Addendum

**Significant developments after outline went to press
and up to July 24, 2007**

CURRENT DEVELOPMENTS IN CHARITABLE GIVING

by

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Addendum

PATENT (AND LAWSUIT?) PENDING—GIFT PLANNERS CAVEAT

It's no secret that clever tax lawyers and accountants can invent new tax-saving strategies. In recent years, some of them have actually patented their tax-strategies.

One more thing on top of which to stay. (You won't catch me ending a sentence with a preposition.) Tax lawyers, in addition to keeping up with the ever-changing laws, have to be sure that advice given to clients doesn't infringe a tax-strategy patent. It's no defense that the lawyer was unaware of the patent and came up with the strategy on his or her own. So granted patents and patent applications will have to be researched.

Who will get sued if a tax patent is infringed? Generally, the client. (Presumably, the client could then sue his or her tax adviser.) The tax adviser, however, can be sued by the patent holder if the adviser induced or encouraged patent infringement.

Recently John Rowe, Aetna Inc.'s CEO, was sued for patent infringement when as a lawyer's client he funded grantor retained annuity trusts (GRATs) involving stock options (SOGRATs). The case has been settled.

Patent litigation isn't cheap. So even if it turns out that a tax-strategy patent doesn't cover a client's situation or even if the patent was improperly granted, the existence of a patent can have a so-called chilling effect on using a fancy tax plan.

The American Bar Association is concerned about tax-strategy patents and is studying the issue. And the American Institute of Certified Public Accountants is urging Congress to restrict the issuance of tax patents or to render them unenforceable against clients and their advisers (tantamount to nullifying the patents).

Meanwhile. Senators Carl Levin (D-MI), Barack Obama (D-IL) and Norm Coleman (R-MN) have introduced S. 681 that wouldn't allow tax patents for any strategy "designed to minimize, avoid, defer or otherwise affect liability for federal, state, local or foreign tax."

As we go to press. Representatives. Rick Boucher (D-VA), Steve Chabot (R-OH) and Bob Goodlatte (R-VA) have introduced H.R. 2365 that would restrict lawsuits for alleged tax-strategy patent infringement—virtually making patents unenforceable. Their bill would eliminate civil actions for infringement, injunctive relief, attorney's fees and damages. Rep.

Goodlatte says this about the bill: "When one individual or business is given the exclusive right to a particular method of complying with the tax code, it increases the cost and complexity for every other citizen or tax preparer to comply with the tax code."

The House bill (H.R. 2365)—supported by AICPA—wouldn't, however, exclude patents for the use of tax-preparation software or other tools used solely to perform or model mathematical calculations or prepare tax or information returns.

Another player enters the fray. IRS is considering making a patented tax scheme a so-called reportable transaction.

What does all this have to do with charitable tax planning? Plenty. The next time a non-vanilla charitable tax plan is proposed, check whether there is a patent or patent pending in addition to whether it will fly with the IRS.

The flip charitable remainder trust (FLIP-CRUT) comes to mind. It was invented by a tax-savvy lawyer well before the Treasury and the IRS sanctioned the FLIP-CRUT by regulations. *Query.* By issuing regulations, would the federal government have aided and abetted patent infringement had the FLIP-CRUT been patented?

Caution. A patent infringer can be successfully sued by the patent owner even if the tax strategy doesn't work.

Biblical note. According to Ecclesiastes (1:9), there is no new thing under the sun. But when it comes to tax-strategy patents, there may be. So be careful out there.

PATENT APPLICATION—USE OF CHARITABLE REMAINDER AND LEAD TRUSTS

FLASH—

The House Judiciary Committee has just approved an amendment to a broader patent bill that would not allow patents for tax planning strategies. (H.R. 1908).

A 47-page patent application for a method to support charitable giving in furtherance of a business objective by establishing either a charitable remainder or charitable lead trust has been published by the U.S. Patent and Trademark Office. The application makes 30 claims.

Here is claim 1: "A method in support of charitable giving in furtherance of a business objective of the business, comprising the step of proceeding with the business objective in response to a decision by a decision maker by: (a) establishing a trust to achieve at least a part of the business objective, the trust having a term, the trust being either a charitable remainder trust or a charitable lead trust; (b) transferring one or more assets of the

business to the trust; (c) disposing of at least one asset within the trust in furtherance of the business objective; and (d) passing benefits resulting from the disposition of the at least one asset from the trust while shielding the business from a tax liability due to the disposing step, if the tax liability is owing."

