

**DRAFTING CHARITABLE LEAD TRUSTS  
AND  
A LOOK AT THE IRS LEAD TRUST FORMS**

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## I. INTRODUCTION

Charitable lead trusts are valuable planning tools for the charitably inclined donor in our current low interest rate and depressed asset value environment. This outline will review the mathematics and qualification rules of charitable lead trusts and discuss how to use them to advantage.

## II. THE BASICS

- A. A charitable lead trust is the reverse of a charitable remainder trust in the sense that it pays a lead unitrust or annuity trust interest to a charity or charities for a term of years or a life or lives, with the remainder passing to family members.
- B. This is the opposite of the charitable remainder trust which pays the annuity or unitrust interest to non-charitable beneficiaries with the remainder to charity. Because a charitable remainder trust accumulates undistributed income (both ordinary and capital gain) for eventual distribution to charity, the trust itself is tax exempt. That is not the case with a charitable lead trust, which is a taxable trust subject to the usual taxation rules applicable to trusts.

## III. MATH 101

It is easiest to understand the mathematics of the charitable lead trust by learning a few basic formulas. Since most charitable lead trusts will be annuity trusts and since most lead trusts will be for a term of years, the examples assume term of years annuity trusts.

- A. The value of a remainder after term of years can be determined by the following formula:

$$\left(\frac{1}{1+i}\right)^t$$

where  $i$  = the section 7520 rate and  $t$  equals the number of years in the term.

For example, the value of the right to receive \$1 in ten years, assuming an

8 percent interest rate is:

$$\left(\frac{1}{1.08}\right)^{10} = .463193$$

1 divided by 1.08 taken to the tenth power equals .463193.

The value of an income interest is 1 minus the remainder. Therefore, as in the above example, 1 minus .463193 equals .536807.

1. The value of an annuity rather than an income interest – i.e., the right to a fixed dollar amount rather than income – is the value of the income after it is divided by the interest rate. Therefore, with an 8% Section 7520 rate the value of \$1.00 of annuity in the above example would be .536807 divided by .08 or 6.7101. This is the value of \$1.00 of annuity. To calculate the value of a \$100,000 per year annuity I simply take the annuity factor of 6.7101 times \$100,000 which makes the value of the annuity \$671,010. The difference between this and the amount transferred to a charitable lead trust would be the amount of the gift to my remainder beneficiaries.
2. Therefore, if a million dollars were transferred to the trust, the gift to the remainder beneficiaries would be \$328,990.

#### IV. WHY ARE LEAD TRUSTS REQUIRED

- A. Why not permit a person to set up a trust paying income to charity for a number of years with remainder to family and still have the lead interest qualify as a charitable interest for gift and estate tax deduction purposes? The reason is that Congress was concerned that grantors would invest the trust for low income, ignoring the interest of the charitable income beneficiary. Although the tables at the time these rules were enacted assumed a 6% income rate, Congress was worried that grantors would invest to achieve a much lower rate of return, thus overvaluing the charitable interest and undervaluing the interest transferred to family members.
- B. Therefore, since 1969, the rules have required that a charitable lead trust pay an annuity or unitrust interest rather than income interest to the grantor in order to qualify the charitable interest for the gift or estate tax charitable deduction. (As we will see, for income tax purposes, usually no deduction is allowed in any event.)

#### V. ECONOMIC ANALYSIS OF THE CHARITABLE LEAD ANNUITY TRUST

- A. Let us look next at the mathematics of creating charitable lead annuity trusts. As we noted above, the value of a remainder after a term of years is calculated by the following formula:

$$\left(\frac{1}{1+i}\right)^t$$

We converted this to an annuity by subtracting the result from 1 and dividing that result by the interest rate. In an idealized example, let us see how the charitable lead trust would perform in practice if we fund a 10-year lead trust with \$1,000,000. We note that the value of an annuity of

\$1.00 paid for a 10-year term (at an 8% Section 7520 rate) is \$6.7101. How much of an annuity, therefore, do we have to pay to have the retained interest exactly equal the amount in the trust? Or to put it another way, what number multiplied by \$6.7101 would equal \$1,000,000?

$$\$6.7101x = \$1,000,000$$

Therefore, X equals \$1,000,000 divided by \$6.7101 or \$149,029. The following spreadsheet shows that if the trust is invested at 8% and pays out an annuity of \$149,029, with the payment of the final annuity in year 10, the trust would be exhausted.

Year	Opening Balance	Assumed Growth	Annuity	Ending Balance
1	\$1,000,000	\$80,000	(\$149,029)	\$930,971
2	\$930,971	\$74,478	(\$149,029)	\$856,419
3	\$856,419	\$68,513	(\$149,029)	\$775,903
4	\$775,903	\$62,072	(\$149,029)	\$688,945
5	\$688,945	\$55,116	(\$149,029)	\$595,032
6	\$595,032	\$47,603	(\$149,029)	\$493,605
7	\$493,605	\$39,488	(\$149,029)	\$384,063
8	\$384,063	\$30,725	(\$149,029)	\$265,759
9	\$265,759	\$21,261	(\$149,029)	\$137,990
10	\$137,990	\$11,039	(\$149,029)	\$0

If, however, the trust earns 10%, at the end of 10 years, the trust will have \$218,596 remaining, which will pass to the beneficiaries free of all transfer tax.

