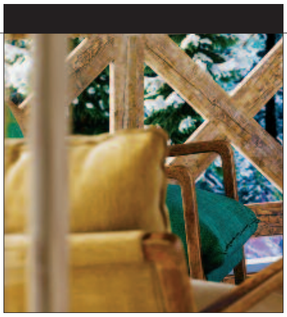
Originally appeared in Estate Planning, a Thomson Reuters publication.



CLTs and CRTs: Benevolence that is Good for the Bloodline

A detailed examination of charitable lead and remainder trusts, and variations thereof.

MARGARET W. SCOTT AND R. MARK WILLIAMSON

Many clients are charitably inclined, but some are hesitant to make large charitable planning decisions because they understandably want to make certain they are taking care of their families as well. And, if there is one thing to learn from the Covid-19 pandemic, it is that the future is hard to predict. Charitable split interest trusts – such as charitable lead trusts and charitable remainder trusts – offer clients a way to help charity without neglecting family, with a large menu of options to suit specific client goals. This article is intended to provide a detailed road map to practitioners whose clients want to deploy their benevolence in a way that is also good for their bloodline.

The Basics.

A charitable lead trust (CLT) is an irrevocable trust created during life or at death which gives charity the first or "leading" interest in the trust. Payments are made to charity for a lifetime or a predetermined number of years, with either a reversion in the grantor or a remainder in family members (typically, the grantor's children or descendants) or other non-charitable remaindermen.[1] A charitable remainder trust (CRT) is an irrevocable trust created during life or at death which gives the grantor (or other named beneficiaries) an income stream from the trust for a term of years or for life. Charity receives the remaining trust assets at the end of the trust term.[2]

Four Types of CLTs

Nongrantor CLTs. Nongrantor CLTs are the most common type of CLT. They can be formed during life or at death and are designed to transfer property to the grantor's descendants or other designated beneficiaries at a reduced gift or estate tax cost. They are typically designed to produce an estate tax or current gift tax charitable deduction that effectively removes the transferred assets from the grantor's federal taxable estate, but the grantor is *not* entitled to an income tax charitable deduction with respect to any portion of the transfer to the trust. The primary tax benefit for an intervivos nongrantor CLT is a gift tax charitable deduction for the value of the charitable lead interest and potentially removing an appreciating asset from the estate of the grantor. Grantor is entitled to an estate tax charitable deduction for the value of the charitable lead interest and the property is included in the grantor's estate with result that there is a stepped-up basis in the property contributed to the trust and eventually passing to the non-charitable beneficiaries.

Grantor CLTs. Grantor CLTs allow a grantor to obtain an immediate income tax charitable deduction upon the funding of the trust equal to the value of the lead interest passing

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to charity, but the grantor remains taxable on the income subsequently earned by the trust and does not receive any additional income tax deductions for distributions made to charity over the term of the trust. As a result, the initial deduction is "recaptured" over the term of the trust as the trust's income is taxed to the grantor. A grantor CLT must be established during life. In most instances, the corpus of the trust will be includible in the grantor's estate for federal estate tax purposes. Grantor CLTs allow grantors to consolidate deductions for future donations into a larger deduction for a single year. With the increased standard deduction, the limitations on deductions for state and local taxes, and the elimination of many other deductions that taxpayers relied upon in the past that came with the 2017 Tax Cuts and Jobs Act, taxpayers who now itemize benefit greatly from grantor CLTs.

Intentionally Defective Grantor CLTs *aka* Super CLTs. Super CLTs are designed to achieve both income tax and estate tax benefits – they have both grantor trust and nongrantor trust characteristics. A super CLT is designed to transfer property to the grantor's descendants or other designated beneficiaries, but the grantor retains just enough rights in the trust for the trust to be considered a grantor trust for income tax purposes and a nongrantor trust for gift and estate tax purposes. As a result, the grantor pays tax on the trust's taxable income, but the trust's assets are excluded from the grantor's estate. The grantor receives both an income tax deduction and gift tax deduction in the year the trust is created. Super CLTs are not specifically authorized in the tax law, but the IRS has issued multiple private letter rulings to individual taxpayers approving these hybrid trusts.[3]

