLATs at 6.0% AFR.

Level Payout Rate	Length of Charitable Term				
	5 years	10 years	15 years	20 years	30 years
4.00%	17.22%	30.09%	39.71%	46.90%	56.28%
5.00%	21.53%	37.62%	49.64%	58.62%	70.35%
6.00%	25.84%	45.14%	59.57%	70.35%	84.42%
7.00%	30.14%	52.66%	69.49%	82.07%	98.49%
8.00%	34.45%	60.19%	79.42%	93.80%	100.00%

Note that a longer charitable term increases the likelihood the CLT trustee will need to invade principal to make the payments. Also, even if the APVCI exceeds 100% of the assets transferred to a CLT, the charitable deduction cannot be greater than the value of the assets given to the CLT.¹² Based on the numbers from Table 1 above, it is highly unlikely that a donor would create a 20-year CLAT with a payout rate higher than 6.00%. While the tables above illustrate deduction factors using payout rates expressed as rounded numbers (i.e., with no values to the right of the decimal point) and depict nonvariable payout rates for simplicity, the payout rate in a typical CLT document will be a percentage extended to 3 or 4 decimal places and may increase from year to year based on an extensive financial analysis of the financial aspects of the CLT plan.

Match the CLT Format to the Charity's Needs. The CLT format, term and payout rate selected may be important in complying with a charity's donor recognition or capital campaign recognition policies. For CLATs that irrevocably name one or more charitable income beneficiaries, such charities can count on the regular cash flow in planning their budgets and programs. In contrast, the CLUT's variable payments may mean the charity cannot be as certain in forecasting the available cash flow for its budgets and programs.

Consider the Prohibition on Self-Dealing. IRC §4947(a)(2) prohibits CLTs from engaging in self-dealing transactions with disqualified persons. In general, a disqualified person includes the donor, the donor's family, the trustee, the trustee's family, any business entities or trusts in which these persons have a greater than 35% interest and a person with a greater than 20% interest in any business entity or trust which is a substantial contributor.¹³ Further, self-dealing transactions include purchases, sales,

¹² See Treas. Reg. §§1.170A-6(c)(3)(i) and (ii).

¹³ IRC §4946(a)(1).

leases, loans, excess compensation and use of trust property.¹⁴ Several exceptions apply.¹⁵

Some common examples of prohibited activities include:

- The donor continuing to reside in a home she has transferred to a CLT;
- The donor's child purchasing property from the CLT; and
- The trustee making a loan from the CLT to a business enterprise he owns.

Care should be exercised in the operation of a CLT because CLTs are not only associated with reducing or avoiding transfer taxes, but also with transferring specific assets to heirs. For example, if the donor's vacation home is transferred to a CLT (along with sufficient other assets to make the charitable payments), it is a prohibited act of self-dealing for the donor and/or the donor's heirs to use the home even if they pay fair market rent.

Consider the Effect of Unrelated Business Taxable Income. Certain types of assets that produce UBTI may limit a non-grantor CLT's IRC §642(c) charitable deduction and therefore may be unsuitable for transfer to or investment by a non-grantor CLT.¹⁶ Common examples of UBTI producing assets include:

- An interest in an active trade or business (regardless of whether it is classified as a sole proprietorship, a general partnership interest, a limited partnership interest, or a LLC interest);
- A working interest in an oil and gas well; and
- Unrelated debt-financed income from trading on margin or other borrowing.

Because the grantor is taxed on all income generated by a grantor or "Super" CLT, there is no tax reason to avoid UBTI in these types of CLTs.

Drafting the CLT

Ensure the Document Drafted Supports the Plan Design. It is important to remember that a CLT is irrevocable. Therefore, it is critical to draft the

document correctly the first time. An example of a good plan gone bad is when the plan requires a CLUT (perhaps for GST reasons) and the document is drafted as a CLAT. Another example is when the plan is to avoid estate tax inclusion but the non-grantor CLT governing instrument reserves to the donors the power to change the charities.¹⁷ This is an even greater danger when the attorney engaged to draft the CLT governing instrument was not involved in the entire planning process.

