CHARITABLE PLANNING

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Charitable contributions will generally have tax consequences to the donor. If the donor makes the contribution during his or her lifetime, there may be income and gift tax consequences. If the contribution is made after the donor's death, then there may be income and estate tax consequences. The following is an overview of the income, gift, and estate tax consequences of the making of a contribution to a charitable organization by an individual either outright or in trust.

I. OVERVIEW OF TAX CONSEQUENCES OF LIFETIME CHARITABLE CONTRIBUTIONS

A. INCOME TAX

1. Allowance of a Deduction

Section 170(a)(1) of the Internal Revenue Code ("the Code") provides the general rule that if a taxpayer itemizes deductions, a deduction will be allowed for any "charitable contribution" which is made during the taxable year. The term "charitable contribution" is defined in § 170(c) of the Code to mean a contribution or gift to or for the use of any of the following:

1. A state, a possession of the United States, or any political subdivision thereof; or under the law of the United States, the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

2. A corporation, trust, or community chest, fund or foundation -
   A. created or organized in the United States or any possession thereof, or under the law of the United States, any state, the District of Columbia, or any possession of the United States;
   B. organized and operated 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 the prevention of cruelty to children or animals;
   C. no part of the net earnings of which inures to the benefit of any private shareholder or individual; and
   D. which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation,

and which does not participate in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office.

3. A post or organization of war veterans, or auxiliary unit or society of, or trust or foundation for, any such post or organization
   A. organized in the United States or any of its possessions, and
   B. no part of the net earnings of which inures to the benefit of any private shareholder or individual.

4. A domestic fraternal society, order, or association operating under the lodge system but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

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 such company or corporation is not operated for profit and no part of the net earnings of such cemetery or corporation inures to the benefit of any private shareholder or individual.

2. Amount of Deduction - General Rule

a. Value of contribution

If the charitable contribution is a contribution of money or a cash equivalent, such as a check, the value of the contribution is the amount of money given. If property, other than money, is given, the value of the contribution is the fair market value of the property at the time of the contribution reduced as provided in § 170(e) of the Code. [See Treasury Regulation § 1.170A-1(c)(1)]. The fair market value of the property is the price at which the property would have changed hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. [Treasury Regulation § 1.170A-1(c)(2)].

If the property being contributed is property that the donor sells in the course of the donor's business, the fair market value is the price the donor would have received, if the donor had sold the property in the usual market in which the donor customarily sells

the property. **Id**. If, however, the donor contributes the stock in trade at a time that the donor could not have expected to have received the usual selling price, the value of the contribution is the amount the donor could have received at the time. [Treasury Regulation § 1.170A-1(c)(3)].

b. Reduction for contribution of appreciated ordinary income property

Section 170(e)(1)(A) of the Code provides that all contributions of "ordinary income property" are required to be reduced by the amount of ordinary income which would have resulted had the contributed property been sold at its fair market value as determined at the time of the contribution. The term "ordinary income property" is defined in Treasury Regulation § 1.170A-4(b)(1) to mean property, any portion of the gain on which would not have been long term capital gain, if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization. Examples of ordinary income property are the following:

1. property held by the donor in the ordinary course of the donor's trade or business;
2. work of art created by the donor;
3. a manuscript prepared by the donor;
4. letters and memorandum prepared by or for the donor; and
5. a capital asset held for less than one year.
[Treasury Regulation § 1.170A-4(b)(1)].

To show how the reduction rule of § 170(e)(1)(A) works, assume the following:

Doe Knor is a sole proprietor and owns a children's coat store. Doe donates five children's coats to the local coats for tots drive. Doe's basis in the coats is $400. If Doe sold the coats in the ordinary course of Doe's business, Doe would have received $1,000. The fair market value of the charitable contribution is $1,000. However, if Doe had sold the coats, Doe would have realized ordinary income of $600 ($1,000 fair market value sale price less $400 basis). Thus, the amount of Doe's charitable contribution, after applying the reduction rule of § 170(e)(1)(A), is $400.

c. Reduction for contribution of long term capital gain property

Section 170(e)(1)(B) of the Code provides that the amount of any charitable contribution of property shall be reduced if the property contributed is (i) tangible

personal property, and (ii) the use of the property by the donee charitable organization is unrelated to the purpose or function constituting the basis for the organization's exemption under § 501. The amount of the reduction shall be the amount of long term capital gain that would have been realized, if the property contributed had been sold by the donor at its fair market value determined at the time of the contribution.

If a donor contributes appreciated tangible personal property to a charitable organization, the donor may treat the property as <u>not</u> being put to an unrelated use by the donee, if at the time of the contribution (i) the donor establishes that the property is not in fact put to an unrelated use by the donee, or (ii) at the time of the contribution it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. [Treasury Regulation § 1.170A-4(b)(3)(ii)]. If a contribution of tangible personal property is made to a museum, and if the object donated is of a general type normally retained by the museum for museum purposes, it will be reasonable for the donor to anticipate, unless the donor has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee. [Treasury Regulation § 1.170A-4(b)(3)(ii)(b)].

To show how this reduction works, assume the following:

> <u>Example 1</u>: Doe Knor is an art enthusiast. Doe contributes a painting to the American Red Cross. Doe purchased the painting in 1990 for $5,000. At the time the painting is contributed to the American Red Cross in 2011 the fair market value of the painting is $10,000. The American Red Cross plans to sell the painting to purchase medical supplies. The amount of the charitable contribution is $10,000, the fair market value of the painting at the time of the gift. However, under § 170(e)(1)(B) of the Code, the amount of the contribution must be reduced by the long term capital gain Doe would have realized if the painting were sold at the time of the gift. The long term capital gain that would have been realized would be $5,000 (the $10,000 fair market value of the painting less Doe's $5,000 basis in the painting). Thus, the value of the charitable contribution will be $5,000, the value of the property less the unrealized long term capital gain.
>
> <u>Example 2</u>: Assume the same facts as in Example 1, except that Doe contributes the painting to the National Gallery, and the National Gallery displays the painting in its permanent exhibit. Again, the amount of the contribution is the fair market value of the painting which is $10,000. However, in this case the use of the tangible personal property is related

to the exempt purpose of the donee. So, in this case the value of the contribution is not reduced. Thus, in this case the value of the charitable contribution will be $10,000.

d. Fifty percent (50%) limitation

The amount that the donor may claim as a deduction will be limited by the amount of the donor's "contribution base." The donor's "contribution base" is defined in § 170(b)(1)(G) of the Code to mean the donor's adjusted taxable income (computed without regard to any net operating loss carryback to the taxable year). A donor's adjusted gross income is the donor's gross income for the year less deductions the donor can claim without itemizing, such as contributions to deductible IRAs, penalties paid because of a premature withdrawal of funds from time savings accounts or deposits, alimony, job related moving expenses, and interest paid on education loans. [See § 62(a) of the Code].