To read the entire U.S. Patent Application 20070088582 (released 4/19/07) go to: www.uspto.gov, patents, Number 5 (Search patents), yellow box, Publication Number Search, enter 20070088582, search, click on number and patent application will appear.

NIM-CRUT TERMINATED—VALUING THE INTERESTS

Watch Out for the MacGuffin. MacGuffin. The word was coined by Alfred Hitchcock to describe a technique he used in his mystery films. It is a plot element that throws the viewer off—sort of a red herring.

Recent letter ruling on a NIM-CRUT has an unintentional MacGuffin. The trust will be terminated before the life beneficiary's death with the assets being divided between the income beneficiary and the charitable remainder organizations. The primary thrust and emphasis of the ruling is that the termination won't involve a prohibited act of self dealing by anybody in sight. But the real significance is how IRS rules on the valuation of the income and remainder interests—not favorable to the donor/income beneficiary.

An aside, but not a MacGuffin. Valuation of a life recipient's interest is important not only for a CRT that is terminated with the assets divided between the income recipient and the charity, but also when a life income recipient contributes his remaining life interest to the charity (thus terminating the trust). He has to value that interest when he claims his charitable deduction.

Here's the letter ruling's plot. Donor created a 10% net-income-with-makeup charitable remainder unitrust (NIM-CRUT). He is the income recipient and publicly supported charities are the remainder organizations. Donor is also a trustee along with an independent special trustee.

Donor wishes to terminate the NIM-CRUT and have the trust assets distributed to him and the charities according to their respective interests. The IRS deems the termination to be a constructive sale of the income recipient's interest and he has a zero basis. If the trust was created more than a year before the CRT's termination, Donor's constructive sale is treated as a sale of a long-term capital asset (taxable at a maximum 15% rate). The gain is the difference between the value of the income recipient's interest and zero. Naturally, an income recipient wants the highest-possible valuation of his interest because he gets more assets—and keeps 85% after paying a 15% tax.

The law in Donor's state permits early termination of the trust provided all the parties agree

(income recipients, trustees and charitable remainder organizations). The state's attorney general and a court needn't be involved as long as all the parties consent. In addition, the Restatement of the Law of Trusts 3d (2001) provides at section 651(1) that ". . . if all of the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust."

As is commonplace in CRT terminations, when a CRUT or CRAT is measured by an individual's life (as opposed to a term of years) Donor represented to the IRS that he was aware of no physical condition that would decrease his normal life expectancy. He also submitted a statement from his physician confirming that he had examined Donor, and that there was no indication that his life expectancy was less than would otherwise be expected for a man his age. Naturally, if someone is at death's door—or closer to the door than normal—his life interest's value is diminished.

The plot thickens. In Donor's initial ruling request, he stated that the actuarial values of the respective interests (his and the charitable remainder organizations) should be calculated using the discount rate in effect under IRC §7520 on the date of the constructive sale, and the method of valuing a charitable remainder in Reg. §1.664-4.

After discussions with the IRS, Donor, as the income recipient, agreed to a different method of calculating the respective interests in the trust. Specifically, the letter ruling stated:

> The Taxpayer understands and agrees that, contrary to the formula assumed in his earlier letter ruling request, the payout rate to be used in calculating the respective interests will be the lesser of the Code Section 7520 rate in effect at the time of termination of the trust and the stated interest rate [unitrust amount] of 10% contained in the trust agreement.

Flashback—
The IRS's rulings on the self-dealing issues:

• The charitable remainder organizations are public charities. (Donor substituted them for previously named private foundation under a power he retained in the trust.) Thus for purposes of IRC §§4941 and 4946, the income beneficiary is not a disqualified person with respect to the charitable remainder beneficiaries.

• IRC §4941 applies to certain transactions between private foundations and disqualified persons. By early termination, the trust will distribute lump sums to the income recipient and the charitable remainder organizations equal to the actuarial value of their interests —taking into account the net-income provisions of the trust (discussed soon). The distributions are treated as a constructive sale between Donor, income recipient, and the charitable remainder organizations. See Rev. Rul. 69-486.