Application of IRC §§4943 and 4944. If the APVCI exceeds 60% of the fair market value on the date of transfer, then the CLT's governing instrument must include the prohibitions against excess business holdings and jeopardizing investments found in IRC §§4943 and 4944.¹⁸

Beware of Using Generic Form Documents. Sample CLT documents are available from a variety of sources including the IRS.¹⁹ Books containing sample trust forms may contain one or more sample CLT documents. Often, continuing legal education seminars will include a copy of the presenter's standard form. Alternatively, it is common to borrow from colleagues that have previously drafted CLTs.

While it is tempting to use a document from one of the above sources and only change the names of the parties, the payout rate and the term; the multitude of design variables (including trust format) makes this practice inadvisable. The author has seen many CLTs that included conflicting provisions because the drafter failed to identify all of the edits necessary to convert a sample trust to one that conforms to the plan designed. Specific examples of errors include trust documents that:

- Refer to a different client and/or the wrong charitable income beneficiary;
- Permit the CLT to be amended as a charitable remainder trust;
- Define the payout in terms of both an annuity and unitrust amount;
- Include a net income provision;
- Include a makeup provision;

¹⁴ IRC §4941(d)(1).

¹⁵ See IRC §4941(d)(2)(B)-(H).

¹⁶ See IRC §681(a).

¹⁷ See IRC §§2036(a) and 2038(a). See PLR 200328030 for an application of this principle.

¹⁸ See IRC §4947(b)(3) and Treas. Reg. §§1.170A-(6)(c)(i)(D), 20.2055-2(e)(2)(vi)(e), & 25.2522(c)-3(c)(2)(vi)(e).

¹⁹ Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (providing forms for inter vivos charitable lead annuity trusts); Rev. Proc. 2007-46, 2007-29 I.R.B. 102 (providing forms for testamentary charitable lead annuity trusts); Rev. Proc. 2008-45, 2008-30 I.R.B. 224 (providing forms for inter vivos charitable lead unitrusts); Rev. Proc. 2008-46, 2008-30 I.R.B. 238 (providing forms for testamentary charitable lead unitrusts).

- Incorrectly specify multiple payout rates;
- Prohibit the trustee from accepting specific types of assets—including the proposed funding asset;
- Prohibit excess business holdings (IRC §4943) when the charitable income interest is under 60% and the proposed funding asset is a large block of stock in a closely-held company;
- Directly authorize acts of self-dealing;
- Omit the power to change the charitable income beneficiary when the donor desires this power;
- Include the power to change the charitable income beneficiary when the donor does not desire this power, for example to qualify for donor recognition or gift matching; and
- Restrict the charitable income interest to public charities when the donor intended to create and fund a private family foundation.

IRS Sample CLT Form Documents. In August 2007, the IRS issued sample inter vivos and testamentary CLAT forms via Revenue Procedures 2007-45 and 2007-46. The following year, the IRS released the complementary CLUT versions via Revenue Procedures 2008-45 and 2008-46. As a general rule, the IRS' sample CLT form documents are well-drafted. Nevertheless, as noted above, the author recommends caution when relying on another drafter's form document.

Adequately Define Principal and Income. Unless the governing instrument is drafted to include capital gains as an item of gross income from which the annuity or unitrust amount may be paid, a §642(c) deduction will not be allowed for the portion allocable to capital gains.

If the CLT administrator prefers a particular principal and income definition, include that definition. The power to deviate from the state law default provisions is explicitly authorized by §103(a)(3) of the Uniform Principal and Income Act of 1997²⁰ (as well as the 1931 and 1962 versions of the Model Act). Every state that has adopted any of the three versions of the Principal and Income Act has included a provision that defers to the governing instrument.

A CLT's governing instrument may require that income in excess of the annuity or unitrust amount be paid to the charity.²¹

Additional Contributions. A CLT's governing instrument must explicitly allow or disallow additional contributions. Almost all CLATs disallow additional contributions because, in a CLAT, no additional charitable deduction can be claimed.²² This means the donor would owe transfer tax for the charitable interest as well as the remainder interest unless the additional contribution is treated as a separate trust. On the other hand, most CLUTs allow additional contributions in order to increase flexibility. Nevertheless, because the APVCI is likely to be less than at the inception of the trust, an otherwise permitted additional contribution to a CLUT may not produce the desired result. Therefore, a new CLUT may be a better option.

