Chapter 14

Split Interest Trusts Created by Entities (and More)*

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Synopsis

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¶ 1400 Introduction

Partnerships and corporations, at least occasionally, create trusts. Trusts also may be created by the trustees of other trusts.[1] Treasury regulations specify when a partnership or the corporation will be treated, for Federal income tax purposes, as the grantor[2] of the trust or when its partner or shareholder will be treated as the grantor, even though the trust "nominally" was created by the entity.[3] Unfortunately, forecasting whether the Internal Revenue Service (the "IRS" or "Service") will treat an entity or an owner of the entity as the grantor of a trust may be difficult in many situations. In contrast, the regulations dealing with the status of a trust as the grantor of another trust are reasonably certain. It does not appear that one trust can be treated for income tax purposes as the grantor (meaning a creator who has made a gratuitous transfer of property to the trust) of another trust although one trust may be treated as the owner of the trust, for Federal income tax purposes, of another trust, in some cases.[4] The

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[1] For example, in doing a "decanting" under Alaska Statutes (AS) 13.36.157-159, the trustees of one trust (the "invaded trust") may pay the corpus to another trust (the "appointed trust"), in certain cases, including, as defined in AS 13. 36.215, "to a new trust created . . . by the trustees, in that capacity, of the invaded trust."

[2] The term "grantor" can have more than one meaning for income tax purposes. A grantor can be the person who creates a trust. A grantor can also be a person treated as the owner of the trust assets for Federal income tax purposes. It is possible to be a grantor without being an owner, and to be an owner without being a grantor. In order to be a grantor that is also treated as an owner for purposes of Section 671 of the Code, as a general matter the person must have made a gratuitous transfer of property to the trust. A person may also become an owner under Section 678, even if that person has not made a gratuitous transfer of property to the trust. Note that in this context, a gratuitous transfer need not have a transfer tax implication. In other words, a gratuitous transfer need not be a gift for gift tax purposes. A gratuitous transfer means only an uncompensated transfer of property.

[3] Although this regulation has been promulgated under Section 671 of the Code, which section is part of the so-called "grantor trust rules," which are contained in subpart E of part 1 of subchapter J of Chapter 1 of Subtitle A of the Code, the determination under the regulation of which taxpayer is the grantor for Federal income tax purposes seems to be for all purposes of the income taxation of estates, trusts and their beneficiaries, not just for purposes of the grantor trust rules. See, e.g., Treas. Reg. § 1.671-2(e)(1), which provides, in part, "For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person . . . ." In other words, this regulations indicates that the determination of the identity of the grantor is not limited to the grantor trust provisions (Sections 671–679) but for all purposes of the income taxation of estates, trusts and their beneficiaries.

[4] "If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as

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determination of the identity of the owner for income tax purposes of a trust can be significant, in some cases.

The basic rule is set forth in Treasury Regulation § 1.671-2(e)(1) and provides that for purposes of the grantor trust rules, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of the regulation) of property to a trust. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under Sections 671 through 677 or Section 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under Sections 671 through 677 or Section 679. However, a person may be treated as an owner of a trust without being a grantor under Section 678. How this rule applies in the case of an entity or a trust that creates a trust can be difficult to analyze.

This article will discuss some of these differences, focusing specifically on charitable contributions made by certain of these entities by transfers to a so-called "split interest" trust, such as a charitable remainder trust ("CRT") described in Section 664(d)[5] or a charitable lead trust ("CLT") described in Section 170(f)(2)(B),[6] where an individual or a trust (or a decedent's estate) is a partner or shareholder. It will suggest ways of making it more certain that the partnership or corporation, rather than its partners or shareholders, will be treated as the grantor (owner) of the trust when that is beneficial. It will also discuss certain other matters relating to split-interest trusts, whether created by an entity or by an individual.

¶ 1401 Some Basic Charitable Deduction Rules

¶ 1401.1 For Individuals

Individuals are entitled, under Section 170(a), to an income tax deduction for certain contributions to charitable organizations that are described in Section 170(c), subject to limitations relating to the individual's contribution base,[7] the type of organization to

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the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code." Treas. Reg. § 1.671-2(e)(5). However, as illustrated by Example 8 in Treas. Reg. § 1.671-2(e)(6), one trust may be the owner, for income tax purposes, of another trust it creates.

[5] Note that, although a charitable remainder trust is described in Section 664, the income tax deduction for the charitable interest in one is allowed under Section 170(f)(2)(A) to the individual who creates one. The gift tax and estate deductions for the charitable interest in a charitable remainder trust are provided under Sections 2522(c)(2)(A) and 2055(e)(2)(A), respectively.

[6] The income tax deduction for a transfer to a charitable lead trust is allowed under Section 170(f)(2)(B) but, as discussed later in this article, only if it is a grantor trust. The gift and estate tax charitable deductions for the creation of a charitable lead trust are under Sections 2522(c)(2)(B) and 2055(e)(2)(B), respectively.

[7] Contribution base is defined in Section 170(b)(1)(G) as adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under Section 172).

which the contribution is made,[8] the nature of the asset donated[9] and other factors.[10]

¶ 1401.2 For Estates and Trusts

The taxable income of a decedent's estate and of a trust that is not a grantor trust[11] is computed in the same manner as an individual's taxable income is computed except to the extent otherwise provided in part 1 of Subchapter J of Chapter 1 of Subtitle A of the Code.[12]

One of the important differences between the manner in which the taxable income of an estate or trust is determined as opposed to that of an individual is the extent of the deduction permitted for gifts or payments to charity. An estate or a non-grantor trust is entitled to a charitable deduction, without limitation, under Section 642(c) for its gross income paid (or, for a decedent's estate, paid or set aside) pursuant to the terms of its governing instrument for a charitable purpose described in Section 170(c). However, no Section 642(c) deduction is allowed for payments from a non-grantor trust for a charitable purpose to the extent the income so paid is allocable to the trust's unrelated business income ("UBI") within the meaning of Section 681. UBI, for this purpose, consists of the trust's income from certain business activities and from certain property acquired with borrowed funds reduced by the modifications listed in Section 512(b). These modifications include a deduction for charitable contributions allowed by Section 170, subject to the percentage limitations applicable to individuals. UBI, within the meaning of Section 681, is essentially the same as unrelated business taxable income or "UBIT"[13] defined in Section 512, which includes income attributable to acquisition indebtedness.[14] Capital gain recognized on the sale of an asset is not

[8] See Section 170(b)(1)(A) and (B).

[9] See Section 170(b)(1)(C).

[10] See, *e.g.*, Sections 170(a)(3) and 170(f).

[11] A grantor trust is one the income, deductions and credits against tax of which are attributed pursuant to Section 671 to the trust's grantor (or technically its "owner") or, if the trust is described in Section 678(a), to another taxpayer.

[12] Section 641(b).

[13] Although the initials are "UBIT," it is commonly pronounced as "UBIT" by practitioners.

[14] If there is no debt on the asset, there can be no acquisition indebtedness. Acquisition indebtedness is defined in Section 514(c)(7). Note that, to the extent Section 681 applies, the limitations relating to the taxpayer's contribution base attributable to individuals apply to the trust. Section 681 does not apply to a decedent's estate. It may also be noted that certain formerly revocable trusts may elect, pursuant to Section 645, to be treated as part of the decedent's estate for Federal income tax purposes, for the time limit specified in the section, which will exempt the trust during that time from Section 681. That will also permit such a trust to be entitled to an income tax deduction for its gross income set aside for a charitable purpose during the period that the Section 645 election is in effect. Note that a decedent's estate will be treated as ceasing to exist for income tax purposes when the administration of the estate is determined to have been unduly prolonged. See Treas. Reg. § 1.641(b)-3(a). In any case, it may be important, in planning, to determine whether there is acquisition indebtedness. Perhaps, it also should be noted that transferring property subject to debt to a charitable remainder trust or a charitable lead trust may be an act of self-dealing exposing the transferor to tax imposed by Section 4941(a). *See* Section 4941(d)(2)(A) (an act of self-dealing occurs if property transferred is subject to a mortgage or similar lien which the

normally UBIT if there is no indebtedness against the property.[15] To the extent the trust has UBI that is paid to charity, its deduction limitations are the same as those for an individual.[16]

¶ 1401.3 For C Corporations

Corporations (so-called "C corporations") that are not so-called "S corporations"[17] are entitled to a deduction under Section 170(a) for contributions to charity but the rules for C corporations are different from those for contributions by individuals, in some ways. For example, as a general matter, a corporation may reduce its taxable income by only ten percent (10%) for such contributions.[18]

¶ 1401.4 For S Corporations

Charitable contributions made by an S corporation pass through to the shareholders, under Section 1366(a)(1)(A), in a manner similar to how contributions by a partnership pass through, under Section 702(a)(4), to the partners.[19]

¶ 1401.5 For Partnerships

As just indicated, charitable contributions made by a partnership pass through, under Section 702(a)(4), to the partners. It is important to note that a decedent's estate or a trust that is not a grantor trust, which is a partner, is entitled to a deduction under Section 642(c) for a charitable contribution made by the partnership from the partnership's gross income even if the governing instrument of the trust or estate does not provide for the making of charitable contributions. Rev. Rul. 2004-5.[20]

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charitable remainder trust assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer).

[15] Section 512(b)(5) provides that from UBIT "There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber."

[16] See Treas. Reg. § 1.681(a)-2(a) (second to last sentence); Section 512(b)(11).

[17] See subchapter S of Chapter 1 of Subtitle A of the Code.

[18] Section 170(b)(2).

[19] For an electing small business trust (ESBT) defined in Section 1361(e)(1), no income or deduction is passed out to the trust that is the shareholder. *See* Section 641(c). For more on a comparison of a charitable contribution by an S corporation as opposed to one by its shareholder, see, generally, C. Hoyt, "Charitable Gifts by Subchapter S Corporations and by Shareholders of S Corporation Stock," ALI-ABA Estate Planning Course Materials Journal April 2006, at http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0604-HOYT_thumb.pdf.

[20] 2004-1 CB 295.

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¶ 1402 More on Non-Grantor Trusts as Partners and S Shareholders

Rev. Rul. 2004-5 states explicitly that a charitable contribution by a partnership was from its gross income although the conclusion (that the trust that is a partner is entitled to take a deduction under Section 642(c) for its share of the partnership's charitable donation) is not expressly limited to a case where the donation is made from gross income. Nonetheless, it appears to be the position of the IRS that, for a charitable contribution by a partnership to be deductible by a trust that is a partner, the charitable contribution must have been made by the partnership from its gross income.[21] It seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset, so acquired with the trust's gross income, should be treated as a contribution of gross income for purposes of Section 642(c).[22] In other words, if gross income is used to acquire an asset, that asset itself should continue to be treated as gross income at least as long as the asset can be traced to such gross income.[23]

Rev. Rul. 2004-5 indicates that Section 681 would apply if the partnership makes the charitable contribution from it gross income that would have been UBI if received directly from the trust.[24] Although the concept of UBI (or UBIT) does not apply to a partnership, the nature of a partnership's income presumably passes through to a trust for UBI purposes.[25]

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[21] See Field Service Advice 200140080 (not precedent).

[22] See, e.g., *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), dealing with the predecessor to current Section 642(c) and in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal. See, also, Chief Counsel Advice (CCA) 201042023 (the Service ruled that a property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income. However, the charitable deduction was limited to the trust's adjusted basis in the property. (Not precedent.) Cf. *Crestar Bank v. Internal Revenue Service*, 47 F. Supp. 2d 670 (E.D. Va. 1999); *Freund's Estate v. Commissioner*, 303 F.2d 30 (2d Cir. 1962); *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970); *Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (3d Cir. 1944); *Estate of Joseph Esposito v. Commissioner*, 40 TC 459 (1963).