Nonqualifying nongrantor (common law) CLTs. Nonqualifying nongrantor CLTs are designed to keep the income of the trust from being taxed to the grantor while avoiding the private foundation restrictions.[4] By design, these trusts do not provide a guaranteed annuity or unitrust interest (which is why they are not qualified), and therefore do not qualify for an initial income or gift tax charitable deduction by the grantor. Such trusts can claim an annual income tax charitable deduction under Section 642(c) when amounts are transferred to charity while avoiding alternative minimum tax and private foundation restrictions. Although no income tax deduction is available to the grantor, neither is any of the trust's income taxable to the grantor, so the net effect to the grantor is as if he or she received a full charitable deduction, even if he or she previously exceeded his or her adjusted gross income (AGI) limits. That could be the case if the grantor has contributed cash or appreciated property to a private foundation with 30% and 20% AGI limits respectively. These trusts also may be attractive to grantors looking to exclude income that could drop the grantor into a lower marginal income tax bracket. Another advantage is that the grantor would have complete flexibility in the choice of what asset to use to fund the trust.[5]

Two Types of CRTS. CRTs cannot be grantor trusts. Qualified CRTs (meaning a trust that meets the requirements under Section 664) are exempt from all taxes unless the trust has unrelated business taxable income within the meaning of Section 512, which is taxed at 100%. CRTs must be either annuity or unitrusts – no hybrid options, although as described below, there are permutations within those categories.

Nonqualified CRTs do not have any of the same tax advantages, but they also need not comply with the term or other restrictions applicable to qualified CRTs. Nonqualified CRTs are frequently established at death to take advantage of the stepped-up basis rules. Such trusts don't have mandatory payout requirements, but their income is taxed like any other complex trust. As such, it often makes sense to distribute all of the trust's current income every year to avoid income taxes and potentially the net investment income tax.

Drafting a CLT or CRT – General Requirements

Guaranteed Payments that Must be Made. To obtain an income, gift, or estate tax deduction, a charitable lead or remainder trust must provide for an annual payment to a qualified charitable organization or noncharitable beneficiary (as the case may be) in the form of a guaranteed annuity or a unitrust interest.[6] The payments *must* be made from the trust regardless of whether the income or cash in the trust is sufficient to make those payments. If cash, for example, is not available, non-cash assets (including even the property originally transferred to the trust) must be distributed to make the annual paymenents.

Choose Annuity or Unitrust Payment and Define Amount. A unitrust payment is fixed percentage of the fair market value of the trust assets determined annually.[7] If the value of the trust assets increases (decreases), the unitrust payment increases (decreases). CLUTs cannot be zeroed out. An annuity payment is a fixed dollar amount – expressed as a dollar amount or as a fraction or percentage of the trust's initial value.[8] It does not change due to fluctuations in the value of the trust. The annuity should be expressed as a percentage of the initial fair market value as finally determined for tax purposes of the assets contributed to the trust. This will limit the tax consequences if that value is determined to be different from the anticipated value. CLATs can be zeroed out, meaning that the annual annuity payments can be structured such that their present value is equal to the initial corpus of the trust, resulting in no portion of the trust being subject to federal transfer tax.

CLAT - Option for Escalating Annuity Payments. If drafting a CLAT, the planner has the option to provide for escalating annuity payments over the term of a CLAT, which allows the trust assets to be invested for a longer period of time, potentially providing additional opportunities for growth in the early years when the corpus is largest. In addition, given the near certainty of market volatility, a backloaded CLAT may be in a better position to recover from poor years than one that pays level annuity payments providing a more certain path of return. The IRS has made clear that the annuity amount may increase over the term of the trust provided that the annuity's value is ascertainable at the time of the funding of the CLAT.[9] In addition, in PLR 201216045, the IRS approved a testamentary CLAT that used an escalating annuity formula designed to zero out the CLAT that increased the annuity payments by 120% of the prior year's payment throughout the term of the trust. Even though PLRs are non-binding, Treasury regulations have approved an escalating annuity formula allowing annual annuity payments to increase by a maximum of 20% per year for GRATs,[10] so it seems very likely the IRS would not contest a 120% escalation formula, but it is unclear whether a 20% increase is the ceiling.

Shark-Fin CLATs. So-called "shark-fin" CLATs are extreme versions of zeroed-out backloaded CLATs, which endeavor to retain for investment the bulk of the trust's assets for the longest possible amount of time. This design provides for minimal annuity payments for the bulk of the trust's term with a final balloon payment. Although attractive in concept, such CLATs have not been endorsed or specifically approved by the IRS so they carry some risk. If the IRS determines that the annuity payment structure of a CLAT does not constitute a guaranteed annuity, the tax consequences could be severe – estate tax inclusion for a testamentary CLAT or denial of gift tax deduction, etc. However, in spite of the IRS's silence, the present value of the payment to charity is ascertainable at the outset and shark-fin CLATs appear to meet all other definitional requirements.

