Advanced Designs
Pocket Guide

Charitable Remainder and Lead Trusts with Life Insurance
Frequently Asked Questions

PACIFIC LIFE

AD-OC-865A

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Introduction

Charitable remainder trusts (CRTs) and charitable lead trusts (CLTs), though similar in name, are distinct estate planning techniques that accomplish different goals for clients. Both strategies benefit one or more charitable entities, but do so in different ways. With the CRT, the charity receives the assets of the trust after the death of the grantor(s). On the other hand, with a CLT, the charity receives an income payout annually from the trust for a term of years, with the remainder going back to the grantor or the grantor’s heirs. This is just one of the differences between the CRTs and CLTs. Whether an individual decides to use a CRT or CLT would depend on their assets and their goals. This pocket guide will address some of the common questions surrounding both CRTs and CLTs. It will also address how life insurance can be used in conjunction with CRTs to preserve the assets going to charity for the grantor's heirs.

Charitable Remainder Trusts

Charitable remainder trusts (CRTs) have become a useful tool used to convert highly appreciated assets into a lifetime income stream without triggering any immediate capital gains tax upon the sale of the assets for individuals who are charitably inclined. Different CRT designs can be used depending on the donors' financial goals.

A CRT is an irrevocable trust in which the donor typically places highly appreciating property. The donor and/or other non-charitable beneficiaries receive an income stream for life or for a term not to exceed twenty years. At the end of the term, the entire remaining value in the trust then passes to the designated charity. Since the transfer of the asset to the CRT is a charitable gift, the donor receives an immediate tax deduction. Furthermore, by gifting the asset and not selling it, the donor does not pay any capital gains on the built-in appreciation of the asset. Moreover, as a tax-exempt entity, the CRT is not taxed on any gain that it realizes upon selling the appreciated property.

CRTs, used in conjunction with life insurance, can assist donors in fulfilling their charitable, financial and estate objectives and still benefit their heirs.

Potential Benefits to Donors Through the Use of CRTs

1. Receive an immediate income tax deduction for the present value of the remainder left to the charity.

2. Receive an income stream for life or specified term of years.

3. Leave a meaningful gift to a donor's favorite charity.

4. Reduce the donor's estate.

1. Who should be trustee?

Generally an independent trustee should be appointed to oversee the trust. The donor can be the trustee, however, the donor must ensure that the trust is properly administered otherwise the donor could lose the tax advantages and/or be penalized.

The trustee is responsible and has a fiduciary duty to both the income beneficiary and the charity. Additionally, the trustee determines the value and negotiates the sale of assets such as real estate, a closely held business and the investment of the asset. An independent trustee, such as a third party administrator, charity or corporate trustee is often recommended to serve as trustee of the CRT.

An independent trustee should generally not be someone who is within close influence of the donor. Someone other than the donor's children, parents, other relatives, business partners or long-term professional advisor should be chosen.

2. Can the terms of the CRT be changed?

The CRT is an irrevocable trust, and changes are generally not permitted. Specifically, the income payout rate, the payment frequency and the type of charity (private foundation versus a public organization) cannot be changed. Public charities are described in IRC Section 170(b)(1)(A). They generally include churches, educational organizations and hospitals. In contrast, private foundations are charitable organizations that are usually created, funded and controlled by a single donor or by members of the donor's family.

The type of charity should not be confused with the ability to change charities. The trust can change the charity, provided that the classification of the charity remains the same. For example, if the charity is a church, the donor can change the beneficiary to a hospital, because both entities are public charities under IRC

Section 170. The donor, however, would not be able to change the beneficiary from a public charity to a private foundation.

The trust typically permits the trustee and the investments to be changed. All other changes would require the trustee to petition and receive permission from the court to make the change. Since the trust is irrevocable, the donor cannot take back the gift. Therefore, it is extremely important to carefully design a trust to fit the donor's intentions.

3. What are the tax consequences of a gift to a CRT?

A gift to a CRT creates an immediate income tax deduction for the donor. This charitable deduction is limited to the fair market value of the remainder interest that will go to charity. The deduction is based upon the following factors: 1) the payout rate (the annuity or unitrust amount that will be paid to the income beneficiary); 2) the frequency of payments to the income beneficiary; 3) the length of the income beneficiary's interest, either based upon a term certain or life expectancy; and 4) the assumed rate of return (IRC Section 7520 rate) used for determining the remainder interest.

The IRC Section 7520 rate is the assumed rate of return the IRS uses to determine the assumed growth rate of the trust corpus that will ultimately determine the remainder value to charity. This rate changes monthly and is equal to 120% of the applicable federal mid-term rate (AFR). The donor has the option of using the IRC Section 7520 rate of the current month or either of the two months immediately preceding the transfer. The rate can be found at www.irs.gov. The higher the IRC Section 7520 rate, the higher the income tax deduction.

The donor can take an immediate income tax deduction in the same year as the gift. Any deduction that cannot be taken in that current year can be carried forward for an additional 5 years.[1] If

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[1] IRC Secs. 170(b)(1)(B); 170 (b)(1)(d)(ii).

the donor is unable to deduct the remaining donation during this carryover period, the remaining deduction is wasted.

Remember that the CRT is a tax-exempt trust. This permits the CRT to convert the full value of the asset into an investment that can provide a lifetime income to the donor. If the donor had sold the asset personally, he or she would have paid capital gains tax on any appreciation in the asset.

4. Is the deduction limited?

Yes. The deduction limit is based upon the type of asset gifted to charity and how the IRS defines the specified organization. The general limitation on charitable deductions for gifts of cash to public charities is 50% of the donor’s adjusted gross income (AGI). In contrast, gifts of cash to private foundations are limited to 30% of the donor’s AGI.[2] Accordingly, public charities and private foundations are often referred to as 50%–30% organizations. The deduction limit may be further reduced depending on the type of property donated.

The 50%–30% rule generally applies to gifts of cash, ordinary income property or long term gain property where the deduction is limited to cost basis. Gifts of appreciated property, however, are reduced to 30% for a public organization and 20% for a private organization.[3] In addition, gifts made “for the use” of charity rather than to charity are also subject to the 30%–20% limitation.[4]

For CRTs, gifts of appreciated property with a public organization as the charitable beneficiary are limited to 30% of AGI. If the charitable beneficiary is a private organization, the limit is 20% of AGI.

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[2] IRC Secs. 170(b)(1)(A); 170(b)(1)(B).
[3] IRC Secs. 170(b)(1)(C); 170(b)(1)(D).
[4] IRC Sec. 170(b)(1)(B). The deduction limit for gifts “for the use” of charity applies to both public or private charity.