[23] *Id.*

[24] The ruling states, in part, "Because none of [the partnership]'s income for the taxable year would be considered 'unrelated business income' for purposes of § 681(a), the amount of the charitable deduction is not limited under § 681." Also, note that Box 20 of Schedule K-1 of a partnership income tax return specifically requires that the share of the partner's UBI of the partnership be disclosed. In Field Service Advice 200140080 (not precedent), which dealt with a trust's distributive share of a partnership's charitable contributions, the IRS stated that although the courts in *Lowenstein v. Commissioner*, 12 TC 694 (1949), aff'd, 183 F.2d 172 (*sub nom First National Bank of Mobile v. Commissioner*) (5th Cir. 1950), and *Estate of Bluestein v. Commissioner*, 15 TC 770 (1950), did not analyze the governing instrument requirement, "the basis for the court's allowance of the deductions appears to be the fact that the contributions were made at the partnership level and that the estate would never receive the benefit of these amounts." The IRS further stated, "Based on the Bluestein and Lowenstein cases, we believe that a trust should be allowed a deduction for its distributive share of charitable contributions made by a partnership even though the trust's governing instrument does not authorize the trustee to make charitable contributions. However, all of the other requirements of IRC § 642(c) must be met, and the limitations of IRC § 681(a) must be taken into account."

[25] Section 513(b).

Nonetheless, when an estate or trust distributes its gross income to charity pursuant to Section 642(c) or otherwise, the gross income should not be treated as UBTI in the hands of the charity even if it would have been UBTI if received directly by the charity.[26] Of course, as mentioned above, Section 681 does not apply to an estate.

In any event, the safer course, in order to allow a non-grantor trust partner to be entitled to the charitable deduction without the limitation on contributions made by the partnership, is to have the contribution made from the partnership's gross income other than what would be UBI.[27]

Although not addressed in Rev. Rul. 2004-5, it may suggest that tracing of the source of the contribution by the partnership may be permitted—that is, because the partnership can make the charitable contribution from its gross income as opposed to any other asset it holds, its seems to follow that it can make it from gross income that would not be UBI (at least to the extent it has gross income that would not be UBI). However, an amendment to the regulations under Section 642(c) provides that, for purposes of determining the type of income deemed distributed from an estate or trust to charity for purposes of "shifting" income to charity, any such distribution will be treated as consisting proportionately of all classes of gross income unless the governing instrument of the estate or trust provides otherwise and such provision has

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[26] This conclusion is based upon the absence of a provision that would cause the distribution to be treated as UBTI in the hands of the charitable recipient, the several provisions that otherwise cause a recipient of a distribution from an estate or trust to treat it as having the same income tax character as it had in the hands of the estate or trust, and the fact that there is an explicit provision requiring a charity that is a partner to treat any partnership income (without applying the rule to distributions from an estate or trust) attributed to it as UBTI if it would have been UBTI if earned directly by the charity. For example, in the case of a partnership, UBTI carries out to any partner that is a charity, as provided in Section 512(c) and as UBI to a trust partner which, to that extent, would be subject the trust's charitable distributions of the UBI to the Section 170 limitations to individuals. However, payments to charity from an estate or trust even if consisting of UBI should not be treated as UBTI in the hands of the charitable recipient. Such transfers from an estate or trust to charity do not qualify for a distribution deduction under Section 651(a) or 661(a) and do not consist of the distributable net income (DNI) of the estate or trust under Section 652(a) or 662(a) whose tax character is also passed out to the non-charitable recipient of the DNI. See Section 663(a)(2), which denies this treatment for amounts paid to charity that are deducted under Section 642(c) (and determined without regard to Section 681) by an estate or trust. This seems consistent with the private foundation rules where the net investment income of a trust or estate does not retain its character in the hands of a private foundation for purposes of Section 4940. See Notice 2004-35, 2004-19 IRB 889. So UBI should not be treated as "carried out" from an estate or trust to a charity and treated as UBIT in its hands. But, as previously mentioned in this article, Section 681(a) provides that in computing the deduction allowable under Section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under Section 642(c) shall be allowed as a deduction with respect to income of the taxable year which is allocable to "unrelated business income." See also Section 642(c)(4), which provides that in the case of a trust (but not an estate), the deduction allowed by Section 642(c) is subject to Section 681 (related to UBI). Cf., also, discussion in J. Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," 26th Annual Heckerling Institute on Estate Planning, Chapter 10 at 1004.3 (1992).

[27] Note that Section 68(a), which provides an overall limitation on itemized deductions, does not apply to a non-grantor trust or a decedent's estate. Section 68(e). The two percent "floor" rule of Section 67(a) does not apply to Section 642(c) deductions. Section 67(b)(4).

independent economic effect.[28] This recent amendment does not, by its terms, apply to income distributed to charity by a partnership where a trust is a partner. Because a non-grantor trust and an estate under the prior regulation could specify the character of the income being distributed to charity and because the amended regulation does not, as just stated, by its terms apply to distributions of income by a partnership of which the trust is a partner, it may be that the partnership may specify the type of income being paid which would be respected for purposes of Section 681.

In any event, under Rev. Rul. 2004-5, if a non-grantor trust is a partner in a partnership, the trust will be entitled to a deduction for charitable contributions made by the partnership (at least if made from the partnership's gross income and potentially subject to Section 681 if paid or deemed paid from what would be UBI if received directly by the trust) and, usually, without the normal limitations (related to "contribution base") of an individual taxpayer.

There is developed law on whether a non-grantor trust that is a shareholder of an S corporation may take a deduction for charitable contributions made by the S corporation.[29] The Treasury regulations dealing with Electing Small Business Trusts ("ESBTs"), defined in Section 1361(e)(1), which are certain trusts that may qualify by electing to be eligible shareholders of S corporations, provide that an ESBT is entitled to a charitable deduction attributable to contributions made by the S corporation from its gross income, although "[t]he limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion."[30] If the shareholder is a grantor trust for income tax purposes (or another is treated as the owner of the trust for income tax purposes under Section 678),[31] the charitable deduction would pass through to the individual who is the income tax owner of the trust. Certain trusts are not grantor trusts but may be eligible shareholders of an S corporation. These consist of voting trusts and the beneficial owners of the trust are treated as the S shareholders (to whom any charitable contribution made by the S corporation would be attributed); certain testamentary trusts, including certain formerly revocable trusts,[32] for a limited period, of which the decedent's estate will be treated as the shareholder (and to which any

[28] See Treas. Reg. § 1.642(c)-3(b)(2).

[29] Although Section 1366(a)(1) provides that an S corporation shareholder may deduct on the shareholder's own income tax return a pro rata portion of the corporation's charitable contributions, Section 1366(d)(1) limits the deduction to the sum of the shareholder's basis in his or her stock and any basis in any indebtedness the corporation owes to the shareholder. For years 2006 through 2013, a somewhat different rule on the limitation for such deductions applied. This limitation does not apply to a partner on charitable contributions made by the partnership.

[30] Treas. Reg. § 1.641(c)-1(d)(2). The "S portion" of the ESBT's income is the income from the S corporation that is attributed to the trust. See, generally, Blattmachr & Boyle, Income Taxation of Estates & Trusts (PLI 2014), Chapter 7.

[31] Note that the beneficiary of a Qualified Subchapter S Trust makes an election pursuant to Section 1361(d)(2) for the trust to qualify by the beneficiary being treated as the income tax owner of the S stock pursuant to Section 678. See Blattmachr & Boyle, supra.

[32] See Section 645.

charitable contribution made by the S corporation would be attributed); and certain tax exempt trusts. In addition, a decedent's estate is an eligible S shareholder.[33] Hence, in circumstances where the decedent's estate is the shareholder or treated as the shareholder of the S corporation, the principles of Rev. Rul. 2004-5 should apply so the estate will obtain a Section 642(c) deduction for contributions by the S corporation (and not limited by Section 681 as that section does not apply to a decedent's estate).

¶ 1403 More on Contribution Limitations

An individual may be entitled to a deduction of up to 50% of his or her contribution base for donations of cash (or non-appreciated property) to a so-called "publicly supported" charity and 30% for cash donations to a so-called "private foundation."[34] Although Section 170(c) permits a deduction for contributions "to or for the use" of charitable organizations, the Treasury Regulations impose a 30% (or with respect to any long-term capital gain property 20%) contribution base limit for contributions "for the use" of charity as opposed to a contribution "to" charity.[35] Levels of contribution are limited to 30% and 20% if the contribution is made to a charitable lead trust.[36]

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[33] For a more complete discussion of these matters, see Blattmachr & Boyle, supra.

[34] See Section 170(b). These deduction limitations are reduced, in general, to 30% and 20%, respectively, to the extent the donation consists of property that includes inherent "long term capital gain," that is, gain that would be taxed as long-term capital gain if the contributed asset were sold by the taxpayer. See Section 170(e).

[35] This conclusion on the limits for contributions to charitable lead trusts seems challenging to reach. Treas. Reg. § 1.170A-8(a)(2) provides that a contribution of an income interest (essentially, the unitrust or annuity interest in a charitable lead trust) is treated as a contribution "for the use" of charity rather than "to" charity. Treas. Reg. § 1.170A-8(b) provides, in part, "To qualify for the 50-percent limitation the contributions must be made 'to,' and not merely 'for the use of,' one of the specified organizations." Hence, if the charitable lead trust is for charities and consists of property that otherwise would entitle the individual taxpayer to a deduction of up to 50% of his or her contribution base, the taxpayer's contribution limit is 30% of the contribution base. *See* Section 170(b)(1)(B)(i). Treas. Reg. § 1.170A-8(c) indicates that the contribution limitation is 20%, not 30%. But the 20% limit was the limit the Code imposed on all contributions to or for the use of charities that were not so-called "publicly supported" ones (that is, other than the entities described in Section 170(b)(1)(A)), such as contributions to or for the use of most private foundations. However, the 20% threshold was increased to 30% by the Deficit Reduction Act of 1984. Treas. Reg. § 1.170A-8 predates the effective date of that Deficit Reduction Act of 1984 change (See T.D. 7207 (10-3-72)) and has not been amended to reflect that change. However, if the contribution to the charitable lead trust consists of long-term capital gain property for a private non-operating foundation, the limit is 20% on account of Section 170(b)(1)(D)(i). Hence, where the contribution to a charitable lead trust is for publicly supported charities the deduction limitation, as a percentage of the contribution base, is 30% whether the contribution is of cash (or other unappreciated property) or of long-term capital gain property. Other limitations on deductions and some elective rules that may raise the contribution level back to 50% or 30%—see, e.g., Sections 170(b)(1)(C)(iii) and 170(e). Note, as mentioned in the text, that an individual is entitled to an income tax deduction for the value of the annuity or unitrust interest committed to charity in a charitable lead trust only if the trust is a grantor trust. See Section 170(f)(2)(B).