For any taxable year, the donor may claim a deduction equal to the lesser of fifty percent (50%) of the donor's contribution base or the aggregate of all gifts or contributions made to any of the following charitable entities:

1. a church or a convention or association of churches,
2. an educational organization which normally maintains a regular facility and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on,
3. an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital, or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital, and during the calendar year in which the contribution is made such organization is committed to spend such contributions for such research before January 1 of the fifth calendar year which begins after the date such contribution is made,
4. an organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from the United States or any State or

political subdivision thereof or from direct or indirect contributions from the general public, and which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an organization referred to in clause (ii) of this subparagraph and which is an agency or instrumentality of a State or political subdivision thereof, or which is owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions,

5. a governmental unit referred to in subsection (c)(1),
6. an organization referred to in subsection (c)(2) which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from a governmental unit referred to in subsection (c)(1) or from direct or indirect contributions from the general public,
7. a private foundation described in subparagraph (E), or
8. an organization described in section 509(a)(2) or (3).

[See § 170(b)(1)(A) of the Code].

e. Thirty percent (30%) limitation

Charitable contributions made to or for any charitable entities not subject to the fifty percent (50%) limit are limited to the lesser of

1. Thirty percent (30%) of the taxpayer's contribution base for the taxable year, or
2. the excess of fifty percent (50%) of the taxpayer's contribution base for the taxable year over the amount of charitable contributions allowable under subparagraph (A) (determined without regard to subparagraph (C)).

[See § 170(b)(1)(B) of the Code].

Charitable contributions to the following types of organizations would be subject to the thirty percent (30%) rule:

1. A post or organization of war veterans, or auxiliary unit or society of, or trust or foundation for, any such post or organization
   a. organized in the United States or any of its possessions, and
   b. no part of the net earnings of which inures to the benefit of any private shareholder or individual.

2. A domestic fraternal society, order, or association operating under the lodge system but only if such contribution or gift is to be used

exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

3. 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 such company or corporation is not operated for profit and no part of the net earnings of such cemetery or corporation inures to the benefit of any private shareholder or individual.

4. Private foundations other than private operating foundations, distributing foundations, and organizations maintaining a common fund.

f. Examples of how the general limitation rules work

<u>Example 1</u>: Doe Knor, a wealthy philanthropist, has adjusted gross income of $500,000 for the taxable year. Doe makes a contribution of $200,000 to the University of New Mexico. Doe's contribution base is $500,000. Fifty percent (50%) of Doe's contribution base is $250,000. Doe may claim a deduction for the entire $200,000 contribution to the University of New Mexico.

<u>Example 2</u>: Same as Example I except Doe also makes a charitable contribution of $200,000 to the Cathedral of Santa Fe during the taxable year. Doe's total charitable contributions for the year are $400,000, the $200,000 contribution to the University of New Mexico and the $200,000 to the Cathedral of Santa Fe. Fifty percent (50%) of Doe's contribution base, however, is $250,000. Thus, Doe may only claim a deduction for the taxable year for $250,000.

<u>Example 3</u>: Same as Example 1, except that Doe also makes a charitable contribution of $200,000 to a private foundation that does not satisfy the requirements for the fifty percent (50%) limitation. Thirty percent (30%) of Doe's contribution base is $150,000 (30 percent times $500,000). The excess of fifty percent (50%) of Doe's contribution base over the charitable contribution allowed for the gift to the University of New Mexico is $50,000 (50 percent of $500,000 contribution base less $200,000 gift). Thus, Doe may deduct $50,000 of the $200,000 given to the private foundation.

Example 4: Same as Example 3, except that Doe does not make a charitable contribution to the University of New Mexico. In this case, Doe would be able to deduct $150,000 of the $200,000 given to the private foundation.

g. Thirty percent (30%) limitation for contribution of long term capital gain property

Section 170(b)(1)(C) of the Code provides that if long term capital gain property, other than tangible personal property, is contributed to a public charity, the donor is limited to a deduction in the amount of thirty percent (30%) of the donor's contribution base for the year.

For example, Doe's contribution base for the year is $100,000. Doe contributes 1,000 shares of stock of Woolite Stock to UNM. Doe bought the stock twenty (20) years ago for $10,000. The fair market value of the stock on the date of the contribution is $50,000. Had Doe sold the stock, Doe would have realized a long term capital gain of $40,000 (fair market value of $50,000 less cost basis of $10,000). Thus, under Section 170(b)(1)(C) of the Code, Doe's charitable contribution deduction for the contribution of the stock is limited to $30,000, thirty percent (30%) of Doe's contribution base.

Alternatively, the donor can elect to have the reduction rules of § 170(e)(1) of the Code apply to all contributions of long term capital gain property, in lieu of the limitation rules of § 170(b)(1)(A) of the Code. [See § 170(b)(1)(C)(iii) of the Code]. This election may be advantageous when there has not been much appreciation in the capital asset.

For instance, assume in the above example that Doe purchased the Woolite stock for $40,000. Under § 170(b)(1)(C) of the Code, D's charitable contribution deduction for the contribution of the stock is $30,000, thirty percent (30%) of Doe's contribution base of $100,000. If Doe elects to have the rules of § 170(e)(1) apply, Doe would be entitled to a charitable contribution deduction of the value of the property, $50,000, less a $10,000 reduction representing the capital gain Doe would have realized, if she sold the stock for its fair market value of $50,000. Thus, by making the election to have § 170(e)(1) apply in lieu of § 170(b)(1)(C), Doe's charitable contribution deduction will be increased from $30,000 to $40,000.

The election to have § 170(e)(1) of the Code apply in lieu of § 170(b)(1)(C) is made by attaching a statement to the tax return that is filed for the year the charitable contribution deduction is made. The attachment merely needs to provide a statement that the election under § 170(b)(1)(C)(iii) is being made for the taxable year. [Treasury Regulation § 1.170A-8(d)(2)(iii)].

If the contribution is made to a non-public charity such as a private non-operating foundation, a veteran's organization, a fraternal society, or a cemetery company, the donor is limited to a deduction that does not exceed the lesser of

(1) twenty percent (20%) of the donor's contribution base for the taxable year; or

(2) the excess of thirty percent (30%) of the donor's contribution base for the taxable year over the amount of the contributions of capital gain property. Contributions of capital gain property shall be taken into account after all other charitable contributions.

[§ 170(b)(1)(D) of the Code].

3. Substantiation

Section 170(f)(8) of the Code provides that any contribution of $250 or more will not be allowed unless the donor substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization. The acknowledgment must contain the following information: (i) the amount of cash and a description (but not value) of any property other than cash contributed; (ii) whether the donee organization provided any goods or services in consideration for the contribution; and (iii) a description and good faith estimate of the value of any goods or services given by the donee organization to the donor. [§ 170(f)(8)(B) of the Code]. The acknowledgment will be contemporaneous, if the donor receives the acknowledgment prior to the earlier of (i) the date the donor files the tax return for the year; or (ii) the due date, including extensions, for filing the return. [§ 170(f)(8)(C) of the Code].