5. What is Revenue Procedure 2005-24 and how does it affect CRTs?

Revenue Procedure 2005-24 added an additional requirement for any CRT created on or after June 28, 2005 to maintain its tax-exempt status if the grantor's surviving spouse has a right to receive a statutory share of the grantor's estate that could be satisfied from the CRT assets. In most common-law states, a surviving spouse has a "statutory right of election." This means that the surviving spouse has the right to take a share of the deceased spouse's estate in lieu of the deceased spouse's testamentary provisions.[5] The Uniform Probate Code (UPC), adopted in several states, extends the spouse's statutory right of election to the "augmented estate." The augmented estate consists of both probate and non-probate assets (including trusts such as CRTs). Consequently, this right of election may allow the surviving spouse, rather than the charity, to take all or a portion of the CRT as part of the augmented estate. A CRT's tax-exempt status and the donor's charitable income tax deduction are based upon the notion that the charity will receive assets upon the termination of the CRT. Thus, for any CRT created on or after June 28, 2005, the mere existence of this right of election will cause the CRT to fail to qualify under IRC Section 664 from the date of the CRT's creation and lose its tax-exempt status.

Revenue Procedure 2005-24 provides a "safe harbor" for CRTs created on or after June 28, 2005 by requiring an irrevocable waiver of the statutory right of election.[6] The waiver does not have to be a waiver of the surviving spouse's entire right of election or a waiver of the right to receive lifetime distributions from the CRT. Rather, the waiver only needs to be a waiver of the surviving spouse's right to invade the CRT assets to fund a statutory share,

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[5] In community property states, elective share provisions are unnecessary because the surviving spouse has vested ownership in one half of the community property.

[6] Even if the donor lives in a state which has not adopted the UPC, it may be prudent to obtain a waiver because the state may later adopt such a law or the donor may move to a state which has such a law. The donor should consult with their tax and legal advisor with regards to this issue.

elective share, or any similar rights by present or future law. If both spouses fund the CRT, both spouses should waive the right of election. The waiver must be valid under state law, in writing and signed and dated. In addition, the waiver must be completed within six months after the Split Interest Trust Information Return (Form 5227) due date[7] for the year in which the later of the following occurs: (1) the creation of the trust; (2) the date of the grantor's marriage to the spouse; (3) the date that the grantor first becomes domiciled in a jurisdiction whose law provides a right of election that could be satisfied from assets of the trust; or (4) the effective date of applicable state law creating a right of election. A copy of the signed waiver must be provided to the trustee of the CRT who shall retain the copy in the official records of the trust.

For CRTs created before June 28, 2005, the IRS will not require a waiver and the mere existence of a right of election will *not* cause the CRT to lose its tax-exempt status; however, these trusts may still lose their tax-exempt status if the surviving spouse *actually* exercises a right of election. If this happens, the CRT will fail to qualify as a tax-exempt entity from the date of creation.[8]

6. What if a public charity and a private foundation are both named as beneficiaries of a CRT?

If gifts are made to both a public charity and a private foundation, the deduction is determined by the private foundation deduction limitations. Even if the donor names a public charity as a beneficiary of the CRT, yet retains the right to change the beneficiary, the deduction will be limited to the lower percentages.[9]

[7] Excluding extensions in time to file actually granted.
[8] Unless the applicable statute of limitations has run, the CRT could be fully taxed on capital gains from the sale of appreciated assets and the donor could lose his or her income tax deduction. In addition, the CRT would be subject to tax on accumulated income.
[9] Rev. Rul. 79-368; 1979-2 CB 109; IRC Sec. 170 (b)(1)(B).

7. What are the different types of CRTs?

There are several types of CRTs. The most common types of the CRTs are the Charitable Remainder Unitrust (CRUT), the Charitable Remainder Annuity Trust (CRAT), the Net Income Make-Up Trust (NIMCRUT), and the Flip Unitrust (FLIP-CRUT).

a. The Charitable Remainder Unitrust (CRUT)

The donor receives a unitrust interest for him/herself, his/her spouse and/or other non-charity beneficiaries. Specifically, the income beneficiaries receive a fixed percentage of the trust corpus. Accordingly, the income received by the beneficiaries will vary based upon the growth of the asset.

b. The Charitable Remainder Annuity Trust (CRAT)

Unlike the CRUT, the income beneficiaries of the CRAT receive a fixed sum each payout. Accordingly, the income payout stream is not dependent upon the growth of the asset. As such, there is a potential of eating into the principal of the asset. Consequently, the CRAT must pass both the 10% remainder test and the 5% probability test that that the trust corpus will not be depleted. (Refer to Question 15).

c. Net Income and Net Income Make-Up Charitable Remainder Unitrust (NIMCRUT)

The Net Income Trust pays out the lesser of the trust net income or the full unitrust percentage.[10] The trust may also be designed to pay income in excess of the full unitrust amount to the extent the aggregate of the amount paid in prior years, was less than the aggregate of the fixed percentage amounts for such prior years. In a year where

[10] This is the Net Income Charitable Remainder Unitrust (NICRUT).

the trust's net income exceeds the fixed percentage, such excess is used to account for past deficiencies in years when the net income was less than the fixed percentage.[11] The trust can, in other words, "make-up" past deficiencies in prior years by paying out on excess income earned in the current year.

The NIMCRUT is advantageous in situations where the donor does not need immediate income and would like to accumulate funds on a tax-deferred basis and receive payments at a later date. Through the careful selection of growth and income assets, the trustee could invest in growth assets for a period of time. During this period, the income beneficiary will receive the distribution based upon the net income. After which, the trust could then switch to income producing investments. The trustee then makes a distribution of the regular unitrust payout percentage and has the option to exercise the distribution of the deficit (make-up) amount.

d. FLIP Unitrust

The FLIP Unitrust is a CRUT that is initially structured as a net income trust, but converts or "flips" to a standard unitrust upon the occurrence of a triggering event or date. The trust changes to a straight unitrust, and any existing deficit is forfeited. The income beneficiary then receives the regular unitrust payout percentage of the remainder for life. The individual does not have the option to receive the deficit or "make-up" amount.

The donor funds the FLIP CRUT with property and picks a date certain and/or a "triggering event," when the trust would "flip." Prior to the triggering event or date certain, the trustee invests the trust assets in growth, non-income producing assets, similar to the NIMCRUT. Upon the

[11] IRC Secs. 664(d)(2) and (d)(3).

triggering event or date certain, the "flip" occurs changing the trust into a straight unitrust.

The FLIP CRUT is useful when donor is seeking a retirement account or deferred income stream and is funded with unmarketable assets.[12]

8. When do you use a CRUT or a CRAT?

There are several factors that apply in the making the decision of using an annuity trust or a unitrust.