• Generally, payments to the income recipient from the trust would constitute self-dealing. However, because the distribution to him equals the actuarial value of the income interest—taking into account the net-income provisions of the trust—the exception to

self-dealing provided by Reg. §53.4947-1(c)(2)(i) applies and the distribution will not be an act of self-dealing. Further, because the charitable remainder organizations are public charities, IRC §4941 doesn't apply to the transaction between Donor and the charitable remainder organization.

The denouement. The appropriate calculation of the actuarial value of the income recipient's interest must take into account the net-income provisions of the trust. That requires the use of a reasonable method for the calculation which doesn't inappropriately inflate the income recipient's interest to the detriment of the charitable remainder organizations. One reasonable method to calculate the actuarial value of the income and remainder interests, rules the IRS:

> The computation of the remainder interest is found using a special factor as indicated in section 1.7520-3(b)(1)(ii) of the regulations. The special remainder factor is found by using the methodology stated in section 1.664-4 for computing the factor for a remainder interest in a unitrust, with the following modification: where section 1.664-4(a)(3) of the regulations provides an assumption that the trust's stated payout percentage is to be paid out each year, instead the assumed payout shall be that of a fixed percentage which is equal to the lesser of the trust's stated payout percentage or the section 7520 rate for the month of termination. The special factor for the non-charitable payout interest is 1 minus the special remainder factor.

Based on this methodology, here's how to calculate Donor's income interest:

> The section 7520 rate for May 2006 is 5.8 percent. Assuming the termination occurred in May 2006, the lesser of this rate and the trust's stated payout percentage is 5.8 percent. The assumed taxpayer's age as of the nearest birthday is 75. Based on Table 90CM, interest at 5.8 percent, an unadjusted payout rate of 5.8 percent, and quarterly payments made at the end of each quarter, the present value of the remainder interest in a unitrust which falls in at the death of a person aged 75 is $0.56904 for each $1.00 of the trust estate. The present value of the payout interest in the same unitrust until such death is $1.00 minus $0.56904, or $0.43096 for each $1.00 of the trust estate.
>
> The income recipient is not expected to receive more than he would during the full term of the trust under the above-described methodology for valuing his interest in a charitable remainder trust with a net income make-up feature.

Additional rulings on self-dealing:

> •Because the effect of the transaction is to vest the income interest and remainder interest in the remainder organization, the trust no longer will be a split-interest trust and section 4947(a)(2) will no longer apply and section 507 will not apply.
>
> • Early termination of the trust will not constitute an act of self-dealing under IRC §4941(a)(1) by Donor individually and as trustee with respect to the NIM-CRUT using the methodology described above.
>
> • Early termination of the trust will not constitute an act of self-dealing under IRC §4941(a)(1) by the NIM-CRUT's independent trustee with respect to the trust using the methodology described above.
>
> • The termination of the NIM-CRUT will not be subject to a termination tax under IRC §507.

Letter Ruling 200725044

Comment. One tax Einstein opines that arguably IRS's method of valuing the NIM-CRUT's income interest is solely to determine whether the self-dealing excise tax applies—and the methodology doesn't necessarily apply to determining the share of the assets to be received by the income recipient.

Another tax genius says that the best way—for all purposes—to determine the value of a NIM-CRUT's income interest is to have a qualified appraisal on what in the real world a reasonable buyer would pay a reasonable seller both having knowledge of relevant facts and neither being under compulsion to buy or sell.

For those not relishing a battle with the IRS, here's a suggested plan for favorably valuing a life interest on a gift or constructive sale (the assets are divided between the income recipient and the charitable remainder organization). This plan should result in the NIM-CRUT's life interest being valued using the same method as is used for the charitable deduction for the remainder interest when the trust is initially funded.

Don't draft a plain old NIM-CRUT. Instead, draft the NIM-CRUT with a *flexible* FLIP-CRUT provision. Then if the income recipient wants to contribute his remaining life interest or receive his share of the trust, he pulls (squeezes according to my old drill instructor) the trigger—and voila we're dealing with a STAN-CRUT. Hey, no problem in getting a more favorable valuation without doing battle with the IRS.

What is a flexible FLIP-CRUT (a FLEX-FLIP-CRUT)? A typical FLIP-CRUT provides that a NIM-CRUT shall flip and become a STAN-CRUT on January 1 of the year following the sale of Greenacre (a nonmarketable asset). And that's often an appropriate time to flip a NIM-CRUT. But instead of doing it that way, fund the trust with Greenacre *and* a few shares of nonmarketable securities (e.g., cookthebooks.com). Make the sale of cookthebooks.com the flipping event. Then if you wish to flip the trust earlier than Greenacre's sale, on its sale, or later than its sale, you can flip at will—by selling the shares in cookthebooks.com.