[36] See Treas. Reg. §§ 1.170A-8(b) (third sentence), 1.170A-8(a)(2) (first sentence), 1.170A-8(c)(1)(ii) and 1.170A-8(d). "For purposes of the income tax charitable deduction, transfers to grantor charitable lead trusts are considered gifts 'for the use of' charity rather than gifts 'to' charity. If the trust makes payments to a public charity, the deduction can be used against up to 30% of the grantor's contribution base with a five year carryover of any excess deduction. If the trust provides income to a private non-operating

0011 [ST: 14-1] [ED: 100000] [REL: 2015] Composed: Thu Apr 30 13:50:05 EDT 2015
XPP 8.4C.1 SP #3 SC_00755 llp 755 [PW=500pt PD=684pt TW=380pt TD=580pt]
VER: [SC_00755-Local:02 Jun 11 16:13][MX-SECNDARY: 30 Apr 15 06:33][TT-: 23 Sep 11 07:01 loc=usa unit=ch0014v49] 0

As detailed below, not only may trusts make contributions to charity, they also may, in some cases, create and make contributions to charitable remainder and charitable lead trusts, and except to the extent such contributions consist of UBI, such a trust would not be subject to the special deduction limitations, computed as a percentage of the contribution base, applicable to individual taxpayers. An income tax deduction is permitted for the value of the remainder committed in a charitable remainder trust described in Section 664(d); provided the value of the remainder interest is at least 10% of the value of the property contributed to the trust.[37] An income tax charitable deduction is permitted for value of the annuity or unitrust interest committed to charity in a charitable lead trust only if it is a grantor trust under subpart E of part 1 of subchapter J of chapter 1 of subtitle A of the Code.[38] However, if the contribution to a charitable lead trust is made to a non-grantor trust, no charitable deduction is allowed to the trust's grantor but the non-grantor trust would be entitled, under Section 642(c), to an unlimited deduction for its gross income paid pursuant to its governing instrument to charity (again subject to the limitations imposed by Section 681 if made from UBI).

¶ 1404 Split Interest Trusts Created by Non-Grantor Trusts

The IRS has issued a private letter ruling[39] holding that a non-grantor trust may transfer assets to a charitable remainder trust ("CRT") described in Section 664(d).[40] The trust, apparently, was not authorized to create a CRT. However, the trust beneficiary held a presently exercisable special (non-general) power of appointment by which, it seems, the beneficiary could create such a trust. Of course, a charitable remainder trust will not be "qualified" until such time that it is not a grantor trust.[41] It is interesting, perhaps, to note that the ruling does not specify whether the trust from which the charitable remainder trust was formed was entitled to an income tax deduction under Section 642(c) for the actuarial value of the remainder to the extent

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foundation, the percentage limitation is reduced to 20%. Any contribution exceeding the amount deductible in the year of contribution can be carried forward up to five additional years." http://www.pgdc.com/pgdc/charitable-lead-trust.

[37] Note that a trust can be a charitable remainder trust under Section 664 only if it never was or when it is no longer a grantor trust. Treas. Reg. § 1.664-1(a)(4) (second sentence). Note, also, that contributions to a charitable remainder trust will be limited to the percentage of the individual's contribution base for transfers to private foundations if the remainder may pass to such a foundation.

[38] See Section 170(f)(2)(B).

[39] Under Section 6110(k)(3), neither a private letter ruling ("PLR") nor a national office technical advice memorandum ("TAM") may be cited or used as precedent.

[40] PLR 9821029 (not precedent). Treas. Reg. § 1.664-1(a)(4) provides that a charitable remainder trust will be treated as created no earlier than when no one is treated as the trust's owner for income tax purposes under the grantor trust rules.

[41] If the trust does not grant a beneficiary such a special power, it may be possible to grant one by "decanting" the trust from the current one to another that permits it. See, generally, D. Zeydel & J. Blattmachr, "Tax Effects of Decanting—Obtaining and Preserving the Benefits," 111 Journal of Taxation 288 (November 2009). However, it is not certain that any deduction for the payment of gross income from the "new" trust will qualify for a Section 642(c) deduction if the original grantor of the property did not "envision" charitable contributions. Cf. *Brownstone v. United States*, 465 F.3d 525 (2d Cir. 2006).

CRT was funded with gross income of the trust.[42] There would not appear to be any reason why it should not be entitled to such a deduction. In fact, it seems that conclusion is consistent with Rev. Rul. 2005-4, allowing a non-grantor trust that is a partner of a partnership to deduct a charitable contribution made by the partnership (at least if made from the partnership's gross income).

The reasoning set forth in the private letter ruling supports the view that a non-grantor trust also may create a charitable lead trust described in Section 170(f)(2)(B).[43] However, an income tax deduction is not permitted for the actuarial value of an interest in a charitable lead trust unless the trust is a grantor trust. It seems that a non-grantor trust may create another trust which is a grantor trust (meaning a trusts whose assets are treated as owned for income tax purposes by the another) under Section 678 as to the non-grantor trust that created it if the non-grantor trust is authorized to do so.[44] A trust may be a grantor trust with respect to the person who made a gratuitous transfer to the trust for many reasons, one of which is that someone holds a power exercisable in a non-fiduciary capacity to substitute property of equivalent value for assets in the trust.[45] In fact, the Internal Revenue Service has held that such provision will cause a charitable lead trust to be a grantor trust.[46] It seems that if, pursuant to a presently exercisable special (non-general) power of appointment held by a beneficiary of a non-grantor trust or pursuant to a power held by the trustees of such trust to do so, a charitable lead trust that is a grantor trust is created from the gross income of the non-grantor trust, the non-grantor trust should be entitled to a deduction pursuant to Section 642(c), except to any extent it is limited by Section 681.

In any case, if a beneficiary of a non-grantor trust does not hold a presently exercisable special (non-general) power of appointment, which may be exercised to create a charitable lead trust, and if the non-grantor trust is not authorized to create

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[42] The beneficiary might have held a power not just to appoint corpus of the trust but tax income as well. In fact, it might be that corpus, for state law accounting purposes, would include capital gain for Federal tax purposes.

[43] The IRS has also ruled (privately) that a corporation may create a charitable lead trust. *See* PLR 9512002 (not precedent).

[44] Treas. Reg. 1.671-2(e)(6), Example 8. It may be of interest to note that the example concludes that the trust created by the non-grantor trust is one described in Section 678. Hence, the creating trust is not the grantor for Federal income tax purposes under Sections 671 through 677 and Section 679, but would be the owner of the trust for income trust purposes. Note that Section 170(f)(2)(B) allows an income tax deduction to the "grantor" who is the owner of the trust for income tax purposes. As discussed elsewhere, one trust cannot, at least as a general rule, be treated as another trust's grantor. It seems likely that if a trust described in Section 678 creates a charitable lead trust that is treated as a grantor trust with respect to the beneficiary who is treated as the owner, the Section 678 owner should be entitled to a deduction for the value in the lead trust committed to charity. However, it may be that having a partnership of which the Section 678 trust is a partner create the lead trust that is a grantor trust with respect to the partnership produces a more certain result of the owner of the Section 678 trust obtaining the deduction.

[45] Section 675(4)(C).

[46] See Rev. Proc. 2007-45, 2007-29 IRB 89, Section 8.09 (1); and Rev. Proc. 2008-45, 2008-30 IRB 224, Section 8.09 (1).

one,[47] it likely will be preferable for any such grantor charitable lead trust to be created by a partnership of which the non-grantor trust is a partner (or a shareholder of an S corporation) as there seems more certainty that a charitable deduction would be available in such a case.

The IRS has also ruled privately that a partnership and a corporation (including an S corporation) may create a charitable remainder trust.[48] Moreover, the Service has issued a private letter ruling on some of the effects of a corporation creating a charitable lead trust, indicating that the Service accepts that a corporation may create a CLT.[49]

Hence, it seems that a partnership (that is not a disregarded entity)[50] may create a charitable lead trust and, if it is a grantor trust with respect to the partnership, an income tax deduction should be passed out to the partners including, under Rev. Rul. 2004-5, to any non-grantor trust that is a partner.[51]

However, even if the partnership or corporation is not disregarded for income tax purposes, an issue is whether, under the Treasury Regulation,[52] the entity will be treated as creating the trust or whether one or more of its owners will.

¶ 1405 Structure of the Partnership and Corporation that Creates the Trust

A partnership may be treated as creating a trust, including a grantor trust, if it is for its benefit as opposed to the personal benefit of a partner as may a corporation if it is for its benefit as opposed to the personal benefit of a shareholder. The regulations provide:

> If a gratuitous transfer is made by a partnership or corporation to a trust *and is for*

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[47] It might be possible, pursuant to a state "decanting" law, to transfer the assets of the non-grantor trust to another non-grantor trust under which a beneficiary holds a presently exercisable special power of appointment, which may be exercised to create a charitable lead trust which would be a grantor trust with respect to the trust over which the special power is held, or under which the trustees may create such a trust. There is, nonetheless, an issue whether a Section 642(c) deduction would be allowed because the original trust from which the decanting occurred did not so authorize the creation of the trust by the trustees or a beneficiary. For information about decanting (the exercise of a power of invasion by the trustee in further trust) and some of the tax effects of decanting, see D. Zeydel & J. Blattmachr, "Tax Effects of Decanting—Obtaining and Preserving the Benefits," 111 Journal of Taxation 288 (November 2009), cited in *Morse v. Kraft*, 466 Mass. 92 (2013).

[48] PLR 9205031and PLR 8102093 (C corporation); PLR 200644013 and PLR 9340043 (S corporation); PLR 9419021 (partnership); PLR 199952071 (limited liability company, treated as a partnership for Federal tax purposes), none of which may be cited or used a precedent.

[49] PLR 9512002 (not precedent).

[50] If the partnership is disregarded for Federal tax purposes (see Treas. Reg. § 301.7701-3 and Rev. Rul. 2004-77, 2004-2 CB 119 (entity with two partners, one of which is disregarded as to the other)), it cannot be classified as a partnership but rather will be treated as a disregarded entity unless it elects to be taxed as a corporation. If the partnership is a disregarded entity, its partners would be treated as creating the trust.

[51] If the trust that is a partner is a grantor trust, then the charitable deduction would be attributed (passed out) to the grantor. See Rev. Rul. 85-13, 1985-1 CB 184.

[52] Treas. Reg. § 1.671-2(e)(4).

> *a business purpose of the partnership or corporation*, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, *if a partnership or corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders*, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.[53] (Emphasis added.)

As reflected by the Treasury Regulation, partnerships and corporations often create trusts for business reasons and, in such a case, presumably would be treated as the grantor of any such trust for Federal income tax purposes. The same would seem true for a charitable remainder trust ("CRT") or charitable lead trust ("CLT") created by the entity as reflected by the private letter rulings cited in this article.

Of course, partnerships (and other business entities, such as S and C corporations) often make contributions to charities. However, there does not seem to be any requirement that the charitable contribution need be for a business purpose in order to be treated as made by the entity for income tax purposes, as opposed to being treated as made its owners.

If the creation of the charitable remainder trust or the charitable lead trust will be in fulfillment of one of the entity's business purposes, it certainly would seem to fall under the foregoing regulation that provides that a partnership or corporation may be treated as the grantor of a trust (whether or not it is a grantor trust for income tax purposes).

Hence, if a partnership or corporation creates a CLT and the entity retains the right annually to choose the charitable recipients or commits the payments to a local charities or charities in the same "industry" as the company (e.g., educational institutions if the company publishes school books and provides other educational goods) and if the remainder reverts solely to the partnership or corporation, as the case may be, when the charitable term ends, it seems the contribution to the trust is for a business purpose of the partnership or corporation and not for the personal benefit of any partner or shareholder.[54] Similarly, if a partnership or a corporation creates a CRT,

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[53] Treas. Reg. § 1.671-2(e)(4).

[54] The IRS has issued private letter rulings, which although they may not be cited or used as precedent, hold that entities, such as partnerships, may create charitable remainder trusts described in Section 664. See, e.g., PLR 9419021. See, generally, Baker & Batson, Charitable Remainder Handbook, p.1, n. 3 ("A sampling of PLRs that permit non-natural person entities to be a CRT donor includes:

it may well be treated as created by the entity (as opposed to any owner of the entity) if there is a business purpose for doing so. As mentioned elsewhere, the IRS has ruled that C corporations, S corporations and partnerships may create CRTs. One reason the entity may do that is because the entity has an asset which if sold (or distributed to its owners) would cause gain recognition. In at least some cases, an appreciated asset may be contributed to a CRT without gain recognition and the CRT may sell the asset without paying any income tax because a CRT is exempt from income tax except that, to the extent it has UBTI, which may include acquisition indebtedness, an excise tax may be imposed on such income.[55]

Even though, ultimately, everything a partnership or an S corporation does is for the benefit of its owners, it seems that creating a CLT as a grantor trust to generate a deduction for the owners or creating a CRT to eliminate income tax on the sale of an appreciated asset should be treated as being done for a business purpose of the entity. However, there seems to be a more assured way of having the creation of a CLT or CRT be treated as being for a business purpose of the entity, so the trust is not treated as created by the entity's owners.