Authority not to Diversify. It is not uncommon for a non-grantor CLT plan to contemplate that the contributed asset will remain in the CLT and be distributed to the remainder beneficiaries after the end of the payments to the charitable income beneficiaries. In such cases, it is important that the trust's governing instrument include language that authorizes or directs the CLT trustee not to diversify that asset. It is important to remember that the Prudent Investor rule is a default rule and §1(b) of the Uniform Prudent Investor Act permits the prudent investor rule to be "expanded, restricted, eliminated, or otherwise altered by the provisions of a trust."²³ Extreme caution should be exercised if the trust instrument does not contain express authority to disregard the default duty to diversify since a New York court did surcharge a CLT trustee who failed to diversify the CLT's assets.²⁴

Computing and Claiming the Income, Estate and Gift Tax Charitable Deduction

The deduction allowed for a transfer to a CLT is equal to the APVCI. The APVCI is computed by multiplying a factor times the value of the asset transferred. Many inputs impact the computation of this factor. Among them are the expected term of the trust, the payout

²⁰ Uniform Principal and Income Act, §103(a)(1), *available at* http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf.

²¹ See Treas. Reg. §§1.170A-6(c)(2)(i)(C) and (ii)(C).

²² Treas. Reg. §§1.170A-6(c)(2)(i); 20.2055-2(e)(2)(vi)(a); 25.2522(c)-3(c)(2)(vi)(a).

²³ Uniform Prudent Investor Act, §1(b), *available at* http://www.uniformlaws.org/shared/docs/prudent%20investor/upia_final_94.pdf.

²⁴ See *In re Estate of Rowe*, 712 N.Y.S.2d 662 (Sup. Ct. 2000).

rate, the AFR, the trust format and the frequency of the charitable payments.

This computation is complex and generally performed using specialized software. Some websites do offer limited versions of calculation software on either a pay, free, or trial basis.

For income tax purposes, the Internal Revenue Code limits the amount of the charitable deduction that individuals and C-corporations²⁵ can claim in any year to a percentage of their adjusted gross income. A CLT interest is considered to be a gift “for the use of”²⁶ charity, which means the donor can claim any income tax charitable deduction against no more than 30% of his or her AGI. To the extent that percentage limitations apply, any unused charitable deduction is carried forward for up to five years. The percentage limitations do not apply for gift, estate, or GST tax purposes.

In order to claim a charitable deduction, strict substantiation requirements must be met. For gifts of unmarketable assets that result in claiming or reporting a deduction greater than \$5,000, a qualified appraisal must be obtained.²⁷ Failure to obtain a qualified appraisal will generally result in the disallowance of the income tax charitable deduction and may result in the imposition of negligence and other penalties.

Operation and Administration

Making Proper Payments. Several potential traps exist regarding the proper amount to pay the income beneficiary. For example, a CLT must use the calendar year as its tax year.²⁸ As a result, it will normally have a short tax year in the first and last years of the trust. It is sometimes forgotten that, for any short year, it is necessary to prorate the annuity or unitrust payment. The proration is done on a daily basis. The proration factor has as its numerator the number of days in the short year, inclusive of the first day of the funding year and the last day of the final year. The denominator is 365, or 366 if February 29 is included in the numerator.

Examples of other traps include:

- Assuming that this year’s unitrust payment will be the same as last year’s payment;

- Failing to make the payments to the charitable income beneficiary; and
- The charitable income beneficiary’s failing to take possession of the payments (e.g., deposit the checks in the charity’s account).

One of the key elements used to compute the APVCI is the frequency with which charitable income beneficiary payments are to be made. While payments must be made at least annually, the trust’s governing instrument may specify that payments are to occur more frequently than annually and that the payments occur at the beginning or end of the period. Making payments without regard to the timing specified in the CLT’s governing instrument violates a key assumption used in computing the amount of the charitable deduction and may call into question the validity of the deduction. In addition, failure to observe and respect the provisions of the CLT’s governing instrument may open the trustee to liability for breach of his or her fiduciary duty. It is therefore clearly advisable to make payments in accordance with the rules specified in the trust document.

