

V. CHARITABLE PLANNING

(A) OVERVIEW OF THE WEALTH TRANSFER CHARITABLE TAX DEDUCTION

(1) Introduction to Charitable Tax Deductions

In 1917, Congress enacted the first legislation providing for the deductibility of charitable contributions by individuals for federal income tax purposes. The Revenue Act of 1917, §1201(2), amended the Revenue Act of 1916 to permit individual taxpayers to deduct up to 15% of their taxable net income for gifts to certain charitable organizations. Since that first legislation, Congress has continued to encourage charitable giving by individuals by providing for charitable contribution income tax deductions as well as unlimited estate and gift tax deductions for transfers to charity. The current provision setting forth the requirements that must be met for an individual's charitable contribution to be deductible for income tax purposes is Section 170 of the Internal Revenue Code ("I.R.C." or "Code"); Sections 2055 and 2522 are the corresponding provisions that apply to estate and gift tax charitable deductions.

To receive a charitable tax deduction, any charitable contribution must be made to a "qualified organization." Qualified organizations include, but are not limited to, Federal, state, and local governments and organizations organized and operated only for charitable, religious, educational, scientific, or literary purposes, or for the prevention of cruelty to children or animals. Generally, organizations can tell you if they are qualified and if donations to them are deductible.

Contributions made to specific individuals, political organizations and candidates, the value of your time or services, and the cost of raffles, bingo, or other games of chance are generally not deductible. Additionally, contributions given to qualified organizations are non-deductible if, as a result of the contribution, the donor receives or expects to receive a financial

or economic benefit equal to the contribution. If a contribution entitles the donor to merchandise, goods, or services -- including admission to a charity ball, banquet, theatrical performance, or sporting event -- a deduction is only available to the extent that the amount contributed exceeds the fair market value of the benefit received.

For a contribution of \$250 or more, a donor can claim a deduction only if he or she obtains a written acknowledgment from the qualified organization. Donors can generally deduct cash contributions as well as the fair market value of any property donated to qualified organizations. The IRS suggests that a donor of personal tangible property should claim only what the item would sell for at a garage sale, a flea market, or a second hand or thrift store. If a donor's total non-cash contributions are more than \$500, he or she must fill out IRS Form 8283, Section A. Last, if a contribution of non-cash property has worth greater than \$5,000, generally an appraisal must be done. In that case, a donor must also fill out Form 8283 Section B.

Although a donor cannot deduct the value of his or her time or services, charitable donors of services can deduct the expenses incurred while donating such services to a qualified organization. If the expenses are for travel, which may include transportation and meals and lodging while away from home, they may be deducted only if there is no significant element of personal pleasure, recreation, or vacation in the travel.

Several limitations apply to the actual amount of the charitable deduction in any one year--especially for individuals' federal income tax returns. Deductions for contributions in excess of 20% of an individual's adjusted gross income may be limited depending on the type of property or the type of organization the donation is made to.

(2) The Gift Tax Charitable Deduction

The gift tax applies to the transfer by gift of any property. You make a gift if you give property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. Additionally, selling property at less than its full value or making interest-free or reduced-interest loans may qualify as making a gift. The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule and the following contributions are not taxable gifts:

- Gifts that are not more than the annual exclusion for the calendar year (\$12,000 per donee or \$24,000 for spouses in 2006);
- Tuition or medical expenses you pay directly to a medical or educational institution for someone;
- Gifts to your spouse;
- Gifts to a political organization for its use; and
- ***Gifts to charities.***

Section 2522 of the Internal Revenue Code (“I.R.C.” or the “Code”) provides an unlimited gift tax charitable deduction for lifetime gifts to charity. I.R.C. §2522(a). The Code also permits non-citizen nonresident aliens an unlimited charitable deduction, but limits their deductible contributions to U.S. based charities. I.R.C. § 2522(b).

(a) Contributions That Do Not Qualify for the Deduction

The Code prohibits a donor from transferring a partial interest in property to or for the use of a charitable recipient, and disallows any donations for less than the donor’s full interest in the property. I.R.C. § 2522(c)(2). However, the exceptions to this general rule almost eclipse its application:

- A donor may contribute an undivided portion, not in trust, of his entire interest in the property contributed. Treas. Reg. § 25.2522(c)-3(c)(2)(i).2;
- A donor may contribute an irrevocable remainder interest, not in trust, in his farm or personal residence. Treas. Reg. § 25.2522(c)-3(c)(2)(ii) and (iii);

- A donor may contribute a qualified conservation contribution. Treas. Reg. § 25.2522(c)-3(c)(2)(iv);
- A donor may contribute a remainder interest to charity through a charitable remainder annuity trust, charitable remainder unitrust, or pooled income fund. Treas. Reg. § 25.2522(c)-3(c)(2)(v);
- A donor may contribute a guaranteed annuity interest or unitrust interest to charity, whether or not in trust. Treas. Reg. § 25.2522(c)-3(c)(2)(vi) and (vii).¹

A donor may not impose conditions, restrictions, or contingencies on his gift that may defeat the contribution. Treas. Reg. § 25.2522(c)-3(b)(1). “[N]o deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.”
Id.

(b) Qualifying Charities

The gift tax charitable deduction only applies to gifts that a donor makes to charitable organizations that qualify under Section 2522(a). This Section identifies these organizations as:

1. The United States, the District of Columbia, any possession of the United States, a state, or any political subdivision of a state, if the donor makes the gift exclusively for public purposes. I.R.C. § 2522(a)(1).
2. A corporation, trust, or community chest, fund, or foundation created or organized exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. I.R.C. § 2522(a)(2).
3. A fraternal society, order, or association, operating under the lodge system, but only if the organization uses the contribution or gift exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. I.R.C. § 2522(a)(3).
4. A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization, but only if organized in the United States or any of its possessions, and if no part of its net earnings inures to the benefit of any private person. I.R.C. § 2522(a)(4). Also, for gifts made by United States citizens or residents, the donor need not limit his gifts for use within the United States, or to or for

¹ In addition, a special exception to the partial interest rule exists only for the gift and estate tax and applies to a donor’s gift of “works of art” contributed to charity. Under this rule, a donor treats his artwork art and its copyright separately for the purposes of the partial interest rule. I.R.C. § 2055(e)(2). Therefore, a qualified contribution of an artwork without its copyright, or a contribution of a copyright without the artwork qualifies for the unlimited gift tax deduction. Treas. Reg. § 20.2055-2(e)(1)(ii)(a).

the use of domestic charities. Treas. Reg. § 25.2522(a)-1(a).

(3) **The Estate Tax Charitable Deduction**

Estate tax may apply to an individual's taxable estate at death. One's taxable estate is the individual's gross estate less allowable deductions. The gross estate includes the value of all property in which the decedent had an interest at the time of death. The gross estate also will include: life insurance proceeds payable to your estate or, if you owned the policy, to your heirs; the value of certain annuities payable to the estate or heirs; and the value of certain property the decedent transferred within 3 years before death.

The allowable deductions used in determining your taxable estate include:

- Funeral expenses paid out of your estate,
- Debts you owed at the time of death,
- The marital deduction (generally, the value of the property that passes from your estate to your surviving spouse), and
- ***The charitable deduction*** (generally, the value of the property that passes from your estate to the United States, any state, a political subdivision of a state, or to a qualifying charity for exclusively charitable purposes).

Section 2055 of the Code allows a decedent's estate a charitable contribution deduction for bequests, legacies, devises, and other testamentary transfers to qualified organizations. Although frequently called an "unlimited" deduction, Section 2055 limits the estate tax deduction to the amount that the decedent's personal representative includes in the decedent's gross estate. I.R.C. § 2055(d). Like the gift tax deduction, the Code prohibits a donor from transferring a partial interest in property to or for the use of a charitable recipient. I.R.C. § 2055(e)(2). The same exceptions under the gift tax partial interest rule also apply to transfers under the estate tax. Treas. Reg. § 20.2055-2(e). Finally, like the gift tax deduction, a decedent cannot impose conditions or contingencies on the transfer that would defeat the bequest or devise. Treas. Reg. § 20.2055-2(b)(1).

(a) Qualifying Charities

Under Code Section 2055(a), the estate tax deduction only applies to transfers to qualified charities, and to employee stock ownership plans under a special deduction found in Subsection (5). These charities are the same as those that qualify for the gift tax deduction, except a “community chest, fund, or foundation” organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes does not qualify for the estate tax deduction. Instead, the Code describes the donee charity only as a corporation, trust, or fraternal society organized for those purposes. Under the Regulations, a “corporation or association” qualifies. Treas. Reg. § 20.2055-1(a)(2). Like the gift tax deduction, the law recognizes a foreign organization as a permitted recipient. Treas. Reg. § 20.2055-1(a).

