

State Bar of Texas

Charitable Lead Trusts

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Information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Annual (or more often) payments to charitable beneficiary for a number of years or for a life or lives in being at the trust's creation.

Annuity Trust - Payment is a fixed dollar amount or a fixed percentage of the initial net fair market value of the trust assets.

Unitrust - Payment is a fixed percentage of the net fair market value of the trust assets determined annually.

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Distributions in Satisfaction of Annuity or Unitrust Payment

The CLT instrument may provide for the payment of the annuity or unitrust interest to be made in cash or in kind.

No Minimum Distribution

Unlike a charitable remainder trust and a private foundation, there is no minimum percentage or amount that must be distributed annually.

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Term

Payments can continue for the life or lives of one or more individuals, all of whom must be living when the trust is created or for a term of years (limited only by the applicable rule against perpetuities).

Testamentary and Inter Vivos CLTs

The charitable lead trust may be established as an inter vivos trust (during life) or as a testamentary trust (at death).

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Remainder Interest

The remainder interest, after payment of the charitable lead amount, is distributed to the noncharitable beneficiary or beneficiaries, which may include (but is not limited to) the donor, donor's estate, children, grandchildren or other trust or trusts for children or grandchildren.

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Private Foundation Rules

- ◆ Self-Dealing
- ◆ Unrelated Business Taxable Income
- ◆ Excess Business Holdings
- ◆ Jeopardizing Investments
- ◆ Taxable Expenditures
- ◆ Termination Tax
- ◆ Governing Instrument

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Self-Dealing

CLT must not be involved in self-dealing whether direct or indirect with disqualified persons.

Includes any direct or indirect:

- a) sale or exchange or leasing of property between trust and a disqualified person;
- b) lending of money or extension of credit between a trust and a disqualified person;
- c) furnishing of goods, services, or facilities between a trust and a disqualified person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the disqualified person;
- d) payment of compensation (or payment or reimbursement of expenses) by a trust to a disqualified person, unless it is for personal services and such compensation is reasonable and necessary to carry out the exempt purpose and is not excessive;
- e) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and,
- f) agreement by a private foundation to make any payment of money or other property to a government official [as defined by § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service, if such individual is terminating his government service within a 90 day period.

ATTRIBUTES OF CHARITABLE LEAD TRUSTS (“CLT”)

Self-Dealing (cont'd)

A “*disqualified person*” is a substantial contributor to the CLT (an individual, trust, estate, corporation or partnership who or which contributes an aggregate amount in excess of \$5,000 to the CLT, if his or her total contributions are more than 2% of the total contributions received), or a family member of a substantial contributor (spouse, descendants and spouses of descendants), or persons owning more than 20% of an entity which is a substantial contributor to the CLT (includes an entity in which a disqualified person owns more than 35%).

Excise Tax

Disqualified Person - 10% of that amount involved in the transaction for each year that the transaction is uncorrected; 200% if not timely corrected

Trustee - who knows the act is prohibited but approves it may also be subject to a tax of 5% of the amount involved (up to \$20,000 for each such act) for each year that the transaction is uncorrected; 50% if not timely corrected

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Excess Business Holdings

CLT must not retain excess business holdings as restricted by IRC § 4943(c).

- ◆ Entity in which interest is held must be engaged in a business enterprise for § 4943(c) to apply.
- ◆ Not engaged in business enterprise if $\geq 95\%$ of gross income is from a passive activity.

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Excess Business Holdings

Permitted Holdings:

- ◆ 20% of the voting stock reduced by the percentage of the voting stock actually or constructively owned by all disqualified persons
- ◆ 35% of the voting stock of a corporation if it is established to the satisfaction of the Secretary that effective control is in one or more persons who are not disqualified persons with respect to the CLT (where CLT and all disqualified persons together do not own more than 35% of voting stock)
- ◆ 2% De Minimus Rule

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Excess Business Holdings (cont'd)

Exceptions/Exit Strategy

Gratuitous Acquisition – 5 plus 5

Corporate Redemption

Excise Tax

CLT - 10% of the value of the excess business; 200% if not timely corrected

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Jeopardizing Investments

CLT must not make investments which would jeopardize the carrying out of the exempt purpose. This restriction addresses actions of investing and does not cover assets received by a CLT by gift or bequest.

Excise Tax

CLT - 10% of the amount of the improperly invested assets; if investment is not disposed of within 90 days, then additional tax of 25% of the amount improperly invested (not to exceed \$10,000).

Trustee - 5% of the amount of the improperly invested assets; if the investment is not disposed of within 90 days after imposition of the initial tax, an additional tax of 5% of the amount of the improperly invested assets.

ATTRIBUTES OF CHARITABLE LEAD TRUSTS (“CLT”)

Taxable Expenditures

CLT must not make taxable expenditures. This covers amounts paid for propaganda or to attempt to influence legislation or the outcome of a public election, amounts paid to carry on any voter registration drive, or amounts paid as certain grants.