Suppose the entity includes in its statement of purposes philanthropic ones. Although it may seem odd that a for-profit entity would be devoted, in part, to philanthropic purposes, this has been done ever since Google created Google.org almost 20 years ago. Google.org's website states that "Google.org develops technologies to help address global challenges and supports innovative partners through grants, investments and in-kind resources." In other words, Google.org is an organization that attempts to accomplish philanthropic goals (although, apparently, its goals are not limited to purely qualified charitable purposes as described in Section 501(c)(3)). Google does so without the restrictions on activities that a tax exempt charity must follow, such as the prohibition on carrying on propaganda or otherwise attempting to influence legislation.[56] For example, apparently, Google.org may and does make "grants" to other for-profit companies that may develop technologies that may benefit human kind (such as cleaner energy). The following is a description of how Google.org is intended to operate: "By choosing for-profit status, Google will have to pay taxes if company shares [that it owns] are sold at a profit—or if corporate earnings are used—to finance Google.org. Any resulting venture that shows a profit will also have to pay taxes. It could, for example, form a company to sell . . . converted cars [that pollute less], finance that company in partnership with venture capitalists, and even hire a lobbyist to pressure Congress to pass legislation granting a tax credit to consumers who buy the cars."[57]

In a circumstance where the purposes of the partnership or corporation include charitable ones within the meaning of Section 664 or 170(f)(2)(B), it seems that the

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C-Corporation—9205031 and 8102093; S-Corporation—200644013 and 9340043; LLC—199952071; Partnership—9419021; and Trust—9821029.").

[55] See 664(c).

[56] See Section 501(c)(3).

[57] See http://www.nytimes.com/2006/09/14/technology/14google.html?pagewanted=all.

deduction for the value of the charitable interest committed in a charitable lead trust that is a grantor trust or a charitable remainder trust created by the partnership or S corporation should pass out to its partners or shareholders, as the case may be. In fact, the governing documents of the partnership or corporation might explicitly authorize the entity to create CRTs and CLTs to carry out its philanthropic purposes. And if an S corporation or partnership, which has such purposes and powers, creates a CRT described in Section 664 or a CLT described in Section 170(f)(2)(B), which CLT is a grantor trust, the deduction allowed for the charitable component of the trust should be deductible for income tax purposes by the shareholders or partners including any non-grantor trust or a decedent's estate that is a shareholder or partner, pursuant to Rev. Rul. 2004-5, under Section 642(c). And unlike C corporations and individuals whose income tax deductions are limited to a percentage of adjusted gross income, a decedent's estate or a non-grantor trust is entitled to an unlimited charitable deduction under Section 642(c) (except to the extent Section 681 applies).

¶ 1406 The Problem of Recapture

As indicated, the grantor of a charitable lead trust is entitled to a deduction in the year the trust is created if it is a grantor trust. However, Section 170(f)(2)(B) (second sentence) provides that all or a portion of the deduction will be recaptured if the trust's grantor trust status terminates, essentially, before the charitable annuity or unitrust term ends.[58]

The tax law provides that the upfront income tax deduction allowed when the taxpayer creates a charitable lead trust that is a grantor trust is recaptured, in whole or in part, in some cases when grantor trust status ends. Grantor trust status, of course, will end not later than when the grantor dies.[59] Unfortunately, the Code and regulatory provisions with respect to the recapture are quite disparate.

When a taxpayer creates a charitable lead trust that is a grantor trust for income tax purposes, the taxpayer may be viewed as trading an upfront income tax deduction for gross income inclusion during the charitable term of the lead trust of gross income the trust earned and without any further deduction even if such income is paid to charity. The taxpayer cannot obtain both an upfront income tax deduction for the value of the interest committed to charity and essentially avoid income tax on the trust's taxable income that is used to fund the payments to charity.[60]

In addition, the upfront income tax deduction, in whole or in part, is recaptured (that is, it must be included in the gross income of the taxpayer) when the trust's grantor trust status ends to the extent, if any, determined on a present value basis, that the upfront deduction is greater than the amount of trust income that has been attributed

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[58] A portion of this part is derived from J. Blattmachr, "Some Recapture Considerations and Other Problems Relating to Charitable Lead Trusts," LISI Charitable Planning Newsletter #172 (February 7, 2011) at http://www.leimbergservices.com.

[59] See Treas. Reg. § 1.170A-6(c).

[60] Section 170(f)(2)(C).

to the grantor under the grantor trust rules.[61]

For example, assume a taxpayer creates a charitable lead trust that is a grantor trust for income tax purposes with $1 million of cash when the applicable section 7520 rate (used to determine the value of the interests in the trust) is 3.2% providing for charity to receive at the end of each year $524,137 for two years, after which the charitable interest will end and the remainder will pass outright to the taxpayer's descendants. The present value of the annuity payments for charity is slightly above $1 million so the taxpayer will be entitled to an income tax deduction (subject to any other limitations imposed by section 170) of $1 million. If the trust earns exactly 3.2% each year, the entire corpus and income of the trust will be paid to charity. The trust will have earned only about $48,252 of income during the two year charitable term. The present value of that $48,252 (as of the creation of the trust) is only about $46,368. Because the trust will be exhausted at the end of the two year charitable term, nothing will pass to the remainder beneficiaries and grantor trust status will have ended. As a consequence, under the provisions of the Code, taken literally, the taxpayer will then have $953,632 of gross income under the recapture rule of section 170(f)(2)(B) (the amount equal to the difference between the value of the income reported by the grantor a result of including the trust's income ($46,368) in the grantor's gross income and the value of the charitable deduction received up front $1 million). That result seems bizarre. The taxpayer could have simply given charity the $1 million of cash, obtained a $1 million income tax deduction (to the extent within the grantor's contribution limits) with no recapture at all.

Apparently, to ameliorate that possible draconian result under the Code, the Treasury Regulations provide, in part, "(4) *Recapture upon termination of treatment as owner*. If for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be treated as the owner of such interest for purposes of applying section 671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under section 170 for the contribution of such interest reduced by (ii) *the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest*."[62] (Emphasis added.)

In other words, recapture of the upfront deduction occurs under the regulation (1) only if grantor trust status ends *before* the charitable lead term ends and (2) only to the extent (based upon present value calculations) charity has received less (whether it is income or corpus or both) than the donor's income tax deduction amount, rather than, as under the Code, only to the extent that the grantor had to include trust income in gross income. Hence, under the regulation, in the foregoing example where the

[61] Section 170(f)(2)(B) (second and third sentences).

[62] Treas. Reg. § 1.170A-6(c).

taxpayer created a $1 million two year charitable lead trust paying $524,137 each year to charity, there would be no recapture because the present value of the payments made to charity during the charitable term would equal the upfront deduction, assuming the grantor did not die or the trust otherwise ceases to be a grantor trust before the end of the two year term. Note that, in fact, no recapture would occur even if the trust's income exceeded 3.2 percent each year because at least $ 1 million, on a present value basis, is delivered to charity.

Therefore, the recapture rules under the Code are starkly different than under the regulation. Which rule prevails? It seems appropriate to note that the Congress apparently intended the literal result dictated under the Code. The General Explanation of the Tax Reform Act of 1969 provides, in part, in discussing the recapture rule, "This is accomplished by treating the donor at the time he ceases to be taxable on the trust income as having received income to the extent the deduction he previously was allowed exceeds the value of the income previously earned by the trust and taxable to him."[63]

It appears that the recapture rule set forth in the regulation, although contrary to the "harsher" provision in the Code, also was intentional.

The Treasury Department Technical Memorandum to the Treasury Decision, by which the regulation was promulgated,[64] explains the limited recapture rule the regulations adopts and states, in part:

> The amount of the charitable contributions deduction required under section 170(f)(2)(B) to be recaptured is measured by subtracting from the amount of such deduction previously taken the discounted value of all amounts of income earned by the trust and taxable to the donor by reason of section 671 before the time he ceases to be treated as the owner of the interest. The amounts of income earned by the trust in each table year and taxable to the donor are discounted to their value as of the date of contribution. The statutory formula raises the question as to whether only those [*32] amounts of income earned by the trust, paid to the charity, and taxable to the donor are taken into account or whether all amounts of income earned by the trust and taxable to the donor, whether or not paid to charity, are to be considered. *The argument was made that a recapture rule conforming to a literal reading of the statute would be illogical because there is no necessary correlation between the charitable contributions deduction previously allowed to the donor and the amount paid to the charity.* Thus, for example, the trust might earn $10,000 annually (all taxable to the donor) and pay $1,000 annually to the charity."

Notwithstanding the helpful language above. The preamble continues as stated

[63] General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation (December 2, 1970), at p. 88.

[64] Technical Memoranda Notice of proposed rulemaking—Amendment of Income Tax Regulations to conform them to section 201 (a) and (f) of the Tax Reform Act of 1969, relating to charitable contributions), *1970 TM LEXIS 26*, December 10, 1970, REFERENCE: CC:LR-1699, Br1:NGZ,ACTION DOC: T.D. 7207.

below, and confusingly, seems to restate the rule set forth in the Code.

> Accordingly, the proposed regulation adopts the position that the amount recapturable is to be measured by subtracting from the amount of the charitable contributions deduction previously allowed to the donor the discounted value of only those amounts which were taxable to the donor and paid by the trust to the charity. It is recognized that this approach is not clearly supportable under the language of section 170(f)(2)(B). Paragraph (c)(4) also adopts the position that, for purposes of applying this recapture rule, trust income of which the donor is treated [*33] as the owner shall be treated as income taxable to him even though it is excluded from his gross income by reason of an exclusion provision of the Code. This appears consistent with the allowance of a charitable contributions deduction to a donor for amounts paid to a charitable organization from amounts as a gift or as exempt income. (Emphasis added.)[65]

The regulation is so explicit that one might conclude that the IRS would accept it as the recapture rule. However, Rev. Proc. 2007-45, promulgated by the IRS to provide sample charitable lead trust provisions, essentially recites the same recapture rule contained in the Code. Specifically, it provides, "If at any time the donor 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 shall be considered to have received an amount of income equal to the amount of any deduction the donor received under § 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. Section 170(f)(2)(B)."[66]

Whether the Service would be bound by the regulation is uncertain. Indeed, it is questionable whether a government agency may ignore the law.[67] Therefore, in the absence of clarification by the IRS, a taxpayer must consider that recapture might occur under the harsher provisions of the Code. Fortunately, if the corporation or the partnership (or a non-grantor trust) will be the grantor (or, for a non-grantor trust, the income tax owner) of the charitable lead trust as it likely can be kept from "dying" before the charitable term of the grantor lead trust ends and the trust otherwise does lose its grantor trust status, recapture of the income tax deduction generated by the creation of the CLAT should not occur assuming the contributor to the CLAT is treated as being the entity itself and not its owners. There is no indication even where the deduction is "passed out" from the partnership or the S corporation to the partners or the shareholders, as the case may be, that the partnership or shareholders should be treated as the grantors for recapture purposes rather than the entity. Indeed, the premise

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[65] Note that the Technical Memorandum provides that it may not be cited or used as precedent.

[66] Rev. Proc. 2007-45 § 8.01(5).