(b) Qualifying Transfers

To qualify for the estate tax charitable deduction, the property given must pass to a charity in a “qualified manner” --that is, by bequest, legacy, devise, or transfer. The Service determines the validity of a bequest under state law. *Estate of Polster v. Commissioner*, 274 F.2d 358 (4th Cir. 1960); *Estate of Carey v. Commissioner*, 9 T.C. 1047 (1947), *aff’d per curiam*, 168 F.2d 400 (3d Cir. 1948). A properly executed beneficiary designation form naming a charity as beneficiary of a qualified retirement plan will qualify as a transfer upon the donor’s death. PLR 199939039. Additionally, only the decedent can make the bequest. An estate does not receive a charitable deduction where the beneficiary assigns his bequest to charity, such as when a church member under a vow of poverty assigns her interest in a bequest to a religious order. TAM 200437032, citing *Estate of Callaghan v. Commissioner*, 33 T.C. 870 (1960). See also Rev. Rul. 55-759, 1955-2 C.B. 607. Likewise, the Tax Court disallowed a charitable deduction when the

decedent's estate passed in trust to a person who had a vested remainder interest, but who predeceased the decedent and left his vested interest to charity. *Estate of Pickard v. Commissioner*, 60 T.C. 618 (1973) *aff'd* 503 F.2d 1404 (6th Cir. 1974).

(c) Other Considerations

In drafting a charitable bequest, a donor should make sure that the instrument adequately identifies the charity, including the charity's legal name and its current address. Additionally, the Code does not permit a charitable deduction unless the amount passing to charity is ascertainable at the time of the decedent's death. A decedent may make a qualifying distribution to charity, allowing his personal representative or some other person to name the specific charitable beneficiaries, as long as the *amount* passing to charity is ascertainable at his date of death. For example, a stated dollar amount, percentage of the estate, or an ascertainable amount determined through a formula clause must be identified with the charitable bequest. If a will or trust provides a personal representative or trustee with discretion to allocate the amount passing to charity, the charitable bequest may not qualify. See e.g. *Estate of Marine v. Comm'r*, 97 T.C. 368 (1991), *aff'd* 990 F.2d 136 (4th Cir. 1993).

(d) Disclaimers

By Regulation, bequests, legacies, devises, and transfers also include any interests that pass to charity because of a beneficiary's exercise of a "qualified disclaimer." Treas. Reg. § 20.2055-2(c)(1). Disclaimed property is treated as if it the disclaiming beneficiary never received it; instead, the law treats the property to have passed directly from the decedent to the charity. Treas. Reg. § 25.2518-1(b). The Code defines a qualified disclaimer as an irrevocable and unqualified refusal to accept an interest in property. The transferee's refusal must meet the

following requirements:

1. The transferee must make an irrevocable and unqualified disclaimer.
2. The transferee must make the disclaimer in writing.
3. The transferor – the decedent’s personal representative in the case of an estate – must receive the disclaimer no later than nine months after the date on which the transfer was made or the intended recipient’s twenty-first birthday (whichever is later). For a testamentary disclaimer, the nine-month period begins on the decedent’s date of death. Treas. Reg. § 25.2518-2(c)(3).
4. The intended recipient must make the disclaimer before accepting any benefits of the interest.

As a result of the disclaimer, the interest must pass without direction of the disclaimant either to the spouse of the decedent, or to a person other than the disclaimant. I.R.C. § 2018(b). If a decedent gives a beneficiary the power to invade the principal of a gift that is otherwise wholly for charity, and the beneficiary fails to exercise the power within nine months after the decedent’s death, the Code treats the failure to exercise the power as a qualified disclaimer by the beneficiary. I.R.C. § 2055(a); Treas. Reg. § 20.2055-2(c)(ii). The transfer qualifies for the estate tax deduction in the decedent’s estate.

(4) The Income Tax Charitable Deduction

Individuals who itemize their deductions is allowed a federal income tax deduction from his adjusted gross income for charitable contributions if the requirements of I.R.C. § 170 and certain other Code sections are met. These requirements address the kinds of organizations to which deductible charitable contributions may be made, the various property interests that may be donated, the imposition of adjusted gross income percentage limitations on deductions, and other prerequisites that must be met in order for a charitable contribution deduction to be allowed. A charitable contribution for which an income tax deduction is allowable generally consists of five elements: (1) a transfer of, (2) money or property, (3) to a permissible donee, (4)

that is both voluntary and without receipt of economic consideration or benefit, and (5) that is in the proper form.

(a) Qualifying Organizations²

A donor obtains an income tax deduction only for contributions to certain tax-exempt organizations specified in the Code. An individual can deduct contributions to, or for the use of, the following organizations defined in I.R.C. § 170(c):

1. The United States, the District of Columbia, any possession of the United States, a state, or any political subdivision of a state, if the donor makes the gift exclusively for public purposes. I.R.C. § 170(c)(1).
2. A corporation, trust, or community chest, fund, or foundation created or organized exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. I.R.C. § 170(c)(2).
3. A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization, but only if organized in the United States or any of its possessions, and if no part of its net earnings inures to the benefit of any private person. I.R.C. § 170(c)(3).
4. A domestic fraternal society, order, or association, operating under the lodge system, but only if the organization uses the contribution or gift exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. I.R.C. § 170(c)(4).
5. A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if not operated for profit and if no part of its net earnings inures to the benefit of any private person. I.R.C. § 170(c)(5).

A comparison with Section 2522(a) shows that these organizations are almost identical to those that qualify for the gift tax deduction, except certain cemetery companies also qualify for

² The Service publishes a list of organizations to which contributions under §170(c) may be made. The “Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986” (Pub. 78), is updated and reissued annually. Additions are published in cumulative quarterly supplements. Pub. 78 and supplements are available on a subscription basis. Pub. 78 is also available on the Service’s website (<http://www.irs.ustreas.gov>). Taxpayers may check the tax-exempt status of a charity by searching the list of nearly 500,000 organizations by name or portion of a name, or by city and state. The listing is updated quarterly.

the income tax deduction.³

(b) Charitable Contribution Deduction Limitations

Unlike the estate and gift tax deductions, income tax deductions for charitable contributions are not unlimited. As a general rule, Section 170(b)(1)(A) limits deductible charitable contributions in each tax year to a maximum of 50 percent of the donor's adjusted gross income for that year. If the gift value exceeds 50 percent of the donor's adjusted gross income, the donor can carry forward and deduct the excess in the five succeeding years (called the "five-year carryover" rule). I.R.C. §170(d)(1); Treas. Reg. §1.170A-10(b).

This "general rule" is subject to certain reduction rules that relate to the amount of the deduction and the percentage limitations. The reduction rules turn on three factors: (1) the nature of the property given to charity; (2) the type of charity to which the contributions is given; and (3) whether the gift is made "to" or "for the use of" the charity. We will discuss the application of each of these factors as they apply to the specific percentage limitations.

(i) 50% Limitations

Contributions to publicly supported organizations ("public charities"), private operating foundations, and two special types of private non-operating foundations are limited to 50% of the individual's contribution base for the tax year. I.R.C. § 170(b)(1)(A). For purposes of computing the limitation, contributions to public charities are considered before contributions to semi-public charities and private foundations, as well as contributions "for the use of" any organization (all discussed below).

The Code makes the 50 percent rule on deductions subject to reduction based on the type

³ Although the omission of cemetery companies as qualifying gift tax charities is less than obvious, the IRS has affirmed that these companies do not qualify for the gift tax deduction. See e.g. Rev. Rul. 67-10, 1967-1 C.B. 272.

of property contributed to the charity as well as the nature of the charity receiving the property. A donor can deduct Gifts of cash up to 50 percent of his adjusted gross income if made to the “proper” charity. I.R.C. §170(b)(1)(A); Treas. Reg. §1.170A-8(b). These organizations, sometimes called “*public charities*” or “*50 Percent Organizations,*” are:

- Churches, and conventions or associations of churches. I.R.C. § 170(b)(1)(A)(i).
- Certain educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes where organization regularly carries on its educational activities. I.R.C. § 170(b)(1)(A)(ii).
- Hospitals and certain research organizations engaged in continuous medical research in conjunction with hospitals. I.R.C. § 170(b)(1)(A)(iii).
- Endowment organizations organized and operated exclusively for the benefit of certain state and local colleges and universities, if these organizations receive a substantial part of their support from the government or public. I.R.C. § 170(b)(1)(A)(iv).
- The United States, the District of Columbia, any possession of the United States, a state, or any political subdivision of a state. I.R.C. § 170(b)(1)(A)(v).
- Corporations, trusts, or community chests, funds, or foundations organized and operated only for charitable, religious, educational, scientific, or literary purposes, or to prevent cruelty to children or animals, or to foster certain national or international amateur sports competition, if a substantial part of their support comes from direct or indirect contributions from the general public or from a governmental unit. I.R.C. § 170(b)(1)(A)(vi); Treas. Reg. § 1.170A- 9(e)(1). The Regulations says that this category includes the United Way and the American Red Cross, history, art or science museums, libraries, community centers to promote the arts, organizations providing facilities to support the opera, symphony orchestra, ballet, or theater. I.R.C. § 170(b)(1)(A)(vi); Treas. Reg. § 1.170A-9(e)(1).
- Private operating foundations, so-called “conduit” private foundations, and so-called pooled fund foundations. I.R.C. § 170(b)(1)(A)(vii).
- So-called “gross receipts organizations” and “supporting organizations.” I.R.C. § 170(b)(1)(A)(viii).