Excise Tax

CLT - 20% of the amount involved; if the taxable expenditure is not corrected, there is an additional tax of 100% of the amount of the expenditure

Trustee - 5% (not to exceed \$10,000) of the amount involved; if the additional tax is imposed and the trustees refuse to agree to the correction of the taxable expenditure, the trustees could face an additional 50% penalty on the amount of the taxable expenditure (up to \$20,000).

ATTRIBUTES OF CHARITABLE LEAD TRUSTS

Termination Tax

CLT is subject to “termination of private foundation status”

Governing Instrument Requirements

CLT must meet “governing instrument language”

BASIC DIFFERENCES BETWEEN GRANTOR CHARITABLE LEAD TRUST AND NON-GRANTOR CHARITABLE LEAD TRUST

Non-Grantor Charitable Lead Trust

- ♦ Grantor (donor) will not receive an income tax charitable deduction
- ♦ Income of the trust is not taxed to grantor
- ♦ The trust receives an unlimited income tax charitable deduction for payments to charitable organizations from gross income

Grantor Charitable Lead Trust

- ♦ Grantor (donor) receives an income tax charitable deduction
- ♦ Grantor (donor) is taxed on the income from the trust as it is earned without a corresponding annual income tax charitable deduction
- ♦ Must be created as an inter vivos trust.

TAXATION OF NON-GRANTOR CHARITABLE LEAD TRUST

Income Tax Attributes

- ♦ **Complex Trust** - non-grantor CLT is a complex trust for income tax purposes
- ♦ **100% Deduction** – receives an unlimited income tax charitable deduction for payments of gross income that are, pursuant to the governing instrument, paid for charitable purposes
- ♦ **UBTI restrictions** - to the extent the lead payments are from unrelated business taxable income, the charitable deduction is disallowed, including debt-financed property
- ♦ **Alternative Minimum Tax** – AMT is applicable to a charitable lead trust only to the extent the alternative minimum tax exceeds the trust's regular tax.
- ♦ **Capital Gains Tax** - Gains may be allocated to corpus or income as governed by the trust instrument. When the instrument is silent on capital gains, local law applies, generally allocating gains to corpus. If gains are allocated to corpus, they will not be income tax deductible even if distributed to a charity as part of a lead trust payment.
- ♦ **Tier System Allocation** - if neither local law nor the trust instrument dictates the nature of payment made to charitable beneficiaries, the amounts may be deemed to be pro rata distributions of the income of the trust.

TAXATION OF GRANTOR CHARITABLE LEAD TRUST

Income Tax Attributes

IRC 671 – When the grantor or another person is deemed the “owner” of any portion of a trust, such owner is then required to include in computing his or her taxable income those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust. AMT and capital gains are tax at grantor level; UBTI and tier system inapplicable

Grantor’s income tax charitable deduction - grantor receives an income tax charitable deduction for value of lead interest passing to charity. Contribution is subject to the 30% limitations because the gift is deemed to be “for the use of” rather than “to” charity. This limitation is imposed regardless of whether the charitable beneficiary is a public or private charity. If the contributed property is appreciated capital gain property, the limitation is 20%.

TAXATION OF CHARITABLE LEAD TRUST

Gift and Estate Tax Attributes

Grantor pays gift tax or estate tax only on the value of the remainder interest.

Generation-Skipping Transfer Tax

Whether or not GST applies depends upon the status of the remainder beneficiaries and whether CLUT or CLAT.

CLUT - the value of the property transferred to the trust is determined on the date of funding or transfer (like for the gift and estate tax).

CLAT - the applicable fraction is redefined for transfers to charitable lead annuity trusts after October 13, 1987, the numerator being the allocated portion of the exemption at the date of funding or transfer increased by the interest determined at the rate used for valuing the charitable interest, compounded annually for the term of the charitable interest, and the denominator being the value of the property in the trust immediately after the termination of the CLAT charitable interest. The amount of the exemption allocated may not be reduced even though it is ultimately determined that the allocation of a lesser amount to the CLAT would have resulted in an inclusion ratio of zero (as where the trust property does not appreciate to the extent expected). This means that the GST exemption cannot be leveraged as to the CLAT but can be leveraged as to the CLUT.

SPECIAL CONSIDERATIONS

Trustee

Independent Trustee or Qualified Appraiser for Valuation of Assets

Although the governing instrument of an inter vivos or testamentary CLT is not required to provide for the appointment of an independent trustee or qualified appraiser for the valuation of those assets that are not readily ascertainable, the initial valuation of those assets must actually be determined by an independent trustee or qualified appraiser according to the income tax substantiation requirements.

Partnership Issues

A transaction between a partnership which has a partnership interest owned by a CLT and a disqualified person is not a direct act of self-dealing because the CLT is not directly involved in such transaction. However, a transaction between such partnership and a disqualified person may be an indirect act of self-dealing.

SPECIAL CONSIDERATIONS

Treatment of CLT Payment Received By Private Foundation (p.28)

Treas. Reg. § 53.4942(a)-2 provides that a private foundation is required to include a CLT's annuity or unitrust payments in its distributable amount

The Tax Court and the Ninth Circuit Court of Appeals invalidated the Regulation, determining that the Regulation was not amended at the time the underlying statute was amended and that the Regulation was an unwarranted extension of the statute.