Additionally, if the donor claims a charitable contribution deduction for a contribution of property that has a fair market value in excess of $500 but not more than $5000, in addition to the substantiation requirements explained above, the donor's records must contain the following information: (i) how the donor received the property

(i.e., by gift, purchase, inheritance); (ii) the approximate date the donor acquired the property, or the date the donor created the property; and (iii) the donor's basis in the property. [Treasury Regulation § 1.170A-13(b)(3)].

If the donor claims a charitable contribution deduction for a contribution of property in excess of $5,000, the donor must satisfy all the substantiation requirements mentioned above. Also, the donor must obtain a "qualified written appraisal" for the contributed property. A "qualified written appraisal" is an appraisal document that (i) relates to an appraisal that is made within sixty (60) days prior to the date of the contribution of the property; (ii) is prepared, signed, and dated by a qualified appraiser; (iii) contains a description of the property; (iv) if the property is tangible personal property, the condition of the property; (v) the name, address, and taxpayer identification number of the appraiser; (vi) the qualifications of the appraiser; (vii) a statement that the appraisal was prepared for income tax purposes; (viii) the date the appraisal was prepared; (ix) the valuation method used; and (x) the specific basis for the valuation. The donor must attach to the tax return an appraisal summary. The appraisal summary must satisfy the following requirements: (i) it must be on a form prescribed by the IRS; (ii) signed and dated by the donee; (iii) signed and dated by the qualified appraiser; (iv) name and taxpayer identification number of the donor; (v) a description of the donated property; (vi) in the case of tangible personal property, the condition of the property; (vii) date and manner by which the donor acquired the property; (viii) the donor's basis in the property; (ix) the name, address, and taxpayer identification number of the donee; (x) the date the donee received the property; (xi) the amount of any consideration received by the donor; (xii) the name, address, and taxpayer identification number of the qualified appraiser; (xiii) the appraised fair market value; (xiv) a declaration by the appraiser that the appraiser holds himself or herself out to the public as an appraiser and that the appraiser understands that an intentionally false statement of value may subject the appraiser to a penalty; and (xv) a declaration by the appraiser that the fee charged is not based on the value of the property appraised. [Treasury Regulation § 1.170A-13(c)].

4. Carryover of unused deduction

If the donor's charitable contribution for a taxable year exceeds the percentage limitations in § 170(b), the donor can carry over the unused deduction to each of the five (5) succeeding taxable years in order of time. [See §§170(d), 170(b)(1)(B), 170(b)(1)(C), and 170(b)(1)(D) of the Code].

B. GIFT TAX

Section 2501(a) of the Code provides the general rule that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year. A deduction from the gift tax, however, is provided for under § 2522 of the Code for gifts made to any of the following organizations:

1. the United States; any State, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

2. a corporation, or trust, or community chest, fund, organized and operated 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), including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office;

3. a fraternal society, order, or association, operating under the lodge system, but only if such gifts are to be used exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals;

4. posts or organizations of war veterans, or auxiliary units or societies of any such posts or organizations, if such posts, organizations, or societies are organized in the United States or any of its possessions, and if no part of their net earnings inures to the benefit of any private shareholder or individual.

The charitable organizations, contributions to which qualify for a charitable contribution deduction for income tax purposes, are similar, but not identical to the charitable organizations that qualify for a charitable contribution deduction for gift tax purposes. Thus, in some instances the gift tax may apply when a gift is made to a charitable organization for which an income tax deduction is allowed. The most notable exception between "charitable organization" for income tax and "charitable organization" for gift tax purposes is "cemetery corporations". A gift to a cemetery corporation may qualify for a deduction for income tax purposes, but not for gift tax purposes.

Even if a gift to an organization does not qualify for the charitable contribution deduction from gift tax under § 2522 of the Code, the gift may still be excluded from the gift tax, if the gift qualifies for the annual exclusion from gifts under § 2503(b) of the Code. Under Section 2503(b) of the Code, each taxpayer is allowed to make annual exclusion gifts. An annual exclusion gift represents the total amount of gifts made to a person during the course of a year that is not in excess of $10,000. The $10,000 annual exclusion from the gift tax is an indexed number and is subject to change depending on the consumer price index for the year. [Code § 2503(b)(2)]. The current annual exclusion amount is $13,000.

Additionally, even if the gift to an organization does not qualify for the charitable deduction from gift taxes, and is in excess of the annual exclusion amount, there still may not be any gift tax liability, if the donor has not fully utilized the unified credit exclusion amount. Currently, the unified credit exclusion amount is $5,000,000. This amount is scheduled to be reduced to $1,000,000 on January 1, 2013, unless Congress enacts new legislation.

Thus, as a practical matter, gifts to charitable organizations should not be subject to the gift tax.

II. OVERVIEW OF TAX CONSEQUENCES OF CHARITABLE CONTRIBUTIONS

Section 2001(a) of the Code provides that a tax is imposed on the taxable estate of every decedent who is a citizen or a resident of the United States. The term "taxable

estate" is defined in Code § 2051(a) to mean the decedent's "gross estate" less certain allowable deductions. The "gross estate" is the crux of the estate tax scheme. The term "gross estate" is defined in § 2031 of the Code to include the value of the decedent's interest in all property whether it be real or personal, tangible or intangible, wherever situated in which the decedent has an interest at the time of death. The Treasury Regulations promulgated under § 2033 of the Code reiterate the fact that the term "gross estate" includes ALL property in which the decedent has an interest at the time of death.

Once a determination is made as to the value of the gross estate, that value is reduced by "allowable deductions" to arrive at the value of the taxable estate. The "allowable deductions" are those deductions permitted by statute in Code §§ 2053 through 2058.

As a general rule, an estate is entitled to a deduction for the amount of all bequests, legacies, devises, or transfers, made to a qualified public, charitable, or religious organization (i.e., those qualifying as Section 501(c)(3) organizations), to the United States, any state, or any political subdivision thereof, or to any veteran's organization. [Code § 2055]. The deduction is allowed only if the transfer was made by the decedent during the decedent's lifetime or is provided for in the decedent's will. [Treas. Reg. § 20.2055-1(a)]. Additionally, the value of the deduction for the property transferred to charity is limited to the value of that property as used for inclusion in determining the gross estate. [Code § 2055(d)]. Thus, if the decedent makes a bequest in his or her will to Charity A of stock the decedent purchased for $1,000 but which has a fair market value of $100,000 on the day of the decedent's death, and if the stock is included in the decedent's gross estate for federal estate tax purposes at $100,000, the charitable deduction for the bequest of the stock will be $100,000. Unlike the charitable deduction for income tax purposes, the charitable deduction for estate tax purposes is not reduced by unrealized gain and is not limited to a specified percentage of the decedent's estate. If the decedent's will provides that the decedent's entire estate is to be given to Charity A, the decedent's estate tax liability should be reduced to zero by virtue of the charitable deduction.