Lead Trust Excess Income. For a CLT, the governing instrument may authorize the distribution to charity of any annual trust income in excess of the annuity or unitrust amount, or it may be retained by the trust. Additional distributions to charity will not increase the grantor's original deduction.[11] However, since a CLT is entitled to an unlimited income tax deduction for distributions to charity made pursuant to the terms of the governing instrument, this can be a good way to avoid income tax to the trust. But watch that this discretionary power is not attributed to the grantor or a non-adverse trustee.[12]

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NIM-CRUTs, etc. Under the applicable regulations, a CRUT (but not a CRAT) may provide for the annual noncharitable payment to be the *lesser of* (1) the regular unitrust amount or (2) the trust's fiduciary accounting income for the year, increased by "shortfalls" for prior years in which fiduciary accounting income was less than the unitrust amount (hence the name "net income with make-up" or "NIM-CRUT").[13] *However, there is no*

1 See generally I.R.C. Section 170(f)(2)(B) and Treas. Reg. section 1.170A-6(c)(2)(i) and (ii).

2 See generally I.R.C. Section 664 and Treas. Reg. section 1.664-1.

3 PLR 199922007 (qualified unitrust that was grantor trust due to retained 675(4) power); PLR 200010036 (level super CLAT approved that held marketable securities); and PLR 199936031 (lead "super" CLT approved that held S-corp stock).

4 When all of the noncharitable interests have expired, private foundation restrictions may apply pursuant to I.R.C. Section 4947.

5 See PLR 9810019, 9407014, 199936031 (involving trusts that qualify for an initial income tax deduction).

6 I.R.C. Sections 170(f)(2), 2055(e)(2)(B), and 2522(c)(2)(B).

7 Treas. Reg. section 1.170A-6(c)(3)(i).

8 *Id.*

9 Rev. Proc. 2007-45 and 2007-46; PLR 9112009 (IRS approved CLAT where minimum annuity amount was specified, but varied each year).

10 Treas. Reg.section 25.2702-3(b)(1)(ii)(A).

11 Treas. Reg.sections 1.170A-6(c)(2)(i)(c), 20.2055-2(e)(2)(vi)(d), and 25.2522(c)-3(c)(2)(vi)(d).

12 I.R.C. Section 674(a).

13 Treas. Reg. section 1.664-3(a)(1)(i)(b).

enhancement of the grantor's charitable deduction on this account (even though the grantor's retained interest is less valuable because payments to the grantor can be deferred or forfeited). In general, fiduciary accounting income is determined under applicable state law, except that (1) trust provisions that "depart fundamentally from traditional principles of income and principle" are not recognized, and (2) the regulations specifically provide that *pre-contribution gain may not be allocated to principal*.[14] The regulations also provide that a CRUT may start out as a NIM-CRUT and then convert or "flip" to a standard CRUT upon a "triggering event" (hence the name "FLIP NIM-CRUT"), and specifically provide that the sale of unmarketable assets is a permissible triggering event. The "flip" must occur at the beginning of the taxable year following the taxable year of the triggering event. *Following the "flip," any shortfalls for prior years in which fiduciary accounting income was less than the unitrust amount disappear*. This is important, and not always adequately explained to potential grantors.

Term. The term can be measured by a term of years (no maximum or minimum, but be careful not to violate the rule against perpetuities), by the life or lives of individuals living at the date of transfer, or by the life or lives of individuals living at the date of transfer plus a term of years.[15] IRS regulations limit the eligible measuring lives that may be used to (1) grantor, (2) grantor's spouse, (3) grantor's descendants, and (4) spouses of grantor's descendants.[16] Most CLTs are structured as term trusts due to the relative predictability of a term. For a CRT, the annuity or unitrust amount must be payable to one or more individuals (living on the transfer date) for their respective lives, or must be payable for a term not exceeding 20 years (or the shorter of lives or term).[17] Any individual can be a beneficiary for his or her life, but an interest measured by the life of another is not allowed.[18]

Minimum or Maximum Distribution Amount. A CLT can pay any amount to charity. There is no minimum payout requirement. The general strategy is to implement a payout that will enable the grantor to achieve the dual goals of preserving the original principal in the trust but simultaneously allowing it to grow for the benefit of the ultimate remainder beneficiaries.