Tax Reporting by the Donor. There are a few forms that a donor may be required to file with respect to his or her transfer to a CLT. If the CLT is a grantor or “Super” CLT (for which the donor is claiming an income tax charitable deduction) and the trust is funded with most assets other than cash, then the donor may be required to attach a completed Form 8283 *Noncash Charitable Contributions* to the donor’s Form 1040.

If the CLT is an *inter vivos* non-grantor or “Super” CLT, the donor must file Form 709 *United States Gift (and Generation-Skipping Transfer) Tax Return* to report the transfer of both the remainder interest to the non-charitable beneficiary (including GST tax if applicable) and the charitable interest for gift tax purposes. However, this is not without benefit because filing Form 709 starts the running of the statute of limitations on the valuation of the contributed asset for gift tax purposes (not for annuity or unitrust valuation purposes).

If a CLT is funded testamentarily, then the executor or personal representative must file Form 706 *United States Estate (and Generation-Skipping Transfer) Tax Return* to claim the estate tax charitable deduction.

²⁵ Gifts by other entities are beyond the scope of this handbook.

²⁶ See Treas. Reg. §1.170A-8(a)(2).

²⁷ See Treas. Reg. §§1.170A-13(c)(1)(i), 1.170A-13(c)(2) and (3).

²⁸ See IRC §644.

Income Ordering Distribution Requirements. On April 16, 2012, the Treasury published final regulations regarding trusts (including non-grantor CLTs) that distribute income to or for a charity.²⁹ Before these regulations, many non-grantor CLT documents were drafted to require the charitable distribution to first come from ordinary income, then from short-term capital gains, then from long-term capital gains, then from unrelated business taxable income, then from tax-exempt interest and finally from trust corpus. This income ordering provision distributed higher tax rate income to the tax-exempt charitable beneficiary before distributing items with a lower tax rate, which meant the non-grantor CLT would pay less tax on its remaining income. The regulations disregard such income ordering provisions unless they have economic effect independent of the income tax consequences.³⁰

Tax Reporting by the CLT. Revenue Procedure 83-32 lists the filing requirements for CLTs. In general, all CLTs must annually file Form 5227 *Split-Interest Trust Information Return*. A copy of the trust document accompanied by a certification of its conformity to the original must be submitted with the initial Form 5227. All IRS Forms 5227 are subject to public inspection. Any person may submit IRS Form 4506-A *Request for Public Inspection or Copy of Exempt or Political Organization IRS Form* to the IRS to receive the public portion of a copy of a CLT's IRS Form 5227 that was filed for a particular year. Further, the IRS publishes the name, EIN, value and trustee's name and address as part of its IRS Business Master File.³¹ For this reason, clients who are concerned about privacy no longer use their name as part of their CLT's name.

Grantor and "Super" CLTs must also follow the filing requirements peculiar to grantor trusts for reporting the trust's items of income, deduction and credit to the donor. Where the trust is funded with joint property, the trust's items of income, deduction and credit should be allocated between the grantors in proportion to their ownership interest in the property gifted to the CLT. Many practitioners prepare a Form 1041 *U.S. Income Tax Return for Estates and Trusts* with the name and address of the trust and trustee; attach a statement of income, deductions and credits; and superimpose a stamp on the face of the return stating this is a grantor trust and that all income is taxable to the grantor under that grantor trust section

of the Code. Because Form 5227 requires a taxpayer identification number (which is different from a social security number), grantor trust reporting methods that utilize the grantor's social security number are not available to grantor CLTs.

A non-grantor CLT must file Form 1041 *U.S. Income Tax Return for Estates and Trusts*.

Other potential filing requirements in conjunction with the funding or operation of a CLT include:

Form 8283 *Noncash Charitable Contributions*. If the donor intends to claim an income tax charitable deduction, then a CLT trustee should sign the donee acknowledgement section of Form 8283.

Form 8282 *Donee Information Return*.³² If Form 8283 was prepared for a contribution to the CLT and the contributed asset is sold within 3 years of the date of gift, then the CLT trustee must file Form 8282 to report the sale price of the asset. The return must be filed within 125 days of the disposition of the contributed property. Note that this provides a way for the IRS to compare the value used to claim the deduction with the amount realized by the CLT.