III. SPECIAL CHARITABLE VEHICLES - CHARITABLE REMAINDER TRUSTS

Sections 170(f)(2) and 2055(e)(2) of the Code provide that charitable contribution deductions for income and estate tax purposes, respectively, will not be allowed for remainder interests to charities made in trust unless the trust is a charitable remainder trust that meets certain statutory and regulatory requirements.

A. WHAT IS A CHARITABLE REMAINDER TRUST?

A charitable remainder trust is a trust that provides for current distributions to be made to one or more non-charitable beneficiaries. The distributions will generally be made for a specified number of years or until the death of the beneficiaries. When the number of years expires, or when the beneficiary dies, the remaining trust property is paid to the charity. Basically, with a charitable remainder trust, the charitable organization will not actually receive the funds or property until sometime in the future.

B. LIFETIME CONTRIBUTION TO A CHARITABLE REMAINDER TRUST

Section 170(f)(2)(A) of the Code provides that a charitable contribution deduction will not be allowed for a contribution to a remainder interest trust unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust described in § 664 of the Code.

1. Charitable Remainder Annuity Trust

The term "charitable remainder annuity trust" ("CRAT") is defined in § 664(d)(1) of the Code as a trust

> (A) from which a sum certain (which is not less than 5 percent nor more than 50 percent of the initial net fair market value of all property placed in trust) is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust) for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,
>
> (B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers

described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c),

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7) in a qualified gratuitous transfer (as defined by subsection (g)), and

(D) the value determined under section 7520 of such remainder interest is at least 10 percent of the initial net fair market value of all property placed in the trust.

a. Requirement Number 1: Sum Certain

The first requirement is that the trust document provides that a sum certain is to be paid not less often than annually. The term "sum certain" for purposes of a CRAT means a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year. [Treasury Regulation § 1.664-2(a)(1)(ii)].

For instance, if the initial value of the CRAT is $100,000, and if the initial income beneficiaries are the donors, Doe Knor and Grant Orr, the CRAT could provide that $20,000 is to be paid to Doe and Grant annually, or to the survivor of them. Alternatively, the CRAT could provide that $10,000 is to be paid to Doe and $10,000 to Grant annually.

Also, the sum certain amount can be expressed as a fraction or percentage of the initial net fair market value of the property transferred to the CRAT. [Treasury Regulation § 1.664-2(a)(1)(iii)]. This method of stating the sum certain may be useful if the CRAT is being established in a document, such as a will, where the donor does not know what the initial fair market value of the property will be. For instance, the donor can provide that the amount to be paid to the non-charitable beneficiary at least annually will be an amount equal to ten percent (10%) of the initial fair market value of the property passing to the CRAT. If after the donor dies the initial amount passing to the

CRAT is $100,000, the amount to be paid to the designated non-charitable beneficiary annually would be ten percent (10%) of $100,000, which is $10,000. If the initial amount passing to the CRAT after the donor dies is $1,000,000, the amount to be paid to the non-charitable beneficiary would be ten percent (10%) of $1,000,000, which is $100,000.

If the first year of the CRAT is a short year, the amount to be paid to the non-charitable beneficiary is to be prorated. The proration will be based on the number of days in the trust's taxable year. [Treasury Regulation § 1.664-2(a)(1)(iv)(a)]. For example, if at the time the CRAT is established and funded there are only 73 days left in the CRAT's taxable year, the distribution to the non-charitable beneficiary for that first year would be 73/365 of the sum certain to be paid annually, which is 1/5 of the sum certain. In the last year that a distribution is to be made to the non-charitable beneficiary, a similar type of proration would also be performed. [Treasury Regulation § 1.664-2(a)(1)(iv)(b)]. Also, as to the last year in which a distribution is to be made to the non-charitable beneficiary, the CRAT may provide that the final payment will be made with the regular payment preceding the termination of the non-charitable beneficiary's interest. [Treasury Regulation § 1.664-2(a)(5)]. For instance, if a CRAT established and funded on February 5, 2005, provides that $10,000 is to be paid annually to Doe Knor's niece, Doe Knee, on December 31 for as long as Doe Knee lives, and that the payments to Doe Knee are to end with the last regular payment preceding the termination period, and if Doe Knee dies on August 1, 2011, the last required payment to Doe Knee would be made to Doe Knee on December 31, 2010.

b. Requirement Number 2: The sum certain must be at least five percent (5%) but not more than fifty percent (50%) of the initial net fair market value of all property placed in trust

As a general rule, it should not be difficult to satisfy the 5/50 percent rule. If the trust document provides that an amount equal to five percent (5%) of the initial net fair market value of the CRAT, or fifty percent (50%) of the initial net fair market value, or any specified percentage between five percent (5%) and fifty percent (50%), this requirement will be satisfied. Issues may arise when there is more than one non-charitable beneficiary. For instance, assume that Doe Knor provides for a CRAT in her

will. The non-charitable beneficiaries are her niece, Doe Knee, and her nephew, Grant Tee. The following distribution provisions would satisfy the 5/50 percent requirement:

1. Ten percent (10%) of the initial net fair market value is to be paid to Doe Knee and Grant Tee for their joint lives and then to the survivor for his or her life.

2. Five percent (5%) of the initial net fair market value is to be paid to Doe Knee for her life and five percent (5%) of the initial net fair market value is to be paid to Grant Tee for his life.

The following distribution provisions would not satisfy the 5/50 percent requirement:

1. Five percent (5%) of the initial net fair market value is to be paid to Doe Knee and Grant Tee for their joint lives, but after one of them dies, 2.5 percent of the initial net fair market value is to be paid to the survivor.

2. Four percent (4%) of the initial net fair market value is to be paid to Doe Knee for her life and four percent (4%) of the initial net fair market value is to be paid to Grant Tee for his life.