For a CRT, the annuity or unitrust amount percentage must be at least 5% and not more than 50%.[19] The value of the charitable remainder interest must be at least 10% of the value of the property transferred to the trust.[20]

Additional Contributions. There does not appear to be any prohibition against additional contributions either to a CLAT or to a CLUT. However, additional contributions to a CLAT will not generate additional income, estate, or gift tax charitable deductions. Where it is important to qualify an additional contribution to an otherwise qualifying CLAT for a gift tax charitable deduction, consider creating a separate trust. In the case of a CLUT, additional contributions are permissible; and charitable deductions are allowed for those contributions. Where additional contributions may be made, the governing instrument should expressly permit additional contributions. Similarly, additional contributions to a CRUT are allowed, but additional contributions to a CRAT are not allowed.[21]

Trustee. Any individual or entity may serve as a trustee of a CLT. However, the grantor should not retain power to designate the income or remainder beneficiaries, or the trust's corpus will be includible in the grantor's estate under Section 2036 or 2038. In general, if part of the planning strategy is to remove the assets from the grantor's estate and the grantor desires to maintain some flexibility with respect to the charitable beneficiaries, the grantor should not serve as trustee. Other than the grantor's spouse,[22] members of the grantor's family are good candidates to serve as co-trustee, but if such family members are also beneficiaries, it is likely wise to appoint an independent trustee as well. Generally, where possible, it is best to appoint an independent trustee. For a CRT, estate tax inclusion is usually not a concern because of the estate tax charitable deduction. And in many cases it is fine for the grantor to serve as his or her own trustee. But give careful consideration to whether an independent, professional trustee is advisable for non-tax reasons.

14 Treas. Reg. sections 1.643(b)-1, 1.664-3(a)(1)(i)(b)(3).

15 Rev. Rul. 85-49, 1985-1C.B. 330.

16 Treas. Reg. section 1.170A-6(c)(2).

17 I.R.C. Section 664(d)(1)(A), (2)(A); see also Treas. Reg. sections 1.664-2, 1.664-3.

18 Treas. Reg. section 1.664-2(a)(5)(i).

19 I.R.C. Section 664(d)(1)(A), (2)(A).

20 I.R.C. Section 664(d)(1)(D), (2)(D).

21 Treas. Reg. section 1.664-2(b).

22 I.R.C. Section 672(e).

23 Rev. Rul. 78-101, 1978-1 C.B. 301.

24 See I.R.C. Sections 2035(a), 2036(a)(2), and 2038(a)(1), and Treas. Reg. section 25.2511-2(c).

25 See I.R.C. Section 2036(a)(2).

26 Sections 4941-4944, 4947(a)(2). The excess business holdings and jeopardy investment rules do not apply to a CLT if the deductible value of the lead interest does not exceed 60% of the fair market value of the trust assets, or to a CRT if no charitable deduction has been taken for any income beneficiary.

27 I.R.C. Section 4943(d)(3).

28 See Rev. Rul. 75-38, 1975-1 C.B. 161, for a list of states having such laws.

29 Rev. Proc. 2007-45.

30 Rev. Proc. 2007-46.

31 Rev. Procs. 2008-45 and 2008-46.

Charitable Beneficiary(ies). One or more charities may be specified in the trust instrument, or the trustee may be empowered to select qualified organizations. Private foundations, supporting organizations, grantor advised funds and public charities are all permissible charitable beneficiaries. The failure to designate a specific charitable beneficiary will not preclude the grantor from receiving a charitable deduction if the trust instrument provides for the selection by the trustee of a charitable beneficiary described in Sections 170(c), 2055(a) and 2522(a).[23] For CLTs, when avoiding estate tax inclusion on the grantor's death is a goal, consider the following:

1. If the grantor is serving as trustee, the trustee's power to select the charitable beneficiaries will cause the gift of the annuity interest to be incomplete for gift tax purposes and may cause some or all of the trust property to be included in the grantor's gross estate.[24]
2. If the charitable beneficiary is a private foundation and the grantor is an officer or director of the private foundation or has decision making authority over the private foundation, some or all of the trust property may be included in the grantor's gross estate.[25]
3. Note that the grantor may retain the right to substitute another charitable beneficiary for the charitable beneficiary named in the trust instrument, but doing so eliminates the transfer tax benefits of the trust. It is preferable to give this power to an independent trustee.