[67] For a discussion of this interesting issue, *see* M. Gans, "Deference and the End of Tax Practice," 36 Real Prop. Prob. & Tr. J. 731 (Winter 2002) at 795–800; and Gans, "Deference and Family Limited Partnerships: A Case Study," 39th Annual Heckerling Institute on Estate Planning, Chapter 5 (2004).

is that the partnership or corporation is the grantor under the regulation. Even if the partners or shareholders are treated as the grantors for recapture purposes, it is likely that any non-grantor trust that is a partner or shareholder also could be structured not to "die" before the charitable term of the lead trust ends.[68]

¶ 1407 The Impossible Dream?[69]

It will be noted that much of the foregoing discussion of the potential benefits of creating a charitable lead trust by an entity (including a non-grantor trust) is where the trust is a grantor trust so a current income tax deduction is generated for the grantor (and, in some cases, transferred, in turn, to the owners of the entity that has created the trust). As explained, the potential adverse effect of doing that is that the taxpayer who is entitled to the income tax deduction is charged with the taxable income generated during the charitable term of the trust without any further deduction. The best of all possible worlds, in the view of some, is to obtain the immediate income tax deduction by creating a charitable lead trust that is a grantor trust while minimizing the amount of taxable income the charitable lead trust generates during the charitable lead term which will be included in the gross income of the grantor. Here are some ways that have been or might be considered to try to achieve that result.

¶ 1407.1 Fund the Charitable Lead Trust with Municipal Bonds

Although the charitable lead annuity trust ("CLAT") or charitable lead unitrust ("CLUT") might hold municipal bonds, the interest on which is not included in gross income,[70] the return on those bonds generally is so low that it is unlikely that the trust will be able both to make the annuity or unitrust payments and have any property (or any significant property) left in the trust that may pass to the remainder beneficiaries when the charitable term ends.[71] Therefore, as a general rule, it is generally necessary that the investment return experienced by the charitable lead trust will be well in excess of that provided from most municipal bonds.[72]

¶ 1407.2 Fund the Charitable Lead Trust with a Roth IRA

One possibility might be to fund the charitable lead trust with a Roth IRA, distributions from which produce no taxable income and which may well have returns

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[68] Many states now permit trusts to last for very long fixed or even perpetual terms. See H. Zaritsky at http://www.actec.org/public/documents/studies/zaritsky_rap_survey_03_2012.pdf.

[69] A significant portion of this part of this article is derived from J. Blattmachr, "Charitable Trusts and Insurance: Setting the Record Straight," 41 Estate Planning 3 (June 2014).

[70] See Section 103.

[71] See D. Zeydel, "Estate Planning in a Low Interest Rate Environment," 36 Estate Planning 17 (July 2009), for a discussion of when a lead trust may be successful.

[72] At least in one circumstance, the acquisition of municipal bonds might prove beneficial for a charitable lead trust. The Section 7520 used to measure the value of interests in the lead trust is based upon the mid-term (three to nine year) applicable Federal rate. If long term rates (that is, the rate on obligations maturing in more than nine years) were significantly greater than the Section 7520 rate, rates on long-term municipal bonds might also well exceed the Section 7520 rate meaning a CLAT funded with such obligations might prove successful without generating gross income during the charitable term.

in excess of those produced by municipal bonds.[73] One pair of commentators believes that, because it is the official position of the Internal Revenue Service that a grantor trust does not exist for income tax purposes and that its assets are treated for such purposes as held by the grantor, the Roth IRA nature of the account continues while it is held by a grantor trust.[74] Whether or not the nature of the Roth IRA continues when it is contributed to a grantor trust is not certain in the view of at least one other commentator and, in any case, loss of Roth IRA status could mean all income earned after the contribution would be taxable to the grantor.[75]

¶ 1407.3 Fund the Charitable Lead Trust with a Paid Up Life Policy that Is Not a MEC

Another strategy is to fund the CLAT or CLUT with a paid up policy that is not a modified endowment contract (“MEC”) as defined in Section 7702A or otherwise subject to its rules. This strategy may be attractive because the policy may produce returns substantially higher than municipal bonds and borrowings of those returns from the cash value of a policy that is not subject to the MEC rules are not included in gross income. Hence, the trust could borrow against the policy’s cash value to make the charitable annuity payments without generating any taxable income.

Borrowings against the cash value of a policy that is a MEC, however, are included in gross income of the policy owner[76] to the extent the cash value has increased above premiums paid. A policy will be a MEC if its premiums are paid too rapidly. Although there are many ways to structure premiums to avoid MEC status, the premiums generally must be paid over at least a few years. If the taxpayer who wishes to create a charitable lead trust that would be a grantor trust has a paid up policy that is not a MEC, he or she could contribute it to the charitable lead trust which could borrow from the policy’s cash value to make the annuity payments with a result that may appear attractive (an upfront income tax deduction with no taxable income imputed back to the grantor).

However, perhaps, there are few taxpayers who have existing paid up policies that

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[73] Because the income of an IRA (whether or not a Roth IRA) is not taxed as earned in the account, it makes no sense, as a general matter, for an IRA to acquire municipal bonds.

[74] See, e.g., S. Horwitz & J. Damicone, “A Decent Proposal,” 150 Trusts & Estates 46 (Nov. 2011).

[75] See, e.g., N. Choate, seminar outline, “The 201 Best & Worst Planning Ideas for Your Client’s Retirement Benefits,” 2014 edition, published electronically as a Special Report by Ataxplan Publications, www.ataxplan.com. See, also, Private Letter Ruling 201129045 (stating without analysis or citation that an IRA will lose its status as such if contributed to a grantor trust); but, cf. CCA 201334021 (which seems critical of the statement in the private letter ruling). Under Section 6110(k)(3), neither a private letter ruling nor a chief counsel advisory (CCA) may be cited or used a precedent.

[76] Although the charitable lead trust, in fact, will own the policy, it will be treated as owned by the grantor for income tax purposes when the trust is a grantor trust. See, e.g., Treas. Reg. § 1.1001-2(c), Example 5 (“T is a ‘grantor trust’. . . and therefore C is treated as the owner of the entire trust*** Since . . . C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a ‘grantor trust’.”)

are not MECs with sufficient cash value to make the creation of the lead trust worthwhile and who would be willing to contribute such a policy to a lead trust.

Although a taxpayer certainly could acquire such a non-MEC policy with an eye to contributing it to a charitable lead trust in a future year, it does not seem likely that many taxpayers would be willing to pay significant premiums over a number of years to make the policy a paid up non-MEC, which could then be contributed to the trust (then generating the income tax deduction if the trust is a grantor trust) so the annuity payments could be funded by income tax free borrowings against the policy's cash value.

¶ 1407.4 Fund a Shark-Fin CLAT with Large Life Policy and a Little Cash

Another suggestion has been to create what is called a "shark fin CLAT,"[77] funding it with a relatively small amount of cash (or single premium immediate annuity) and a significant paid-up life insurance policy.[78] Under the trust provisions, small annuity payments would be made each year until the insured dies at which time a sufficiently large payment would be required to be paid to charity so the remainder would be "zeroed out" as of the inception of the trust and the payment at death would be paid from the income tax free life insurance proceeds paid on the death of the insured when the charitable term of the trust ends.[79]

The reason the annuity payments are kept so small until the insured[80] dies is because a recently acquired policy likely will constitute a MEC, so that borrowings against its cash value will be included in gross income as ordinary income to the extent the cash value has appreciated above premiums paid. Some have suggested that a small "side fund" of cash (or some assets that have a stable value and that can be readily converted to cash) or an single premium immediate annuity (called a "SPIA") could be contributed to the trust which can be used to make these small initial payments and make borrowing against the cash value of the contributed MEC policy unnecessary. There may well be some challenges in using that structure.

First, at least one set of commentators has contended that a trust that provides for

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77 It is beyond the scope of this article to discuss the matter in detail but it almost never is preferable to create a charitable lead unitrust rather than a charitable lead annuity trust. See, generally, J. Blattmachr "A Primer on Charitable Lead Trusts: Basic Rules and Uses," 134 Trusts & Estates 48 (April 1995). A senior person at a major bank has advised that the IRS refused to issue a favorable private letter ruling for such a trust where the final payment was to arise at the grantor's death.

78 A paid-up policy is one that, at the time of transfer, requires no more premiums to keep it in force until the death of the insured. And a policy can be paid up with a single premium. See, generally, J. Blattmachr & M. Pasquale, "Buying Life Insurance to Fund Estate Taxes: A Counter Intuitive Approach," 151 Trusts & Estates 27 (2012). As will be explained in detail later in this article, if the policy is not paid up, Section 170(f)(10) may apply causing devastatingly adverse tax effects.

79 As a general rule, proceeds paid upon the death of the insured are not included in gross income. Section 101(a)(1).

80 The insured can be anyone. However, it likely would be the grantor who would face recapture. For example, if the insured is the spouse or a child of the insured, the grantor might die before the insured does in which case there likely could be a significant recapture.

small ("de minimus") annuity payments until the insured dies may not constitute a "qualified" charitable lead trust.[81] Others contend to the contrary.[82]

Second, in any case, even assuming (which may be reasonable based upon the explicit regulation that indicates that annuity payments may vary from year to year as long as the amounts are essentially determinable from the inception of the trust)[83] that small initial payments may be provided for from a lead trust, there is a significant potential for income tax recapture with respect to the final "big" payment to be made from the income tax free insurance proceeds when the insured dies.

Recapture occurs under the regulation, as mentioned above, (1) only if grantor trust status ends *before* the charitable lead term ends and (2) only to the extent (based upon present value calculations) that charity has received less, on a present value basis, than the amount of the donor's income tax deduction.

The regulation does not seem to contain any special or unique definition of the term "before." The regulation is quite clear that grantor trust status must end *before* the charitable interest does in order for recapture to be triggered. One event occurs either before, after, or *simultaneously* with another event. Literally, for recapture to occur, the grantor trust status must end before the termination of the charitable annuity (or unitrust) interest.

However, by the time the charitable term ends (by the trust's provisions, at the grantor's death) has grantor trust status certainly ended? It seems not. Rather, it is apparent that grantor trust status terminated (by reason of the grantor's death) and the charitable term terminated simultaneously—rather than the grantor trust status ending *before* the charitable term does. However, the charity will likely not have received its final payment when its entitlement to the final payment arose (at the grantor's death) and grantor trust status ends. It is possible that the regulation means the grantor trust status cannot end before charity, in fact, receives the final payment.

Why should the IRS care? It seems that the regulation is seeking a result whereby all taxable income that will be used to fund the unitrust or annuity payments will be taxed to the grantor. Hence, if the final annuity payment to charity is made after the grantor's death, it might be paid with income earned after that time and this income will not be taxed to the grantor. This would appear to create at least some risk that there will be recapture to the extent of the final payment.

This problem for a term-of-years CLAT might be ameliorated by providing language in the trust document so that grantor trust status cannot end (other than by the grantor's death) before all unitrust or annuity payments, in fact, are made to charity. For example, the trust could be drafted so that any power of substitution (which, if

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[81] See R. Fox & M. Teitelbaum, "Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance." The article does not provide guidance as to what the commentators believe should not be viewed as de minimus. LISI Charitable Planning Newsletter #162 (October 2010).

[82] D. Pratt, S. Goldberger & P. Lee, "Biting Back: Responding to the Attack on Shark-Fin CLATs," LISI Charitable Planning Newsletter # 163 (October 2010).

[83] See Treas. Reg. § 1.170A-6(c)(2)(i)(A) (second sentence); cf. Treas. Reg. § 20.2055-2(e)(2)(vi)(a).

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described in Section 675(4)(C), causes the trust to be a grantor trust during the time the power is outstanding) would not expire until sometime after the final payment to charity is made. But there is a risk that the grantor will die prior to the end of the term of years and, of course, grantor trust status automatically will end when the grantor dies. Moreover, although this might be a solution for CLATs in general, if cannot be a solution for a CLAT funded with insurance.