In both of these last two situations, after the first non-charitable beneficiary dies, the amount that would be paid out would be less than five percent (5%) of the initial net fair market value of the CRAT. In the situation where five percent (5%) is to be paid to Doe Knee and Grant Tee for their joint lives, but then 2.5 percent to the survivor, the CRAT would satisfy the 5/50 percent requirement, if after the death of the first non-charitable beneficiary, one-half (1/2) of the CRAT was distributed to the charitable beneficiary. [Treasury Regulation § 1.664-2(a)(5)(ii)].

c. Requirement Number 3: Permissible non-charitable recipients

The annuity amount must be or for the use of at least one named person who is not an organization described in § 170 (c) of the Code. An organization described in § 170 (c) is a charitable organization. Thus, at least one of the recipients of the annuity amount must not be a charitable organization. The term "person" for tax purposes includes an individual, a trust, an estate, a partnership, an association, a company, and a

corporation. [§ 7701(a)(1) of the Code]. If an annuity amount is to be paid to an individual or individuals, all such individuals must be alive at the time of the creation of the CRAT. [Treasury Regulation § 1.664-2(a)(3)(i)]. Named persons may include members of a named class, such as the class "my children." However, if the class includes an individual, all individuals generally must be alive and ascertainable at the time the CRAT is created. **Id**. Thus, in the case of a trust created in a will, an appropriate class would be "all my children living at my death". If the CRAT is only for a term of years, though, all class members do not have to be alive at the time the CRAT is created.

d. Requirement Number 4: Maximum term for annuity payments

As a general rule, the maximum term over which the annuity payments may be made is twenty (20) years. If the recipient of the annuity payment is an individual, the annuity may be paid over the individual's lifetime, even if the period is longer than twenty (20) years. If an individual is to receive an annuity for life, the life over which the annuity is to be paid is that individual's life. [Treasury Regulation § 1.664-2(a)(5)(i)]. Thus, the CRAT document could not provide that payments are to be paid to Doe Knee for the life of Grant Tee. Also, if one of the annuity recipients is an organization described in § 170(c), distributions to that organization can be for a term based on an individual's life expectancy. **Id**. The CRAT document may also provide that the annuity payment is to be paid to Doe Knee for her life, and then to Grant Tee for his life, provided both persons are alive at the time the CRAT is established.

e. Requirement Number 5: No payments may be made other than the annuity payment

The effect of this requirement is that the CRAT document may not give the trustee the power to invade the trust principal or income for the purpose of making any payment other than the annuity payment to any person. There is one exception to this general rule. The exception is that a payment, in addition to the annuity payment, may be made to an organization described in § 170(c). [Treasury Regulation § 1.664-2(a)(4)]. Thus, if two individuals are entitled to receive an annuity payment, the CRAT document

may provide that on the death of the first individual, one-half (1/2) of the trust principal will be paid to an organization described in § 170(c). **Id**. The CRAT document, however, could not provide that on the death of the first individual, one-half (1/2) of the trust principal will be paid to that individual's children.

f. Requirement Number 6: After the termination of the annuity payments the remainder interest is to be transferred to or for the use of a § 170(c) organization

At the time the annuity payments stop, either because the term set forth in the CRAT document has expired or the individuals to whom payments were being made for their lifetimes have died, the entire trust corpus is required to be transferred to or for the use of one or more organizations described in § 170(c) or retained for such use.

If the property is retained in the trust for the use of one or more organizations described in § 170(c), the trust would cease to be a CRAT after the end of the annuity period. The trust at that time may qualify for exemption under § 501(a) of the Code. [Treasury Regulation Section 1.664-2(a)(6)(ii)].

The CRAT document must provide that if at the time the property is to be transferred to or for the use of an organization described in § 170(c) or retained in trust for such organization the organization is not an organization described in § 170(c), such amount should be transferred to or retained in trust for one or more organizations described in § 170(c). [Treasury Regulation § 1.664-2(a)(6)(iv)].

g. Requirement Number 7: The value of the remainder interest must be at least ten percent (10%) of the initial net fair market value of the property placed in trust.

In order for the trust to qualify as a CRAT, the value of the remainder interest, the interest going to a charitable organization after the annuity term ends, must be an amount that is equal to or greater than ten percent (10%) of the initial net fair market value of the property as of the applicable valuation date. [§ 664(d)(1)(D) of the Code]. The valuation date is the date the property is transferred to the CRAT regardless of the date the CRAT is created. [Treasury Regulation § 1.664-2(c)].

In computing the value of the remainder interest, the interest rate provided under § 7520 of the Code must be used. [§ 664(d)(1)(D) of the Code]. The § 7520 interest rate is issued each month by the Internal Revenue Service. As a general rule, the donor must use the § 7520 rate that is in effect for the month in which the property is transferred to the CRAT. The donor may elect to use the § 7520 rate that is in effect for either of the two months preceding the month in which the property was transferred to the CRAT. [§ 7520(a) of the Code].

h. Additional contributions

After the initial contribution is made to a CRAT, the CRAT may not accept additional contributions. The CRAT document must provide that additional contributions may not be made to the CRAT. [Treasury Regulation § 1.664-3(b)]. Thus, if a donor established a CRAT during lifetime, the donor's will may not provide for a contribution to the CRAT after his or her death. If the donor establishes a CRAT in his or her will, all property passing to the CRAT as a result of the donor's death will be treated as one initial contribution, even if not made on the same day. **Id**.

i. Changing the interest of the non-charitable beneficiaries

As a general rule, once the trust is established, the donor may neither change the non-charitable beneficiaries nor change the amounts that are to be paid to any non-charitable beneficiary. [Treasury Regulation § 1.664-2(a)(3)(ii)]. The donor, however, may retain a testamentary power of appointment to revoke or terminate the interest of any non-charitable beneficiary. [Treasury Regulation §§ 1.664-2(a)(3)(ii) and 1.664-2(a)(4)].

2. Charitable Remainder Unitrust

The term "charitable remainder unitrust" is defined in § 664(d)(2) of the Code as a trust

> (A) from which a fixed percentage (which is not less than 5 percent nor more than 50 percent) of the net fair market value of its assets, valued annually, is to be paid, not less often than annually, to one or more persons (at least one of which is not an organization described in section 170(c) and, in the case of individuals, only to an individual who is living at the time of the creation of the trust)

for a term of years (not in excess of 20 years) or for the life or lives of such individual or individuals,

(B) from which no amount other than the payments described in subparagraph (A) and other than qualified gratuitous transfers described in subparagraph (C) may be paid to or for the use of any person other than an organization described in section 170(c),

(C) following the termination of the payments described in subparagraph (A), the remainder interest in the trust is to be transferred to, or for the use of, an organization described in section 170(c) or is to be retained by the trust for such a use or, to the extent the remainder interest is in qualified employer securities (as defined in subsection (g)(4)), all or part of such securities are to be transferred to an employee stock ownership plan (as defined in section 4975(e)(7) in a qualified gratuitous transfer (as defined by subsection (g)), and

(D) with respect to each contribution of property to the trust, the value (determined under section 7520) of such remainder interest in such property is at least 10 percent of the net fair market value of such property as of the date such property is contributed to the trust.

As a general rule, the requirements that apply to CRATs also apply to CRUTs. The two differences are the calculation of the amount to be paid to the recipients of the unitrust payments, and additional contributions to the trust.

a. Calculation of unitrust amount

At least annually, an amount equal to a fixed percentage of the net fair market value of the trust assets, which is determined annually, must be paid to at least one or more persons who is not an organization described in § 170(c). [§ 664(d)(2)(A) of the Code]. The amount to be distributed annually must not be less than five percent (5%) nor more than fifty percent (50%) of the net fair market value of the assets determined annually.