Form 4720 *Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code*. As previously noted, a CLT is subject to the private foundation rules regarding self-dealing. If a CLT has engaged in an act of self-dealing with a disqualified person, then Form 4720 is used to disclose the act, describe the corrective action taken and compute the excise taxes on the foundation manager (i.e., the trustee) and the disqualified person.

Form 1041-ES *Estimated Income Tax for Estates and Trusts*. For non-grantor CLTs, the Form 1041-ES is used to make estimated payments of the tax liability due for the year.

Valuation. Unmarketable assets provide the greatest challenge in valuing a trust's assets. A CLT trustee will need to know the value of the trust's assets in a number of situations. For example:

- Valuing the initial contribution to the trust;
- Determining the annual valuation of the trust's assets and liabilities required to compute the unitrust amount;

²⁹ See Treas. Reg. §1.642(c)-3(b)(2).

³⁰ See Treas. Reg. §1.642(c)-3(b)(2) Example 1.

³¹ During July 2013, the IRS suspended its practice of including CLT information in the IRS Business Master File.

³² See Treas. Reg. §1.6050L-1.

- Valuing additional contributions for the incremental change in the unitrust amount; and
- Computing how much of an asset to transfer to make an in-kind distribution.

For CLTs, this is an area with limited authoritative guidance. Many administrators refer to the charitable remainder trust rules at Treas. Reg. §1.664-1(a)(7).

Compliance. In order to ensure the continued qualification of a CLT, it is important for the trustee, the investment manager, the administrator, the attorney (and any other professional advisor) to be familiar with the laws and regulations governing CLTs and the terms of the governing instrument. All of the parties to a CLT must continually monitor the activity of the trust for compliance. Among the specific areas of concern are trustee powers, prohibited investments, self-dealing transactions and (for non-grantor CLTs) transactions that could produce UBTI.

Annual Reporting. In some states, the trustee is required to provide a periodic statement or accounting to the income beneficiaries, remainder beneficiaries and/or a court. Charities that prepare financial statements in accordance with generally accepted accounting principles (GAAP) are required to include certain information about charitable lead trusts if the charity knows the CLTs name the organization. The type of information to be included depends on whether the charity serves as trustee (or not) and whether the charity's interest is revocable or irrevocable.

Investments

Prudent Investor Standard. In structuring a CLT's investment portfolio, the trustee must be aware of the standard under which his or her decisions may be evaluated. Since its promulgation in 1994, many states have enacted a version of the Uniform Prudent Investor Act. This act permits a trustee to invest for total return based on Modern Portfolio Theory. A trustee is therefore evaluated on the performance of a portfolio considered as a whole, rather than the performance of each individual asset.

Ensure the Investment Philosophy (i.e., the Risk Profile) is that of the CLT—not Just the Charitable Income Beneficiary and not Just the Remainder Beneficiary. By definition, a CLT is a split-interest trust. As such, the trustee has a duty to impartially balance the interests of the income and remainder beneficiaries. This duty extends to the identification of a risk profile that blends the relative risk profiles of the income and remainder beneficiaries. In identifying the CLT's risk profile, the trustee should consider such

factors as the remaining term of the trust, the sophistication of the income and remainder beneficiaries, prevailing economic conditions, inflation, the required trust payout, the trust format and liquidity needs, tax efficiency (as described below) and restrictions in the governing instrument. The bottom line is that when an investment manager invests the assets for more than one CLT, they should not necessarily be invested the same way.

Tax Efficiency and Grantor and "Super" CLTs. In selecting investments for grantor and "Super" CLTs, it is necessary for the trustee to be aware of the impact that income produced by the trust will have on the donor. For example, tax loss harvesting by the CLT can be used to offset other gains realized by the donor (and vice versa).

For Non-Grantor CLTs, Be a Slave to the §642(c) Deduction. For non-grantor CLTs, it is important to carefully monitor the production of taxable income and net realized capital gains compared with the IRC §642(c) charitable deduction for a particular tax year. It is highly desirable to match the realized investment return to the payout rate. Generate too little realized income and some of the charitable deduction will be wasted. Generate too much realized income and the trust will owe income tax.

For example, if a non-grantor CLT needs to make a \$70,000 charitable distribution this year, but the trust has realized only \$64,000 of taxable income and net capital gains, the investment manager should seek prudent methods of generating additional income or realizing gains (even short-term gains).