Additionally, a donor must reduce a gift of ordinary income property, real estate, securities, or tangible personal property held short-term to a public charity by the amount that he would have realized as gain if he had sold the property. I.R.C. §170(e)(1)(A); Treas. Reg. §1.170A-4(a)(1). The “five-year carryover” applies to excess contributions.

To utilize the charitable deduction a donor must make contributions to these organizations for the religious, charitable, scientific, literary, or educational purposes of the organizations. A

donor may not deduct a contribution he makes for non-charitable purposes.

(ii) 30% Limitations

The 30% limitation applies to contributions to “semi-public” charities, including non-operating private foundations, veteran’s organizations, domestic fraternal societies, and non-profit cemeteries private foundations, and to contributions “for the use of” any charitable organization. I.R.C. § 170(b)(1)(B). Contributions of long-term capital gain property to “public charities” described above are also subject to the 30% limitation. I.R.C. § 170(b)(1)(C). The maximum deduction allowable for such contributions is an amount equal to the lesser of: (1) 30% of the taxpayer’s contribution base; or (2) the amount of the taxpayer’s 50% limitation remaining after the taxpayer's contributions to public charities are considered. For example, if a taxpayer contributes an amount equal to 40% of his contribution base to public charities, he is limited to a deduction equal to 10% of his contribution base for contributions to which the 30% limitation applies. However, the 30% limitation for contributions of capital gain property applies only if the donor wishes to deduct the fair market value of the property. The donor may elect to deduct only his or her basis in the property, in which case the 50% limitation will apply.

The 30% limitation also applies to a gift of a remainder interest in trust designated to be received by a public charity where the donor retains or gives to a life beneficiary of the trust the power to designate a public charity, semi-public, or private charity to receive the remainder interest. Rev. Rul. 79-368, 1979-2 C.B. 109. Thirty percent contributions (including contributions of capital gain property) which exceed the 30% limitation in the year of the gift may be carried over to the five succeeding years.

(iii) 20% Limitations

Contributions of appreciated property to semipublic charities and private foundations are deductible only to the extent of 20% of the donor's contribution base. I.R.C. § 170(b)(1)(D)(i). Twenty percent contributions are taken into account only after all other kinds of contributions are taken into account. *Id.* Thus, if a donor has already exceeded the 30% limitation for donations of appreciated property to public charities, no 20% contributions will be allowed in that year. Like all other contributions, contributions limited by the 20% rules may be carried over for a five-year period

(iv) Gifts “to” or “For the Use of” Charity

The Code imposes the percentage limitations discussed above on contributions made “to” qualified public charities. Contributions made “*for the use of*” a public charity are subject to the limitations prescribed for the “30 Percent Organizations” mentioned above. I.R.C. §170(b)(1)(B). Under the Regulations a gift will be determined as “*for the use of*” a charity when the donor makes it to an entity that pays an income interest to charity (i.e., a charitable lead trust), or to a charitable remainder trust in which the remainder interest continues in trust for the benefit of the charity. Treas. Reg. §1.170A-8(a)(2). The Legislative History shows the term “*for the use of*” to be roughly equivalent to “*in trust for.*” *Rockefeller v. Commissioner*, 676 F.2d 35 (2d Cir. 1982), acq. Rev. Rul. 84-61, 1984-1 CB 39. The Supreme Court has also interpreted the phrase to mean “*in trust*” for a charity, or in a similarly enforceable legal arrangement for the benefit of a charity. *Davis v. United States*, 495 U.S. 472 (1990).

(B) CONSIDERATIONS IN ASSETS TO DONATE
(1) Income in Respect of a Decedent ("IRD")

For charitably motivated clients, the best practice is to satisfy charitable bequests using

IRD assets. Because of the income tax savings, even clients who are not charitably motivated should consider making a charitable bequest of IRD assets. While there is no universal definition of IRD found in the IRC, Treasury Regulations section 1.691(a-b) provides a general guideline that IRD includes “those amounts to which a decedent was entitled as gross income but which were not properly includable in computing taxable income for the taxable year ending with the date of his death.” Some examples of IRD include: 1) accrued interest (to date of death) on such items as savings bonds and certificates of deposit; 2) capital gain deferred by election of installment sale treatment; 3) capital gain on a sale transaction that the decedent had brought to a point of no return; 4) post-mortem commissions due the estate of an insurance agent; 5) distributable share of post-mortem partnership earnings; 6) unused vacation pay; 7) pension and profit-sharing plans, IRAs, and deferred compensation; and 8) non-qualified stock options.

Since IRD assets are not included on the decedent’s income tax return, the IRS taxes the income to the beneficiary. IRD generating assets retain the same character when taxed to the beneficiary as they would have had in the hands of the decedent; that is, unlike other assets included in the gross estate of a decedent, they receive no step-up in basis. I.R.C. § 1014(c). Thus, IRD gifts are excellent assets to pass to a charity, because, unlike an individual beneficiary who will pay income tax on all the IRD, a charity, as a tax-exempt entity, will not pay any taxes.

Additionally, the IRD asset is included in the decedent’s gross estate for estate tax purposes under Section 691(a)(1). However, a decedent’s estate can avoid estate taxes on the IRD asset by distributing the asset to a tax-exempt charity and not to the trust or estate. The best practice is to make specific, in-kind distributions of IRD assets to a charity. The trust should distribute the IRD asset directly to the charity and the charity will recognize income from the IRD. Treas. Reg. § 1.691(a)-4(b)(2); Rev. Rul. 64-104, 1964-1 C.B. 223. *See also* PLR

200012076.

(2) Retirement Plans

For retirement plans or other IRD assets that pass by beneficiary designation, the safest practice is to designate the charity through the beneficiary designation. Because donors can easily make testamentary gifts of retirement plan benefits by beneficiary designation, many charitably motivated donors designate both charity and individuals as beneficiaries of their retirement plans. However, the beneficiaries can lose many important income tax benefits, such as the beneficiary's ability to stretch the distribution over his life expectancy, if plan administrators pay qualified plan proceeds directly into a trust for division among charitable and non-charitable beneficiaries.

Three strategies exist for ensuring that the individual beneficiary does not lose any income tax benefits. First, the regulations permit the beneficiaries to establish separate accounts for each beneficiary no later than the end of the year following the year of the participant's death. Treas. Reg. § 1.401(a)(9)-8, Q&A 2(a). Thus, under this rule, if the beneficiaries establish separate accounts by the end of the year following the year of the participant's death, the plan administrator looks to the beneficiary of each separate account to determine the MRD rules for the beneficiary of that separate account.

Second, if the plan administrator pays out a beneficiary's share prior to September 30 of the year following the year of the participant's death, the law deems the remaining beneficiaries as the only beneficiaries for purposes of the MRD rules. Treas. Reg. § 1.401(a)(9)-4, Q&A 4(a).

Finally, if the participant named his spouse as one of the beneficiaries and along with a charity, the spouse can roll over her share of the account balance following the participant's death into her own IRA.

(C) CHARITABLE LEAD TRUSTS

(1) Introduction

Conceptually, a Charitable Lead Trust (“CLT”) is the opposite of a Charitable Remainder Trust (“CRT”). A CLT is a “split-interest” irrevocable trust that is made in favor of a charitable organization that allows the charitable organization to receive income payments from the trust for a specified term of years or the lifetime of one or more individuals after which term the trust property reverts to a non-charitable remainder interest in designated beneficiaries or the settlor’s estate.

Unlike CRTs, CLTs are not tax-exempt trusts. The Code taxes most CLTs as complex trusts under Subchapter J. Thus, no income, estate, or gift tax deduction is allowed for the charitable interest unless it is in the form of a “guaranteed annuity” or “unitrust” interest.⁴ I.R.C. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B).

A CLT created during the donor’s lifetime may be either a grantor or non-grantor trust.⁵ However, an income tax deduction for a contribution to a CLT is allowed only for grantor lead trusts. I.R.C. § 170(f)(2)(B). The amount of the charitable deduction is based on the actuarial value of the charitable lead interest. A donor bases his or her deduction on the Section 7520 rate and actuarial assumptions found in the Service tables. Like the valuation of the interest in a CRT, a donor may value the interests in a CLT using the Section 7520 rate applicable on the date of the transfer or during either of the two immediately preceding months.

With a CLT, neither the grantor nor any other person may possess the power to revoke the

⁴ The annuity or unitrust interest functions like the Annuity Amount or Unitrust Amount paid by a CRT, except that there is no minimum five percent or maximum fifty percent payout requirement for a CLT.