Private Foundation Restrictions. CLTs and CRTs are subject to the private foundation self-dealing, excess business holdings, jeopardy investments, and expenditure responsibility rules, and also the private foundation governing instrument and termination rules.[26] Under those governing instrument rules, the trust instrument must contain specific prohibitions as follows:

1. The governing instrument should prohibit self-dealing (as defined in Section 4941).
2. The governing instrument should prohibit taxable expenditures (as defined in Section 4945).

GST exemption can be allocated to a CRT, if the annuity or unitrust amount is payable to a skip person. However, this is usually not an efficient use of GST exemption.

3. If applicable (see above), the governing instrument should prohibit excess business holdings (as defined in Section 4943) and jeopardy investments (as defined in Section 4944). The restriction against excess business holdings may require a grantor of closely held stock to keep the deductible value of a charitable lead interest below 60% in order to avoid the problem. Under Section 4943, a business enterprise does not include a functionally related business (as defined in Section 4942(j)(4)) or a trade or business at least 95% of the gross income of which is derived from passive sources.[27] Therefore, a contribution to a CLT of an interest in a family limited partnership holding only publicly traded securities or other passive investment assets should not create excess business holdings problems.
4. Some private foundation provisions applicable to CLTs or CRTs may be deemed to be part of the governing instrument by state law.[28] However, it is safer to spell out the private foundation provisions in the trust instrument rather than rely on state law, especially given the age of the ruling.

IRS Sample Forms for CLTs and CRTs. The IRS has provided sample trust forms satisfying the requirements for a grantor or inter vivos nongrantor CLAT for a term of years, plus annotations.[29] In addition, the IRS has provided a sample trust form satisfying the requirements for a testamentary CLAT for a term of years, plus annotations.[30] In 2008, the IRS issued sample forms for inter vivos grantor and nongrantor CLUTs and testamentary CLUTs.[31] The IRS has also provided sample trust forms satisfying the requirements for CRTs. Revenue Procedures 2005-52 through 2005-59 provide forms for inter vivos and testamentary CRUTs and CRATs for various terms (one or two measuring lives or term of years).

Does the Historically Low 7520 Rate Matter? The Section 7520 rate is the approved rate used by the IRS for discounting present values, annuities, or future interests. It is pegged monthly at 120% of the mid-term AFR rate and rounded to the nearest two-tenths of a percent. In November 2020, the rate was 0.4%. The November 2021 rate is 1.4%. For frame of reference, in 1989, the 7520 rate was 11.6%!

1. Yes, for a charitable lead annuity trust, the lower the Section 7520 rate, the higher the charitable income, gift, and estate tax deduction. As such CLATs are favored in this environment.
2. Yes, for a CRAT, because a lower Section 7520 rate means a lower charitable deduction.
3. No, for a charitable lead or remainder unitrust because the payout is a fixed percentage of the trust's annual value, and interest rates have very little effect on the unitrust's valuation.

Gift Tax Considerations.

The gift tax law allows a gift tax charitable deduction for the actuarial value of the charity's lead or remainder interest.[32] Thus, a person who creates a charitable lead or remainder trust is treated as making a taxable gift equal only to the value of the remainder which will pass to the non-charitable beneficiaries after the charitable lead interest ends (in the case of a CLT), or the value of the annuity or unitrust interest payable to noncharitable beneficiaries (in the case of a CRT). Unless the noncharitable interest is held by the grantor, or by the grantor's spouse in a form that qualifies for the marital deduction, the value of the noncharitable interest will be subject to gift tax at the time the lead trust is created. As stated above, CLATs may be zeroed out for gift tax purposes, but CLUTs cannot because the amount payable to charity fluctuates over time.

Value of Gift. The value of the noncharitable gift is determined by determining the value of the annuity or unitrust interest (in the case of a charitable remainder interest), or by subtracting the value of the charitable annuity or unitrust interest from the value of the property transferred to the trust (in the case of a CLT). The grantor may value the interests in the trust based on the Section 7520 rate for the month in which the trust is created (or property is transferred to the trust) or for either of the two previous months.[33] As a general rule, the lowest of those three monthly rates will produce the best results with a CLT—this will maximize the value of the lead interest committed to charity and minimize the value of the remainder. Choosing the month with the highest rate will maximize the charitable deduction for a CRT.