Cost. The retained interest in a CRAT is a fixed dollar amount. Accordingly, the CRAT offers primary benefits of simplicity and certainty. Consequently, there is no need for an annual revaluation as with the CRUT. For that reason, the CRAT will be easier and less expensive to administer than a CRUT, especially when funding the trust with hard to value assets.

Inflation. The CRAT offers a fixed annual return, which can have significant consequences in the event of inflation. The income payout will not be reduced if the value of the trust decreases, unless the trust is completely liquidated by distributions. Younger donors tend to gravitate towards the use of a CRUT as opposed to the fixed payments of the CRAT. This is often because younger donors tend to be less concerned with receiving a sum certain.

Contributions. Another issue to consider when deciding between funding a CRAT or a CRUT is whether additional contributions to the trust are being contemplated. A donor can make multiple contributions to a single CRUT, but the initial contribution is the only contribution that can be made to a CRAT.

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[12] Unmarketable securities include assets that are not cash, cash equivalents and assets that can be readily sold or exchanged for cash or cash equivalents such as, real property, closely held stocks and an unregistered security for which there is no available exemption permitting public sale. Treas. Reg. Sec. 664-1(a)(7)(ii).

9. Are there any general guidelines with respect to the percentage of a client's estate that may be transferred to a CRT?

While there are no limits as to how much a client may transfer to a CRT, as proscribed in the Internal Revenue Code, one general guideline that a client should consider is whether or not he or she can afford to make the gift. A client should work with his or her professional advisors to determine the appropriate asset to give and that he or she has sufficient remaining assets.

10. What kind of assets should be used to fund the CRT?

The CRT should be funded with highly appreciating assets. Ideally, assets such as publicly traded securities, land, or rental real estate should be used to fund the trust. These assets generally have a low income tax basis and generate greater income tax savings for the donor.

Mortgaged/encumbered property should not be used to fund a CRT. The use of mortgaged or encumbered property could potentially disqualify a CRT, because the trust income may be used to discharge an obligation of the owner.[13] In addition, gifts of interests in many types of operating business interests such as partnership interests, or limited liability company membership units can expose a CRT to often problematic situations such as, Unrelated Business Taxable Income ("UBTI"), bargain sales and/or pre-arranged sales.

a. What is UBTI?

Unrelated Business Taxable Income (UBTI) is generally defined as income derived from an unrelated trade or business that is not substantially related to the exercise of

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[13] Treas. Reg. Sec. 1.677(a)-1(d).

the organization's charitable functions.[14] UBTI can arise from income derived by an organization from any unrelated trade or business regularly carried on by the organization in excess of $1,000.[15] Specifically, the existence of debt within a business interest can create unrelated debt-financed income, a form of UBTI. In addition, the sale of property or inventory held primarily for the sale to customers in the ordinary course of business, borrowing from an insurance policy, and/or holding property subject to debt can also create UBTI. Previously, a CRT that had UBTI would lose its tax exempt status for the year that it had UBTI. The Tax Relief and Health Care Act of 2006, effective January 1, 2007, changed this to a 100% excise tax on the amount of the UBTI.[16] This effectively means that the entire portion of the UBTI earned by the CRT will be confiscated by the IRS.

b. *What is a bargain sale?*

If property subject to indebtedness is transferred to a CRT, the donor is treated as having been relieved of the debt under the bargain sale rules. The amount of the debt is treated as an amount realized by the donor, even though the transferee does not agree to assume or pay the debt.[17]

The IRS has determined that bargain sale transactions would disqualify a CRT because the trust income may be used to discharge an obligation of the owner.[18] Accordingly, the trust would not qualify as a CRT as the donor would be considered to be the owner of the trust.

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[14] IRC Sec. 512(b)(12).
[15] IRC Sec. 513(a).
[16] Treas. Reg. Sec. 1.664-1(d)(2).
[17] IRC Sec. 1011(b); Treas. Reg. Sec. 1.1011-2(a)(3); Hoffman, Marc D. and Hoffman, Jr. Leland E. *Harnessing the Power of the Charitable Remainder Trust;* PhilanthroTec, Inc. (1993).
[18] IRC Sec. 7872(c)(1)(D).

c. *What is a pre-arranged sale?*

Great care and caution must be exercised when a donor seeks to transfer property to a CRT prior to an upcoming sale. Often a donor will already have a buyer ready to purchase the property he or she intends to transfer to the CRT. Instead of directly selling the property, the donor quickly attempts to establish a CRT before closing the deal. The trust then sells the asset bypassing any recognition of capital gains by donor.[19]

Donors need to be aware that this arrangement may result in the donor recognizing capital gain on the sale of the property. The transfer to the CRT must be defensible as a gift followed by a sale. If the donor has already entered into a binding agreement to sell the asset prior to the transfer, the IRS might challenge the characterization of the gift. The donor may recognize capital gain if he has already agreed, either orally or in writing, to the sale of the property to a purchaser before transferring the asset into the CRT. If the transactions were "pre-arranged," the donor would recognize gain on the sale of the property by the CRT. The transfer of the property to the trust and the decision by the trustee to sell the property must be made independently of each other.[20]

11. Can a CRT be used to transfer closely held business interests?

The CRT can hold closely held business interests in certain scenarios. Generally, charitable donations of privately held business are among the most complex and potentially troublesome. There are five general types of business structures, each of which has a distinct combination of tax, liquidity, and transferability issues.

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[19] Rev. Rul. 60-370, 1960-2 C.B. 203; Ferguson v. Commissioner, 108 T.C.14 (1977).
[20] Martin v. Machiz, 251 F.Supp. 381 (D.C. Maryland 1966).

a. Sole Proprietorship

In a sole proprietorship, all risk, income and losses are attributed to the sole proprietor. Since the sole proprietorship is a pass-through entity, generated income may potentially be considered UBTI. In addition, UBTI may also be created if the sole proprietorship is transferred to a CRT with debt. Accordingly, a CRT owning a sole proprietorship risks losing its tax-exempt status. For this reason, CRTs typically do not own sole proprietorships.

b. Partnerships

A CRT may be funded with partnership interest and a general partner may be trustee of the CRT. As a pass through entity, the major concern involves the character of income earned by the trust.

UBTI can be produced by: 1) a trade or business that is regularly carried on by the partnership, which is unrelated to the charitable purpose of the trust, or 2) the ownership by the partnership of property that causes debt-financed income.[21] The sale of the partnership itself will not create UBTI.[22] UBTI will be realized if the partnership engages in an unrelated trade or business which produces a net income over $1,000.[23] If the unrelated trade or business generates rental income from real property, UBTI will only be realized if the property is debt-financed.[24] If the partnership has any debt, the transfer of partnership interests to a CRT would be considered a relief of indebtedness, which could potentially subject the CRT to a 100% excise tax on the UBTI.