Make Sure the Person Picking the Investments Knows the Rules. It is important that the person selecting the CLT investment portfolio is aware of the rules peculiar to CLTs. For example, assets that produce UBTI should be avoided in non-grantor CLTs. It is important to avoid transactions that are subject to the IRC §4941 excise taxes on self-dealing. If the initial charitable interest is greater than 60%, then the trust must avoid excess business holdings (IRC §4943) and jeopardizing investments (IRC §4944).

Gift, Estate and GST Tax Considerations

General Comments. Even in an era of \$5,000,000 transfer tax exemptions that are indexed for inflation, it is a trap for persons who create a CLT to be unaware of the impact of transfer taxes in CLT planning. A charitable lead trust should not pay the estate tax or gift tax of the donor because it is a prohibited act of self-dealing. The best practice is for

a CLT's governing instrument to prohibit the payment of gift or estate taxes during the charitable term. Although Revenue Ruling 82-128 does not specifically address CLTs, most practitioners believe that the inclusion of this provision helps the charitable income interest to qualify as a guaranteed annuity or unitrust interest.

Gift Tax. If the donor or the donor's spouse is not a recipient of the remainder interest (e.g., the donor's children are the named recipients in a non-grantor or "Super" CLT) and the APVCI is less than 100%, then the donor has made a taxable gift. The amount of the gift is the value of the property transferred less the APVCI. Because it is a gift of a future interest, this gift will not qualify for the annual gift tax exclusion.³³ As a result, either the donor's lifetime gift tax applicable exclusion amount will be reduced or gift tax will be due. Many CLTs are designed so that no gift tax will be due for the gift of the charitable interest.

Estate Tax. If the donor dies during the charitable term of a grantor CLT and the donor retained control over the CLT such as the power to modify the identity or purpose of the charitable payments, the CLT's fair market value will be included in the donor's gross estate. The donors' estate will receive a charitable deduction for the remaining APVCI calculated as of the donor's date of death.

If the donor dies during the charitable term of a grantor CLT and the donor did not retain sufficient control over the trust to bring the entire trust back into the donor's estate, then only the present value of the donor's retained interest in the CLT will be included in the donor's gross estate. In either case, for most estates, the only estate tax impact of a grantor CLT is that the present value of the donor's remainder interest is included in the donor's estate.

One of the chief purposes of an *inter vivos* non-grantor or "Super" CLT is to remove the CLT's assets from the donor's estate. To achieve this result, provisions such as the following are typically avoided:

- Donor or donor's spouse serves as Trustee;
- Donor or donor's spouse being named as a beneficiary;
- Donor or donor's spouse directly or indirectly retaining control over the CLT's assets (e.g., retaining the power to vote shares contributed to

the CLT; retaining the power to direct the CLT's investments; or retaining the power to control the CLT's distributions paid to a private foundation controlled by the donor or donor's spouse);

- Donor or donor's spouse retaining the power to change the charitable income beneficiary; and
- Donor or donor's spouse retaining the power to change the remainder beneficiary.

As a reminder, any one of these items—by itself—is sufficient to cause possible estate tax inclusion. When included in an *inter vivos* non-grantor or "Super" CLT, the assets will be in the donor's gross estate if the donor dies during the charitable term or within three years of relinquishing such power.

As with all estate tax computations, if the gross estate (including the CLT assets and other lifetime gifts) is valued at less than the estate tax applicable exclusion amount, the inclusion of the CLT assets will not create an estate tax liability. For estates whose value exceeds the estate tax applicable exclusion amount, a testamentary CLT is a viable strategy for reducing the value of the estate below the limit, while providing a benefit to the donor's spouse, heirs and charity. Note that the fact that the gross estate, net of the estate tax charitable deduction from funding a CLT, is less than the estate tax applicable exclusion amount does not eliminate the requirement to file Form 706.

Generation-Skipping Transfer Tax. Planning for allocation of a donor's GST exemption is an important design consideration for CLTs that could benefit grandchildren or other skip-persons.³⁴ When a CLT includes a generation-skipping transfer, it is possible for the donor to allocate all, or a portion, of his or her GST exemption.