When the final payment to charity arises by reason of the grantor's death, there is no opportunity to extend grantor trust status—the grantor's death ends that status as to the grantor no matter what. The status will end no later than when the grantor dies even if it is a term-of-years lead trust as opposed to one for life.

This result would be quite severe if the trust were a so-called "shark fin" CLAT—a charitable lead trust that provides small payments until the very end of the charitable term when a very large payment to charity arises. Again, the chance of being able to pay charity with cash simultaneously with the grantor's death likely cannot occur. Hence, if charity's interest is not deemed to have ended before the final payment to charity is actually made, there may be significant recapture.

Is there a solution? There may well be ones. To understand it, we have to look at charitable remainder trusts ("CRTs") and grantor retained annuity trusts ("GRATs").[84]

In *Atkinson v. Commissioner*,[85] the Tax Court and the United States Court of Appeals for the Eleventh Circuit held that a trust was not a qualified charitable remainder trust because the annuity payments required under the trust were not made "on time." The IRS, in audits, has contended that, if a GRAT does not make annuity payments timely (including within the 105 day regulatory "grace" period),[86] there is no qualified annuity interest within the meaning of Section 2702 from inception causing the entire amount transferred to the GRAT to be treated as a taxable gift.

To avoid that problem, some GRAT forms provide, in effect, that, if the annuity from a GRAT is not made on time, the donor-annuitant will become vested absolute in a portion of the trust's assets so that the annuity will be deemed paid in full. An example of this type of language is:

> **Payments to Vest.** If any portion of the annuity payable to the Grantor or the Grantor's estate, as the case may be, on a particular date is not distributed in its entirety by the Trustee to the Grantor or the Grantor's estate, as the case may be, by the end of the last day (the "Annuity Amount due date") on which it must be paid in order for the Annuity Amount to be treated as a qualified annuity for purposes of Section 2702 of the Internal Revenue Code, including any applicable grace period (such unpaid portion of the Annuity Amount being hereinafter

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84 A GRAT is a trust from which annuity payments are made to the grantor for a period of time. If properly structured, the standard actuarial value of the annuity stream due the grantor is subtracted from the value of the assets contributed to the GRAT for purposes of determining the gift tax value of the remainder. See Section 2702(b).

85 115 TC 26 (2000), aff'd, 309 F 3d 1290 (11th Cir. 2002).

86 Treas. Reg. § 25.2702-3(b)(4).

> sometimes referred to as the "undistributed Annuity Amount"), then, at the end of the Annuity Amount due date, the Annuity Property (as hereinafter defined) held by the trustee shall vest absolutely in the Grantor or the Grantor's estate, as the case may be. The trust shall immediately terminate as to the Annuity Property, and the Trustee, in the Trustee's capacity as Trustee, shall have no further duties, power, authority or discretion to administer the Annuity Property notwithstanding any provision of applicable law or this Agreement to the contrary. If the Annuity Property shall remain in the hands of the Trustee after the Annuity Amount due date, the Trustee shall hold such property exclusively as nominee and agent for the Grantor or the Grantor's estate, as the case may be. The Grantor hereby authorizes the Trustee, but only as nominee and agent for the Grantor or the Grantor's estate, as the case may be, to invest the Annuity Property on the Grantor's behalf or on behalf of the Grantor's estate, as the case may be, with the same authority as the Grantor or the Grantor's estate, as the case may be, could individually. The Trustee, both as Trustee and as such nominee and agent, is hereby relieved of any liability for commingling assets that have vested absolutely in the Grantor or the Grantor's estate, as the case may be, with assets that remain part of the trust estate under this Article. Any Annuity Property that shall have vested in the Grantor as hereinbefore provided shall, upon the Grantor's subsequent death, vest in the Grantor's estate. For purposes of this Article, the term "Annuity Property" shall mean that portion of the trust estate having a fair market value as finally determined for Federal gift tax purposes equal to the lesser of (x) all property held by the Trustee, in the Trustee's capacity as Trustee, at the end of the Annuity Amount due date or (y) the undistributed Annuity Amount. If the fair market value as finally determined for Federal gift tax purposes of the property then held by the Trustee is greater than the undistributed Annuity Amount at the end of the Annuity Amount due date, the Annuity Property shall consist of those assets having the lowest income tax basis as finally determined for Federal income tax purposes compared to their current fair market values as finally determined for Federal income tax purposes, and if more than one asset has the lowest basis for Federal income tax purpose, the Annuity Property shall consist of a proportionate share of each such asset. The Annuity Property shall include all income, appreciation and depreciation on all assets that are used to fund the Annuity Property, and all other incidents of ownership attributed thereto.[87]

It should be noted that all property is either owned by the trust or by the donor, not both. Obviously, this language would need to be revised to refer to the charitable annuitant rather than the Grantor and the Grantor's estate.

For a charitable lead trust, the following is a potential sample provision:

> **Payments to Vest.** If, upon the death of the Grantor, any annuity payment arises upon and is payable to the charitable beneficiary hereunder (the "Final Annuity Payment"), then, upon the Grantor's death, an amount of trust property having a

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[87] This provision is derived from Wealth Transfer Planning, a computerized system for lawyers, published by Interactive Legal, and is reproduced here with its permission.

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value, as finally determined for Federal tax purposes as of the Grantor's death, equal to the Final Annuity Payment shall vest absolutely and simultaneously with the death of the Grantor in the charitable beneficiary and without any further action of the Trustee acting hereunder or by the charitable beneficiary. The trust shall upon and simultaneously with the death of the grantor immediately terminate as to such trust property (the "Charitable Trust Property"), and the Trustee, in the Trustee's capacity as Trustee, shall have no further duty, power, authority or discretion to administer the Charitable Trust Property, notwithstanding any provision of applicable law or this Agreement to the contrary. The Charitable Trust Property may remain in the hands of the Trustee after the Grantor's death but the Trustee shall hold the Charitable Trust Property exclusively as nominee and agent for the charitable beneficiary. The Trustee is hereby authorized, except to the extent the charitable beneficiary instructs otherwise, but only as nominee and agent for the charitable beneficiary, to hold and invest the Charitable Trust Property. The Trustee, both as Trustee and as such nominee and agent of the charitable beneficiary, is hereby relieved of any liability for commingling the Charitable Trust Property with assets that remain part of the trust estate. For purposes of this paragraph, the term "Charitable Trust Property" shall mean that portion of the trust estate having a fair market value as finally determined for Federal tax purposes as of the death of the Grantor equal to the lesser of (x) all property held by the Trustee, in the Trustee's capacity as Trustee, upon the death of the Grantor or (y) the Final Annuity Payment. If the fair market value as finally determined for Federal tax purposes of the property then held by the Trustee is greater than the Final Annuity Payment as of the death of the Grantor, the Charitable Trust Property shall consist of cash and, to the extent the Final Annuity Payment exceeds the amount of cash held by the Trustee as of the Grantor's death, those assets having the highest income tax basis (not in excess of the fair market value of any such asset at that time) as finally determined for Federal income tax purposes compared to their current fair market values as finally determined for Federal income tax purposes, and if more than one asset has the highest basis for Federal income tax purpose, the Charitable Trust Property shall consist of that asset which has or those assets which have a fair market value at the time of distribution in satisfaction of the Final Annuity Payment greater than the amount of the Final Annuity Payment but as close to the Final Annuity Payment as possible.

Despite the lack of legal authority, the foregoing provision, if respected, should avoid any recapture.[88]

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[88] Some have contended that recapture at death is "not so bad" because the income tax recapture will be imposed on the decedent's final income tax return and will be deductible under Section 2053 for estate tax purposes. Of course, if the grantor would not otherwise have a taxable estate (e.g., it all passes to the grantor's surviving spouse under the protection of the estate tax marital deduction under Section 2056), the deduction may be viewed as worthless in reducing the cost of the recapture.

¶ 1407.5 Fund the CLAT with Cash and a Policy That Is *Not* Paid Up

Another suggestion is to contribute a policy that is not paid-up and also contribute sufficient cash to continue to pay premiums until it is no longer a MEC. Despite being widely promoted, including allegedly by one of the country's largest life insurance companies, the strategy potentially triggers the application of Section 170(f)(10) which may cause doomsday results. Section 170(f)(10) disallows any charitable deduction if any charity "directly or indirectly" pays (or has paid) any premium on any "personal benefit contract" or there is an understanding or expectation that "any person" will, directly or indirectly, pay any premium on any personal benefit contract. A personal benefit contract is any life insurance, annuity or endowment contract if any "direct or indirect" beneficiary is the transferor, any member of the transferor's family or anyone (other than a charity) designated by the transferor. (It seems nearly certain that the remainder beneficiaries of a lead trust who would succeed to any life insurance proceeds not paid to charity would be designated by the trust's grantor.) In addition, a 100% excise tax is imposed on any charity equal to the premiums it pays on such a personal benefit contract. As a consequence, where Section 170(f)(10) applies, the taxpayer receives no income tax charitable deduction, receives no gift tax charitable deduction (and, therefore, must pay gift tax on the value of what has been committed to charity in the trust), and the assets essentially will be confiscated by the IRS.

It is uncertain whether or to what degree Section 170(f)(10) applies to a charitable lead trust.[89] There is at least some indication that it does apply.

The section applies where, among other things, charity "directly *or indirectly* pays . . . any premium." (Emphasis supplied.) It does not seem highly unlikely that a court might find that the charity that is the beneficiary of the lead trust has made an indirect payment when the lead trust pays the premium, at least to the extent of the charitable interest in the trust (which, at inception, might approach or equal the entire interest in the trust). Although that may not be certain, it seems to raise the possibility to such a result cannot or should not simply be ignored.

Certainly, the section is not limited to situations where a charitable organization make the premium payment. Not only does the section speak in terms of direct and *indirect* payments (which, perhaps, might include payments made on behalf of charity), but it contains somewhat limited and strict exceptions for charitable gift annuities[90] and charitable remainder trusts[91] and essentially provides that, if the limited exceptions do not apply, the section will apply to such annuities and remainder

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[89] Compare Jansen, "Charitable Lead Trusts: The Underused Family Wealth Transfer and Income Tax Technique for the Charitably Inclined," 37th Annual Notre Dame Tax and Estate Planning Institute (2011), at pp. 21–28, 29 (" 'Furthermore, the IRS has declined to issue a private letter ruling that such section [170(f)(10)] did not apply and the author has been told that the IRS agent involved states that it was his personal opinion that IRS Section 170(f)(10) did apply") and Shark-Fin CLAT" at http://www.disinherit-irs.com/~disinher/files/Shark-Fin_CLAT_Case_Study.pdfD., with J. Smith, "Time to Head Back into the Water," 153 Trusts & Estates 47 (December 2014).

[90] See Section 170(f)(10)(D) and (G).

[91] See Section 170(f)(10)(C) and (E).

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trusts. It might be contended that Congress was concerned with only certain gift annuities and charitable remainder trusts and, therefore, expressly put in a rule to cover those and, if it had been concerned with charitable lead trusts, it would have provided coverage for those, and, because it did not, lead trusts are not covered by the section. On the other hand, it may be rationally contended, it would seem, that Congress intended the section to apply to all charitable lead trusts and did not carve out any exception as it did for certain gift annuities and remainder trusts. Also, if lead trusts are not covered, the section is rather shallow in application and easily can be avoided without losing the benefits of having a charitable organization directly involved. The lead trust may be structured so 100% of the trust is deemed dedicated to charity and, therefore, a complete gift tax deduction would be permitted, and if the trust is structured as a grantor trust the grantor will be entitled to the same income tax deduction would be allowed as if the property transferred to the lead trust had been given directly to charity.