Year	Opening Balance	Assumed Growth	Annuity	Ending Balance
1	\$1,000,000	\$100,000	(\$149,029)	\$950,971
2	\$950,971	\$95,097	(\$149,029)	\$897,038
3	\$897,038	\$89,704	(\$149,029)	\$837,712
4	\$837,712	\$83,771	(\$149,029)	\$772,454
5	\$772,454	\$77,245	(\$149,029)	\$700,670
6	\$700,670	\$70,067	(\$149,029)	\$621,708
7	\$621,708	\$62,171	(\$149,029)	\$534,849
8	\$534,849	\$53,485	(\$149,029)	\$439,304
9	\$439,304	\$43,930	(\$149,029)	\$334,205
10	\$334,205	\$33,421	(\$149,029)	\$218,596

1. Note that what we are removing from the grantor's estate on a tax-free basis is growth in excess of the Section 7520 rate.
2. As you can see, charitable lead trusts work only if the lead trust investment return is in excess of the Section 7520 rate when the trust is established. If the trust will not outperform the Section 7520 rate, the lead trust is of no

advantage and may even overvalue the gift to the remainder beneficiaries. Charitable lead trusts work best, therefore, when interest rates are relatively low.

3. Note that like a GRAT, a charitable lead trust can be zeroed out with no gift.
4. Usually, lead trusts are set up with annuities as this freezes the amount paid to the charity regardless of the trust's economic performance. Many generous donors find the unitrust attractive as a way of sharing the wealth with the charity, however. If analyzed on the basis of how much it costs the family to get each dollar to charity, a charitable lead unitrust can sometimes offer an attractive alternative. When the lead trust is expressed as an annuity, it is most typical, as with GRATS, to express the annuity as a fixed percentage of finely determined fair market value of the a contribution to the trust so it can adjust with changes in finely determined value. This is very useful in the case of hard to value assets.

## VI. BASIC REQUIREMENTS

- A. As noted above, the payment must be in the form of an annuity or unitrust interest. Although the regulations include detailed drafting requirements for charitable remainder unitrust and annuity trusts, there is relatively little regulatory guidance for charitable lead trusts, and many of the requirements applicable to remainder trusts will not apply to lead trusts.
  1. For example, there is no requirement that the payout be at least 5% of the initial fair market value (in the case of an annuity trust) or 5% of the fair market value as revalued annually (in the case of a unitrust).
    - a. This makes sense, given the purpose of the 5% payout requirement for remainder trusts, namely, to prevent circumvention of the private foundation rules.
  2. Note that unless the specific requirements, such as they are, are met, no income, gift or estate tax deduction will be available for transfers to a charitable lead trust.

## VII. OTHER REQUIREMENTS

- A. The payments must be made at least annually and may be made in periodic intervals. Again, unlike the requirements for a charitable remainder trust, there is no requirement that a term of years trust be limited to 20. This is another case in which the requirements are different.

- B. The private foundation excise taxes generally applicable to private foundations apply to charitable lead trusts.
1. A special rule applies in the case of excess business holdings and jeopardy investments. In those cases, the sections do not apply unless the value of the lead interest exceeds 60% of the aggregate value of the trust assets.
  2. In the so-called “ghoul” or “vulture” trust, the term of the charitable lead trust is fixed to the life of an individual with reduced mortality (but not so reduced that the mortality tables are inapplicable) but whose age under the tables would produce a much greater valuation for the lead interest. This valuation abuse was first dealt with in proposed regulations issued in October and made final on January 4, 2001. The proposed regulations provided that the only persons who could be used as measuring lives for a charitable lead trust were the donor, the donor’s spouse or a lineal ancestor of the remainder beneficiaries. The final regulations expand this class so that individuals who are lineal ancestors or spouses of lineal ancestors of beneficiaries may be used as measuring lives. The final regulations also add an actuarial safe harbor so that remainder beneficiaries with less than a 15% probability of receiving the trust remainder may be measuring lives. Collateral family members such as nieces and nephews can, therefore, be contingent beneficiaries under this more generous rule.

### VIII. CHARITABLE BENEFICIARIES

The charitable beneficiaries can be public charities or private foundations, and the non-charitable beneficiaries may be individuals or entities.

- A. In the case of an inter vivos charitable lead trust, special cautions are in order in two respects:
1. First, the donor should not retain the power to select charitable beneficiaries. This will cause inclusion in the estate for federal estate tax purposes.
  2. Second, if the beneficiary is a private foundation of which the grantor is a director, this power indirectly to control charitable beneficiaries is also a power which will cause estate tax inclusion. See Estate of Revson v. United States, 5 Cl. Ct. (1984). See also Rev. Rul. 72 -552, 1972-2C.B. 525. In a number of private letter rulings, the Internal Revenue Service has ruled that charitable lead trusts will not be includible in the estate even where paid to a private foundation of which the grantor is a trustee, so long as those funds are isolated and the grantor does not participate in decisions as to distribution of those funds. A possible solution which should work is a distribution to a donor-advised fund at a community

foundation. Since the donor's only powers are to make non-binding suggestions, the retention of this power should be permissible even though the donor is an advisor to the donor-advised fund.