⁵ Most typically, individuals are the grantors of CLTs. The Service, however, has approved a lead annuity trust in which an S Corporation was the grantor. PLR 9512002.

trust because IRS Regulations require that the lead interest to the charitable beneficiaries be irrevocable. Treas. Reg. § 1.170A-6(c)(2)(i)(A) and (ii)(A); 20.2055-2(e)(2)(vi)(c) and (vii)(c) and 25.2522(c)-3(c)(2)(vi)(c) and (vii)(c). Interestingly, the arrangement need not be a trust if the charitable lead interest is a guaranteed annuity interest or unitrust interest paid by an insurance company or by an organization that regularly engages in issuing annuity contracts or interests that otherwise meet the requirements of a unitrust interest. Treas. Reg. §§ 20.2055-2(e)(2)(vi)(c) and (vii)(c). and 25.2522(c)-3(c)(2)(vi)(c) and (vii)(c). By contrast, a donor can only create a CRT as a *trust*.

Under these rules, a charitably-minded donor can create a CLT that allows him to:

- Create an income stream for charities that the donor supports, over a period of time he selects at the outset of the trust;
- Reduce or eliminate federal gift and estate tax both on the assets transferred to the trust and on the subsequent appreciation of those assets;
- Transfer a substantial amount to family members at the termination of the trust, with little or no gift tax cost when the trust is established; and
- Pass substantial assets to grandchildren and other remote descendants without imposition of the generation-skipping transfer tax on the transaction.

(2) Types and Characteristics of Charitable Lead Trusts

The trustee must make the payout as *either* a guaranteed annuity interest or Unitrust Amount. A trust that defines the payout as a hybrid will not qualify as a CLT. Treas. Reg. §§ 1.170A-6(c)(2)(i)(B), 1.170A-6(c)(2)(ii)(B), 20.2055-2(e)(2)(vi)(b), 20.2055-2(e)(2)(vii)(b), 25.2522-2(c)(2)(vi)(b), 25.2522-2(c)(2)(vii)(b). So, for example, a CLT that pays an amount to charity equal to the lesser of a guaranteed sum or a fixed percentage of the net fair market value of the trust's assets, determined annually, will not qualify as a CLT.

(a) Guaranteed Annuity Interest

Internal Revenue Service Regulations define “guaranteed annuity interest” as the charitable income beneficiary’s irrevocable right to receive a periodic payment, at least annually, of a determinable amount for a specified term. Treas. Reg. §§ 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi), 25.2522(c)-3(c)(2)(vii). The governing instrument must guarantee the annuity interest in every respect. Treas. Reg. §1.170A-6(c)(2)(i)(B). However, the specified term may be either a term of years or the life of an individual (or the lives of more than one individual). If the term is the life of the individual, that person must be living on the date of the transfer to create a valid trust. Additionally, the specified terms may be combined: the annuity can be paid for the life of a named individual plus a term of years. See “Issues Regarding Term of the Trust,” *infra*, Section 4.

Generally, a charitable lead annuity trust will provide more to the non-charitable remaindermen at the end of the trust term when it is expected that the assets contributed to the trust will appreciate during the trust term.

(i) Variable Amounts ⁶

The trust can also define the payout using a formula if the annuity interest amount is determinable at the outset of the trust. A CLT can specify the annuity interest, by formula, in order to produce a specified value as the charitable income interest. PLR 9118040. This can be especially useful in planning and drafting testamentary CLTs. Additionally, under the current

⁶ “Stating a dollar amount for each payment satisfies the determinability test for the payments, but it can make the value of the taxable remainder harder to anticipate. If the trust is funded with assets that fluctuate in value, or with hard to value assets that turn out to have a value much different from what was expected, the taxable remainder will be higher or lower than planned. Conversely, if the percentage of value option is used, the deduction will remain at the planned percentage of the gross gift value, but both the charity’s dollar payout and the dollar value of the deduction will be higher or lower than originally estimated.” J. Schumacher, “How to Design a Charitable Lead Trust,” *Journal of Taxation of Exempt Organizations* at 31 (July/August 1997).

IRS Regulations, the trust can define the annuity interest by reference to a fluctuating index as of the date the grantor funds the trust--such as a fraction or percentage of the cost of living index as of the funding date. Treas. Reg. § 1.170A-6(c)(2)(i)(A). This technique is useful for testamentary planning if the grantor is unsure what amount the trust should pay, but wishes to tie the figure to an amount that will reflect economic realities of the estate when the trust is funded. It is important to note, however, the trust cannot use an index that periodically adjusts the annuity interest. *Id.* For example, the law does not permit an annuity interest expressed as the “prime interest rate on January 1 of each year of the trust term.”

In contrast, the trust can link the annuity interest to a rising, falling, or otherwise varying annuity interest or percentage equivalent, so long as it is determinable at the outset for the entire term. Treas. Reg. § 1.170A-6(c)(2)(i)(A). And, “the annuity may be paid for the life of A plus a term of years. An amount is determinable if the exact amount which must be paid under the conditions specified in the governing instrument of the trust can be ascertained as of the date of transfer. For example, the amount to be paid may be a stated sum for a term, or for the life of an individual, at the expiration of which it may be changed by a specified amount.” *Id.* As another example, the annuity interest might be described as \$100,000 for the first year and, in each succeeding year until termination, an amount equal to 104 percent of the prior year’s amount. See PLR 9112009 (in which a CLT was funded by rental real estate and the annuity interest was tied to the net lease amounts on the realty).

(ii) “Commutation” & Prepayment in Charitable Lead Annuity Trusts

The IRS has held that the law does not allow commuting the charitable interest--that is, terminating the trust before the end of its term and distributing an amount to charity that equals the present value of the income interest. Rev. Rul. 88-27, 1988-1 C.B. 331. The reasoning

behind the IRS's position is that a prepayment is inconsistent with an annuity interest fixed and guaranteed at the outset, as required by the Code. Accord Crown Income Charitable Fund v. Comm'r, 98 T.C. 327 (1992), aff'd 8 F.3d 571 (7th Cir. 1993). The IRS retreated from this position in three Private Letter Rulings that are only slightly distinguishable from Rev. Rul. 88-27: PLRs 200225045, 199952093, and 9844027.

In these three rulings, the trustee proposed to prepay the *undiscounted* annuity interest obligations to the income beneficiaries of the trust. In two rulings, the trustee proposed to then immediately terminate the trust and distribute the remaining trust corpus to the remainder beneficiaries. PLRs 200225045 and 199952093. In the other ruling, the charitable lead annuity trust would remain in existence for another seven years before terminating. PLR 9844027. Additionally, the Attorney General was a party in the proceedings. In each case, the IRS approved the prepayment saying that it would not trigger the private foundation termination tax under I.R.C. § 507, and the trust would not incur the other private foundation excise taxes because of the transaction. The question then, is how did these cases differ from Rev. Rul. 88-25? In these three cases, the trustee did not discount the prepaid amounts; the state courts were to pass judgment on the validity of the transaction; and the court joined the state Attorney General as a party. It appears that the first factor is the most important: The trustee proposed to structure the distribution so that the charity got the same amount, or more, than it would have received if the charitable lead annuity trust in each case had lasted the whole term which was an amount more than merely the present value of the income interest.

(b) Unitrust Interest

A "unitrust interest" is the irrevocable right of the charity to receive payment equal to a fixed percentage of the net fair market value of the trust assets as determined annually. The

unitrust interest must be paid at least annually. Treas. Reg. §§ 1.170A-6(c)(2)(ii)(A), 20.2055-2(e)(2)(vii), 25.2522(c)-3(c)(2)(vii). The Regulations do not require a minimum or maximum percentage by which the trustee must calculate the unitrust interest.

For example, Client A creates a charitable lead unitrust trust that defines the unitrust interest as an amount equal to 10 percent of the net fair market value of the trust, valued annually. The trust is funded with \$100,000 and will continue for a term of 20 years. In the first year, the trust would pay \$10,000 to the charitable income beneficiary--10 percent of \$100,000. If, in the second year, the fair market value of the trust rises to \$110,000, the trust distributes \$11,000 as the unitrust interest. Generally, the trustee is required to add any excess income not paid to the trust principal. And if the trust income is not sufficient to pay the unitrust interest, the trustee must use capital gains or trust principal to make up the deficit.

Similar to charitable lead annuity trusts, the IRS has ruled that it will not allow a gift or estate tax charitable contribution deduction if the trustee can commute, or terminate, and prepay the lead unitrust interest before the specified term ends. PLR 9734057 (following the rationale of Rev. Rul. 88-27, 1988-1 C.B. 331, discussed above).

(c) “Sprinkling” Distributions to More Than One Charitable Beneficiary

The IRS has provided that a grantor can draft a charitable lead unitrust trust so that it will permit the trustee to “sprinkle” the unitrust interest among several qualifying charitable beneficiaries. PLR 200240027. Under the facts of this ruling, a married couple established three charitable unitrust trusts for each of their three children. The grantor named one of the children as the trustee. The grantors retained no power to remove or replace the trustee. Each trust provided, “The trustee shall pay (in cash, in kind, or partly in each) to such organization or

organizations selected by the trustee that is/are described in each of sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a), to be used in furtherance of each organization's religious and charitable purposes, in such proportions as are determined by the trustee, in each taxable year during the trust term, an amount equal to six percent of the net fair market value of the trust assets (valued as of the first day of each taxable year of the trust)." Id. The IRS noted that (1) the trusts were irrevocable; (2) the grantors had not retained reversion interest in the trusts; (3) the grantors had no right to alter, amend, or revoke the trusts, or to receive an annuity or other payment from the trusts during their lifetimes; and (4) the grantors held no general power of appointment over the trusts' property. The ruling also assumed that there was no understanding, express or implied, between the grantors and the trustee regarding the disposition of the amounts paid by the trusts. Under those facts, the IRS held that the charitable unitrust trusts qualified for the gift tax charitable deduction for the actuarial value of the income interest to charity and the grantor's personal representative would not include any of the trust assets in the grantor's gross estate for federal estate tax purposes. *Accord* PLR 200043029.