There are three exceptions to this general rule. The first exception is that the CRUT document can provide that the amount to be paid out annually will be the lesser of the unitrust amount or the trust income. [§ 664(d)(3)(A) of the Code]. This type of CRUT is also referred to as a NICRUT (net income charitable remainder trust). For

example, if the CRUT document provides that the lesser of ten percent (10%) of the net fair market value of the trust or trust income is to be paid to Grant Tee each year, and if the net fair market value of the trust is $1,000,000, but the trust income for the year is only $90,000, the amount to be distributed to Grant Tee that year would be $90,000.

The second exception builds on the first exception. The second exception provides that the CRUT document may allow the trustee to pay an amount that is equal to the following:

1. The amount of trust income for a taxable year to the extent that such amount is not more than the unitrust amount; plus

2. An amount of trust income for a taxable year that is in excess of the unitrust amount to the extent the aggregate of the amounts paid in prior years was less than the aggregate unitrust amounts.

[Treasury Regulation § 1.664-3(a)(1)(i)(b)].

This type of trust is also referred to as a NIMCRUT, because it provides for the distribution of net income if lower than the unitrust amount plus it provides for a make up distribution if an amount less than the unitrust amount was paid in a prior year. To show how this exception works, assume in the above example that in the year after the $90,000 was paid to Grant Tee, the net fair market value of the trust again was $1,000,000, but the trust income was $110,000. The unitrust amount for the year again is $100,000. The unitrust amount is less than the net income so $100,000 will be paid to Grantee. But, in the prior year when the unitrust amount was $100,000, Grant Tee only received $90,000. Thus, in this year when the net income of the trust is greater than the unitrust amount, Grant Tee will receive the unitrust amount of $100,000 plus an additional $10,000, to make up for the $10,000 he did not receive in the earlier year.

The third exception builds on the first two in that the trust document may provide that a CRUT may start as a NICRUT or a NIMCRUT and then flip to a regular CRUT. [Treasury Regulation § 1.664-3(a)(1)(i)(c)]. This type of CRUT is referred to as a Flip CRUT. In order to be a Flip CRUT, the three following conditions must be satisfied:

1. The change for the net income or net income plus make up must occur as a result of a triggering event that must not be discretionary or subject to any one's control;

2. The change from a NICRUT or NIMCRUT to a regular CRUT must occur as of the beginning of the taxable year following the taxable year in which the triggering event occurred; and

3. Following the conversion to the straight CRUT, only unitrust amounts may be paid, no make up contributions may be made.

[Treasury Regulation § 1.664-3(a)(1)(i)(c)].

The following triggering events are permissible under the Treasury Regulations: marriage; divorce; death; birth of a child; sale of a residence contributed to the trust; sale of stock contributed to the trust; and the attainment of a certain age by the non-charitable beneficiary. [Treasury Regulation §§ 1.664-3(a)(1)(i)(d); and 1.664-3(a)(1)(i)(e)]. The following events are not permissible under the Treasury Regulations: a determination by the non-charitable beneficiary's financial advisor that the trust should change to the second method; and a request by the non-charitable beneficiary to change to the second method. [Treasury Regulation § 1.664-3(a)(1)(i)(e)].

One word of caution in using a NICRUT or a NIMCRUT is that if the donor contributes appreciated property to the trust, the pre-contribution appreciation realized on a future sale of the asset by the trust will be allocated to principal and not income. [Treasury Regulation §§ 1.664-3(a)(1)(i)(b)(3) and 1.664-3(a)(1)(i)(b)(4)].

b. Additions to a CRUT

The other major regulatory difference between a CRAT and a CRUT is that a CRUT may receive additional contributions, provided the CRUT document contains provisions that provide as follows:

1. If the valuation date for the taxable year occurs prior to the making of the additional contribution, the additional contribution will be valued as of the contribution date;

2. The unitrust amount for the year will be increased as a result of the contribution of the additional property. The amount of the additional property will be prorated to account only for the portion of the year for which the property is in trust.
   [Treasury Regulation § 1.664-3(b)].

For example, assume that Doe Knor established a CRUT that provided for a ten percent (10%) unitrust amount. When there are seventy-three (73) days left in the CRUT's taxable year, Doe Knor makes an additional contribution to the CRUT. The value of the additional contribution is $100,000. In addition to the unitrust amount already calculated for the year, the CRUT would have to distribute an amount equal to ten percent (10%) of $100,000 times the period the property is in the CRUT 73days/365 days, which amount would be $2,000.

3. The Amount of the Deduction

For both CRATS and CRUTS, the starting point for determining the amount of the charitable contribution deduction for the contribution made to a CRAT or CRUT is the fair market value of the remainder interest. A charitable contribution deduction is not allowed for any other interest that is given in the trust to a charitable organization. [Treasury Regulation §§ 1.664-2(d) and 1.664-3(d)]. Also, if the property contributed is ordinary income property or tangible personal property, the reduction rules under §170(e)(1) will apply. **Id**. After the proper value is placed on the contribution, the normal limitation rules of Section 170 apply. **Id**.

4. Income Taxation of Charitable Remainder Trusts

Section 664(c) of the Code provides the general rule that a charitable remainder trust is not subject to income tax.

5. Trustee

There are no explicit restrictions on who may be the trustee of a charitable remainder trust. The donor may be the trustee of a charitable remainder trust. [Private Letter Ruling 7730015]. However, if the donor is also the trustee, extreme care must be taken to make sure that the trustee does not have any powers that would cause the trust to be subject to the grantor trust rules under §§ 671 to 677 of the Code. If the grantor were to be treated as the owner of the trust under §§ 671 to 677 of the Code, the trust would fail to qualify as a charitable remainder trust. [Treasury Regulation § 1.664-1(a)(4)].

6. Substantiation Requirements

A deduction for a contribution to a CRAT or CRUT must be supported by a full statement attached to the income tax return showing the present value of such interest. [Treasury Regulation §§ 1.664-2(d) and 1.664-4(c)].

7. Gift Tax Consequences of Making a Contribution to a Charitable Remainder Trust

The normal gift tax rules that apply to charitable contributions apply to gifts made to trusts that qualify as charitable remainder trusts. The normal gift tax rules provide that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year. [§2501(a) of the Code]. With a gift to a charitable remainder trust, though, there may be two gifts, a gift of the income interest and a gift of the remainder interest. If the grantor is the sole non-charitable income beneficiary, there will not be a gift of the income interest. If anyone other than the grantor will be entitled to receive payments before the final distribution is made to the remainder beneficiary, there will be a gift of that interest. If the other non-charitable beneficiary has a present right to receive payments from the trust, the gift should qualify for the annual exclusion from gift tax under § 2503(b) of the Code. If the only non-charitable beneficiary of the trust is the donor's spouse, the gift to the spouse will qualify for the marital deduction. [§2523(g) of the Code]. If the non-charitable beneficiary is anyone other than the spouse, and if the value of the gift to the income beneficiary exceeds the § 2503(b) amount, the gift will be subject to gift taxes. However, if the donor has not fully utilized the unified credit exclusion amount, then no gift tax may be owing. Currently, the unified credit exclusion amount is $5,000,000. The unified credit exclusion amount, however, will be reduced to $1,000,000 on January 1, 2013, unless Congress enacts legislation prior to that date. [§ 2010 of the Code].