If any portion of the donor's GST exemption³⁵ is to be allocated to the CLT, then care should be exercised in selecting the trust format (i.e., annuity format versus unitrust format). While the GST inclusion ratio for CLUTs is ascertainable as of the funding date, the GST inclusion ratio for CLATs cannot be ascertained until the lead interest terminates.³⁶ This uncertainty causes most planners to recommend CLUTs when skip-persons are potential remainder beneficiaries of a CLT.

As a final comment on GST and CLTs, the GST tax will not apply to a skip-person's portion of the

³³ See Treas. Reg. §25.2503-3(a).

³⁴ See IRC §2613 for the definition of a skip person.

³⁵ The lifetime GST exemption is now indexed for inflation. It was \$5,000,000 during 2011; \$5,120,000 for 2012; \$5,250,000 for 2013; \$5,340,000 for 2014; \$5,430,000 for 2015; and \$5,450,000 for 2016. See IRC §2623(c).

³⁶ See IRC §2642(e).

remainder interest if the intervening generation predeceases *funding* of the CLT.³⁷ As a consequence, for testamentary CLTs the executor should be granted discretion to create separate CLTs for skip-persons and non-skip persons and allocate the GST exemption accordingly.

A CLT can empower donors to realize charitable goals that seem beyond their reach. For example, a CLT may enable a donor to commit to a multi-year pledge to the local hospital's capital campaign, while retaining ultimate use of the principal.

Post-Mortem Planning with CLTs

As noted above, the AFR is an essential component in determining the APVCI of a CLT. Unfortunately, the AFR for testamentary CLTs is almost always a variable that cannot be known until the donor's death. Some donors find comfort in learning that it is possible to give the executor a direct instruction to create a CLT while still granting the executor enough discretion to choose the appropriate payout rate and charitable term. It is important to keep the discretion sufficiently limited so that the charitable deduction is not lost. A best practice for testamentary CLT planning is to use a formula clause so that the charitable interest can be determined with certainty as of the donor's death.³⁸

Disclaimer Planning with CLTs

Opportunities exist for donors to use disclaimer planning to create alternative scenarios in their estate plan. For example, a donor's will could provide that \$4 million be transferred outright to her spouse, however if the spouse disclaims the interest,³⁹ then the \$4 million would be transferred to a CLT for the benefit of a named charity and their children.

Benefits to Donors

The charitable lead trust is a useful tool in the gift planner's toolbox. While less familiar than CRTs and CGAs, CLTs are flexible enough to meet many charitable, financial and non-financial goals for donors. For example, CLTs can:

- Reduce income, gift, estate and/or generation-skipping transfer taxes
- Transfer money, stock and/or illiquid assets to heirs
- Maximize charitable giving
- Avoid the adjusted gross income limitations on the deductibility of charitable gifts

³⁷ See IRC §2651(e). Note this exception does not help if the intervening generation dies after the CLT is funded.

³⁸ See Treas. Reg. §20.2055-2(e)(2)(vi)(a).

³⁹ See IRC §2518.

Appendix A

IRS Charitable Lead Trust Statistics⁴⁰

Each year, the Statistics of Income division of the IRS publishes tables and a paper based on a statistical study of IRS Forms 5227, which were filed for the stated tax year.⁴¹ The tables below present a compilation of selected statistics from the last several tax years of data published by the IRS.

Tax Year	Number of CLTs	CLT Book Value
2000	4,571	\$10,810,272,000
2001	5,292	\$15,075,433,000
2002	5,481	\$12,781,399,000
2003	5,658	\$12,318,893,000
2004	6,168	\$15,500,073,000
2005	6,298	\$16,485,658,000
2006	6,377	\$18,093,904,000
2007	6,521	\$19,648,472,000
2008	6,626	\$18,274,043,000
2009	6,609	\$19,338,914,000
2010	6,617	\$20,945,036,000
2011	6,498	\$23,705,416,000

⁴⁰ Source: IRS Statistics of Income Report Tables www.irs.gov/uac/SOI-Tax-Stats-Split-Interest-Trust-Statistics.

⁴¹ Because the study covers IRS Form 5227, the annual study also addresses some data about Charitable Remainder Trusts and Pooled Income Funds.