#### IX. INCOME TAXATION OF CHARITABLE LEAD TRUSTS

- A. The most typical kind of charitable lead trust, the non-grantor type, is subject to the regular rules of income taxation of subchapter J of the Code. To the extent income is distributed to charity, it is deductible under section 642(c), which permits trusts a deduction for distributions to charity from gross income.
- B. Under a special rule, the deduction can be taken for a current year even if the payment is made in a subsequent year if the trustee makes an election under section 642(c)(1). No set-aside deduction is permitted for charitable lead trusts as it is, for example, for estates or for revocable trusts which make an election to be treated as estates pursuant to Code section 645.
- C. The tier system applicable to charitable remainder trusts has no counterpart in the taxation of charitable lead trusts which, as noted above, are taxed like all other taxable trusts under subchapter J. Many charitable lead trusts provide that payments from the lead trust will be made in the least desirable form first so that there is no question as to the nature of the income being distributed. Therefore, ordering provisions in many charitable lead trusts provide that income is distributed first from ordinary income, then from capital gains, then from unrelated business income, then from tax-exempt income, and finally from trust corpus.
- D. If a trust makes distribution in kind in satisfaction of a pecuniary amount, as will often be the case where distributions of appreciated property are made in satisfaction of the lead payment, the income realized on satisfaction of the pecuniary obligation will be carried out under 642(c) and be deductible by the trust.

#### X. SOME TECHNICAL REQUIREMENTS

- A. Commutation clauses. Commutation clauses would be very useful in a charitable lead trust because they would allow prepayment of the lead interest at a time when interest rates are high, thus depressing the value of the charitable lead annuity interest. Because of this "self selection" ability of donors to take advantage of shifting interest rates, the Internal Revenue Service in Rev. Rul. 88-27, 1988-1 C.B. 331 ruled that commutation clauses would disqualify charitable lead trusts. A charitable lead trust must therefore prohibit prepayment of the lead interest. Note however that Private Letter Ruling 9844027 permitted a prepayment in full (without discount) of the lead interest. There is no policy reason such a

prepayment in full should not be permitted—but the IRS sample declarations of trust simply prohibit prepayment.

- B. More on Private Foundation Restrictions. As noted above, the private foundation excise tax rules in sections 4940 et. seq. apply to a charitable lead trust, except in some cases the excess business holdings and jeopardy investment restrictions of sections 4943 and 4944. Those sections apply only if the actuarial value of the charitable lead interest is less than 60% of the value of all interests in the trust, valued as of the inception of the trust. An excess business holding is defined as, including, among other things, an interest in a business enterprise only to the extent that the foundation and all disqualified persons own in the aggregate more than 20% of the voting stock. Note that even in cases where the interest is an excess business holding, a business interest received by gift or bequest can be held for up to 5 years after acquisition.

## XI. GRANTOR LEAD TRUSTS

- A. Most inter vivos lead trusts will be of the non-grantor type. In the typical non-grantor inter vivos lead trust, the grantor does not retain powers over the trust which would cause it to be owned by the grantor for income tax purposes. In the case of a non-grantor type lead trust created during lifetime, no income tax deduction is available.
1. That is because Internal Revenue Code section 170(f)(B) provides that no deduction is allowed for the value of any interest in property other than a remainder interest transferred in trust unless the interest is in the form of a guaranteed annuity [or unitrust interest] and the grantor is treated as the owner of such interest for purposes of applying section 671.
  2. The policy reason a donor is not allowed an income tax deduction is that in the case of a non-grantor trust, the donor is not taxed on the income in the trust. As a general rule of tax law, taxpayers are not allowed to deduct from income amounts which have never been included in income in the first place. The one great exception to this rule is the allowance of a deduction for the full fair market value of appreciated long-term capital gain property given to a public charity. In that case, the deduction is allowed for the unrealized capital gains even though the capital gains are not required to be taken into income. This policy reason for denying the income tax deduction is the same reason that a donor who permits a charity to use property rent-free does not receive an income tax deduction. If the donor were paid the rent by the charity and then endorsed the rent check back to the charity, the result would be a wash, which is the same result if no deduction is allowed in the first place and nothing is included in income.

3. In the case of a grantor lead trust, where the grantor retains powers which cause the trust to be treated as though owned by the grantor for income tax purposes, the grantor is allowed a deduction the year the trust is established for the actuarial value of the annuity or unitrust income stream to be paid to the charity. The downside of getting the deduction is that during the lifetime of the trust, the grantor will be taxed on the income of the trust even though the grantor does not receive the income. Still, this can be a useful technique for accelerating a charitable deduction into the year in which the grantor has unusually high income.
  - a. For example, a grantor who makes \$100,000 of charitable gifts each year anyway and who has a large gain from the sale of a business in a particular year may wish to establish a charitable lead trust that year to accelerate the deduction for the gifts he will be making anyway in future into the current year.
  - b. Because the gift is “for the use of” a charity rather than a gift to charity, the percentage limitation would be 30% rather than 50% even for cash gifts. Because of the uncertainties spawned by Private Letter Ruling 8824039, it is not clear that the unused part of the deduction is eligible for the 5-year carryover, although this is uncertain.
4. If the trust is a grantor trust, the trust is simply ignored for all income tax purposes and the income is directly taxable to the grantor. The charitable deduction for distributions made to charities in future years, however, will not be allowed since the donor has received a deduction for the discounted value of the income stream in year one.
  - a. Note that section 170(f)(2)(B) requires that the grantor be treated as the owner of the income stream, but does not require that the grantor be treated as the owner of the trust corpus. Most grantor lead trusts are structured so the grantor is treated as the owner of the entire trust, but this is not a requirement.
  - b. One advantage of the grantor lead trust, in addition, is that if the trust has unrelated business income, the denial of the section 642(c) deduction by section 681 will not apply. Private foundation rules, however, do apply to a grantor lead trust.
5. Note what happens if the grantor trust status ends. Remember that the price of getting the up front charitable deduction was taxation on the trust income during the term. If the grantor trust status should end prematurely, however, the grantor will never have picked up the income for the unexpired portion of the term. Therefore, if the grantor trust status ends