[21] IRC Sec. 514.
[22] IRC Sec. 512(b)(5).
[23] IRC Secs. 572(a) and 512(b)(12).
[24] IRC Secs. 512(b)(3) and 512(b)(4).

CRTs are also subject to private foundation excise taxes imposed on acts of self-dealing between the trustee and disqualified persons.[25] Acts of self-dealing include a sale, exchange or lease, a loan or other credit, furnishing goods, services or use of trust property, or payment of compensations, income or use of assets, by a CRT (private foundation) to a disqualified person. The initial funding of the CRT with partnership interests when the trustee of the CRT is the general partner of the partnership, will not be an act of self-dealing.[26]

A CRT will not be subject to the excess business holdings or jeopardizing investment rules unless it includes an IRC Section 170(c) organization as an income recipient. A CRT has excess business holdings when all disqualified persons aggregately own more than 20% of the voting stock or interests in a business enterprise.[27] Generally, if CRT acquires excess business holdings by a gift or bequest, the CRT has 5 years from the date it acquires such holdings to dispose of them. If the CRT invests any amount that may jeopardize the CRT's ability to carry out its charitable purpose it may incur an excise tax.[28] Accordingly, if the transfer is followed by a sale, these two problems should disappear.[29]

c. C-Corporations

If closely-held stock is transferred to a charitable trust and held for investment, UBTI, self-dealing, excess business holdings and jeopardy investments may apply.[30] Specifically, if 50% of the corporation's stock is transferred into a CRT, thus constituting a controlled entity, then UBTI

[25] Disqualified person is defined in IRC Sec. 4946.
[26] Priv. Ltr. Rul. 9633007.
[27] IRC Sec. 4943.
[28] IRC Sec. 4944.
[29] Priv. Ltr. Rul. 9210005; IRC Sec. 4947(b)(3)(B).
[30] See analysis of self-dealing, UBTI, excess business holding and jeopardy investments under Partnerships.

may be created.[31] The liquidation of non-publicly traded stock through a CRT can be advantageous. If the donor transfers the stock to a charitable trust and the trust then sells the stocks to an unrelated third party, the donor recognizes no capital gains (unless the sale is considered to be pre-arranged, as discussed previously in this publication).

d. *S-Corporations*

A CRT is not a permissible holder of S-Corporation stock, and once transferred to the CRT, the S-Corporation loses its S-Corporation status. Even if the corporation accepts this outcome, issues of self-dealing and UBTI still exists.[32]

Both the corporation and the shareholder could benefit if the S-Corporation contributed its assets to a CRT and then the CRT sold the assets. First, the charitable deduction flows through to the shareholder's individual return and second, no capital gain will be recognized from the sale (CRT is a tax-exempt entity). The CRT retains a larger amount of cash that can be invested to produce a greater cash flow to benefit the S-Corporation and ultimately its shareholders.

An S-Corporation is a pass-through entity. All income, gains, losses and deductions, including charitable deductions, by an S-Corporation will "flow or pass through" to the individual shareholders. The charitable deduction is limited to the shareholder's basis in the S-Corporation stock.[33] To the extent the charitable deduction has flowed through to an individual shareholder, that shareholder's basis will be decreased by the value of the deduction.

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[31] IRC Sec. 512(b)(13).
[32] With respect to a C-Corporation, securities may be transferred to a CRUT.
[33] IRC Sec. 1366(d)(1).

e. *Limited Liability Companies (LLC)*

State law generally governs LLC rules and requirements. These companies may be taxed as a partnership or a corporation. Accordingly, if treated as a partnership, the issues that arise with partnerships will also exist. Similarly, if treated as a corporation, then the donations will comply with the regulations pertaining to corporations.[34]

12. Can a C-Corporation set up a CRT?

A C-Corporation can create a CRT provided that the trust is established for a term of years (maximum of 20 years).[35] The corporation is allowed a charitable deduction based upon the fair market of the asset contributed. The deduction, however, is limited to 10% of the corporation's taxable income.

As a permissible donor of a CRT, a C-Corporation may contribute its assets to a CRT. The C-Corporation[36] creates a CRT with corporate assets and income from the CRT is paid to the C-Corporation for the specified term. The appreciated land or asset transfers to the CRT which can then sell it without recognizing capital gains.

There is recognition of gain at the corporate level if "substantially all" the assets are given to charity or to a charitable remainder trust.[37] "Substantially all" is not specifically defined. The IRS indicated that "substantially all" will refer to the transfer of assets amounting to at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets that were held prior to the transfer.[38] A conservative approach is to limit transfers to 65% of the assets.

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[34] See analysis of partnerships and corporations.
[35] Priv. Ltr. Rul. 9340043; Treas. Reg. Secs. 1.664-2(a)(5) and 1.664-3(a)(5).
[36] The corporation can be either a C or S-Corporation.
[37] Treas. Reg. 1.337(d)-4.
[38] IRC Sec. 368(a)(1)(C); Reg. 1.514(b)-1(b)(1)(ii); Reg. 53.4942(b)-1(c); Reg. 3.4946-1(b)(2); Reg. 1.401(k)-1(d)(1)(ii).

13. Can stock options be gifted to a CRT?

There are two types of stock options: incentive stock options (ISO) and non-qualified/statutory stock options (NSO). The effectiveness of making a gift of an option depends on the type of stock option the employee holds.

ISOs are one of several kinds of "statutory options." Statutory options cannot lose their character regardless of subsequent events. If the transfer of stock acquired through exercise of an ISO meets certain requirements (qualifying transfer), no income will be recognized at the time the option is exercised.[39] ISOs are generally non-transferable, meaning that the option itself cannot be gifted to charity. Once the option is exercised, the stock can be gifted to a CRT. Since the exercise of the option is a non-taxable event, the gift of stock can be an effective technique. The stock, however, must be held for 2 years prior to exercising and 1 year after the exercise of the option in order to qualify for favorable tax treatment.

When an NSO is transferred, the option holder must recognize ordinary income on the difference between option price and the fair market value of the stock at the time of the exercise. Accordingly, income tax is not avoided on the gift and the income tax due may exceed the allowed charitable deduction. Consequently, NSOs are a less attractive asset for charitable giving than ISOs.

14. Can you fund a CRT with a qualified plan asset?

It depends. A CRT cannot be funded with qualified plan assets during the participant's life. Upon the participant's death, however, testamentary gifts of retirement plan dollars can be a very effective planning tool. The donor may choose to name the

[39] IRC Sec. 421(a).

CRT as the primary or successor beneficiary of the qualified plan or establish a testamentary CRT and name the CRT as beneficiary of the qualified plan.

a. Primary Beneficiary

If the CRT is the primary beneficiary, upon the participant's death, the plan assets will go into CRT. There are no tax consequences to the CRT for this transfer, because of the tax-exempt status of the CRT. The use of the CRT may also reduce significant estate taxes[40] on the asset in the trust. At death, the amount in the plan is includible in the participant's estate, although, this value may be offset by the estate tax charitable deduction for the remainder actually going to charity. Moreover, the present value of the spouse's income may be eligible for the marital deduction, as the income will cease upon her death.