(d) Frequency of Payments

The Trustee must pay the guaranteed annuity interest or unitrust interest *at least annually*. Like a CRT, the drafting attorney can decide whether the trustee should make the payments monthly, quarterly, semiannually, or annually, and whether the trustee should make payments at the beginning or end of each payment period. These decisions can have a slight bearing on the amount of the gift value of the gift. A payment at the beginning of the period will give a slightly larger deduction, but this benefit is probably outweighed by the administrative difficulties it creates for the Trustee. More frequent payments during the tax year will also slightly increase

the value of the income interest and, thus, the deduction.

(e) Excess Income

A donor has two choices in the trust's treatment of income in excess of the guaranteed annuity or unitrust interest: (1) the trustee can either distribute income in excess of the guaranteed annuity interest to the charitable income beneficiaries, or (2) retain the income in trust and add it to the trust principal. Treas. Reg. §§ 1.170A-6(c)(2)(i)(C) and (ii)(C), 20.2055-2(e)(2)(vi)(d) and (vii)(d), and 25.2522(c)-3(c)(2)(vi)(d) and (vii)(d). Importantly, however, the trust must not direct distributions of excess income to the *non-charitable remainder* beneficiaries, the consequences of which may invalidate the entire trust. Rev. Rul. 88-82, 1988-2 C.B. 336 (ruling that a purported lead annuity trust providing for distributions of excess income to the remainder non-charitable beneficiaries will not have a guaranteed annuity interest and, thus, fails to qualify as a CLT).⁷

(3) Income Tax Consequences of CLTs

A key distinction between CRTs and CLTs is that the former are tax-exempt trusts while the latter are not. Unless drafted as a grantor trust, a CLT is a complex trust subject generally to the trust taxation rules contained in Subchapter J. The Tax Code, however, allows the trust a charitable contribution deduction for income paid by the trust as part of the annuity interest or unitrust interest, whether or not the trust pays the income interest to a foreign or domestic charity. I.R.C. §642(c)(1). This deduction is not limited to a percentage of the trust's adjusted

⁷ If the CLT pays the excess income to the charitable income beneficiaries, the trust will receive a charitable deduction for the excess income paid to such beneficiaries. I.R.C. § 642(c). However, such distributions of excess income to the charitable income beneficiaries deny growth of the trust that would otherwise occur if the excess income were added to the trust's principal.

gross income, but there is no carryover. To the extent that the trust has income in excess of the deductible amounts, the IRS will tax that income at the rate established for trusts in the Code. To this extent, the Code may require the CLT to make estimated tax payments. I.R.C. § 6654(1).

(a) “Grantor” CLTs

The grantor of a “grantor” CLT is entitled to an immediate income tax charitable contribution deduction in the year the grantor funds the trust equal to the present value of the charity’s income interest. I.R.C. §170(f)(2)(B); Treas. Reg. 1.170A-6(c)(1). However, there are unfavorable tax consequences as well. For example, following commencement of the trust, all trust income paid to charity is taxable to the grantor under I.R.C. § 671, and neither the grantor nor the trust will be entitled to income tax charitable contribution deductions for payments to charity. I.R.C. §170(f)(2)(c); Treas. Reg. §1.170A-6(d)(1). However, the Code allows the grantor to take all deductions and credits otherwise attributable to the trust. I.R.C. §671. The deduction carries with it these rules:

- **30 Percent Limitation.** A contribution to a CLT is considered a contribution “for the use of” a charity, and the income tax deduction is limited to 30 percent of the grantor’s adjusted gross income. I.R.C. §170(b)(1)(B). A donor may not carry forward contributions that exceed the 30 percent limit. PLR 8824039.
- **Calculating the Deduction.** The charitable deduction for the “guaranteed annuity interest” is determined as set forth in Treas. Reg. 1.170A-6(c)(3)(i), 25.2522(c)-3(d)(2)(iv) and (v), using *I.R.S. Publication 1457*. Computing the charitable deduction for a charitable lead unitrust trust is the reverse of the method used for a charitable remainder unitrust trust.
- **Recapture Rules.** If Code ceases to treat the grantor as owner of the trust before the income interests expire, the grantor receives as ordinary income an amount equal to (1) the amount of any charitable contribution deduction received under I.R.C. § 170(f)(2)(B), as (2) reduced by the discounted value of income earned by the trust, paid to charity and taxed under I.R.C. §671 when the grantor was treated as owner. Treas. Reg. §1.170A-6(c)(4).
- **Capital Gains.** If the Code treats the grantor or his spouse as owner of the CLT, and the trust generates capital gain, the grantor must include those gains in his taxable income at the time the trust realizes the gain, even if the trust provisions allocate the gain to principal. I.R.C. §677(a). The donor cannot reduce the amount of gain by a

charitable contribution deduction.

(i) Gift Tax Consequences

To the extent the income interest to charity exceeds the annual gift tax exclusion, it will qualify for a gift tax charitable contribution deduction equal to the present value of the income interest. I.R.C. §2522(c)(2)(B); Treas. Reg. §§25.2522(c)-3(c)(2)(vi) and (vii). A gift of the remainder interest to the grantor's spouse should also qualify for the gift tax unlimited marital deduction. I.R.C. §2523(a); Treas. Reg. §25.2523(a)-1(d).

(ii) Estate Tax Consequences

If the grantor creates a "grantor" CLT and dies during the trust term, included in the grantor's estate will be the value of the trust, offset by an estate tax charitable contribution deduction for the value of the charitable income interest at the date of death. Any assignment of the grantor's interest which terminates treatment of the trust as a "grantor trust" will cause the value of the trust to be included in the grantor's estate if the grantor's death occurs within three years after the assignment. I.R.C. §2035(d).

(b) "Non-Grantor" CLTs

Unlike a CRT, in a "non-grantor" lead trust, the grantor receives no immediate charitable contribution deduction upon transfer of cash or assets to a CLT, but the trust will receive a deduction for income paid to the charitable organization. I.R.C. § 642(c). Because no percentage limitation applies to the deduction (unless the trust has unrelated business taxable income), a non-grantor charitable lead trust can be advantageous for donors that regularly make charitable contributions exceeding the 50 percent limitation on contributions by individuals.

Because there is no charitable deduction for distributions of tax-exempt income,⁸ in order to guarantee the maximum deduction, the trust should provide characterization of distributions according to the source of the income. These “source-ordering” provisions thereby allow the trustee to treat the tax-advantaged income, tax-exempt income, and principal as distributed last to the charitable income beneficiaries. See Treas. Reg. § 1.643(a)-5(b).⁹

(i) Gift Tax Consequences

The charitable income interest, to the extent it exceeds the gift tax annual exclusion, qualifies for a gift tax charitable contribution deduction equal to the present value of the income interest. I.R.C. §2522(c)(2)(B); Treas. Reg. §§25.2522(c)-3(c)(2)(vi) and (vii). The Code treats the gift to the remaindermen as a gift of a future interest and the annual exclusion therefore is *not* available. I.R.C. §2503(b). To the extent the exemption equivalent does not offset the remainder gift, a gift tax will be due. The Code prescribes the method used to value the present value of the guaranteed annuity interest or unitrust interest to charity in Section 7520. The grantor values these interests by reference to an interest rate equal to 120 percent of the applicable federal midterm rate for the month in which the valuation date falls or for either of the preceding two months. I.R.C. § 7520(a)(2). The grantor then uses the AFR rate to determine the applicable valuation factor from the appropriate tables published by the Service (either *IRS Publication 1457* for charitable lead annuity trusts or *IRS Publication 1458* for charitable lead unitrust trusts. I.R.C. § 7520(a)(1)).

(ii) Estate Tax Consequences

⁸ See Treas. Reg. § 1.642(c)-3(b)(1).

⁹ Even these “source-ordering” provisions will be disallowed by the IRS unless the donor created the provision independent of the tax consequences and the clause has “substantial economic effect.” See e.g. PLRs 200404009, 200240027, and 199908002.

If the grantor creates a qualified CLT, the law will exclude the value of the trust from the grantor's gross estate at death. However, to the extent the transfer resulted in a taxable gift at creation, the grantor's personal representative must then add the gift value to the decedent's taxable estate for purposes of computing the estate tax. I.R.C. § 2001(b)(1)(B). But if the grantor retains control over the payment of the interests to charity, he will include the assets in his estate under I.R.C. § 2036(a).