As to the remainder gift, the gift to the charitable organization, a deduction from the gift tax is provided for under § 2522 of the Code, provided the charitable organization qualifies as a charitable organization under § 2522 of the Code. [See Section I.B above

for a list of the organizations that qualify as charitable organizations for purposes of the gift tax charitable contribution deduction.]

If the remainder charitable beneficiary qualifies as a charitable beneficiary for income taxes but not gift tax purposes, the gift will not qualify for the $10,000 annual exclusion from gifts, because the gift will not be a gift of a present interest. [§ 2503(b) of the Code]. However, there still may not be any gift tax liability, if the donor did not exhaust the unified credit exclusion amount.

8. Estate Tax Consequences of Lifetime Transfers to Charitable Remainder Trusts

If the donor creates a charitable remainder trust during lifetime, and if the donor is not one of the non-charitable beneficiaries of the trust, the trust property will not be included in the donor's estate, because the donor will not have any interest in the property.

If, however, the donor is the non-charitable beneficiary of the charitable remainder trust, the value of the trust will be included in the donor's estate for estate tax purposes. [§ 2036 of the Code]. However, as a general rule, the estate will be entitled to a charitable deduction, if the charitable remainder beneficiary is a qualified public, charitable, or religious organization (i.e., those qualifying as § 501(c)(3) organizations), the United States, any state, or any political subdivision thereof, or to any veteran's organization. [Code § 2055]. The value of the deduction will be the value of the trust property included in the donor's gross estate. [Code § 2055(d)].

If there other non-charitable beneficiaries of the trust, the value of the charitable deduction will be less than the value of the trust property. However, if the only other non-charitable beneficiary is the donor's surviving spouse, the interest passing to the survivor's spouse will qualify for the marital deduction. [§ 2056(b)(8)]. Thus, between the marital and charitable deduction, the entire value of the trust property would be deducted from the value of the donor's gross estate.

If, however, there are non-charitable beneficiaries, other than the surviving spouse, the interest passing to those beneficiaries would not be deducted from the value

of the donor's gross estate. However, if the donor had not fully utilized the unified credit exclusion amount, there may not be any estate taxes.

C. TESTAMENTARY CONTRIBUTION TO A CHARITABLE REMAINDER TRUST

As a general rule, the estate tax rules described above concerning lifetime contributions to charitable trusts apply to transfers to charitable remainder trusts that take effect as a result of the donor's death. The value of the property will be included in the donor's gross estate. But, the estate will be entitled to a charitable deduction for the value of the remainder interest. If the only non-charitable beneficiary is the donor's spouse, the transfer to the trust will qualify for the marital deduction for the non-charitable interest, and the charitable deduction for the charitable interest. Again, as pointed out above, care needs to be taken in drafting charitable remainder trusts to make sure that the charitable beneficiary qualifies as a charitable beneficiary under § 2055(e) of the Code, as § 2055(e) does not include all the organizations in Section 170(c) of the Code.

D. INSTANCES WHEN CHARITABLE REMAINDER TRUSTS SHOULD BE CONSIDERED

A main advantage of charitable remainder trusts is that, as a general rule, charitable remainder trusts are not subject to income taxes. Thus, charitable remainder trusts often are good candidates for receiving property that is "income in respect of a decedent property," also known as "§ 691 property." Also, charitable remainder trusts are good candidates for receiving property that has greatly appreciated in value and in which the donor has a low basis.

1. Qualified Retirement Plans

A donor may consider creating a testamentary charitable remainder trust as the beneficiary of a qualified retirement plan. The reason for this is that an interest in a qualified retirement plan is generally "income in respect of a decedent property." [§ 691 of the Code]. "Income in respect of a decedent" is income that a decedent had a right to receive, but which was not received by the decedent during his or her lifetime. If income

is income in respect of a decedent, the recipient of the income is permitted to take a deduction in the year the income is received and included in the recipient's income. The deduction is in essence that amount of the estate tax that is attributable to the item of income that was included in the decedent's estate and received by the recipient. [See § 691(c) of the Code]. The estate tax for purposes of the income in respect of a decedent deduction does not include the state death taxes that are paid and is computed after taking into consideration all credits. [See Treas. Reg. §§ 1.691(c)-1(a)(2) and 1.691(c)-1(d) Example 1]. Thus, the problem with retirement assets, such as assets in a traditional IRA, 401(k) plan, or profit sharing plan, is that they may be subject to both estate and income taxes. This problem can be compounded if the retirement plan only provides for a lump sum distribution. As charitable remainder trusts, though, are not subject to income taxes, the receipt of the distribution from the retirement plan will not result in income taxes.

2. Appreciated Assets

Since charitable remainder trusts are not subject to income tax, there may be an advantage to transferring highly appreciated, low income basis property to them. The reason for this is that the gain realized on the sale of the asset will not currently be subject to income tax. Thus, by transferring the asset to a charitable remainder trust and having the charitable remainder trust sell the asset, the donor may actually be in a better position than by retaining the asset because all of the net proceeds from the sale, not just after tax net proceeds, could be invested. This in turn may result in a better investment return for the donor.

V. <u>CHARITABLE LEAD TRUST</u>

A. WHAT IS A CHARITABLE LEAD TRUST?

A charitable lead trust is a trust that provides for current distributions to be made to one or more charitable beneficiaries. The distributions will generally be made for a specified number of years or until the death of the donor, the donor’s spouse or a named lineal ancestor of the remainder beneficiary. When the number of years expires, or when the person who is the measuring life dies, the remaining trust property is paid to the non-

charitable beneficiary. Basically, with a charitable lead trust, the charitable organization will receive distributions for a limited time period.

B. LIFETIME CONTRIBUTION TO A CHARITABLE LEAD TRUST

As with charitable remainder trusts, there are two types of charitable lead trusts, charitable lead annuity trusts (CLATS) and charitable lead unitrusts (CLUTS). Again as with the charitable remainder trusts, the distribution from a CLAT to the initial beneficiary will be a fixed amount that is established at the creation of the trust. That fixed amount will be paid out each year. The distribution with the CLUT as with the CRUT will be based on the value of the CLUT. Thus, as the value of the CLUT increases or decreases so will the distributions to the initial beneficiary. With lifetime CLUTs and CLATS, however, there are also two different types of CLUTs and CLATS: there are grantor CLUTS and CLATS, and non-grantor CLUTs and CLATs. With the grantor CLAT or CLUT the grantor is allowed to claim a charitable contribution deduction for the present value of the charitable interest. However, the grantor must then include in income the income and capital gain earned by the CLAT or CLUT each year. [See §170 (f)(2)(B) of the Code]. With the non-grantor CLAT or CLUT, the grantor is not allowed to claim a charitable contribution deduction for the contribution of the property to the trust, however, the grantor also is not required to include in income the income and capital gains received by the trust. [See Revenue Procedure 2008-45 §3, Rev. Proc. 2007-45 § 3, and § 642(c) of the Code].