The non-charitable income beneficiary will receive income from the CRT during the term of the trust. At the end of the CRT term, the charity will receive a lump sum distribution from the qualified plan. Using a CRT as primary beneficiary will not provide the spouse with much flexibility, as the spouse will be unable to roll the qualified plan to his/her own name and take distributions from the plan.

b. Successor Beneficiary

With this scenario, the surviving spouse is the beneficiary of the participant's qualified plan. The surviving spouse can roll the qualified plan into his/her own name or leave it in the participant's name. Assuming that the spouse keeps

[40] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

the CRT as beneficiary of the qualified plan, the plan assets are distributed into the CRT as a lump sum distribution at the death of the surviving spouse. The children then become life income beneficiaries of the CRT and upon the death of the last child, the remaining assets in the CRT subsequently pass on to charity. Accordingly, if the CRT is the successor beneficiary, the charity ultimately receives a smaller portion of the plan assets.

Accordingly, no estate[41] or income taxes will be due at the first death because of the unlimited marital deduction. At the second spouse's death, the estate will includes the value of the qualified plan, however, the estate will receive a charitable estate tax deduction for the amount going to charity.

15. What about Income In Respect of Decedent (IRD) taxation when qualified plan assets fund a CRT?

When the retirement plan and/or Individual Retirement Account makes a distribution to the CRT at the death of the participant or the second spouse, the lump sum distribution is treated as income in respect of decedent (IRD). Since the CRT is a tax-exempt entity, no income tax is owed by the trust on the distribution.

Income beneficiaries of the CRT must recognize tax on the income received based upon the 4-tier taxation system. The distribution would be treated as income taxable to the CRT beneficiaries (please refer to question 18 of this pocket guide).

[41] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

16. What is the form of the income payout?

The donor or other selected non-charitable beneficiary will receive an income stream for the length of the trust. A CRT can be set up for one or multiple lives. Generally, the trust is set up for either the life of the donor and/or the donor's spouse. The trust could also be for a term certain not to exceed 20 years.[42]

The income stream payable to non-charitable beneficiary can be paid out annually, semi-annually, quarterly, or monthly as either a fixed percentage of the trust corpus (CRUT-charitable remainder unitrust) or a fixed sum (CRAT-charitable remainder annuity trust).

The income payout must be at least 5%, but no more than 50% of the initial fair market value ("FMV") of the property placed in the CRT and must be paid to one or more non-charitable beneficiaries.[43] In addition, the remainder interest must equal at least 10% of the initial FMV of the property placed in the trust.[44] This means that at least 10% of the trust corpus must go to the designated charity at the end of the trust term.

In addition to the 10% remainder rule, the charitable remainder annuity trust must also comply with the 5% probability test.[45] A charitable remainder annuity trust may fail to qualify as charitable trust if there is more than a 5% probability, actuarially determined, that the trust assets would be exhausted before the remainder vests. Accordingly, the trust corpus of the CRAT may not be exhausted in order to qualify as a CRT.

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[42] Treas. Reg. Sec. 1.664-1(a)(1)(i).
[43] IRC Sec. 664(d)(1); IRC Sec. 664(d)(2).
[44] IRC Sec. 664(d)(1)(D); IRC Sec. 664(d)(2)(D).
[45] Rev. Rul. 77-374.

17. How is the income stream from the CRT structured?

The trust income, which is taxable in the year it is received, can be paid to the donor and/or the donor's spouse for either of their lives. The donor can add other income beneficiaries, such as their children. When the trust is first set up, however, the 10% remainder to charity CRT requirement must still be met.

The trust income can also be paid to children or any person or entity in lieu of the donor and/or spouse. There are, however, gift and estate consequences if someone other than the donor and donor's spouse receives the income from the trust.

The present value of the annuity or unitrust interest created in another individual is a taxable event.[46] The gift will qualify for the annual gift exclusion,[47] satisfying the present interest requirement if the trustee is required to make annual distributions.[48] The annual exclusion for gift tax is not, however, available for gifts of an annuity or unitrust interest that commences on the occurrence or non-occurrence of a future event, because that type of condition gift is not a present interest gift.[49] Such a gift would include subsequent payments to successive recipients of the income stream.[50] If the donor retains the testamentary power to revoke the income beneficiary's interest, the gift will be incomplete and thus the assets are subject to revocation and are includable in the donor's estate. The donor would ultimately receive a charitable deduction for the value of the interest passing to charity.

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[46] IRC Sec. 2511(a).

[47] Treas. Reg. Sec. 25.2503-3(c), Example 5. As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).

[48] Treas. Reg. Sec. 25.2503-3(b); *See e.g. Comr. Sharp*, 153 F.2d 163 (9th Cr. 1946).

[49] Treas. Reg. Sec. 25.2503-3(c), Example 5. In order to qualify a gift for the annual exclusion from gift tax, a gift must be of a present interest. A donee is given a present interest if he or she receives an unrestricted right to the immediate use, possession, or enjoyment of the transferred property. Treas. Reg. Sec. 25.2503-3(B).

[50] Treas. Reg. Sec. 25.2503-3(c), Example 5.

18. How are CRT income payouts taxed?

Remember that CRTs are tax-exempt entities, however, the payments to the donor(s) are taxable. The tax treatment of the distribution is determined by the "4 tier system." The "4 tier system" treats payments to the donor as being paid in the following manner:

1. First, as ordinary income to the extent the trust has ordinary income for the current year or undistributed ordinary income from prior years;

2. Second, as capital gain, to the extent the trust has capital gain for the current year, or undistributed capital gain from prior years;

3. Third, as tax exempt (for other income), to the extent the trust has other income for the current year or any undistributed other income from prior years;

4. Fourth, as distribution of trust corpus.[51]

The income beneficiary recognizes taxable income on distributions before any non-taxable distributions are made.

19. Can a CRT own life insurance?

The benefits of a CRT owning life insurance are extremely limited. While life insurance is generally thought of as a wealth replacement vehicle for assets gifted to a CRT,[52] it can also be used as a funding asset inside a CRT. Specifically, a CRUT may be directly funded with life insurance.[53] A CRAT, however, cannot hold life insurance that still requires premiums, because no

[51] IRC Sec. 664(b).
[52] Life Insurance used to replace the value of the asset gifted to the CRT is generally owned by an irrevocable life insurance trust.
[53] Priv. Ltr. Rul. 7928014.

additional contributions can be made after the initial funding of the trust.[54]

The use of life insurance inside a CRT is not the ideal strategy to maximize the potential benefits to the donor. It does potentially increase benefits to the charity. Since life insurance is generally not an income-producing asset, a standard CRUT funded with life insurance would not generate any income to be paid out. This raises several concerns such as jeopardizing investments, prohibited transactions, UBTI and several other issues.