(iii) Generation Skipping Tax Consequences

If a transfer occurs that invokes the generation skipping tax rules, the tax is calculated by multiplying the top federal estate tax rate at the time of the taxable event by the "inclusion ratio." I.R.C. §§ 2602 and 2642(a). The best way to understand how the generation-skipping transfer tax applies to CLTs is in the historical context. The *Tax Reform Act of 1986* created the rules regarding calculation of the "inclusion ratio." The "inclusion ratio" means the excess of one over the "applicable fraction." I.R.C. §2642(a). The "applicable fraction" is a fraction, the numerator of which is the amount of the generation skipping tax exemption allocated to the trust involved in the transfer, and the denominator is the value of the property transferred to the trust, reduced by the sum of (i) any federal estate or state death tax actually recoverable from the trust and attributable to the contributed property, and (ii) *any charitable deduction allowed under I.R.C. §§2055 or 2522 with respect to such property.* I.R.C. §2642(a)(2)(A) and (B) (emphasis added).

(iv) Non-grantor Charitable Lead Trust As "Freeze" Device.

A non-grantor charitable lead trust can be utilized to transfer assets to future generations at little or no estate and gift tax cost. Although no income tax deduction is permitted on

contribution to the trust itself (and a gift or estate tax is triggered by the transfer of the non-charitable remainder, unless left to a spouse), the estate or gift tax charitable deduction helps to offset such tax. Secondly, future appreciation of the trust assets is transferred out of the settlor's estate at no additional tax cost. By valuing the gift at the time of transfer to the lead trust, a non-grantor CLT operates to "freeze" the remainder's transfer tax cost value, while the actual value of the trust assets may increase over time. Additionally, this "freeze" can be even more significant if the assets contributed to the trust can be valued at a discount for gift tax purposes, e.g., a minority interest discount or lack of marketability discount.

(4) Issues Regarding the Term of the Trust

As mentioned above, the trustee can distribute the annuity or unitrust interests of a CLT for a specified term or for the life or lives of an individual or individuals who are living and ascertainable on the transfer date. The trust can specify the duration of the payments by a combination of a life span and a term of years. Treas. Regs. §§ 1.170A-6(c)(2)(i)(A) and - (2)(ii)(A), 20.2055(e)(2)(v) and -(2)(vi)(a), 25.2522(c)-(3)(c)(2)(v) and 2(vi)(a). However, according to the IRS, some taxpayers attempted to take advantage of the prior scheme by using an unrelated individual with a serious (though not terminal) illness as the person whose life would measure the trust's term. The donor would base his deduction on actuarial tables that do not take into account the illness of the person whose life was the measuring term. Thus, when that person died prematurely, the charity would receive an amount significantly less than the amount on which the grantor based the charitable deduction. Conversely, the amount actually transferred to the remainder beneficiaries would be significantly greater than the amount subject to estate or gift tax.

To combat this practice, the IRS issued final Regulations that require that the measuring life of a CLT to be one or more of the donor, the donor's spouse, and an individual who, with respect to all non-charitable remainder beneficiaries, is either a lineal ancestor of the spouse or the spouse of a lineal ancestor of those remainder beneficiaries. Treas. Reg. §§ 1.170A-6(c)(2), 20.2055-2(e)(2)(vi), (vii), 25.2522(c)-3(c)(2)(vi), (vii). Stated conversely, only the descendants of the person whose life is the measuring life of the CLT term can be remainder beneficiaries. When the trust defines its term as a term of years, however, any individual can be a remainder person. In addition, "[a] trust will satisfy the requirement that all non-charitable remainder beneficiaries are lineal descendants of the individual who is the measuring life, or that individual's spouse, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus [calculated using Treasury Tables]." Treas. Reg. § 1.170A-6(c)(2)(i) and (ii). This limitation does not apply to CRTs, nor does it apply to a CLTs measured by a term of years. The Regulations are effective for transfers to trusts made on or after April 4, 2000. Subject to transition rules, the Regulations also apply to transfers made under wills or revocable trusts where the decedent dies on or after April 4, 2000.

(5) Issues Regarding the Charitable Recipients

(a) Requirement for Charitable Recipients in General

To qualify as a charitable lead trust, the trust must describe the income beneficiaries as charities defined in Code Sections 170(c), 2055(a), and 2522(a). A CLT is qualified even if there is no specific designation of the charity in the trust agreement and the trust agreement empowers the trustee to select the charity subject only to the charity's qualification under Code Sections 170(c) and 2522(a). *See* Rev. Rul. 78-101, 1978-1 C.B. 301 and PLR 200240027. The

IRS has also approved a charitable lead unitrust trust making its required contributions to an “advise and consent” fund (or sometimes called a “donor advised fund”) at a public charity. See PLR 9633027. The IRS stated that distribution of the annual unitrust interest to the fund will not result in inclusion of the trust assets in the grantor’s estate because the grantor is not the trustee or an officer or director of the public charity and retains no control over the distributions from the lead unitrust. *Id.*

Although allowing the charities to be named later is permissible, this approach can be problematic for two reasons: (1) permitting the grantor to name the charitable recipient during the trust term can create estate and gift tax inclusion for the grantor and (2) permitting another person to name the charitable recipient during the trust term can create GST problems for the non-charitable remainder beneficiaries.

The IRS has said, however, that language which permits the grantor to “request but not direct” the trustee to consider charitable income beneficiaries suggested by the grantor will not cause estate tax inclusion. PLR 8332045. See also PLR 9532007 and 9304020. Additionally, there is no problem if a member of the grantor’s family is given authority to make the change because section 2038 does not result in estate inclusion if the document grants this power to the grantor’s spouse or other related parties. PLR 8316052.

The trust should include a provision granting to the trustee the power and responsibility to name qualified successor charitable recipients if all of the named charities should at some point fail to be qualified organizations. If the grantor retains the power to name the beneficiaries or allocate the distributions among beneficiaries, the value of the trust at his or her death will be included in the grantor’s estate under I.R.C. §§ 2038 or 2036. However, another PLR holds that the grantor can hold the power because the grantor has no control over the occurrence of the

contingency and does not retain any power to compel the change. PLR 9219025.

(b) Non-Charitable Recipients

Occasionally, a grantor wants to provide an income interest from his CLT for both charitable and *non-charitable* interests. Formerly, the Regulations permitted a guaranteed annuity interest or unitrust interest for a non-charitable income beneficiary if (1) the obligation to pay the charitable interest preceded the non-charitable interest in time, and (2) the trust's governing instrument did not provide for any preference or priority in favor of the non-charitable interest. Thus, a CLT could not pay its guaranteed annuity interest or unitrust interest to a non-charitable beneficiary for a period, and then to the charitable beneficiary--the payment to the charitable beneficiary had to come first. The Treasury has now issued final regulations that allow an income, gift, and estate tax deduction for a guaranteed annuity interest or unitrust interest created following a non-charitable interest in the same CLT. Treas. Regs. §§ 1.170A-6(c)(2)(i)(E) and (ii)(E), 20.2055-2(e)(2)(vi)(f) and (vii)(e), 25.2522-3(c)(2)(vi)(f) and (vii)(e). Therefore, under the amended IRS Regulations, to qualify as a valid CLT, the trust document must not give any preference or priority in favor of the private interest over the charitable interest, but may provide for a non-charitable interest to precede the charitable distribution.

A CLT can also provide payments for private purposes at the same time it makes payment for charity if it makes these private payments from a group of assets specifically segregated and designated exclusively for private purposes. Treas. Regs. §§ 1.170A-6(c)(2)(i)(E) and (ii)(E), 20.2055-2(e)(2)(vi)(f) and (vii)(e), 25.2522-3(c)(2)(vi)(f) and (vii)(e). The trustee must segregate these assets for accounting purposes and must treat the trust as two separate trusts. *Id.*

(6) Trustee Issues

As with CRTs, the grantor of a CLT has three choices for trustee: an institutional trustee; the charitable lead beneficiary itself; or the donor or a family member.¹⁰ Importantly, if the grantor himself or herself intends to serve as trustee of a CLT, the trust instrument should not give the trustee discretion to allocate the guaranteed annuity interest or unitrust interest among charitable beneficiaries. This discretionary power will cause the entire trust corpus to be included in the Grantor's estate. I.R.C. § 2038.

If a donor wants the power to “sprinkle” distributions between several charitable beneficiaries, he should give this power to his competent adult children, or make the trustee's selection subject to the consent of those children. See PLRs 200240027, 9532007, and 9304020. Although the donor's retention of “sprinkling” powers can cause estate tax inclusion of the trust's assets, the estate tax rules do not attribute those powers to the donor if granted to the donor's spouse or related or subordinate persons. PLRs 200029033 and 9748009. Alternatively, to avoid both grantor tax issues, the donor might grant the “sprinkling” powers instead to an independent special trustee.