It seems that the risk of the section applying is not de minimus and its application would be extremely adverse: no income tax deduction, no gift tax deduction (so the grantor would be treated as making a taxable gift of the entire amount transferred to the trust) and possibly a 100% excise tax. Although it has been contended that the section cannot apply to a lead trust because the tax is imposed upon the charitable organization,[92] it seems possible that a court would find that, to the extent the interest in the trust is held by charity, the excise tax may be applied to the charitable interest in the trust (that is, the part of the trust dedicated to charitable organizations).

It is less certain that the lead trust, if it paid any premium, would be subject to the excise tax imposed by the section. The tax is imposed upon a charity described in section 170(c), which does not seem to include a charitable lead trust. The Treasury Department is directed to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of [section 170(f)(10)], including regulations to *prevent the avoidance of such purposes*." (Emphasis added.) It might not be surprising if the Treasury adopted regulations that made the section, including the excise tax, applicable to lead trusts. In any event, it would appear "risky" to proceed on the basis that the section does not apply to charitable lead trusts (after all, it applies at least to some charitable remainder trusts with typically have a smaller charitable component than do lead trusts). And, perhaps, the regulation could be made retroactive. Section 7805(b), entitled "Retroactivity of Regulations," essentially says a regulation cannot be made applicable before public notice of such regulation *except* "(2) . . . [where] . . . regulations [are] filed or issued within 18 months of the date of the enactment of the statutory provision to which the regulations relate" and "(3) . . . any regulation may take effect or apply retroactively *to prevent abuse*." (Emphasis added.) Arguably, having a regulation provide that the excise tax applies to a lead trust is to prevent the abuse of attempting to avoid its application with a lead trust.

In any case, the application of Section 170(f)(10) may cause such tremendously

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[92] See J. Smith, *supra*, at 53–55.

adverse results that it appears unwise even to consider going forward with a charitable lead trust plan expecting to be able to establish that the section cannot apply.

¶ 1407.6 Fund the CLAT Initially with Cash and Substitute a Non-MEC Policy in Later

It has been suggested that one way to avoid the Section 170(f)(10) problem is currently to fund the grantor charitable lead trust initially with cash, have someone acquire a policy and hold it until it is fully paid up and sufficient premiums are paid over time that the policy is a not a MEC, and then to "exchange" the policy for the cash in the lead trust.

It has been contended that this is "ok" because a Revenue Procedure issued by the IRS expressly permits making a charitable lead trust a grantor trust by giving someone a "power of substitution" described in Section 675(4)(C). However, having the grantor hold that power of substitution and exercising it to get the non-MEC policy into the lead trust (so the annuity payments may be made from income tax free borrowings from the policy's cash value) cause at least two significantly adverse tax consequences.

First, there is at least some risk the Service successfully could argue that Section 170(f)(10) applies by reason of the application of the step transaction doctrine.[93] It is beyond the scope of this article to discuss that doctrine in detail, but there is probably some risk it could be applied where it was understood from inception that the policy would be substituted for the trust's cash. And, as stated above, the results of the application of the section are so adverse that it just does not seem wise to take the risk that the grantor of the lead trust can successfully argue against the application of the doctrine. It seems unlikely that many well informed taxpayers would engage in such a plan even if the risk of the application of the section applying is only, for example, ten percent. It certainly seems to be at least that great.

But there is another potential adverse consequence that means any reasonably informed taxpayer almost certainly would not go forward with the substitution plan.

Specifically, Rev. Proc. 2007-45[94] provides in part: "The donor to a CLAT may claim an income tax charitable deduction under § 170(a) if the donor is treated as the owner of the entire CLAT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Paragraph 11, Retained Powers and Interests, of the sample trust in section 7 creates a grantor CLAT through the use of a power to substitute trust assets under § 675(4) that is held by a person *other than the donor, the trustee, or a disqualified person* as defined in § 4946(a)(1), and is exercisable only in a nonfiduciary capacity."[95] (Emphasis added.)

Note that the Revenue Procedure expressly states that the power of substitution is held by someone other than the donor (the grantor of the lead trust), the trustee or a disqualified person. The grantor and the trustee are also disqualified persons. The

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[93] See, e.g., *Commissioner v. Clark*, 489 U.S. 726 (1989).

[94] 2007-29 I.R.B. 89.

[95] Rev. Proc. 2007-45 at Section 8.09.

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reason they are excluded from holding the power of substitution is that virtually any economic transaction between a charitable lead trust and a disqualified person will constitute an act of self-dealing under Section 4941 and thereby subject the disqualified person to an excise tax of up to 200%.[96]

¶ 1408 Reaching the Dream: Fund the CLAT with a Multi-Life Policy

¶ 1408.1 Introduction to the Potential Solution

As explained above, the "ideal" to many would be to create a charitable lead trust (probably a charitable lead *annuity* trust)[97] as a grantor trust so the grantor is allowed an income tax deduction equal to the value of the interest in the trust committed to charity (which could be 100% of the value of the property contributed to the trust) but without having the trust experience any appreciable taxable income during the charitable term as it would all be included in the grantor's gross income even to the extent it is paid by the trust to charity. As discussed above, although life insurance may, in some cases, allow income tax free returns, there are several complications and, often, problems with trying to use life insurance to accomplish the ideal result. However, if the trust could be funded only with tax free death benefit and tax free borrowing, the result would probably be viewed as beneficial for the grantor of the trust. It may be possible to achieve that but the details are complex.

¶ 1408.2 Background on Fundamental Income Taxation of Life Policies

Unless the Code has a specific rule to the contrary (as it does for interests in certain retirement plans and accounts and zero coupon bonds)[98] and except where the income

[96] Section 4941 imposes a tax on virtually all economic transactions (e.g., a sale or exchange) between a private foundation and a disqualified person equal to 10% of the amount involved which, if not "corrected" within the meaning of the section, results in an additional tax of 200%. The tax is made applicable to such economic transactions between a disqualified person and a charitable remainder trust (described in Section 664) and a charitable lead trust pursuant to Section 4947(a)(2). Disqualified person is defined in Section 4946. Although no act of self-dealing would occur if someone who was not a disqualified person did the substitution, it seems unlikely any such person would be motivated to do so. If the grantor of the charitable lead trust provided an inducement for someone to do so (e.g., loaned funds to the person who is not disqualified to buy the policy and made some guarantee that he or she would not suffer any loss), it might be that the person would be viewed simply as the grantor's "straw man."

[97] It is possible to "zero out" the value of the remainder (so the charitable lead interest is worth 100 percent of the value of the property contributed to the trust) with a fixed term annuity trust but not a unitrust because, with the latter, a constant percentage of annual value is paid. Even if it is assumed, actuarially, that the unitrust will exceed the assume Section 7520 rate return each year and, therefore, the value of the trust annually will decline, at least some portion of the trust will remain (unless, perhaps, which is highly doubtful to occur) that the unitrust percentage exceeds 50%. Although the Code (Section 664(d)(2)(A)) provides that the unitrust percentage for a charitable remainder unitrust cannot exceed 50%, there is no such percentage limitation for a charitable lead unitrust.

[98] Although a taxpayer may have, under traditional notions of constructive receipt of income in a retirement plan described in Section 401 of the Code or an individual retirement account (IRA) under Section 408, the Code does not require the taxpayer to report such constructively received income into gross income as earned. Section 1272 provides the income tax treatment of so called "original issue discount" obligations (such as zero coupon bonds).

has been actually received, the determination of when a taxpayer must report an item in gross income turns on the doctrine of "constructive receipt."

The regulations set forth the doctrine as follows:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.[99]

In fact, the timing of taxation of the growth in value in or receipt of income by a policy of life insurance is based upon the doctrine. In what may be viewed as a seminal case,[100] to which the Commissioner has acquiesced,[101] the United States Tax Court stated, in part and in conclusion, "[W]e hold that the petitioner's right to receive the cash surrender value including periodic increments thereof was subject to such 'substantial restrictions' as to make inapplicable the doctrine of constructive receipt. Petitioner would have been required to surrender his entire investment in the policies in order to realize that income."

Hence, the investment component in the life policy would grow tax free and the receipt of that component at death as a death benefit was (and is) excludible as a general rule from gross income.[102]

¶ 1408.3 Meaning of Life Insurance for Tax Purposes

Until the enactment of the Deficit Reduction Act of 1984, the Internal Revenue Code did not have a definition of life insurance although it had many specific rules dealing with tax matters relating to life insurance. In order to obtain the benefits of income tax free growth in the cash (or investment) value of a policy and to receive that growth income tax free at death, all the contract had to be was a life insurance policy under applicable law. As a consequence, many policies were sold to provide those tax benefits with minimal shifting of risk on account of the death of the insured.

However, the Deficit Reduction Act of 1984 added Section 7702(a) to the Code to provide a definition which a policy had to meet so that the growth or income on the investment or cash value component of the policy (such growth or income commonly called the "inside buildup") would grow income tax free.

A contract is a life insurance policy so the growth or income on its cash value would not be taxed when earned only if it is a life insurance contract under applicable law and it meets (1) a certain cash (investment) value accumulation test or (2) a guideline

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[99] Treas. Reg. § 1.451-2(a).

[100] *Cohen v. Commissioner*, 39 TC 1055 (1963).

[101] 1964-1 CB 4.

[102] See Section 101(a)(1).

premium test and falls within a certain cash value corridor, all as set forth in Section 7702(a).

Section 7702(g) specifies the tax consequences if the contract is a life insurance policy under applicable law but does not meet either the cash value accumulation or the guideline premium test/cash value corridor provision under Section 7702(a). Section 7702(g) provides that, in such a case, the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year. However, essentially, the amount of income is limited to the increase in the *net* surrender value of the contract during the taxable year plus the cost of life insurance protection provided under the contract during the taxable year over the premiums paid under the contract during the taxable year. This seems to mean that the owner of the contract must include in gross income the increase in net cash surrender value and the cost of any term component essentially paid by the cash value component of the policy.

Section 7702(g) goes on to provide that, if any contract, which is a life insurance contract under the applicable law but does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 (exclusion from gross income, as a general rule, of proceeds paid by reason of the death of an insured)[103] and for estate and gift tax purposes.

Therefore, if a contract is a life insurance policy under applicable law but does not meet the definition of a life insurance policy under Section 7701(a) and if its net cash surrender value never exceeds the premiums paid, there will be no amount generated by the policy that the owner must include in gross income[104] (although, to the extent the cash value is used annually to pay term premiums inside the policy it will be included in gross income for such year) and neither borrowing against the policy (limited to no more than the lesser of the net cash surrender value and premiums paid) nor the receipt of death benefit will produce gross income. However, as discussed below, the policy will have to insure a sufficient number of lives so that a reasonable actuarial forecast of the receipt of death benefits can be made to ensure the annuity payment under the lead trust can be made.

¶ 1408.4 Modified Endowment Contract Rules

Despite the enactment of a statutory definition of life insurance, life insurance policies could produce significant income tax benefits by avoiding taxation of growth in the cash value component of a policy and permitting that income to be accessed, in certain ways, income tax free.

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[103] Section 7702(g)(2).

[104] Policies that never have the net cash surrender value exceed premiums paid are call "frozen cash value policies." See, generally, G. Nowotny, "Frozen Cash Value Life Insurance," 151 Trusts & Estates 33 (July 2012).

Those benefits are discussed in the legislative history (Conference Report)[105] to the Technical and Miscellaneous Revenue Act of 1988 ("Act") which provides, in part, that "the undistributed investment income (sometimes called the 'inside buildup') earned on premiums credited under a contract that satisfied *a statutory definition of life insurance* is not subject to current taxation to the owner of the contract. Amounts received under a life insurance contract prior to the death of the insured generally are not includible in gross income to the extent that the amount received does not exceed the taxpayer's investment in the contract. Amounts borrowed under a life insurance contract generally are not treated as received and, consequently, are not includible in gross income." (Emphasis added.)