Think of the issues at the outset when drafting the NIM-CRUT. This plan won't help the hapless donor in this letter ruling.

As the school master in *The History Boys* might say: "Foresight and flexibility lads, those are the lessons that I want you to learn."

Parthian shot. This letter ruling deals with a net-income-with-makeup unitrust. IRS would likely apply the same computation method to a net-income-with-no-makeup unitrust (NI-CRUT). As a practical matter, the life interest for that trust would be worth even less because deficiencies can never be made up.

SAFE-HARBOR CHARITABLE LEAD ANNUITY TRUSTS

IRS Issues Samples:

- Inter Vivos CLATs (Nongrantor and Grantor)
- Testamentary CLAT
- Numerous Alternate Provisions
- Instructive Annotations

The IRS's guarantee. Charitable lead annuity trusts (CLATs) that are "substantially similar" to the Service's sample trusts (or properly integrate one or more of the IRS's sample alternate provisions) will, the IRS assures, be qualified trusts and the donor will receive the applicable charitable deductions.

As with all guarantees, it's important to read the fine print. So in addition to substantially following the IRS's samples, the trust must be a valid trust under applicable local law, operate in a manner consistent with the trust's terms "and . . . all other requirements for deductibility [must be] satisfied."

The safe-harbor assurance also applies if the CLAT satisfies all the above requirements except that it: (1) reflects the choice of a different power or provision sufficient to make the donor the owner of the entire CLAT if it is a grantor CLAT (more about that trust later) provided that the power or provision selected is consistent with a CLAT's requirements; (2) defines the annuity amount as an increasing amount for which the value is ascertainable at the creation of the trust; and/or (3) provides for a different disposition of trust assets upon the CLAT's termination.

Not to worry (too much). Trusts that omit, substitute or add provisions not found in the Service's specimens aren't necessarily disqualified. But you won't have a guarantee in your back pocket as you would if you follow the IRS's sample trusts (or properly substitute its published alternate provisions).

Some background. In 2003 the IRS announced that it planned to publish sample charitable *lead* trusts and invited public comments (it had earlier provided sample charitable *remainder* unitrust and annuity trusts). Guidance from the Service for charitable lead trusts is especially important because unlike charitable remainder trusts, there aren't regulations fleshing out the Code provisions enacted back in 1969 (seems like just yesterday). Lawyers who have drafted CLATs—and the lawyers at the IRS—often looked to the CRT regulations and the Service's sample CRT forms for guidance. You'll notice when reviewing the CLAT samples that the Service borrowed heavily from the charitable remainder annuity trust samples.

Not many took the IRS up on its 2003 invitation to submit suggestions for sample lead trusts and annotations. My law firm's Charitable Planning Group did submit suggestions and it's nice to report that the Service adopted almost all of them. Many of the sample CLAT provisions echo the IRS's comparable CRAT sample provisions (many of which

reflected suggestions that our firm and others made when those sample trusts were being drafted by the IRS). The lesson here is that when the IRS invites suggestions, it thoughtfully listens.

Bottom line—IRS has done an excellent job. The sample trusts, alternate provisions and annotations are a virtual course on charitable lead annuity trusts. I have just a few criticisms and I'll point those out along the way.

What about specimen charitable lead unitrusts? Those trusts are in the IRS's pipeline. So for now, the Service only takes you by the hand for charitable lead annuity trusts (more frequently used than lead unitrusts). A good way to anticipate what the Service will eventually publish for charitable lead unitrust guidance is to review IRS's sample charitable remainder unitrusts.

To get the whole ball of tax

For inter vivos nongrantor and grantor charitable lead annuity trusts (the IRS's sample trusts, alternate provisions and annotations), see Rev. Proc. 2007-45. For testamentary charitable lead annuity trusts (sample trust, alternate provisions and annotations), see Rev. Proc. 2007-46.

Another way to get the whole shebang, kit and caboodle, shooting match, nine yards (including the kitchen sink): Go to taxwisegiving.com; click on IRS's sample charitable lead annuity trusts.

WHAT'S IT ALL ABOUT ALFIE?

Let's get down to business. I'll give you the English translation (still heavy going) sprinkled with legal citations so that you'll know where to go to dig deeper.