SPECIAL CONSIDERATIONS

Sale of Remainder Interest

Service has stated that the remainder beneficiary in a CLAT would be treated as the “transferor” for GSTT purposes when the remainder beneficiary assigns his remainder interest to a GSTT trust

Service might collapse the entire transaction as a disregarded transaction and treat the CLAT creator as the “transferor”, thereby resulting in GSTT being applied at the end of the CLAT term.

If the remainder interest is sold, rather than gifted, it is arguable that the GSTT trust has paid fair-market value for what it received and it is merely an asset of the trust.

If a sale is anticipated, the CLT document should modify a spendthrift provision to allow the transfer.

RELATED PARTY TRUSTEE/RELATED CHARITY

Donor —————> CLT —————> Private Foundation

Donor Not Trustee —————> Donor is director/officer
Mandatory payment to Private foundation

Nexus
(§ 2036 inclusion)

RELATED PARTY TRUSTEE/RELATED CHARITY

Donor's Children Trustees/Donor cannot participate in decisions as to distribution of unitrust amount paid by Private Foundation

Mandatory payment to → → Private Foundation

Nexus Broken
(No § 2036 inclusion)

ADVANTAGES/LIMITATIONS OF CHARITABLE LEAD TRUST

ADVANTAGES OF CHARITABLE LEAD TRUST

- ◆ Leverage gifts to non-charitable beneficiaries, i.e. children, grandchildren or trusts for their benefit
- ◆ Maximize gifts to charitable beneficiaries
- ◆ Estate tax reduction

DISADVANTAGES/LIMITATIONS OF CHARITABLE LEAD TRUST

- ◆ Failure to meet income/growth projections minimizes gifts to non-charitable beneficiaries
- ◆ Compressed rates for complex trusts for excess income
- ◆ Deferred benefit for to non-charitable beneficiaries

DRAFTING CONSIDERATIONS / FILING REQUIREMENTS

1. Make election by attaching information to first return on which take a charitable deduction.
2. Trustee should have power to name successor charitable organization in case the current organization loses its charitable qualification.
3. Set forth a tier system, not contrary to state law, for allocation of payments to charitable beneficiaries; otherwise local law may characterize (but will be ignored unless there is a non-tax reason for the tier system).
4. Allocate trustee fees to income so they may be deducted by the trust.
5. File Form 1041 and Schedule K-1, possibly Form 1041-A, and Form 5227. Possibly use Form 4720, Breach of Excise Tax, if a violation of the private foundation rules occurs.

DRAFTING CONSIDERATIONS / FILING REQUIREMENTS

6. Instrument should expressly negate any local statutory power of invasion if allowed under state law.
7. Must make quarterly payments of taxes resulting from UBTI. (Form 990W).
8. To minimize CLT income tax as to the non-grantor CLT, the trust instrument should allow for a reserve for depreciation, and depletion deductions. Otherwise, these items will be allocated pro rata between the CLT and charity based on income retained/received by each. It is also appropriate to give the Trustee the power to allocate capital gains between income and corpus so a charitable income tax deduction can be achieved if it is necessary to distribute gain to charity as part of a lead trust payment.

DRAFTING CONSIDERATIONS / FILING REQUIREMENTS

9. The trust instrument should preclude payment of estate taxes from the trust and, regarding a testamentary lead trust, should state specifically that the trust will not be funded until all estate taxes are paid.
10. The trust instrument should contain a provision covering the lead trust payment of a short taxable year.
11. The trust instrument should give the Trustee the power to amend the trust for the purpose of maintaining the trust's tax qualified status as a qualified guaranteed annuity interest or guaranteed unitrust interest.
12. The charitable lead annuity trust instrument should prohibit additional contributions.

DRAFTING CONSIDERATIONS / FILING REQUIREMENTS

13. The CLT instrument should provide for an independent valuation trustee.
14. The CLT instrument should set forth how to distribute or accumulate excess income, after considering the tax implications resulting from each alternative.
15. Consider whether to include a spendthrift provision based upon whether or not the remainder interest in the trust will be sold.
16. Consider final regulations applicable to measuring lives for determining appropriate term and any necessary reformations.

FORMS

Prescribed Forms

1) **Charitable Lead Unitrusts**

The IRS has issued sample forms, along with annotations and alternative provisions, for testamentary Charitable Lead Unitrusts, as well as inter vivos grantor and non-grantor Charitable Lead Unitrusts. See Rev. Proc. 2008-45, 2008-30 I.R.B. 224 (July 28, 2008) [inter vivos] and Rev. Proc. 2008-46, 2008-30 I.R.B. 238 (July 28, 2008) [testamentary]

2) **Charitable Lead Annuity Trusts**

The IRS has issued sample forms, along with annotations and alternative provisions, for testamentary Charitable Lead Annuity Trusts, as well as inter vivos grantor and non-grantor Charitable Lead Annuity Trusts. See Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (July 16, 2007) [inter vivos] and Rev. Proc. 2007-46, 2007-29 I.R.B. 102 (July 16, 2007) [testamentary]

Sample Forms

Bourland, Wall & Wenzel, P.C. – See Website: www.BWWLaw.com

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