The NIMCRUT based upon two lives may be an ideal situation in which life insurance could be used to fund the trust. The NIMCRUT provides that the lesser of income or the unitrust percentage must be paid out. If no income is generated then the trust does not need to pay out the income stream. Life insurance is purchased on each spouse. Upon the death of the first spouse, proceeds of one life insurance policy can substantially increase the remainder value of the trust, providing a larger payout to the surviving spouse. At the death of the surviving spouse, the other life insurance proceeds provide a larger gift to the donor's selected charities when the trust terminates.

20. What are the consequences of funding a CRT with life insurance?

As earlier discussed, several issues are raised and must be carefully examined when funding a CRT with life insurance. These concerns could potentially disqualify the CRT or cause the CRT to lose its tax-exempt status.

a. Grantor Trust

If the CRT is determined to be a grantor trust, the trust will fail to qualify as a tax-exempt trust. The grantor trust rules provide that if income of the trust is used to pay the

[54] Treas. Reg. Secs. 1.664-3(b); 1.664-2(b).

premiums on insurance policies on the grantor's life, then the trust is treated as a grantor trust.[55] To avoid such treatment, the trust document must provide that the premiums must be paid from the principal and further, any policy dividends or policy withdrawals will be treated as principal.

To make certain that the CRT is not characterized as a grantor trust, the trust should be set up as a NIMCRUT. Unlike the CRT, the NIMCRUT is limited to the payment of the trust income at all times and will not pay out principal to the income beneficiary. The CRT requires the payout of principal to the income beneficiary whenever the trust income is insufficient to meet the fixed income payout percentage. Since the NIMCRUT is an "income exception" unitrust, the amount payable to the non-charitable beneficiaries is limited to the trust's income.[56]

Ensuring that all amounts received with respect to the insurance policies are allocated to principal confirm that the policies are irrevocably payable to charity, and thus would not be deemed a grantor trust. The trust agreement should provide that amounts received with respect to insurance policies on the grantor's life are allocated to the principal of the trust and thus become part of the remainder payable to charities.[57]

b. Prohibited Transactions and UBTI

The purchase of life insurance with trust assets by the trustee does not necessarily violate the prohibition against payments to non-charities outside the designated income beneficiaries, assuming that full and adequate consideration was paid.[58] No amount other than the unitrust amount may

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[55] IRC Sec. 677(a)(3).
[56] Priv. Ltr. Rul 9227017.
[57] *Id.*
[58] IRC Sec. 4947(a)(2); Ltr. Rul. 8745013.

be paid to any person other than the designated organization under IRC Section 170(c).[59] The replacement of one asset for another, such as a life insurance policy, will not constitute a "prohibited transaction," if the exchange was for full and adequate consideration.[60] The trust instrument must not restrict the trustee from investing the trust assets in a manner that could result in the realization of income or gain from the sale of the trust assets.[61]

The trustees of CRTs have a fiduciary responsibility to invest their assets wisely. Problems may arise if the insurance policy at the date of purchase does not provide a sufficient rate of return that it jeopardizes the charitable purpose of the trust.[62] The purchase of life insurance should not jeopardize the charitable status of the trust as long as the death benefit will be greater than the net sum of the premiums.[63]

In addition, the IRS has ruled that policy loans for investment purposes may generate UBTI. There is no problem as long as the borrowing against a policy is for a purpose inherent to the performance of the charity's exempt purpose.[64] However, UBTI may be created if the CRT uses policy cash values or uses the policy as collateral to finance and purchase a new income-producing investment, the income produced by that debt financing may be considered UBTI. UBTI, as previously indicated, can cause the CRT to lose its tax-exempt status, and recognize all income for each year that UBTI is recognized.[65]

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[59] Treas. Reg. Sec. 1.664-1(a)(4).
[60] Treas. Reg. Sec. 1.664-3(a)(4).
[61] Treas. Reg. Sec. 1.664-1(a)(3).
[62] IRC Sec. 508(e).
[63] Specifically, the use of the NIMCRUT will potentially prevent the occurrence of a jeopardy investment.
[64] Leimberg, Stephan R. and Gibbons, Albert E., *Life Insurance as a Charitable Planning Tool: Part II,* Gift Planner's Digest, 07/03/2002.
[65] Treas. Reg. Sec. 1.664-1(d)(2).

c. Acquisition Indebtedness

Acquisition indebtedness refers to the unpaid amount of debt that was incurred by the CRT in acquiring or improving the acquired property.[66] This incurred debt will result in UBTI for the CRT and be subject to the 100% excise tax.[67]

Debt financed property is any property that is held to produce income with respect to the "acquisition indebtedness" at any time during the year.[68] Be mindful that debt financed property does not include any property that is substantially related to the exercise, function or performance by the designated charity.[69] Specifically, in order to avoid acquisition indebtedness, the incurred obligation must be inherent to the performance or exercise of the particular CRT's exempt purpose or function.[70]

While the CRT has an obligation to distribute the trust amount to the income beneficiaries, the borrowing of funds to achieve this objective is not inherent to the performance of the organization's exempt function. The trustee should not be required to borrow from the insurance policy and invest such funds to create income. The decision to borrow from the insurance policy, to provide an income to the non-charitable beneficiaries, is an independent decision that is not inherent in the organization's purpose. Consequently, if the trustee borrows from the policy, and invests the proceeds to create income, acquisition indebtedness will occur.[71]

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[66] IRC Sec. 514(c)(1)(A).
[67] Treas. Reg. Sec. 1.664-1(d)(2).
[68] IRC Sec. 514(b).
[69] *Id.*
[70] Priv. Ltr. Rul 8745013.
[71] IRC Sec. 514(c)(1)(A); Priv. Ltr. Rul. 8745013.

> Life insurance inside a CRT should be limited to the use of a NIMCRUT based upon two lives. The potential problems that could result outweigh any benefit that life insurance may provide inside the trust. As an alternative, the donor may consider owning the policy and naming the charity as beneficiary of the policy, permitting the donor to achieve the same desired result.

21. How do we replace what is lost to our heirs?

One potential drawback of the CRT for heirs is the remaining assets in the trust at termination pass to charity. The CRT effectively disinherits the heirs who normally would have received the property. The creation and funding of a wealth replacement trust is a common planning strategy that addresses this problem. Through the use of the wealth replacement trust, donors are able to provide for their heirs and still be able to give to charity. To accomplish this, the donor needs to establish an irrevocable trust for the benefit of the donor's heirs. The trust could be funded with any type of asset, but life insurance purchased on the life/lives of the donor(s) is most commonly used.

