Charitable Trusts

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I. Charitable Lead Trust - split interest trust that pays an amount to charity during initial term and then assets that remain at end of charitable term are distributed to non-charitable beneficiaries

II. Testamentary Charitable Lead Trusts In General

A. Created under a revocable trust or Will

B. Non-grantor trust because the grantor is deceased at the time the trust is established

C. Assets distributed to one or more charities - must be qualified charities under Internal Revenue Code § 170(c)

D. Amount to charity paid at least annually but may be paid semi-annually, quarterly, monthly, or weekly

E. Payments to charity will be paid for a term specified in the trust

F. Term begins on donor's date of death

G. Term can be based on a term of years or based on a life or the lives of certain individuals (or both)

H. Payments to charity can be equal over the term, can be structured so amount to charity in first year is relatively small and increases gradually over the term of the trust, or can be de minimis in early years with a balloon payment in final year ("Shark-Fin" CLAT) (see Brentmark examples)

I. Charitable lead interest and remainder interest are included in the grantor's estate for estate tax purposes

J. Unlimited estate tax charitable deduction for amount that passes to the charity

K. Assets receive a basis adjustment to fair market value on trustor's (or testator's) date of death

L. Charitable lead unitrust vs. charitable lead annuity trust

III. Income Tax Issues for Charitable Lead Trusts

A. Charitable lead annuity trust taxed as complex trust

B. Charitable income tax deduction for gross income paid to charity

C. If income in excess of annuity amount is paid to charity, trust receives charitable income tax deduction under Internal Revenue Code § 642(c) - it does not receive an additional estate tax charitable deduction

D. Gains from sale or exchange of capital assets may be allocated to income or principal

IV. GST Tax Issues for Charitable Lead Trusts - naming skip persons as remainder beneficiaries

A. Charitable lead unitrust (Internal Revenue Code § 2642(d)) vs. charitable lead annuity trust (Internal Revenue Code § 2642(e))

B. Charitable lead annuity trust - adjusted GST exemption applies and inclusion ratio determined at expiration of charitable lead term

C. Sale or gift of the remainder interest in a charitable lead annuity trust to dynasty trust as to which new transferor's GST exemption is allocated - but see Private Letter Ruling 200107015 in which the IRS ruled there would be two transferors with respect to the assets of the CLAT on the date of the gift of the remainder interest (the GST exemption of the remainder beneficiary who gifted his interest in the CLAT could be allocated only to the present value of the gift of the remainder beneficiary's interest in the CLAT on the date of the gift and the balance of the assets in the CLAT remained with the original transferor subject to the delayed allocation rule)

V. Drafting Considerations

A. Revenue Procedures 2007-45 and 2007-46 - sample charitable lead annuity trust forms

B. Taxable year of the trust must be a calendar year

C. Trust must state that it will pay either unitrust amount or guaranteed annuity

D. If charitable lead annuity trust, annuity must be paid periodically, not less often than annually - for a set term or for the life or lives of certain individuals

E. If term is based on the life or lives of certain individuals, individuals must be living and ascertainable on decedent's death

F. Permissible measuring lives limited to decedent's spouse and individuals who are either a lineal ancestor (or the spouse of a lineal ancestor) of all of the noncharitable remainder beneficiaries

G. Rule against perpetuities - must use a period for vesting of twenty-one years after the deaths of the measuring lives who are selected to maximize, rather than limit, the term of the trust

H. Use of a formula for a zeroed out charitable lead annuity trust - See e.g. Letter Ruling 9840036 (the term of the charitable lead trust was to begin on the date of the surviving trustor's death and end on as many whole years later as necessary to produce an initial value for the remainder interest that would come closest to, but not exceed, the surviving trustor's available GST exemption), Letter Ruling 199927031 (IRS approved the use of a formula if the formula creates a "determinable amount, ascertainable as of the Taxpayer's death"), Private Letter Ruling 9631021 (taxpayer's daughter was granted a limited power of appointment to select which trust, among two charitable lead trusts, would be funded), and Private Letter Ruling 9128051 (assets remaining in the trust on surviving trustor's death passed to a charitable lead trust, but if any descendant of the trustors was living thirty days after the surviving trustor's death, the property passing to the charitable lead trust would not exceed one-half of the gross estate of the surviving trustor reduced by the surviving trustor's debts. The annual annuity was then calculated by a formula contained in the trust)

I. Payment of estate tax from assets used to fund the charitable lead trust should be prohibited

J. A charitable lead trust should likely not include a no-contest clause

K. Payment of annuity before the trust is funded

L. No prepayment of the lead interest - See Revenue Ruling 88-27 - If trustee has discretion to prepay annuity, then charitable interest is not payable over a specified period of time

M. Consider including provision that would reduce or eliminate devise to charitable lead trust

VI. Planning Considerations

A. Is there a better alternative?

B. Does client understand tax and economic effects of prescribed planning?

C. Is client willing to delay child's inheritance?

VII. Funding the Charitable Lead Trust

A. Fund with liquid assets

B. Avoid funding with assets subject to mortgage or lien

C. Consider funding with closely held business interests to leverage the return through the use of discounts, but need to assure that the business produces enough cash flow to satisfy the annuity payment otherwise the trust should be funded with cash in addition to the business interests

VIII. Charitable Remainder Trusts - A trust that initially provides a benefit to an individual with the remainder of the trust being distributed to a charity or charities.