(D) CHARITABLE REMAINDER TRUSTS

(1) Introduction

In addition to Charitable Lead Trusts, Charitable Remainder Trusts (“CRTs”) are one of the statutorily prescribed estate planning mechanisms that allow for split-interest transfers while still preserving the income, gift and estate tax charitable deductions. Governed by Section 664 of the Code and the corresponding Treasury Regulations, a charitable remainder trust is defined as:

¹⁰ Regarding selection of the charitable beneficiary, some charities are more reluctant to serve as trustee of a CLT than a CRT, believing the opportunities for complaint by the family remainder beneficiaries is greater.

“. . . a trust which provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of which is not a charity, for life or a term of years, with an irrevocable remainder interest to be held for the benefit of, or paid over to, charity.” Treas. Reg. § 1.664-1(a)(1)(i).

Charitable Remainder Trusts are appropriate for individuals with large taxable estates who wish to provide an income stream to themselves or another designated beneficiary for life or for a term of years with the remainder of the trust passing to a qualified charity. Under Code Section 664, Charitable Remainder Trusts, when drafted properly, provide four immediate benefits, namely that: 1) the donor receives an income tax charitable deduction in the year the trust is created for the current gift of a future interest; 2) the donor does not have to pay capital gains taxes on the sale of appreciated assets transferred to the trust; 3) the trustee is permitted to invest and diversify the sales proceeds in a tax-free investment environment similar to an IRA; and 4) the donor is able to control the trust’s investments if he serves as his own trustee. In addition to these immediate benefits, CRTs also eliminate estate taxes on any trust assets that pass to a charity upon the death of the donor. Although, CRTs are subject to I.R.C. § 2036(a), which provides that property held in trust for the benefit of the donor during his life shall be included in his gross estate, trust assets that are distributed directly to a qualified charity upon the donor’s death, qualify for an offsetting estate tax charitable deduction.

(2) Types and Characteristics of Charitable Remainder Trusts

In order to qualify for the charitable income, estate, or gift tax deductions, as with charitable lead trusts, a charitable remainder trust must be either in the form of an annuity trust or a unitrust. As described in further detail below, the difference between CRATs and CRUTs is the way in which the annual payments to an income beneficiary are determined. An annuity trust pays to the income beneficiary at least annually a fixed sum without regard to the current value

of the trust. I.R.C. § 664(d)(1)(A). The unitrust, on the other hand, pays to the income beneficiary at least annually a fixed percentage of the current value of the trust corpus. I.R.C. § 664(d)(2)(A). A CRT must function either exclusively as a CRUT or as a CRAT; it cannot be a “hybrid trust” incorporating features of both. Treas. Reg. § 1.664-1(a)(2).

Both CRATs and CRUTs must function exclusively as an irrevocable trust from the onset of their creation. Treas. Reg. § 1.664-1(a)(4). Furthermore, the Treasury Regulations state that “[t]he trust must not be subject to a power to invade, alter, or revoke for the beneficial use of a person other than” a charitable organization. Treas. Regs. § 1.664-2(a)(4) and -3(a)(4).

Typically the grantor of a CRT is an individual or individuals, but the IRS has now ruled that Neither the Code nor Regulations put limits on whom nor what can establish a CRT, only that corporations and limited partnerships can establish CRTs. PLRs 9340043 and 9205031 (corporations); PLR 9419021. (limited partnerships).

(a) Charitable Remainder Annuity Trusts (CRATs)

As governed by I.R.C. §664(d), a CRAT is a trust that pays the income beneficiary at least annually a fixed dollar amount of not more than fifty percent nor less than five percent of the *initial* net fair market value of property placed in the trust. I.R.C. §664(d)(1)(A). Treas. Reg. §1.664-2(a)(2)(i). The Regulations define this amount as the “*Annuity Amount*.” Treas. Reg. §1.664-1(a)(1)(iii)(b). The Annuity Amount can be expressed as a dollar amount or as a percentage of the initial net fair market value of the trust assets. Since the Annuity Amount is fixed, any subsequent appreciation in the value of the trust assets benefits the charitable remainder interest. CRATs are most appropriate for older individuals in their late seventies or eighties, since there is no inflation protection in a fixed payout.

In determining whether the Annuity Amount should be expressed as a dollar amount or a

percentage of the initial fair market value of the initial contribution to the trust, it is important to consider whether the property contributed is hard-to value or the value of the property is not certain. If the donor contributes hard-to-value property to the trust and the trust expresses the Annuity Amount as a fixed dollar amount, the trust may be disqualified if the final value of the property is greater than the donor anticipated. *See* Rev. Rul. 78-283, 1978-2 C.B. 243. Similarly, if the trust expresses Annuity Amount as a fixed dollar amount and the value of the contributed property is not certain, the trust may fail the minimum 5% payout test.

The annuity term may be measured by the lives of beneficiaries, by a set term not to exceed twenty years, or by a certain combination of both. However, if an individual receives payments for life, the measuring life must be his own. See “Issues Regarding Term of the Trust,” *infra*, Section 4.

Upon the death of the income beneficiary, the remainder of the trust assets must be distributed to a qualified I.R.C. § 170(c) charity.

(b) Charitable Remainder Unitrusts

The Internal Revenue Service Regulations define a charitable remainder unitrust as a trust that pays to the beneficiary at least annually a fixed percentage that is not more than fifty percent nor less than five percent of the net fair market value of the trust assets valued annually. I.R.C. §664(d)(1)(A). The Regulations call this amount the “Unitrust Amount.” Treas. Reg. §1.664(a)(1)(iii)(c). Although the percentage remains fixed throughout the trust term, the Unitrust Amount may vary year-to-year since the trustee bases it on the annual net fair market value of the trust assets.

Charitable remainder unitrusts must be valued each year. In determining the net fair

market value of the trust assets of unitrusts, all trust assets and liabilities shall be taken into account whether or not those items are taken into account in determining the income or principal of the trust. Treas. Reg. § 1.664-3(a)(1)(iv)

Trustees must determine the fair market value of the trust assets on the same day each year or take the average of valuations made on more than one date during the taxable year of the trust, so long as they use the same valuation date or dates and use the same valuation methods each year. Treas. Reg. § 1.664-3(a)(1)(iv).

(i) Net Income Unitrusts (NI-CRUTs)

One variation of the traditional unitrust is a “net income” charitable remainder unitrust (NI-CRUT), which defines the Unitrust Amount as the lesser of (i) the trust’s annual income or (ii) a fixed percentage that cannot be less than 5 percent or more than 50 percent of the net fair market value of the trust assets valued at least annually. I.R.C. § 664(d)(3)(A). Generally, “*trust income*” is fiduciary accounting income determined under the terms of the trust or the governing state law. I.R.C. § 643(b).

(ii) Net Income Plus Make-Up Unitrusts (NIM-CRUTs)

Another variation of the Unitrust is the “Net Income with Make-up” Unitrust (NIM-CRUT), which defines the Unitrust Amount as the lesser of (i) the trust income or (ii) an amount calculated by reference to a fixed percentage (which cannot be less than 5 percent) of the net fair market value of the trust assets valued at least annually. In subsequent years, the trust makes up deficits from prior years (i.e. where trust income was less than the amount calculated by reference to the fixed percentage) if the trust income exceeds the amount calculated by reference to the fixed percentage. I.R.C. §664(d)(3)(B).

(iii) FLIP-CRUT

A third variation of a charitable remainder unitrust is a FLIP-CRUT, which is a charitable remainder unitrust that begins as either a NI-CRUT or NIM-CRUT but is then converted into a traditional unitrust upon the happening of a “triggering event” that is “not discretionary with, or within the control of, the trustees or any other persons.” Treas. Reg. § 1.664-3(a)(1)(i)(c)(1). Once the “triggering event” occurs, however, the change from the NI-CRUT or NIM-CRUT payout method to the traditional charitable remainder payout method must occur at the beginning of the taxable year immediately following the triggering event, and, after the conversion to the traditional charitable remainder unitrust payout method, the trust forfeits the deficiency amount. Treas. Reg. § 1.664-3(a)(1)(i)(c)(2) and (3).

In order for a FLIP-CRUT to qualify as a unitrust, the IRS must permit the respective “triggering event.” Permissible triggering events as defined in the IRS’s regulations, include the sale of a residence, the sale of an unregistered security or the lifting of sale restrictions on the security by the SEC, a specific birth date of the beneficiary, marriage of the donor, the donor’s divorce, and the birth of the beneficiary’s first child. These examples are not exclusive. Any triggering events that are beyond the discretion of the grantor or another person should qualify. Conversely, if the event is based on the sale of unmarketable assets,³² the “marriage, divorce, or birth of a child,” or a date certain, the Regulations will not treat these events as discretionary by the trustee or other persons. Treas. Reg. § 1.664-3(a)(1)(i)(d).