What is a CLAT? It is an irrevocable split-interest trust that provides for a specified amount to be paid to one or more charitable beneficiaries during the trust's term. The remaining trust principal at the end of the term is paid to—or held in a continuing trust for—a noncharitable beneficiary or beneficiaries identified in the trust.

Who creates a CLAT? A well-off (a.k.a high-net-worth) individual who wants to benefit a charity up front and make a gift to family members down the road at greatly reduced—or no—gift or estate tax cost. The value of the family members' remainder interest is reduced by the value of the charity's lead interest.

The charity's lead interest—tax benefits. If the CLAT satisfies the Code's requirements, the charitable lead annuity interest qualifies for the IRC §2522(c)(2)(B) gift tax charitable deduction and/or the IRC §2055(e)(2)(B) estate tax charitable deduction. And sometimes the gift of the charity's lead annuity interest in an inter vivos trust also qualifies for the IRC §170(a) income tax charitable deduction. More about that later when we get to grantor CLATs.

The gift of the noncharitable remainder interest. This is a gift by the donor to the remainder takers (family members) valued at the time the trust is created. As noted, the value of the gift is minimized because of the charity's lead interest.

TWO TYPES OF INTER VIVOS CLATS
Nongrantor and Grantor

Nongrantor CLAT. The donor isn't entitled to an income tax charitable deduction. Technically speaking, the nongrantor CLAT is subject to the provisions of part I, subchapter J of chapter 1 of subtitle A of the Internal Revenue Code and is allowed a deduction under IRC §642(c)(1) in determining its taxable income for any amount of gross income paid for purposes specified in IRC §170(c).

Grantor CLAT. The donor may be entitled to an income tax charitable deduction but the "price" is that he will be taxable on the income paid to the charity. More about this later. Technically speaking, a trust is a grantor CLAT if the donor is treated as the owner of the entire CLAT under subpart E, part I of subchapter J, chapter 1, subtitle A of the Code.

Rules That Apply to Both Inter Vivos Nongrantor and Grantor CLATs (Unless Otherwise Specified)

• ***Permissible term.*** Payments may be to the charity (or charities) for a specified term of years. Note that there is no 20-year cap as for charitable remainder trusts.

• ***CLAT measured by a life or lives—limitations.*** As an alternative to a term-of-years CLAT, the trust instrument may provide for payment of the annuity amount for the life or lives of an individual or individuals. However, 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 IRC §§170, 2055, or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. A trust will satisfy the requirement that each measuring life is a lineal ancestor (or the spouse of a lineal ancestor) of all noncharitable remainder beneficiaries if there is a less than a 15% probability at the time of the contribution to the trust that individuals who are not lineal descendants of an individual who is a measuring life will receive any trust principal. The probability must be computed under the applicable tables in Reg. §20.2031-7. Reg. §§20.2055-2(e)(2)(vi)(*a*) and 25.2522(c)-3(c)(2)(vi)(*a*). Each person used as a measuring life for the annuity period must be living on the date assets are transferred to the trust. Reg. §§20.2055-2(e)(2)(vi)(*a*) and 25.2522(c)-3(c)(2)(vi)(*a*).

Why the restrictions on the lives that can be used to measure the trust term? It's the IRS's response to the so-called ghoul lead trust where the donor used the measuring life of an individual who was at death's door. The family members would get the remainder interest much earlier because the person whose life measured the trust term died way before the end of his actuarial life expectancy. But the value of the charity's lead interest for purposes of computing the gift tax charitable deduction was based on his actuarial (not actual) life expectancy. So this short-lived scheme promised the best of all worlds (except

for the sick guy who was the measuring life): an inflated gift tax charitable deduction making the actuarial value of the family member's remainder interest much smaller; and the family member got his remainder interest much earlier than if he had to wait until the death of an individual who had a normal life expectancy.

• ***Permissible lead annuity beneficiaries.*** A CLAT must have one or more charitable lead beneficiaries. The failure to designate a specific charitable beneficiary won't preclude the donor from receiving a charitable deduction if the trust provides for the selection by the trustee of a charitable beneficiary described in IRC §§170(c), 2055(a), and 2522(a). Rev. Rul. 78-101, 1978-1 C.B. 301.