To curb some of these perceived benefits, the Act added a new rule for life insurance policies that the Act defined as "modified endowment contracts," under new Section 7702A, which is any contract that "satisfies *the present-law definition of a life insurance contract* but fails to satisfy a 7-pay test" that the Act introduced.[106] (Emphasis added.) Under that new law enacted as part of the Act, "amounts received under modified endowment contracts are treated first as income and then as recovered basis. In addition, loans under modified endowment contracts and loans secured by modified endowment contracts are treated as amounts received under the contract."[107]

Therefore, the increase in the investment component (the inside buildup) of a policy that meets the definition of a life insurance policy under Section 7702(a) (that is, one that is a life policy under applicable law and meets (1) a certain cash value accumulation test or (2) a guideline premium test and falls within a certain cash value corridor) is not currently taxed but, if the premiums are withdrawn or borrowing against the cash value occurs, the inside build up is taxed under Section 72 if the policy is a modified endowment policy.

¶ 1408.5 More on the Definition of a Modified Endowment Contract

Section 7702A, as indicated, contains the definition of a modified endowment contract as "any contract meeting the *requirements* of section 7702 . . . which . . . fails to meet the 7-pay test of subsection (b)." (Emphasis added.) Quite apparently, this means a contract meeting the definition of a life insurance contract under Section 7702(a) that fails to meet the 7-pay test as suggested by emphasized portions of the Conference Report quoted above. Although no regulation has been issued discussing the definition of modified endowment contracts, it seems quite certain that it includes only Section 7702(a) contracts and not one dealt with under Section 7702(g).

First, as noted, the Conference Report certainly must be referring only to insurance policies defined in Section 7702(a) by referring to "the present-law definition of a life insurance contract." Indeed, there is no other definition of a life insurance contract in the Code other than in Section 7702(a).

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[105] H.R. 4333.

[106] Id. at p. 96.

[107] Id. at p. 97.

Second, Section 7702A refers only to a contract that meets the "requirements" of Section 7702 and only Section 7702(a) has requirements. Section 7702(g) does not contain "requirements." It deals with the "Treatment of [a contract] which . . . [is a] life insurance contract under the applicable law [but] does not meet the definition of life insurance contract under subsection (a)." Hence, all that Section 7702(g) does is provide the income tax rule of a contract that does not meet the tax definition of life insurance under Section 7702(a); it provides no "requirements" at all.

Third, as described above, Section 7702(g) eliminates the income tax free buildup in investment value and provides that such buildup is taxed to the policy owner each year but it limits the amount of gross income to the annual increase in the net surrender value (and the cost of term insurance essentially paid by the cash value). Therefore, there would be no need to include a contract that does not meet the definition of life insurance under Section 7702(a) falling under the treatment of modified endowment contracts under Section 7702A and Section 72. (Section 72 essentially provides that any withdrawal of premium or borrowing of cash value is first treated as income earned on the cash value before being treated as a tax free return of premium (investment).) Any increase in value (inside buildup which means earnings on the cash value) is taxed annually upon its receipt for a non-Section 7702(a) policy pursuant to Section 7702(g). The treatment of a modified endowment contract generally is more beneficial under Sections 7702A and 72 than the treatment of a policy under Section 7702(g): the owner can avoid any taxation of the inside buildup for a modified endowment contract merely by not surrendering or borrowing; but the inside buildup of a policy that is not described in Section 7702(a) cannot be avoided, except this gross income is limited to "the increase in the net surrender value of the contract during the taxable year, and the cost of life insurance protection provided under the contract during the taxable year" over premiums paid that year. Hence, it seems there would be no reason for the definition of a modified endowment contract to include one that is not described in Section 7702(a). This is borne out by the words of the phrasing of Section 7702A and the legislative history of the Act by which that section was added to the Code.

However, there may be one way in which a policy not meeting the definition of Section 7702(a) may fare better than a modified endowment contract. As mentioned above, a modified endowment contract is taxed under Section 72. See Section 72(e)(10) which provides that Sections 72(e)(2)(B) and 72(e)(4)(A) apply to a modified endowment contract. Section 72(e)(2)(B) provides, in effect, that distributions under the contract shall be included in gross income to the extent allocable to income on the contract, and shall not be included in gross income to the extent allocable to the investment in the contract. Section 72(e)(2)(C) provides that the amount allocable to income is limited to the "cash value of the contract (*determined without regard to any surrender charge*) immediately before the amount is received, over . . . the investment in the contract at such time." (Emphasis added.) Hence, an increase in cash value of a modified endowment contract will be included in gross income (to the extent of a withdrawal or borrowing) even to the extent there is a cash surrender charge. For a policy not described in Section 7702(a) and the income taxation of which is described in Section 7702(g), the inside buildup is taxed (annually without regard to any surrender or withdrawal) only to the extent there is no surrender charge.

Notwithstanding this latter point, it seems relatively certain that borrowing against a policy that is not described in Section 7702(a) does not result in income tax inclusion although any increase in net cash surrender value each year would.

¶ 1408.6 Putting It Altogether with a Multi-Life Policy

Many are familiar with the relatively common "second to die" policies, typically insuring the lives of two spouses and which pay the death benefit only when the surviving spouse dies. However, policies may be acquired that insure more than one life and pay a death benefit as each dies.

Hence, if a policy is acquired by a taxpayer and it insures such a sufficient number of lives that the timing of deaths may be forecast with reasonable actuarial accuracy, it could be contributed to a charitable lead annuity trust structured for a sufficient charitable term and with increasing annuity payments over that term to "zero out" the value of the remainder but with adequate actuarial assurance that sufficient death benefit will be received (income tax free) to make the annual annuity payments. Of course, no actuarial matter can be forecast perfectly and, if the trust borrows from the cash value of the policy in any year because the death benefit is insufficient to make the annuity payments, taxable income will be generated with a MEC policy. But with a Section 7702(g) "frozen" cash value policy, as explained above, the owner (which, in this context, nominally would be the charitable lead trust but for income tax purposes would be the grantor of the trust because it is a grantor trust) may borrow (up to the limit of net cash surrender value or premiums paid) without generating any taxable income.

Of course, as indicated, the policy must insure a sufficient number of lives to be able to forecast the timing and level of death benefit receipts (which, of course, should not be included in gross income). Although there must be an insurable interest present to acquire insurance on the life of any individual, many businesses (such as a partnership) may have an insurable interest in the lives of many of its employees.[108] By insuring them all (through multiple individual policies or a multi-life one), a reasonable actuarial forecast may be made and, if the policy or policies are frozen cash value ones, the trust can borrow (but only up to the premiums paid) to make up any shortfall in sufficient death benefit proceeds received to make the annuity payments called for under the lead trust.[109]

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[108] Cf. *Mayo v. Hartford*, 354 F.3d 400 (5th Cir. 2004) (no insurable interest under Texas law on lives of ordinary employees).

[109] Any actuarial forecast of when the deaths of identified individuals will change as time goes on. Although there will be fewer lives in the pool, they will have fewer years, actuarially, that they will live. Hence, an annually increasing annuity payment stream probably is appropriate to consider. Although, as mentioned above, some commentators believe that a significant increase in annuity payments from a charitable lead trust may not be "allowed," it seems that structuring one as the regulations permit a grantor

¶ 1409 Donor for Gift, Estate and GST Tax Purposes

Although, as demonstrated above, an entity, such as a corporation or partnership, may itself be treated as creating a trust for income tax purposes, it seems that, in all cases, only an individual owner or owners will be treated as transferring assets to the trust for gift, estate and generation-skipping transfer tax purposes.[110] Therefore, it seems that any transfer by an entity to a split-interest trust will cause the owners to be treated as making a non-charitable gift to the extent the transfer does not qualify (as the remainder in a charitable lead trust likely would not qualify) for the gift tax charitable deduction.[111]

¶ 1410 Other Potential Planning Enhancement of Entity Created Trusts?

It has been suggested that certain estate planning arrangements may be better accomplished by having an entity engage in them rather than having the owner or owners of them do so. For example, it has been contended that the potential estate tax planning benefits of a self-cancelling installment sale (for which the seller of property receives a note that will be cancelled if the seller or some other designated person dies before the note payment date, a so-called "self-cancelling installment note" or "SCIN") to a grantor trust may be more efficiently accomplished if a corporation creates a trust that is a grantor trust with respect to the corporation and makes the sale rather than having the shareholder make a sale of the stock in the corporation.[112]

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retained annuity trust to be structured (that is, annual increasing of 20% of the annuity) almost certainly would be "allowed." See Treas. Reg. § 25.2703-3(b)(1)(ii). It should be noted that that regulation does not "prohibit" annual increases of the annuity greater than 20% but it limits the value that will be deemed retained by the grantor to 20% a year. In any event, the IRS has issued a private letter ruling, which cannot be cited or used as precedent, "approving" a charitable lead trust under which the annuity payments increased by 20% each year. See PLR 201216045 (not precedent).

[110] See Treas. Reg. § 25.2511-1(h)(1). As mentioned above, it seems that a non-grantor trust, if so authorized by its terms, may create a grantor trust. However, a trust cannot make a gift per se. See, generally, M. Gans, J. Blattmachr & S. Heilborn, "Gifts by Fiduciaries by Tax Options and Elections," 18 Probate & Property 39 (November/December 2004), republished in Digest of Tax Articles, March 2005.

[111] This gift of the remainder in the lead trust would not qualify for the gift tax annual exclusion under Section 2503(b) because it is a gift of a future and not a present interest. However, if the remainder is vested absolute in the transferor's spouse, it may qualify for the gift tax marital deduction. See Rev. Rul. 68-554, 1968-2 CB 412. The gift of a current annuity or unitrust interest in a charitable remainder trust could so qualify. See Treas. Reg. § 25.2503-3(b).

[112] S. Horwitz & J. Damicone, "BIDIT: New Twist on Trust Design Provides Superior Results," 41 Estate Planning 3 (July 2014). The comparison made in the article may not be entirely accurate. For example, it is stated, "As stated above, with a [sale to a grantor trust for a note], [the seller/grantor] would receive a series of payments pursuant to the promissory note. If [the seller/grantor] died during the term of the note, the former 'grantor' trust would no longer be treated as a grantor trust. This means that [the seller/grantor]'s estate would recognize income on the hypothetical sale of the stock to the trust. (This assumes that [seller/grantor]'s basis in his shares is less than the outstanding amount due on the note on the date of death.)" However, as discussed in detail in J. Blattmachr, M. Gans & H. Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 Journal of Taxation 149 (September 2002), and confirmed in CCA 200923024 (not precedent), no gain or income is recognized in such a situation. Other issues may arise when attempting to use such a structure.

¶ 1411 Summary and Conclusions

In some cases, a better result may be obtained if a partnership or a corporation creates a charitable split interest trust, such as a charitable remainder trust or charitable lead trust, than if the trust is created by the partners or shareholders. No income tax deduction for a creation and funding of a charitable lead trust is permitted unless the trust is a grantor trust. That means that all income earned during the charitable term of the trust will be taxed to the grantor without any further deduction. In addition, the amount by which an individual may reduce his or her taxable income tax by the deduction allowed is limited to 30% or 20% of the contribution base. Also, the deduction allowed may be recaptured when grantor trust status ends (which will be no later than the death of the grantor). However, a non-grantor trust that is allowed by deduction for creation of a charitable lead trust created by a partnership of which the trust is a partner may be unlimited (that is, not limited by a percentage of any contribution base) as a general rule. Furthermore, properly structured, it seems that recapture that may occur when the lead trust is a grantor trust likely can be avoided if an entity creates the trust.