for any reason, including the death of the grantor, the unrealized income for the rest of the term is immediately accelerated and picked up in the donor's taxable income. The amount of this additional tax, pursuant to section 170(f)(2)(B), is an amount of income equal to the amount of any deduction received for the contribution reduced by the discounted value of all amounts of income earned by the trust and taxable to the grantor before the time at which the grantor trust status ends. The amounts of income are to be discounted to the date of contribution. See Reg. § 1.170A-6(c)(4).

- B. It is critical in the case of a grantor lead trust (which, by definition, will always be an inter vivos trust) that the powers used to cause grantor trust status not also cause estate tax inclusion. In addition, as noted earlier, some powers which will not cause grantor trust status for income tax purposes will cause estate tax inclusion, such as a right to select charitable beneficiaries or to determine, in the capacity of a director of a foundation, how funds distributed from a lead trust to the foundation will be further distributed.
- C. The grantor lead trust has one other advantage from a transfer tax standpoint. Since the grantor will be taxed on income not received, additional amounts will be removed from the grantor's estate by virtue of the fact that the grantor will be paying someone else's income tax liability. However, this needs to be weighed against the fact that if the trust were able to deduct all of its income in payment of the lead amount, no income tax might be payable. This comparison must take into account the income generated by the trust versus the amount expected to be paid in lead payments. The grantor type lead trust has another disadvantage: use of appreciated property to satisfy the annuity obligation will trigger gain at the grantor level. See, e.g., Rev. Proc. 2007-45, section 8.02(2) and PLR 200920031.
- D. 200747001 shows some clever use of grantor trust planning. The ruling involved a charitable lead annuity trust with a 5-year term, at which time the trust terminated in favor of descendants. Because the trust was to be funded with stock of an S corporation, the grantors wanted the trust to be a grantor trust for income tax purposes. Since most of the powers we normally use to invoke grantor trust treatment would be self dealing if used in a lead trust the drafters used a power in a non-adverse party to distribute trust assets to charitable organizations rather than descendants at the end of the term. In default of exercise the trust would terminate in favor of descendants. Why doesn't the 674(b)(4) exception to allocate among charitable beneficiaries prevent grantor trust treatment? Because that exception only applies if the corpus or income is irrevocably payable for charitable purposes. (That is the exception that keeps a donor's private foundation from being a grantor trust if the donor is the trustee.) Then the Service went on to note—citing section 674(b)(2)—that the trust would still not be a grantor trust unless the power would be one which would cause the grantor to be treated as the owner of the trust under section 673 if the grantor had a reversionary interest. The Service calculated that the actuarial value of the assets remaining at

the end of the trust term would exceed 5% of the value of the assets contributed to the trust.<sup>1</sup> Two things in this ruling are worth remembering. First, the exception in section 674(b)(4) to allocate among charitable beneficiaries does not apply if a class of charitable beneficiaries can be added in place of non-charitable beneficiaries, because of the requirement that income or corpus be irrevocably dedicated to charity. Second, you can't just stop there – if the trust term were long enough, the 673 exception in section 674(b)(2) would still keep this from being a grantor trust. One's initial reaction might be “Why bother to look at that section since there is no reversion at all in this trust.”

As noted later in this outline, the Rev. Proc. pro forma's use of a substitution power is a lot simpler. Since the ruling request was undoubtedly submitted before the Rev. Proc. came out, I suspect the drafters were afraid to use the swap power for fear that the word “reacquire” would keep 675(4) from applying if the swap power were held by someone other than the grantor—a fear finally put to rest by the Rev. Proc.

## XII. NON-GRANTOR LEAD TRUSTS

Charitable lead trusts created at death will always, by definition, be of the non-grantor type. Charitable lead trusts created during lifetime may or may not be grantor lead trusts, as noted above. Many donors do not like the idea of being taxed on income they do not receive, and this is mostly appropriate as a way of accelerating a deduction into high tax bracket years. Non-grantor lead trusts have an additional useful application, namely a way of avoiding income tax percentage limitations for the especially generous donor. Some donors, either because they are very generous or because they have little taxable income because of investments in municipal bonds cannot deduct all of their contributions to charity. One solution is the non-grantor type lead trust. This does not generate a deduction, but the grantor is not taxed on the income, resulting in a wash. But a wash is the same result as if the donor were taxed on the income and then received a 100% offsetting charitable deduction. This is a very useful application of the non-grantor lead trust.