The donor transfers a highly appreciating asset to a CRT. The donor(s) then receive savings from income tax deduction and the CRT can sell the asset tax-free. During the term of the trust, the donor(s) takes an income stream from the CRT. The donor(s) then sets up the wealth replacement trust (an Irrevocable Life Insurance Trust (ILIT)). Using the income stream, the donor(s) pays for the premiums for the life insurance policy inside the trust. If properly structured, the donor(s) may use his/her ability to make gift tax-free annual exclusion gifts[72] to the trust to gift the life insurance premium payments to the trust.[73]

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[72] As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).
[73] For additional information about wealth replacement trusts, please see Pacific Life's or Pacific Life & Annuity's publication titled "Charitable Remainder Trust Using a Wealth Replacement Strategy with Life Insurance."

Upon the death of the donor(s), the designated charity receives the remainder value in the CRT and the heirs of the donor(s) receive the proceeds from the wealth replacement trust.

22. How much life insurance should be purchased?

There are four different way to calculate the amount of insurance that the donor may wish to purchase to compensate his or her heirs for the property passing to charity.

EXAMPLE

Donor gifts $1,000,000 to a CRT. At life expectancy, the CRT remainder value is $2,000,000. The donor receives a 7% payout and the donor's income tax rate is 35%. The donor's estate tax[74] bracket is 40%.

a. Full Replacement

The full replacement value is the amount equal to the CRT remainder value. This means that the amount that goes to charity when the trust terminates will be the amount of life insurance that the donor will purchase. In the above example, the full replacement value would be $2,000,000. This is equal to the amount that is going to charity at the end of the trust term.

b. Equal Value

The equal value is the amount that was initially contributed to the CRT. The equal replacement value from our example would be $1,000,000.

[74] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

c. Net Replacement

The net replacement is the amount equal to the remainder net of the estate tax.[75] Specifically, this is the value that the heirs would have received if no charitable remainder trust had been established. Applying this to our example, the net replacement value would be $1,200,000 ($2,000,000 x 0.40 = $800,000; $2,000,000 - $800,000 = $1,200,000).

d. Realistic Replacement

The realistic replacement represents the amount of life insurance that the donor(s) can afford to purchase. This is based upon the income stream of the CRT. The amount of life insurance is dependent upon the value of the income stream from the CRT. Generally, this requires the solving of a death benefit for a specified premium. In our example above, the realistic replacement value would be the amount of death benefit that $45,500 will buy ($1,000,000 x 0.07 = $70,000; 70,000 x 0.35 = $24,500; $70,000 - $24,500 = $45,500 annually).

For a comparison of how the CRT used in conjunction with the wealth replacement trust may be more beneficial than a direct sale of the asset, please refer to Appendix A.

23. Is a CRT creditor proof?

No amount other than the income payout may be paid to or for the use of any person other than an organization described in IRC Section 170(c).[76] The trust may not be invaded for the benefit of a person other than the designated charity.[77]

[75] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

[76] IRC Sec. 664(d)(2)(B); Treas. Reg. Sec. 1.664-3(a)(2).

[77] Treas. Reg. Sec. 1.664-3(a)(4).

Self-dealing may be perceived if the trust distributes assets to creditors in order satisfy any outstanding debts of the donor. The act of self-dealing includes any direct or indirect transfer to or use by a disqualified person of the income or assts of the trust. [78] A 5% excise tax on the amount involved is imposed on each act of self-dealing between the disqualified person and the CRT.[79] The distribution of assets to settle any liabilities would exceed the income payout and deplete the CRT's assets for the benefit of the income beneficiary.[80]

In establishing a CRT, the donor irrevocably gives a contingent remainder interest to the charity and only retains an interest in the income stream.[81] This income stream and not the entire trust corpus is the property of the donor. Creditors cannot disregard the trust as an entity and invade the interest that the donor(s) relinquished in creating the trust.[82] Any invasion, alteration, amendment or revocation of the trust for the benefit of any person or entity other than the designated charity is prohibited.[83] Moreover, since the charity has a vested interest in the trust, any invasion of the trust corpus without adequate consideration for the vested remainder interest is invalid.[84]

Laws permit creditors to attach to the donor's income stream/payout.[85]

Conclusion

A CRT can be a beneficial tool to convert a highly appreciated asset into a lifetime income stream without triggering any

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[78] IRC Secs. 4941(d)(1)(E), 4947(a)(2).
[79] IRC Secs. 4941(a)(1), 4947(a)(2).
[80] IRC Sec. 4941(d)(1)(E).
[81] IRC Sec. 664.
[82] FSA 200022005.
[83] Treas. Reg. Sec. 1.664-3(a)(4).
[84] FSA 200022005.
[85] BKY01-40629, US Bankruptcy Ct., D. Minn (Nov 2, 2001) Kleinrock (KTC) 2001-502.

immediate capital gains tax upon the sale of the asset. In order to take advantage of this planning technique, however, the donor(s) must want to give to charity. Potentially, the specified charity will benefit from the CRT and the heirs of the donor(s) may be left with nothing. With proper planning an individual can benefit both charity and their heirs. It is important to remember that the donor must first and foremost be charitably inclined in order to receive any benefits from the CRT.

Charitable Lead Trusts

Charitable lead trusts (CLTs) have become a popular charitable planning technique in recent years. In addition to charitable planning, CLTs are also utilized for income and transfer tax planning. Donors have been using CLTs to structure a charitable gift that may also benefit children and grandchildren. Additionally, in times of low interest, CLTs can be beneficial for donors who wish to do charitable planning, as well as maximize the wealth transferred to heirs. Depending on how the CLT is structured, the donor will either obtain an income or estate tax[86] deduction for the charitable interest or the leveraging of his or her gift to the heirs, and the exclusion of the CLT property from the estate.

1. What is a charitable lead trust (CLT)?

A charitable lead trust (CLT) is one form of a split interest charitable trust. Conceptually, the CLT is the opposite of the charitable remainder trust (CRT) because the charity receives an income payout from the CLT on an annual basis and the grantor or his or her heirs receive the remainder. CLTs have become one of the more valuable planning strategies available for individuals who wish to give to charity but also want to provide for family members.

An individual may establish a CLT either during life or at death, and the CLT will pay either an annuity or a unitrust amount to charity during its term. The charitable lead annuity trust (CLAT) will provide an annuity payment to a charity which will be a fixed amount each year, expressed as either a dollar amount or as a percentage of the CLAT's initial value. A charitable lead unitrust (CLUT) will pay to the charity a fixed percentage of the fair

[86] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%. As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).

market value of the CLUT assets as determined annually. If the value of the CLUT increases or decreases, the unitrust amount distributed to the charity will also increase or decrease.