Annual Exclusion and Marital Deduction. For CLTs, the remainder interest is a future interest; so a gift to the noncharitable remainderman does not qualify for the gift tax annual exclusion. However, a gift to the grantor's spouse of a remainder interest in a lead trust should qualify for the gift tax marital deduction as long as the spouse is a U.S. citizen. For CRTs where the grantor is not the only noncharitable beneficiary, the grantor can retain a testamentary right to revoke the other noncharitable interests in order to prevent a completed gift of that interest when the trust is created. A special rule allows a marital deduction for the interest of the grantor's spouse if the grantor and/or spouse are the only noncharitable beneficiaries.[34] An annuity or unitrust interest which commences immediately should qualify for the annual exclusion.[35]

Completed Gift. If a grantor to a CLT retains the right to select the charitable beneficiaries after the trust is created, the grantor has not parted with control over the trust property; and the charitable gift is incomplete. When the grantor's power to designate the charitable beneficiary ends (*i.e.*, when the grantor exercises the power or allows it to lapse), the gift is completed and becomes subject to gift tax. A gift tax charitable deduction should be allowed at that time.[36] Similarly, with a CRT, the grantor can prevent a completed gift of any noncharitable interests held by others by retaining the testamentary right to revoke those interests. If the grantor specifies in the trust the charity or charities which will receive payments from the trust or leaves the selection up to the trustee, the grantor has parted with control and the gift is complete from the outset. However, the grantor is allowed a gift tax charitable deduction in the year the trust is created. If the grantor to a CLT or CRT is deemed to control the payments to charity, as indicated above, the gift will be incomplete; and the entire value of the trust assets may be includable in the grantor's gross estate (but in the case of a CRT, an estate tax charitable deduction will be allowed for the interest passing to charity at that time). This occurs if the grantor (1) has the right to designate the charitable beneficiaries, (2) can vote stock transferred to the trust, or (3) holds a fiduciary position with a charitable beneficiary (*e.g.*, is an officer or director of a charity to which the income is payable). If payments from a CLT will be made to a charity of which the grantor is an officer or director, it should be possible for the gift from the lead trust to be isolated and held in a separate

32 I.R.C. Section 2522(c)(2)(B); Treas. Reg. section 25.2522(c)-3(c)(2)(vi) and (vii).
33 I.R.C. Section 7520(a).
34 I.R.C. Section 2523.
35 Treas. Reg. section 25.2503-3(b).
36 See PLR 9742006.
37 See e.g., PLR 9823005.
38 I.R.C. Section 2055(e)(2)(B); Treas. Reg. section 20.2055-2(e)(2)(vi) and (vii).
39 I.R.C. Section 2056(b)(8).
40 See PLR 9533017.
41 See PLR 200043039.
42 I.R.C. Section 2642(a)(2).
43 I.R.C. Section 2642(e)(1)(B).
44 I.R.C. Section 2612(a)(1).
45 I.R.C. Section 2652(c)(1).
46 I.R.C. Section 2651(e).

fund subject to the control of the other officers and directors.[37]

Estate Tax Considerations

An estate tax charitable deduction is allowed for the actuarial value of a charitable lead or remainder interest.[38] The estate tax charitable deduction is calculated in the same way as the gift tax charitable deduction in the case of a lifetime charitable lead or remainder trust. For a CRT, a marital deduction is allowed for the noncharitable interest passing to the grantor's spouse if he or she is the only noncharitable beneficiary.[39] With CLTs, if highly appreciated assets are involved, the testamentary lead trust may be preferable to the inter vivos trust because the basis of the assets transferred to the trust is stepped up to the estate tax value of the assets. Since the lead trust is a fully taxable trust, this will reduce the capital gains tax payable by the trust (or by the remainder beneficiaries) when the assets are sold.

Generation-Skipping Transfer Tax Considerations

CLTs are often very attractive to grantors who wish to benefit much younger family members, i.e. grandchildren. In general, the goal with GST planning is to leverage a client's GST exemption and avoid inadvertent generation-skipping transfers. For example, if the grantor's children are the remainder beneficiaries of the trust, it is not advisable to name the grandchildren as contingent beneficiaries. Instead it is better to provide that a deceased child's share would go to his or her estate[40] or give the child a general power of appointment over the remainder interest.[41]

CLUT. In the case of a CLUT, the applicable fraction for generation-skipping transfer tax purposes can be calculated with precision when the trust is established: the applicable fraction is equal to (a) the amount of the GST exclusion that is allocated to the trust divided by (b) the fair market value of the property transferred to the trust reduced by the deductible value of the lead interest.[42] For example, if the full $11.7 million GST exemption is allocated to a charitable lead unitrust that is funded with $15 million, and the deductible value of the unitrust interest is $8 million, the numerator of the applicable fraction is $11.7 million, and the denominator is $7 million, the applicable fraction is more than 1, so that trust will be fully exempt from the GST tax. If the grantor's unused GST exemption is less than the deductible value of the unitrust interest, the applicable fraction can be easily calculated at the time of funding to determine what portion of the trust assets will be subject to GST tax upon termination of the lead interest. If the intended beneficiaries of the trust are skip persons, charitable lead unitrusts are better vehicles.