## XIII. GENERATION SKIPPING CONSIDERATIONS

The generation skipping treatment of charitable lead trusts is complex, in part because Chapter 13 treats charitable lead unitrusts and charitable lead annuity trusts differently.

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<sup>1</sup> There is one puzzling comment in the ruling. The Service notes that the applicable federal rate would make the trust a grantor trust if the trust is funded in that month or the following two months, but goes on to say that the ruling is subject “to the condition that husband and wife have an annuity amount (based on the section 7520 calculation) such that the present value of the assets remaining at the end of the trust term is greater than 5% of the amount contributed to the trust.” But of course the grantors do not have any annuity amount so this is obviously a mistake.

For purposes of computing exclusion ratio in charitable lead unitrusts, the basic rule of section 2642(d) applies. The numerator of the applicable fraction is the amount of generation skipping tax exemption allocated, and the denominator is the amount transferred to the trust less federal estate or state death tax actually recovered from the property and less any deduction allowed. Thus, with a charitable lead unitrust, it is possible to know at the creation of the trust whether the distribution at termination will be fully covered by generation skipping tax exemption. In the case of a charitable lead annuity trust, however, amendments made in 1987 provide a special rule in section 2642(e) for lead annuity trusts. In that case, the numerator is the amount of GST exemption allocated to the trust, but increased at the section 7520 rate used to value the charitable deduction for the actual period of the term of the annuity trust. The denominator is the amount actually in the trust upon termination of the annuity interest. Thus, because it is unknown at the time the trust is created how well the trust's investments will perform, it is not possible to know in advance what the final treatment of the distribution will be.

Fortunately, one problem has been fixed permanently. Take this case based on an actual situation: Donor has no children and his primary beneficiary is a child of a deceased niece. Before the law was fixed, if the donor created a testamentary charitable lead trust terminating in favor of the child of the deceased niece, distribution of the trust assets to the great-niece on termination would be a generation skipping transfer (a taxable distribution) even though a straight outright bequest at death to the great-niece would not have been. This was because, first, the predeceased child exception did not apply to non-lineal descendants and, second, because the predeceased child exception applied only to direct skips and not to taxable terminations. This problem has been fixed in two ways. First, section 2651(e) was added to the Code for terminations, distributions and transfers occurring after December 31, 1997. Before the 1997 Act revision, the Code, in section 2612(c), provided only that direct skips to grandchildren were exempt where the parent of the grandchild was deceased. Section 2651(e) applies the predeceased child exception to taxable terminations as well as to direct skips and, in addition, extends the predeceased child protection to collateral heirs – i.e., child of deceased nieces and nephews – so long as the transferor has no lineal living descendants. This will be very useful with charitable lead trusts, which are always treated as taxable terminations rather than direct skips.

#### XIV. IRS SAMPLE DECLARATIONS OF TRUST

In June, 2007, the Internal Revenue Service issued sample charitable lead annuity trusts. (Sample lead unitrusts will undoubtedly follow.) The forms provided in Rev. Procs. 2007-45 and 46 are, respectively, inter vivos charitable lead annuity trusts (both grantor and non-grantor type) and a testamentary charitable lead annuity trust.

- A. Inter Vivos Lead Annuity Trust Form. The inter vivos form includes options both for a non-grantor CLAT and a grantor CLAT and the introductory material notes that the income tax consequences are different for each as more fully discussed in the above outline. As with the charitable remainder unitrust and annuity trust forms, the Service noted that generally the service will not issue a letter ruling on whether a charitable lead annuity trust qualifies for income, estate and/or gift tax

charitable deductions, but will generally issue rulings related to the tax consequences of inclusion in a CLAT of a substantive trust provision different from those set forth in the revenue procedure. A form not following the IRS form does not necessarily fail to qualify, but will not be eligible for the safe harbor.

- B. Sample Inter Vivos Non-Grantor Charitable Lead Annuity Trust. The sample inter vivos non-grantor charitable lead annuity trust is straightforward and does not have the interesting grantor trust issues of the grantor lead trust. The default provision states the annuity in terms of a percentage of the initial fair market value, which provides protection against faulty evaluations if what is contributed to the trust is not marketable securities or cash.

Note several things about the form. Probably the most interesting is the discussion in the annotations of a qualifying annuity. The annotation says the following in describing an 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 one or more measuring lives. See section 5.02(4) for a discussion of the permissible term of a nongrantor CLAT. An amount is determinable if the exact amount that must be paid under the conditions specified in the instrument of transfer may be ascertained at the time of the transfer to the trust.

This language has made possible the so-called shark-fin CLAT, with payments that follow any fixed payment schedule. Unlike a GRAT, payments could increase by more than 20% a year, or could be very small at first with a balloon at the end. Commercial software has already incorporated this important feature which will be a basic part of future lead trust planning.

The form provides specifically that no person can hold any power that would cause the donor to be treated as owner of any portion of the trust for income tax purposes. Retention of the power to designate charities would not be a faulty power for income tax purposes because of section 674(b)(4), although such a power would cause estate tax inclusion under section 2036.

The annotations note that the trust is a complex trust under subchapter J of the Code. And note specifically that income paid to charity is deductible under section 642(c)(1). Annotations further note that the income will be deductible even if paid to a foreign charity.