Caution. If the donor is serving as the trustee, the trustee's power to select the charitable beneficiaries will cause the gift of the annuity interest to be incomplete for gift tax purposes (by itself not a problem) but may cause some or all of the trust property (depending on the date of the donor's death) to be included in the donor's gross estate. See IRC §§2035(a), 2036(a)(2), and 2038(a)(1) and Reg. §25.2511-2(c*).* Also if the charitable beneficiary is a private foundation and the donor is an officer or director of the private foundation—or possesses certain decision-making authority in the private foundation—some or all of the trust property may be included in the donor's gross estate. See IRC §2036(a)(2).

• ***Donors who qualify for the safe harbor.*** For qualification under the IRS's revenue procedure, the donor may be an individual or a husband and wife.

Comment. If joint donors aren't husband and wife, but are siblings, domestic partners or non-traditional couples, for examples, the CLAT won't qualify for the safe harbor. This is an unwise and unjustified rule in otherwise exemplary guidance from the IRS.

• ***Computation of estate and gift tax charitable deductions*****.** Generally, the estate and gift tax charitable deductions available under IRC §§2055(e)(2)(B) and 2522(c)(2)(B) for contributions to a CLAT equal the present value of the annuity interest. IRC §7520 requires that an annuity interest must be valued using the IRS's tables. The method for valuing a charitable lead annuity interest is in Reg. §§ 20.7520-2 and 25.7520-2.

• ***Payment of annuity amount in installments*****.** The amount of the charitable deduction is affected by the frequency of the payments, whether the installments are equal or unequal, and whether each installment is payable at the beginning or end of the period. See Reg. §§25.2512-5 and 20.2031-7.

• ***Excess income.*** Trust income in excess of the amount required to pay the annuity may be retained by the trust or distributed currently to the charitable beneficiary. If the governing instrument of a nongrantor charitable lead trust provides for the payment of excess income to or for the use of the charitable beneficiary, no additional estate or gift tax charitable deductions are available for the excess of income distributed to the charitable beneficiary. See Reg. §§20.2055-2(e)(2)(vi)(*d*) and 25.2522(c)-3(c)(2)(vi)(*d*). However, the trust is

entitled to a charitable income tax deduction under IRC §642(c)(1) for any amounts of excess income paid to the charitable beneficiary. See Situation 2 of Rev. Rul. 88-82, 1988-2 C.B. 336, for the gift tax consequences of the payment of excess income to a noncharitable beneficiary.

• ***Generation-skipping transfer tax.*** If a CLAT has or may have a skip person, as defined in IRC §2613(a), as a remainder beneficiary, the transfer to the trust will be subject to the generation-skipping transfer (GST) tax. Under IRC §2651(f)(3), a charitable organization is deemed to be in the same generation as charitable lead trust's donor. Thus the GST potential of a charitable lead trust is dependent upon whether any noncharitable beneficiary is a skip person. The rules for determining the inclusion ratio for a CLAT are in IRC §2642(e) and provide that the inclusion ratio is determined at the termination of the annuity period, rather than on the funding of the trust. [For a charitable lead *unitrust*, the inclusion ratio is determined on the trust's funding.]

• ***No additions to the trust.*** For purposes of qualification under the IRS's safe-harbor revenue procedure, the trust must contain a provision that prohibits additional contributions. A CLAT that permits—or doesn't specifically prohibit—additional contributions will not qualify for safe-harbor treatment.

Comment. Although additional contributions are not allowable for charitable *remainder* annuity trusts, I believe there is no policy reason for prohibiting additions to charitable *lead* annuity trusts. If permissible, the provisions governing an additional contribution to a lead annuity trust would be the same as those governing the original contribution. Thus if the annuity amount is 7%, the additional payment based upon the additional contribution would also be 7%. The ability to add can only benefit the charitable lead organization. Additional contributions can, of course, be made to a charitable *remainder* unitrust and additional contributions should be appropriate for lead unitrusts too.

Additional comment about the no-additional-contribution governing instrument provision. IRS isn't saying that a trust without that prohibition won't qualify—just that the trust won't get safe-harbor protection.

Suggestion. If the ability to make additional contributions to a CLAT is important, seek a favorable letter ruing beforehand. The ability to add to a CLAT can, in effect, be achieved by creating an additional separate trust. But why have the expense of creating and administering s separate trust—especially if the would-be additions are relatively small.