Charitable Lead Annuity Trust. In the case of a CLAT, however, the calculation is far more complicated, and 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." The numerator of the applicable fraction is the amount of the exclusion allocated to the trust adjusted by compounding it for the term of the trust by the discount rate in effect at the time the trust is established.[43] Therefore, if the assets in the trust outperform the Section 7520 rate, there will be GST tax owed at the termination of the lead interest.

CRTs. GST exemption can be allocated to a CRT, if the annuity or unitrust amount is payable to a skip person. However, this is usually not an efficient use of GST exemption.

ETIP Rules. For a charitable lead or remainder trust that will be included in the grantor's gross estate at death, do not forget: GST exemption cannot be allocated until the end of the "estate tax inclusion period."

Taxable Termination vs. Taxable Distribution. If a skip person gets the trust assets outright at the end of the term of a CLT, a taxable termination occurs if the charitable beneficiaries were named at the outset because an "interest," as defined in Section 2652(c)(1)(A), has terminated.[44] The trustee is liable for the GST tax.If the charitable beneficiaries were not named at the outset, then a taxable distribution under Section 2612(b) occurs because no "interest" has terminated.[45] The skip person is liable for the tax.

Pre-Deceased Child Exclusion. Note that the GST tax will not apply if the grantor's child (the grandchild's parent) is not alive at the time the trust is created. Nor will the GST tax be levied on a grandnephew's or grandniece's remainder interest if his or her parent is not alive at the trust's creation *and* the trust's grantor has no lineal descendants.[46]

Income Tax Considerations

Nongrantor CLTs. A nongrantor qualifying CLT is a separate taxpayer taxed as a complex trust under Section 661 et seq. Although not exempt from income tax, a CLT is entitled to an unlimited income tax deduction under Section 642(c) for its gross income which is paid to charity each year pursuant to the terms of the trust instrument. As discussed above, the charitable contributions are not limited by the individual taxpayer percentage limitations imposed by Section 170(b).[47]

Disallowance of Deduction for Unrelated Business Income. Section 681 disallows a charitable income tax deduction to the extent that a payment to charity consists of unrelated business income. In general, this would not appear to be an issue since the trust is entitled to an unlimited income tax deduction for income paid to charity, but with respect to UBI, the IRS imposes the individual taxpayer percentage limitations imposed by Section 170(b).[48] Note that the deductibility limits are applied only against UBI and not the entire value of the trust. The issue is that even though it is likely the income is required to be paid out to charity, the trust would have to pay tax on the UBI, which could cause unanticipated invasions of principal to pay the tax.

Ordering of Income. Unlike CRTs, the character of payments made to charitable beneficiaries of CLTs for income tax purposes is not determined by a statutory tier system. In the absence of specific provisions in the governing instrument, local law may characterize the payments. If it does not, payments made to the charitable beneficiaries of a CLT will be considered to consist of a pro rata portion of all of the items of the trust's income.[49]

Maximizing Deductibility. To maximize the deductibility of payments to charity, the trust should specify that income be paid out before principal; and the following order should be established:

- Ordinary income;
- Capital gain;
- Unrelated business taxable income;
- Tax-exempt income; then
- Trust principal.

Caution:

The IRS has ruled that the "ordering of income distributions provided... will not be given effect for federal income tax purposes because the ordering provision has no economic effect on the distributions independent of tax consequences."[50]

Grantor CLTs. A grantor CLT is not a separate taxpayer and instead is taxed to the grantor. Accordingly, if the grantor is treated as the owner of the trust under the grantor trust rules,[51] when the grantor funds the trust, he or she receives a current income tax deduction for the present value of the lead interest passing to charity.[52] The present value of the lead interest is determined under IRS regulations.[53]

Limitation on Deduction to Amount Received. Grantor's deduction may be limited if based on the totality of the circumstances, it appears charity may not receive the full benefit of the lead interest, such as if the present value of the lead interest exceeds the value of the trust assets.[54]