The annotations remind us that an annuity expressed as the right to receive an annual payment equal to the lesser of a sum certain or a fixed percentage of the trust assets (determined annually) is not a guaranteed annuity interest. Since that

sounds more like a unitrust than an annuity trust payment, this comment is puzzling.

The annotations note that a trust will not be qualified if the trustee has the discretion to “commute and prepay” the charitable interest prior to termination of the annuity. As noted above, prepayment without discount should be permitted and the Service has previously so ruled by private letter ruling.

The annotations note that CLATs are not subject to minimum or maximum payout requirements – unlike charitable remainder trusts. The payout can be less than five percent or more than fifty percent. In connection with the payout, the annotations note that as per Rev. Rul. 83-75, 1983-1 C.B. 114, gain realized on satisfaction of the annuity with appreciated property will be deductible under section 642(c)(1).

Where a measuring life is used rather than a term of years, the annotations note that only the donor, the donor’s spouse or an individual who is a lineal ancestor or spouse of a lineal ancestor of the beneficiary may be used as a descendant of the remainder beneficiary who is ineligible as a measuring life.

The annotations note that if the donor is serving as trustee and retains the power to select the charitable beneficiaries, the gift will be incomplete for gift tax purposes. This is clearly correct. However, the comment goes on to note that such a power may cause some or all of the trust property to be included in the donor’s gross estate. This is odd – I would have thought there is no question that such a power will cause estate tax inclusion as per the Revson case discussed above. In fact, the annotation discusses the very situation involved in Revson and notes that if the donor-trustee is an officer or director of the private foundation and possesses authority to make charitable distribution, some or all of the trust property may (rather than will) be included in the donor’s gross estate.

The annotations note that although the sample trust provides for retention of excess income by the trust (where it will be taxable) the governing instrument may instead provide that the excess income may be distributed to the charitable beneficiary. No additional estate or gift tax deduction will be allowed, but the income will at least not be subject to tax.

- C. Sample Inter Vivos Grantor Charitable Lead Annuity Trust. Many of the provisions are, of course, the same as in the non-grantor form. But the most interesting aspect of the grantor trust form is the selection of the particular grantor trust power used to trigger grantor trust treatment. This is not an easy choice because many of the powers which we normally use to invoke grantor trust treatment would be self-dealing transactions if used in a charitable lead trust – such as the donor’s right to borrow from the trust or to substitute assets. The IRS form triggers grantor trust treatment by using a section 675(4) substitution power

held by a person other than the donor, the trustee, or a disqualified person as defined in section 4949(a)(1) which is exercisable only in a non-fiduciary capacity. This answers the question many of us have worried about for a long time – whether the use of the word “reacquire” in section 675(4) means that only the grantor can trigger grantor trust treatment with a substitution power. The annotation seems to put that issue to rest and is good authority for using this power in other contexts.

XV. SAMPLE TESTAMENTARY CHARITABLE LEAD ANNUITY TRUSTS.

The testamentary form is much simpler since we don't have to worry either about gift tax or grantor trust issues and the comments regarding the non-grantor inter vivos trust above will be generally relevant to the testamentary form.

## Sample Inter Vivos Nongrantor Charitable Lead Annuity Trust

On this \_\_\_\_ day of \_\_\_\_\_, 20 \_\_, I, \_\_\_\_\_ (hereinafter “ the Donor” ), desiring to establish a charitable lead annuity trust within the meaning of Rev. Proc. 2007-45, hereby enter into this trust agreement with \_\_\_\_\_ as the initial trustee (hereinafter “ the Trustee” ). This trust shall be known as the \_\_\_\_\_ Nongrantor Charitable Lead Annuity Trust. All references to “ section” or “ § ” in this instrument shall refer to the Internal Revenue Code of 1986, 26 U.S.C. § 1, et seq.

1. Funding of Trust. The Donor hereby transfers and irrevocably assigns to the Trustee on the above date the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property under the terms set forth in this trust instrument.

2. Payment of Annuity Amount. In each taxable year of the trust during the annuity period, the Trustee shall pay to [designated charitable recipient ] an annuity amount equal to [number representing the annual annuity percentage to be paid to the designated charitable recipient] percent of the initial net fair market value of all property transferred to the trust, valued as of the date of the transfer. If [designated charitable recipient] is not an organization described in § § 170(c), 2055(a), and 2522(a) at the time any payment is to be made to it, the Trustee shall instead distribute such payments to one or more organizations described in § § 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in such proportions as the Trustee shall decide, from time to time, in the Trustee's sole discretion. The term “ the Charitable Organization” shall be used herein to refer collectively to the organization(s) then constituting the charitable recipient, whether named in this paragraph or subsequently selected as the substitute charitable recipient. During the trust term, no payment shall be made to any person other than the Charitable Organization. The annuity period is a term of [number of years of annuity period] years. The first day of the annuity period shall be the date the property is transferred to the trust, and the last day of the annuity period shall be the day preceding the [ordinal number corresponding to the length of the annuity period] anniversary of that date. The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Charitable Organization (in the case of an undervaluation) or receive from the Charitable Organization (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

3. Proration of Annuity Amount. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. In the taxable year in which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

4. Distribution Upon Termination of Annuity Period. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due to the Charitable Organization under the provisions above) to [remainder beneficiary ].