A. Charitable Remainder Annuity Trusts - The IRS has published several revenue rulings with sample language and forms the IRS considers acceptable.

1. Annuity payment must be in an amount not less than 5% of the value of the assets and not more than 50% of the value of the assets.

2. Trust agreement must provide that the trust will pay a "sum certain" not less often than annually to an individual or individuals. A "sum certain" is defined as a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of such period.

3. Trust agreement must provide that if the market value of the property passing to the trust is incorrectly determined by the fiduciary, the trust will pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between: (i) the amount the trust should have paid the recipient if the correct value has been used; and (ii) the amount the trust actually paid the recipient.

4. If the annuity is to be paid to an individual or individuals based on their lifetimes, all of the individuals must be living at the time the trust is created. A named person or persons may include members of a named class provided that, if a class includes any individual, all of the individuals must be alive and ascertainable at the time of the creation of the trust unless the term of the annuity is for a term of years.

5. Annuity payments must be made to the beneficiary, not less often than annually.

6. Annuity term must be for the life of the individual beneficiary or for a term of years (not longer than twenty years).

7. Value of the interest to be distributed to the charitable organization must be at least 10% of the value of the trust.

8. A trust that uses a term based on the life or lives of a named individual or individuals must also meet the 5 percent probability test.

9. No additional contributions may be made to the trust after the initial funding of the trust.

B. Charitable Remainder Unitrusts - A trust that provides for a fixed percentage of the fair market value of the trust assets to be distributed to an individual, and the remainder of the trust is distributed to a charity or charities.

1. Percentage of the trust to be distributed to the individual must be not less than 5% of the value of the assets and not more than 50% of the value of the assets.

2. Distribution to the individual beneficiary must be made not less often than annually.

3. Period for distributions to the individual beneficiary must be for the life or lives of the named beneficiary or beneficiaries or for a term of not more than twenty years.

4. Individual beneficiary must be living on the date the trust is created.

5. Remainder must be distributed to a qualified charity described in section 170(c).

6. Value of the charitable remainder interest must be at least 10% of the net fair market value of the property contributed to the trust on the date the property is contributed.

7. Unitrust may be drafted as a standard unitrust, a net income unitrust, a net income unitrust with a makeup provision, or a "flip" unitrust.

8. A unitrust must either prohibit additional contributions or provide special rules for valuing the unitrust payment in the case of additional contributions to the trust.

C. Additional Drafting Considerations

1. Trust agreement may give the income beneficiary a power of appointment under which the beneficiary could designate the qualified charitable remainder beneficiaries to receive the assets in the trust upon the income beneficiary's death.

2. Trust agreement may permit the grantor to, at any time, substitute another qualified charitable organization as the remainder beneficiary of the trust to replace the charitable organizations originally named in the trust agreement.

3. Grantor may serve as the trustee of the trust, but if the grantor serves as the trustee, the grantor should not retain any powers that would cause the trust to be subject to the grantor trust rules.

4. Trust agreement may give an independent trustee the power to sprinkle the annuity amount among a class of noncharitable beneficiaries.

5. If a trust is the recipient of the annuity amount, the trust agreement must provide for the payment of the annuity amount for a term of years not to exceed 20 years. (But see Revenue Ruling 76-270 which approved a charitable remainder trust that provided for payments of the annuity amount to a second trust that was to be administered solely for the benefit of an incapacitated income beneficiary during his lifetime.)

6. Trust will not be a qualified charitable remainder trust if the trust is subject to a power to invade, amend, or revoke for the benefit of a person other than a qualifying charity.

7. Trust may provide that the term will terminate early upon the occurrence of a "qualified contingency" and the trust assets will distribute early to the charitable remainder beneficiary.

8. If the trust restricts the trustee from investing the assets in the trust in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of the assets in the trust, the trust will not qualify as a charitable remainder trust.

9. Trust provision that states that the assets would be returned to the grantor if the grantor does not receive the desired tax results (e.g. the disallowance of the income tax deduction for the charitable remainder interest) will disqualify the trust.

D. Tax Considerations

1. If transfer is made to a charitable remainder annuity trust or a charitable remainder unitrust during the grantor's lifetime, then the grantor is entitled to an income tax charitable deduction.

2. If transfer is made to a charitable remainder annuity trust or a charitable remainder unitrust during the grantor's lifetime, then the grantor is entitled to a gift tax charitable deduction.

3. A qualified charitable remainder trust is a tax-exempt trust.

4. All or part of the income will be distributed to the beneficiary of the lead interest of the trust, and it will be subject to income tax when distributed to the beneficiary.

5. If the charitable remainder trust is established on the donor's death, the donor's estate is entitled to an estate tax charitable deduction in an amount equal to the fair market value of the charitable remainder interest.