Recapture Possibility. If the grantor trust status ceases prior to the end of the lead term, then the grantor will be forced to recognize income in an amount equal to the difference between (1) the deduction the grantor received upon the trust's creation LESS (2) the present value, on the date of the trust's creation, of all amounts that were required to be, and actually were, paid to charity pursuant to the terms of the trust.[55]

CRTs. Although a CRT is generally exempt from income tax, distributions to the noncharitable beneficiaries are taxable under the "tier system": ordinary income first (to the extent of taxable ordinary income for the current year and undistributed taxable ordinary income for prior years), capital gain second (to the extent of capital gain for the current year and undistributed capital gain for prior years), other amounts (such as tax-exempt interest) third, and corpus fourth.[56] CRTs should avoid unrelated business income within the meaning of Section 512. Although such income no longer disqualifies a CRT entirely, the tax on such income is 100%.[57] The grantor trust rules of Sections 671 to 679 do not apply to a qualified CRT.

Who Is a Good Candidate for a CLT or CRT?

Good CLT Candidates. Generally, a CLT of any type should only be used by a grantor who can afford to forego income from one or more income producing assets for a period of years. Two major objectives in creating a CLT are to achieve: (i) an annuity or unitrust amount which can be paid without consuming significant amounts of principal, and (ii) a charitable term which will not be unduly prolonged. A person already making substantial contributions to charity each year could make them using a CLT and likely save on transfer taxes by getting an appreciating asset out of his or her estate. A person whose gifts exceed the percentage of adjusted

47 Treas. Reg. section 1.642(c)-1(a)(1).
48 Treas. Reg. section 1.681(a)-2(a).
49 Treas. Reg. sections 1.643(a)-5(b) and 1.662(b)-2; Rev. Rul. 71-285, 1971-2 C.B. 248.
50 PLR 9808035. See also Letter Ruling 9808031, in which the IRS reaches the same result. But see PLR 9721006, in which the IRS held that an ordering provision was effective for income tax purposes, except as to unrelated business income.
51 I.R.C. Sections 671 to 679.
52 I.R.C. Section 170(f)(2)(B).
53 Treas. Reg. sections 1.170A-6(c)(3)(i)(annuity payment) and 1.170A-6(c)(3)(ii)(unitrust payment).
54 Treas. Reg. section 1.170A-6(c)(3)(iii).
55 I.R.C. Section 170(f)(2)(B), Treas. Reg. section 1.170A-6(c)(4).
56 I.R.C. Section 664(b).
57 I.R.C. Section 664(c)(2)(A).

gross income ceiling on deductibility, but who wants to maximize his or her charitable footprint. Because income generated by the CLT is removed from the grantor's personal gross income (if the trust is not a grantor trust), the income tax effect of the trust is equivalent to the grantor personally receiving an income tax charitable deduction each year. Distributions from the CLT are deductible by the CLT and are not subject to the percentage limitations, so the grantor can direct more to charity.

Good CRT Candidates. A grantor with an established pattern of charitable giving may want to create a CRT naming the grantor and/or the grantor's spouse as the noncharitable beneficiaries and irrevocably designating a favorite charity as the remainder beneficiary. The grantor will receive a current income tax deduction (based on the fair market value of the property transferred to the trust if the applicable requirements are satisfied), and appreciated property transferred to the trust can be sold tax-free, with the grantor's share of that capital gain deferred until distributions are received under the tier system. If the charity's remainder interest is irrevocable, the charity may be able to count its interest in the trust towards matching goals and other fundraising purposes. Generally, a CRT makes sense for someone who wants to retain a stream of income for life and then support his or her favorite charity – particularly if the trust can be funded with appreciated property. Generally, a grantor transferring illiquid property to a CRT may prefer a NIM-CRUT, so that in-kind distributions of partial interests won't be required during the period of illiquidity. But beware of FLIP NIM-CRUTs, because all make-up amounts "disappear" in the year following the flip. The goal would be for the investments to be managed after the period of illiquidity to generate enough fiduciary accounting income to pay the unitrust amount even if the trust remains a NIM-CRUT.

Conclusion

The tax law affords many ways for philanthropically-minded individuals to support their favorite causes in a tax-efficient way. But many of these strategies can backfire when the "fit" is not right – in particular, when investments under-perform their hoped-for results. Proper use of these charitable planning techniques requires a detailed analysis of the client's personal needs and objectives, the time at which the client wants the charities to benefit, and the effect of current rates and tables on a given planning strategy. In most cases, the client is well-served by illustrations and projections that show what is likely to happen under different assumptions and scenarios. ■