5. Additional Contributions. No additional contributions shall be made to the trust after the initial contribution.

6. Prohibited Transactions. The Trustee shall not engage in any act of self-dealing within the meaning of § 4941(d), as modified by § 4947(a)(2), and shall not make any taxable expenditures within the meaning of § 4945(d), as modified by § 4947(a)(2). The Trustee shall not retain any excess business holdings that would subject the trust to tax under § 4943, as modified by § § 4947(a)(2) and 4947(b)(3). In addition, the Trustee shall not acquire any assets that would subject the trust to tax under § 4944, as modified by § § 4947(a)(2) and 4947(b)(3), or retain assets which, if acquired by the Trustee, would subject the Trustee to tax under § 4944, as modified by § § 4947(a)(2) and 4947(b)(3).

7. Taxable Year. The taxable year of the trust shall be the calendar year.

8. Governing Law. The operation of the trust shall be governed by the laws of the State of \_\_\_\_\_ . However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the requirements for the charitable deductions available to a charitable lead annuity trust or for contributions to a charitable lead annuity trust.

9. Limited Power of Amendment. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the annuity interest passing to the Charitable Organization is a guaranteed annuity interest under § § 2055(e)(2)(B) and 2522(c)(2)(B) and the regulations thereunder and that payments of the annuity amount to the Charitable Organization will be deductible from the gross income of the trust to the extent provided by § 642(c)(1) and the regulations thereunder.

10. Investment of Trust Assets. Except as provided in paragraph 6 herein, nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

11. Retained Powers and Interests. Notwithstanding any other provision of this trust instrument to the contrary, no person shall hold any power or possess any interest that would cause the Donor to be treated as the owner of any portion of the trust under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Internal Revenue Code.

[Signature block]

## Sample Inter Vivos Grantor Charitable Lead Annuity Trust

On this \_\_\_\_ day of \_\_\_\_\_, 20\_\_, I, \_\_\_\_\_ (hereinafter “ the Donor” ), desiring to establish a charitable lead annuity trust within the meaning of Rev. Proc. 2007-45 hereby enter into this trust agreement with \_\_\_\_\_ as the initial trustee (hereinafter “ the Trustee” ). This trust shall be known as the \_\_\_\_\_ Grantor Charitable Lead Annuity Trust. All references to “ section” or “ § ” in this instrument shall refer to the Internal Revenue Code of 1986, 26 U.S.C. § 1, et seq.

1. Funding of Trust. The Donor hereby transfers and irrevocably assigns to the Trustee on the above date, the property described in Schedule A, and the Trustee accepts the property and agrees to hold, manage, and distribute the property under the terms set forth in this trust instrument.

2. Payment of Annuity Amount. In each taxable year of the trust during the annuity period, the Trustee shall pay to [designated charitable recipient ] an annuity amount equal to [number representing the annual annuity percentage to be paid to the designated charitable recipient] percent of the initial net fair market value of all property transferred to the trust, valued as of the date of the transfer. If [designated charitable recipient] is not an organization described in § § 170(c), 2055(a), and 2522(a) at the time any payment is to be made to it, the Trustee shall instead distribute such payments to one or more organizations described in § § 170(c), 2055(a), and 2522(a) as the Trustee shall select, and in such proportions as the Trustee shall decide, from time to time, in the Trustee's sole discretion. The term “ the Charitable Organization” shall be used herein to refer collectively to the organization(s) then constituting the charitable recipient, whether named in this paragraph or subsequently selected as the substitute charitable recipient. During the trust term, no payment shall be made to any person other than the Charitable Organization. The annuity period is a term of [number of years of annuity period] years. The first day of the annuity period shall be the date the property is transferred to the trust, and the last day of the annuity period shall be the day preceding the [ordinal number corresponding to the length of the annuity period] anniversary of that date. The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal tax purposes, the Trustee shall pay to the Charitable Organization (in the case of an undervaluation) or receive from the Charitable Organization (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

3. Proration of Annuity Amount. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. In the taxable year in which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

4. Distribution Upon Termination of Annuity Period. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due to the Charitable Organization under the provisions above) to [remainder beneficiary ].

5. Additional Contributions. No additional contributions shall be made to the trust after the initial contribution.

6. Prohibited Transactions. The Trustee shall not engage in any act of self-dealing within the meaning of § 4941(d), as modified by § 4947(a)(2), and shall not make any taxable expenditures within the meaning of § 4945(d), as modified by § 4947(a)(2). The Trustee shall not retain any excess business holdings that would subject the trust to tax under § 4943, as modified by § § 4947(a)(2) and 4947(b)(3). In addition, the Trustee shall not acquire any assets that would subject the trust to tax under § 4944, as modified by § § 4947(a)(2) and 4947(b)(3), or retain assets which, if acquired by the Trustee, would subject the Trustee to tax under § 4944, as modified by § § 4947(a)(2) and 4947(b)(3).

7. Taxable Year. The taxable year of the trust shall be the calendar year.

8. Governing Law. The operation of the trust shall be governed by the laws of the State of \_\_\_\_\_ . However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the requirements for the charitable deductions available for contributions to a charitable lead annuity trust.

9. Limited Power of Amendment. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the annuity interest passing to the Charitable Organization is a guaranteed annuity interest under § § 170(f)(2)(B), 2055(e)(2)(B), and 2522(c)(2)(B) and the regulations thereunder.