(c) “Sprinkling” of Distributions to More Than One Beneficiary

As with Charitable Lead Trusts, a donor can establish a CRAT or CRUT that makes payments among named beneficiaries or among a class of beneficiaries as their needs require (“sprinkling powers”), as long as all of the beneficiaries are named in the trust instrument and are alive and ascertainable when the trust is created. Treas. Reg. §§ 1.664-2(a)(3)(i) & (ii) and -

3(a)(3)(i) & (ii); Rev. Rul. 77-73, 1977-1 C.B. 175. Additionally, a donor may name a qualified charitable organization, as defined by I.R.C § 170(c), as one of the beneficiaries of the annuity income payment. However, if a charitable organization is named as a beneficiary, there must also be at least one non-charitable beneficiary. Treas. Reg. 1.664-2(a)(3)(i) and -3(a)(3)(i).

(d) Frequency of Payments

Like a CLT, a CRT must provide the beneficiaries with payments of the Annuity Amount or Unitrust Amount *at least annually*. Treas. Reg. § 1.664-1(a)(1)(i). Thus, the trust can make payments more frequently: annually, semi-annually, quarterly, monthly, and at either the beginning or end of the payments period prescribed in the trust agreement.

(e) Payout Requirements

The trustee must comply with the five-percent minimum payout rule for the full term of the annuity or unitrust. Some examples of acceptable annuity and unitrust terms which meet the minimum payout requirements, include: 1) a five-percent annual payout to X and Y during their joint lives with five percent annually to the survivor until his death; 2) a five percent annual payout to X for life or for a term of twenty years, whichever is shorter; 3) a five percent annual payout to X for twenty years and then to Y for life (as long as both X and Y are both living when the trust is established).

A CRUT may permit additional contributions to the trust corpus, but a CRAT cannot. The CRAT agreement must prohibit additional contributions to a CRAT. Treas. Reg. § 1.664-2(b). A CRUT must either prohibit or permit additional contributions to the trust. If additional contributions are prohibited, such prohibition must extend to everyone, not just the trustmaker(s). PLR 7727019. If trust permits additional contributions, the trust must provide for adjustment of the Unitrust Amount to reflect the additional trust value. Treas. Reg. § 1.664-3(b).

(3) Issues Regarding the Term of the Trust

As with Charitable Lead Trusts, the annuity and unitrust term may be measured by the lives of the beneficiaries, by a set term not to exceed twenty years, or by a certain combination of both. Payments to a qualified charity may be for a term of years or for the life of an individual. If an individual receives payments for life, the measuring life must be his own.

(4) Issues Regarding the Charitable Beneficiary

Upon termination of all non-charitable recipient interests, the trustee must distribute the remainder to an organization or organizations described in Code Section 170(c), retain the assets in trust for charitable use, or both. Treas. Reg. §§1.664-2(a)(6) and 1.664-3(a)(6). In order to ensure that the CRT will only allow public charities to be qualified remaindermen, and that the organizations will qualify for the gift and estate tax charitable deductions, the definition of a qualified charity in the document should be limited to charitable organizations described in I.R.C. §§ 170(b)(1)(A), 170(c), 2055(a), and 2522(a).

(5) Trustee Issues

Like CLTs, the grantor of a CRT has three choices for trustee: an institutional trustee; the charitable remainder organization; or the grantor or a family member. However, if the grantor himself intends to serve as trustee, he must not retain any administrative powers or interests -- such as the power to distribute, apportion or accumulate income among or for designated beneficiaries, the power to remove the trustee, or the power to value unascertainable property -- or the Code will treat the grantor as “owner” of the trust for income tax purposes, thereby disqualifying the trust from tax-exempt treatment. I.R.C. § 2038.

(6) The Income Tax Consequences

The grantor is entitled to an income tax charitable contribution deduction in the year he

creates the trust (or, in the case of a CRUT, makes an additional contribution to it). I.R.C. §170(f)(2)(A). The deduction is only for the present value of the remainder; the donor makes no adjustment in his deduction for any Annuity Amounts or Unitrust Amounts paid to any charity that is a recipient of the trust.

Essentially, a donor qualifies his contributions to a CRT for the income tax charitable contribution deduction as follows: (1) the donor must determine the fair market value of the property on the date of the contribution; (2) the donor must determine the actuarial value of the charitable remainder interest; (3) the donor must determine how much of the deduction can be taken for the year of the gift using the percentage limitations and reduction rules of Section 170; (4) the donor must substantiate his deduction according to the rules set out in the Treasury Regulations governing the income tax charitable contribution deduction.

In determining the actuarial value of the remainder interest, the grantor must consider the duration of the trust, the Section 7520 rate, the type of trust selected, and the trust's payout rate. The higher the payout rate and the longer the terms of the trust, the lower the deduction. The Code allows a charitable deduction only for the present value of the remainder interest. The law allows no additional deduction for any portion of the Annuity Amount or Unitrust Amount paid to any charitable recipient. Treas. Reg. §§ 1.664-2(d) and -3(d). However, the early acceleration of the entire annuity or unitrust interest to the charitable remaindermen qualifies for the income tax and gift tax charitable contribution deductions. Rev. Rul. 86-60, 1986-1 C.B. 302.

(7) The Beneficiaries' Income Tax Consequences

A beneficiary pays tax on income payments he receives from the trust. Under Code § 664(b) beneficiaries are taxed on distributions received from charitable lead trusts based on an order of priority or tiers as follows:

Tier One: All amounts distributed to the beneficiaries are characterized and taxed as ordinary income to the extent of trust ordinary income for the year and undistributed ordinary income for past years. I.R.C. § 664(b)(1); Treas. Reg. § 1.664-1(d)(1)(i)(a)(1). The trustee uses an “ordinary loss” for the current year to reduce undistributed ordinary income for prior years, and carries forward the excess indefinitely to reduce ordinary income in future years. Treas. Reg. § 1.664-1(d)(iii)(a). The trustee calculates income for any current or prior year without regard for any deduction for net operating losses under Sections 172 and 642(d). *Id.*

Tier Two: If the Annuity Amount or Unitrust Amount exceeds the total amount of ordinary income for the current year or accumulated ordinary income from past years, the trustee distributes capital gains to the extent of the trust capital gains for the year and undistributed capital gains for prior years. I.R.C. § 664(b)(2); Treas. Reg. § 1.664-1(d)(1)(ii)(a)(2).

Tier Three: If the Annuity Amount and the Unitrust Amount exceed the total of current and accumulated ordinary income and capital gains for the year of distribution, then the trustee distributes “other income” to the extent of the trust’s “other income” for the year and such income that is undistributed for prior years. I.R.C. § 664(b)(3); Treas. Reg. § 1.664-1(d)(1)(ii)(a)(3). “*Other income*” generally means income excluded from a taxpayer’s gross income under Code Sections 101-140.

Tier Four: If any portion of the Unitrust Amount or Annuity Amount in a given year exceeds the sum of current and accumulated income, and other income, the Regulations treat the balance as a distribution of corpus. I.R.C. § 664(b)(4); Treas. Reg. § 1.664-1(d)(1)(ii)(a)(4).

(8) Estate and Gift Tax Consequences

A charitable remainder trust’s remainder interest qualifies for the gift and estate tax unlimited charitable deductions.

(a) Gift Tax Consequences

The grantor of a CRT is entitled to a gift tax charitable contribution deduction for the value of the charitable remainder interest. I.R.C. §2522(c)(2)(A). If the spouse is the only non-charitable beneficiary, an interest for the grantor's spouse qualifies for the gift tax unlimited marital deduction. I.R.C. §2523(g).

When a grantor names himself as primary beneficiary, gifts to secondary beneficiaries who are not his spouse, do not qualify for the annual exclusion, as they are considered gifts of a future interest. I.R.C. §2503(b); Treas. Reg. §25.2503-3(a). The grantor will have to pay gift tax, if the gift tax annual exclusion amount does not offset the tentative tax.

A grantor who is the primary beneficiary can avoid creating a gift of the future interest by reserving in his Will the right to accelerate the charitable remainder and revoke the non-charitable interest. This retained power makes the gift incomplete for gift tax purposes, yet preserves the income tax charitable contribution deduction. Treas. Reg. §§ 1.664-2(a)(4), 3(a)(4), and 25.2511-2(c); Rev. Rul. 74-149, 1974-1 C.B. 138; PLR 7830103. The grantor need not actually exercise the right; the mere retention of the right avoids a completed gift to the successor recipient. Rev. Rul. 79-243, 1979-2 C.B. 343. The grantor can exercise the right to revoke only by will and cannot retain an intervivos right to revoke. Treas. Reg. §§ 1.664-2(a)(4), and -3(a)(4).

(b) Estate Tax Consequences

The grantor of a CRT is entitled to an estate tax charitable contribution deduction for the value of the charitable remainder interest. I.R.C. §2055(e)(2)(A). If the spouse is the only non-charitable beneficiary, an interest for the grantor's spouse qualifies for the estate tax unlimited marital deduction. I.R.C. §2056(b)(8).

(c) Generation-Skipping Transfer Tax Consequences

If the grantor establishes a CRT for a beneficiary who is two or more generations below the grantor, the gift to such a skip person will not result in generation-skipping tax to the trust. The only taxable events arising from a CRT are taxable distributions, and because the beneficiary must pay income tax on the distribution, the trust will not be subject to generation-skipping transfer tax. *See* I.R.C. §2603(a)(1).