1. Charitable contribution deduction for lifetime transfers to charitable lead trusts

As mentioned above, a charitable contribution deduction will only be allowed for a contribution to a charitable lead trust if the income interest is in the form of a guaranteed annuity or a fixed percentage distributed yearly of the fair market value of the trust property to be determined yearly and the grantor is treated as the owner of such interest for the purposes of applying § 671 of the Code.

a. What is a guaranteed annuity?

Treasury Regulation § 1.170A-6(c)(2)(i) defines a guaranteed annuity interest as follows:

> An income interest is a "guaranteed annuity interest" only if it is an irrevocable right pursuant to the governing instrument of the trust to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term of years or for the life or lives of certain individuals, each of whom must be living at the date of transfer and can be ascertained at such date. Only one or more of the following individuals may be used as measuring lives: the donor, the donor's spouse, and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in section 170, 2055, or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.

Unlike, the CRAT, there is generally no limit as to the amount that is required to be distributed.

b. What is a fixed percentage or unitrust interest?

Treasury Regulation § 1.170A-6(c)(2)(ii) defines a unitrust or fixed percentage amount as follows:

> An income interest is a "unitrust interest" only if it is an irrevocable right pursuant to the governing instrument of the trust to receive payment, not less often than annually, of a fixed percentage of the net fair market value of the trust assets, determined annually. In computing the net fair market value of the trust assets, all assets and liabilities shall be taken into account without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the year or by taking the average of valuations made on more than one date during the year, provided that the same valuation date or dates and valuation methods are used each year. Where the governing instrument of the trust does not specify the valuation date or dates, the trustee shall select such date or dates and shall indicate his selection on the first return on Form 1041 which the trust is required to file. Payments under a unitrust interest may be paid for a specified term of years or for the life or lives of certain individuals, each of whom must be living at the date of transfer and can be ascertained at such date. Only one or more of the following individuals

> may be used as measuring lives: the donor, the donor's spouse, and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in section 170, 2055, or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.

2. Income Taxation of Charitable Lead Trusts

As mentioned above, the income taxation of a charitable lead trust is dependent on whether the charitable lead trust is a grantor or non-grantor trust. If the charitable lead trust is a grantor trust, such that the grantor received a charitable contribution deduction on the contribution to the trust, the grantor will pay the income taxes on the income and gain earned by the trust. [See § 170(f)(2)(B) of the Code]. If the charitable lead trust is a non-grantor trust it will be subject to income tax under Subchapter J of the Code and will be allowed a charitable contribution deduction for the amount contributed to the charity. [See §§ 641 and 642(c) of the Code].

3. Trustee

There are no specific limitations on who may be the trustee of a charitable lead trust. The donor may be the trustee of a charitable lead trust. [See Private Letter Ruling 8237065 and Rev. Proc. 2008-45, 2008-30 I.R.B. 224, § 5.02(5)]. However, if the donor is also the trustee, and if one of the goals of the trust is that the property will not be included in the donor's gross estate for federal estate tax purposes care must be taken to make sure that the trustee does not have any powers that would result in the trust property being included in the donor's estate. [See Rev. Proc. 2008-45, § 5.02(5)].

4. Gift Tax Consequences of Making a Contribution to a Charitable Lead Trust

The normal gift tax rules that apply to charitable contributions apply to gifts made to trusts that qualify as charitable lead trusts. The normal gift tax rules provide that a tax is imposed for each calendar year on the transfer of property by gift during the calendar year. [Section 2501(a) of the Code]. With a gift to a charitable lead trust, though, there may be two gifts, a gift of the income interest and a gift of the remainder interest. If the grantor is the sole non-charitable remainder beneficiary, there will not be a gift of the remainder interest. If anyone other than the grantor will be entitled to receive the

remainder of the trust assets following the charitable term, there will be a gift of that interest. However, if the donor has not fully utilized the unified credit exclusion amount, then no gift tax may be owing. Currently, the unified credit exclusion amount is $5,000,000. The unified credit exclusion amount, however, is scheduled to be reduced to $1,000,000, on January 1, 2013, unless Congress enacts legislation prior to that date.

As to the gift of the lead interest to the charitable organization, a deduction from the gift tax is provided for under Section 2522 of the Code, provided the charitable organization qualifies as a charitable organization under Section 2522 of the Code. [See I.B above for the list of organizations that qualify as charitable organizations for gift tax purposes.]

In some instances the gift tax may apply when a gift is made to a charitable organization for which an income tax deduction is allowed. The most notable exception between "charitable organization" for income tax and "charitable organization" for gift tax purposes is "cemetery corporations". A gift to a cemetery corporation may qualify for a deduction for income tax purposes, but not for gift tax purposes.

5. Estate Tax Consequences of Lifetime Transfers to Charitable Remainder Trusts

If the donor creates a charitable lead trust during lifetime, and if the donor is not one of the non-charitable remainder beneficiaries of the trust, the trust property will not be included in the donor's estate because the donor will not have any interest in the property. If, however, the donor is the non-charitable remainder beneficiary of the charitable lead trust, the value of the trust will be included in the donor's estate for estate tax purposes. [§ 2037 of the Code]. However, as a general rule, the estate will be entitled to a charitable deduction if the charitable lead beneficiary is a qualified public, charitable, or religious organization (i.e., those qualifying as Section 501(c)(3) organizations), the United States, any state, or any political subdivision thereof, or to any veteran's organization. [Code Section 2055]. The value of the deduction will be the value of the remaining lead interest.

C. TESTAMENTARY CONTRIBUTION TO A CHARITABLE LEAD TRUST

As a general rule, the estate tax rules described above concerning lifetime contributions to charitable trusts apply to transfers to charitable lead trusts that take effect as a result of the donor's death. The value of the property will be included in the donor's gross estate. But, the estate will be entitled to a charitable deduction for the value of the lead interest. Again, as pointed out above, care needs to be taken in drafting charitable lead trusts to make sure that the charitable beneficiary qualifies as a charitable beneficiary under Section 2055(e) of the Code, as Section 2055(e) does not include all the organizations in Section 170(c) of the Code.

D. DRAFTING CHARITABLE LEAD TRUSTS

In drafting a charitable lead trust it is advisable to refer to the sample charitable lead trust agreements provided by the IRS in Revenue Procedures, 2007-45, 2007-46, 2008-45, and 2008-46.

VI. CONCLUSION

This provides a basic overview of the income, gift, and estate tax consequences to think about when making a contribution to a charitable organization either outright or in trust. The tax consequences may impact the timing of the contribution, the type of property contributed, or the vehicle to be used outright or in trust.