10. Investment of Trust Assets. Except as provided in paragraph 6 herein, nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

11. Retained Powers and Interests. During the Donor's life, [individual other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1)] shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value.

[Signature block]

## Sample Testamentary Charitable Lead Annuity Trust

I give, devise, and bequeath [property bequeathed] to my Trustee in trust to be administered under this provision. I intend this bequest to establish a charitable lead annuity trust, within the meaning of Rev. Proc. 2007-46. This trust shall be known as the \_\_\_\_\_ Charitable Lead Annuity Trust, and I hereby designate \_\_\_\_\_ as the initial trustee (hereinafter “ the Trustee” ). All references to “ section” or “ § ” in this instrument shall refer to the Internal Revenue Code of 1986, 26 U.S.C. § 1, et seq.

1. Payment of Annuity Amount. In each taxable year of the trust during the annuity period, the Trustee shall pay to [designated charitable recipient] an annuity amount equal to [number representing the annual annuity percentage to be paid to the designated charitable recipient] percent of the initial net fair market value of all property passing to this trust, as finally determined for federal estate tax purposes. If [designated charitable recipient] is not an organization described in § § 170(c) and 2055(a) at the time any payment is to be made to it, the Trustee shall instead distribute such payments to one or more organizations described in § § 170(c) and 2055(a) as the Trustee shall select, and in such proportions as the Trustee shall decide, from time to time, in the Trustee's sole discretion. The term “ the Charitable Organization” shall be used herein to refer collectively to the organization(s) then constituting the charitable recipient, whether named in this paragraph or subsequently selected as the substitute charitable recipient. During the trust term, no payment shall be made to any person other than the Charitable Organization. The annuity period is a term of [number of years of annuity period] years. The first day of the annuity period shall be the date of my death, and the last day of the annuity period shall be the day preceding the [ordinal number corresponding to the length of the annuity period] anniversary of that date. The annuity amount shall be paid in equal quarterly installments at the end of each calendar quarter from income and, to the extent income is not sufficient, from principal. Any income of the trust for a taxable year in excess of the annuity amount shall be added to principal. If the initial net fair market value of the trust assets is incorrectly determined, then within a reasonable period after the value is finally determined for federal estate tax purposes, the Trustee shall pay to the Charitable Organization (in the case of an undervaluation) or receive from the Charitable Organization (in the case of an overvaluation) an amount equal to the difference between the annuity amount(s) properly payable and the annuity amount(s) actually paid.

2. Deferral Provision. The obligation to pay the annuity amount shall commence with the date of my death, but payment of the annuity amount may be deferred from this date until the end of the taxable year in which the trust is completely funded. Within a reasonable time after the end of the taxable year in which the trust is completely funded, the Trustee must pay to the Charitable Organization the difference between any annuity amounts actually paid and the annuity amounts payable, plus interest. The interest for any period shall be computed at the § 7520 rate of interest in effect for the date of my death. All interest shall be compounded annually.

3. Proration of Annuity Amount. The Trustee shall prorate the annuity amount on a daily basis for any short taxable year. In the taxable year in which the annuity period ends, the Trustee shall prorate the annuity amount on a daily basis for the number of days of the annuity period in that taxable year.

4. Distribution Upon Termination of Annuity Period. At the termination of the annuity period, the Trustee shall distribute all of the then principal and income of the trust (other than any amount due to the Charitable Organization under the provisions above) to [remainder beneficiary ].

5. Additional Contributions. No additional contributions shall be made to the trust after the initial contribution. The initial contribution, however, shall be deemed to consist of all property passing to the trust by reason of my death.

6. Prohibited Transactions. The Trustee shall not engage in any act of self-dealing within the meaning of § 4941(d), as modified by § 4947(a)(2), and shall not make any taxable expenditures within the meaning of § 4945(d), as modified by § 4947(a)(2). The Trustee shall not retain any excess business holdings that would subject the trust to tax under § 4943, as modified by § § 4947(a)(2) and 4947(b)(3). In addition, the Trustee shall not acquire any assets that would subject the trust to tax under § 4944, as modified by § § 4947(a)(2) and 4947(b)(3), or retain assets which, if acquired by the Trustee, would subject the Trustee to tax under § 4944, as modified by § § 4947(a)(2) and 4947(b)(3).

7. Taxable Year. The taxable year of the trust shall be the calendar year.

8. Governing Law. The operation of the trust shall be governed by the laws of the State of \_\_\_\_\_. However, the Trustee is prohibited from exercising any power or discretion granted under said laws that would be inconsistent with the requirements for the charitable deductions available to a charitable lead annuity trust or for contributions to a charitable lead annuity trust.

9. Limited Power of Amendment. This trust is irrevocable. However, the Trustee shall have the power, acting alone, to amend the trust from time to time in any manner required for the sole purpose of ensuring that the annuity interest passing to the Charitable Organization is a guaranteed annuity interest under § 2055(e)(2)(B) and the regulations thereunder and that payments of the annuity amount to the Charitable Organization will be deductible from the gross income of the trust to the extent provided by § 642(c)(1) and the regulations thereunder.

10. Investment of Trust Assets. Except as provided in paragraph 6 herein, nothing in this trust instrument shall be construed to restrict the Trustee from investing the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

[Signature block]