• ***Prohibitions against certain investments and excess business holdings.*** Prohibitions against retaining any excess business holdings within the meaning of IRC §4943, as modified by IRC §§4947(a)(2) and 4947(b)(3), and against investments that jeopardize the exempt purpose of the trust within the meaning of IRC §4944, as modified by IRC §§4947(a)(2) and 4947(b)(3), are generally required. If (1) the present value of the charitable interest doesn't exceed 60% of the aggregate value of all amounts in the trust,

(2) the trust instrument doesn't provide for the payment of any of the income interest to a noncharitable beneficiary, and (3) the trust instrument doesn't provide for the payment of excess income to a noncharitable beneficiary, the references to IRC §§4943 and 4944 may be removed from the trust instrument. IRC §4947(b)(3) and Reg. §§53.4947-2(b)(1)(i), 20.2055-2(e)(2)(vi)(e), and 25.2522(c)-3(c)(2)(vi)(e).

• ***Unrelated business taxable income.*** Under IRC §681, a nongrantor charitable lead trust's deduction under IRC §642(c)(1) is disallowed in any year to the extent that the deduction is allocable to the trust's unrelated business taxable income, as defined in IRC §512, for that taxable year. See IRC §681 and Reg. §1.681(a)-2. However, a partial deduction is allowed under IRC §512(b)(11) for amounts allocable to unrelated business taxable income. See IRC §512(b)(12) and Reg. §1.681(a)-2(a).

• ***Calendar year.*** A charitable lead trust's taxable year must be a calendar year. IRC §644(a).

• ***Capital gains.*** Gains from the sale or exchange of capital assets may be allocated to the trust's income or principal. If the governing instrument is silent, capital gains are allocated by following local law. Even if gains are allocated to principal, they will be deductible under IRC §642(c)(1) if they are paid to the charitable beneficiary as part of a charitable annuity payment. Rev. Rul. 83-75, 1983-1 C.B. 114.

• ***Apportionment of the annuity amount in the discretion of the trustee.*** The donor or the trustee of a nongrantor charitable lead trust may be granted the power to apportion the annuity payment from time to time among a class of qualifying charitable beneficiaries. See IRC §674(b)(4). That power will not cause the donor to be treated as the owner of the trust for income tax purposes. IRC §674(b)(4). Note, however, that the power retained by the donor, but not the donor's spouse, will cause the gift of the annuity interest to be incomplete for gift tax purposes and will cause some or all of the trust property to be included in the donor's gross estate. See IRC §§2035(a), 2036(a)(2), and 2038(a)(1) and Reg. §25.2511-2(c).

• ***Trustee provisions.*** The trust instrument may name alternate or successor trustees and/or may include a method for the appointment of unnamed alternate or successor trustees. In addition, the trust may contain administrative provisions relating to the trustee's duties and powers.

• ***Power to commute.*** A charitable lead annuity trust is not qualified if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the annuity period. Rev. Rul. 88-27, 1988-1 C.B. 331.

• ***Payment requirements.*** CLATs aren't subject to minimum or maximum payout requirements. Thus there are no 5% minimum and 50% maximum requirements as there are for CRTs. CRTs have a 10% minimum remainder interest requirement. There is no

comparable requirement that the charitable lead interest be a minimum of 10%.

• ***The annuity payments may be made in cash or in kind.*** If the trustee distributes appreciated property in satisfaction of the required annuity payment, the trust will realize capital gain on the assets distributed to satisfy part or all of the annuity payment. The trust will be allowed an IRC §642(c)(1) deduction for the realized capital gains. Rev. Rul. 83-75, 1983-1 C.B. 114.

GRANTOR CHARITABLE LEAD TRUSTS—QUALIFYING FOR THE INCOME TAX CHARITABLE DEDUCTION

For a donor to claim an *income* tax charitable deduction under IRC §170(a) in the year of his contribution to the trust (for the present value of the charity's lead annuity interest), the trust must be structured as a grantor charitable lead trust. See IRC §170(f)(2)(B).

The rules governing grantor charitable lead trusts are similar to those relating to nongrantor charitable lead trusts (detailed above). The most significant difference is the income tax treatment of the trust income. A charitable lead trust is a grantor charitable lead trust if the donor to the trust is treated as the owner of the entire trust for income tax purposes. That means that he's taxable on the income paid to the charity.

• ***Donor's income tax charitable deduction and taxation of trust's income.*** The donor may claim a federal income tax charitable deduction under IRC §170(a) in the year that assets are irrevocably transferred to the trust. During the charitable lead annuity period, the donor is taxed on all income earned by the trust and doesn't receive any charitable deduction under IRC §170 for the annuity payments to the charitable beneficiary as they are made. In addition, the trust doesn't receive a charitable deduction under IRC §642(c)(1). See Reg. §1.671-4 for the income tax reporting requirements for a grantor charitable lead annuity trust.

• ***Income tax deductibility limitations*.** The donor's income tax charitable contribution under IRC §170(a) equals the present value of all future payments that are to be made to the charitable beneficiary. Reg. §1.170A-6(c). However, a contribution of a charitable income interest in property for which a deduction is allowable under IRC §170(a) is considered to be made "for the use of" rather than "to" a charitable organization. Reg. §1.170A-8(a)(2). Under the "for-the-use- of" rule the income tax charitable deduction is generally limited—as set forth in IRC §170(b)(1)(B)—to 30% of the donor's adjusted gross income. However, if the property contributed to the CLAT is capital gain property—as defined in IRC §170(b)(1)(C)(iv)—and the charitable beneficiary (including any alternate charitable beneficiaries named in the trust or selected by the trustee) is not limited to an organization described in IRC §170(b)(1)(A) (a "public charity"), the individual taxpayer's income tax charitable deduction generally is limited—as set forth in IRC §170(b)(1)(D)—to 20% of the donor's adjusted gross income. IRC §170(b)(1)(D). See Reg. §§1.170A-8(c) and (d). In addition, the amount of a charitable contribution of certain types of property may be reduced under IRC §170(e). See Reg. §1.170A-4.

Caution. Letter Ruling 8824039 holds that the five-year carryover isn't available when the lead interest is payable to a private foundation.

• ***Recapture by the IRS of tax benefits.*** If at any time the donor of a grantor CLAT ceases to be treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code, the donor is considered to have received income equal to the amount of any deduction he received under IRC §170(a) for the contribution to the trust, reduced by the discounted value (as of the date of the contribution to the trust) of all amounts of income earned by the trust and taxable to the donor before the time that the donor ceased to be treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. IRC §170(f)(2)(B).

TESTAMENTARY CLATS

Generally, the rules described above for inter vivos trusts also apply to those created by will (or by a revocable living trust—a will substitute). Here are provisions that specifically apply to testamentary CLATs:

• ***Computation of estate tax charitable deduction*.** The estate tax charitable deduction available under IRC §2055(e)(2)(B) for contributions to a CLAT equals the present value of the annuity interest. IRC §7520 requires that an annuity interest be valued using the IRS's tables. The method for valuing a charitable lead annuity interest is in Reg. §20.7520-2. If estate or other death taxes are paid from the assets used to fund a testamentary CLAT, the amount deductible under IRC §2055 is the amount that passes to charity, reduced by the amount of estate or death taxes paid. IRC §2055(c).

• ***Permissible term*.** The rules are the same as for inter vivos CLATs.

• ***Deferral of requirement to pay annuity amount.*** The IRS's sample testamentary trust authorizes the trustee to defer the payment of the annuity amount until the end of the taxable year of the trust in which the trust is completely funded.

• ***Interest on annuity payments*.** The deferral provision in the sample trust provides for the payment of interest, compounded annually, for any underpayment of the annuity amount during the period of estate administration. The sample trust requires that interest be computed at the effective IRC §7520 rate on the date of the decedent's death. To the extent that interest payable under state law exceeds the applicable IRC §7520 rate, the payment of interest at the rate prescribed by state law will be deemed to satisfy the interest payment requirement provided in the trust.

You can't get a "comfort" ruling. Now that the IRS has issued safe-harbor CLAT samples, it generally will not issue a letter ruling on whether a CLAT is qualified and qualifies the donor for income, gift and/or estate tax charitable deductions. *However*, the IRS generally will issue letter rulings relating to the tax consequences of the inclusion in

a CLAT of substantive trust provisions other than those contained in its sample CLATs (and sample alternate provisions). So you can get a ruling on a specific provision that isn't part of the IRS's safe-harbor package. But the Service won't bless the entire trust.

Parthian shot. Helpful as the IRS's sample trusts are, it's not "just fill in the blanks." Lawyers still have to know what alternate provisions to use and when to substitute and/or add their own handiwork—taking into account each situation. Hey, that's what we get paid for.

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.