The payment to the charity may be structured as a term of years or for a life or lives in being at inception of the CLT. Unlike a CRT, the term of years for a CLT may exceed 20 years. Current regulations limit the measuring lives that can be used for a CLT to the grantor, his or her spouse, descendents of the grantor, and spouses of such descendents.[87] In addition, a CLT may pay any amount to the charity and is not restricted to a minimum five percent payout like the CRT. As family members may be the remaindermen of a CLT, the payout should not invade the principal of the trust, in order to maximize the wealth transferred to the remaindermen.

2. What types of CLTs are there?

Several types of CLT structures are available to donors. The donor's needs and financial objectives will determine which type of CLT structure will be used.

3. What is a grantor lead trust?

Unlike a CRT, a CLT is not a tax-exempt entity. The way in which trust income is taxed depends upon whether the CLT is structured as a grantor or a non-grantor trust. If the CLT is structured as a grantor trust, the grantor ("donor") will be treated as the owner for federal income tax purposes.[88] If a CLT is created with assets exceeding five percent of the total value reverting back to the grantor, then the CLT will automatically be a grantor trust.[89] Each year the donor will recognize the CLT's income, gain, loss, deductions and credits on his or her personal income tax return. In

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[87] Treas. Reg. Secs. 1.170A-6(c)(2), 1.170A-6(e), 20.2055-2(e)(2), 25.2522(c)-3(c)(2).
[88] Any retention of power listed in Internal Revenue Code (IRC) Sections 671 through 679 will cause the trust to be a grantor trust.
[89] IRC Sec. 673(a).

the year that the trust is established, the grantor CLT will provide the donor with an immediate income tax deduction for the present value of the annuity or unitrust amounts to be paid to charity.[90] It is important to note that this income tax deduction occurs only in the year the CLT is established; the donor will not receive an income tax deduction in succeeding years.

The charitable income tax deduction for the distributions over the term of the lead trust is deemed "for the use of charity" and the charitable deduction is limited to 30 percent of the donor's adjusted gross income (AGI).[91] If the donor is unable to take the full deduction in the first year, any remaining deduction may be carried forward for an additional five years. If the donor were to die during the term of the CLT or the CLT ceases to be a grantor CLT for income tax purposes, all or part of the charitable income tax deduction would be recaptured.[92] Accordingly, the donor will be considered as having received income equal to the amount of any deduction allowed reduced by the discounted value of the amounts that were required to be and actually were paid to charity before the CLT ceased to be a grantor CLT.[93]

4. When is a grantor lead trust used?

Generally, grantor CLTs will be used when the donor or donor's spouse retains a reversionary interest in the trust. The grantor CLT is usually used for charitable and income tax planning. For example, a grantor CLT may be utilized when the income tax rate of the donor is considerably higher in one year due to an individual circumstance. It may benefit the donor to establish a grantor CLT in that year to receive a lump sum deduction and invest the tax savings. In addition, a grantor CLT may be considered when a large gain is going to be experienced in one year due to a sale of a large asset, such as a business or securities. The donor may fund

[90] IRC Sec. 170(f)(2)(B); Treas. Reg. Sec. 1.170A-6(c)(1).
[91] IRC Sec. 170(b)(1)(B).
[92] Treas. Reg. Sec. 1.170A-6(c)(4).
[93] *Id.*

the grantor CLT with the proceeds of the sale to create a lump sum charitable income tax deduction.[94]

5. What is a family or non-grantor lead trust?

A family or non-grantor CLT is taxed as a complex trust for income tax purposes.[95] This means that the CLT is taxed on all of its net undistributed income and on all capital gains. However, unlike the grantor CLT, the non-grantor CLT receives an unlimited charitable income tax deduction for items of gross income that are paid to a qualified charity each year.[96] This deduction is not limited by the percentage limitations that apply to individuals.[97] However, the trust's charitable deduction will be reduced by any unrelated business taxable income (UBTI)[98] realized by the CLT during the year to the extent the UBTI exceeds the percentage limitations attributable to individuals under IRC Section 170(b)(1)(A).[99]

6. When is a family or non-grantor lead trust used?

A family CLT is generally used as a method of transferring major assets to children and grandchildren with reduced federal gift and estate tax[100] consequences. The remainder beneficiaries of a family CLT would be the donor's heirs. If the family CLT is established during the donor's lifetime, the donor is considered to have made a taxable gift to the CLT equal to the initial value of the assets contributed less the value of the charity's interest in the trust. The value of the charity's interest in the trust is computed by using the

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[94] Jane Peebles, Esq, *Carpe Diem! Charitable Lead Trusts Look Better Than Ever*, April 2003 at 3-4.
[95] IRC Sec. 661.
[96] IRC Sec. 642(c)(1).
[97] Cash contributions to public charities are deductible up to 50 percent of the donor's adjusted gross income. IRC Sec. 170(b)(1)(A).
[98] The term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business regularly carried on by it. IRC Sec. 512(a)(1).
[99] IRC Secs. 681, 512(b)(11).
[100] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

IRC Section 7520 rate published each month by the Treasury. If the assets in the CLT appreciate at a rate greater than the Section 7520 rate, the family will receive assets in excess of that which was reported as a taxable gift without any additional gift tax consequences. If the donor establishes a CLAT and the assets in the trust are highly appreciating and income producing, it may be possible to "zero out" the gift in the year that the CLAT is established. With a "zeroed-out" CLAT, the donor is not treated as making a gift to the CLAT because the value of the charity's retained interest is equal to the value of the property the donor transferred to the CLAT.

If the CLT is established at the donor's death, through a will or revocable living trust, the value of those assets will be includable in the donor's estate. However, the estate will receive a charitable estate tax deduction for the present value of the unitrust or annuity amounts distributable to charity over the term of the trust.

7. What is a super lead trust?

The charitable "super lead trust" is a CLT which attempts to take advantage of aspects from both the grantor and non-grantor lead trusts by allowing the donor to receive an immediate charitable income tax deduction and also remove the trust assets from the donor's estate. The super lead trust is structured similar to a family lead trust, with the donor's heirs as the trust remainder beneficiaries. In addition, like a grantor CLT, the donor retains a power over the trust, sufficient to cause the donor to be taxed on the income of the trust under the grantor trust rules,[101] but does not cause inclusion of the CLT assets for purposes for federal estate tax.[102] The preferred retained power is usually the power held by a

[101] IRC Sec. 671-678.

[102] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

non-adverse party, in a non-fiduciary capacity to reacquire the corpus by substituting assets of equivalent value.[103]

The super lead trust differs from the other CLT structures because it provides the donor with both the income tax deduction in the year the CLT is established (like the grantor CLT) and the charitable gift or estate tax deduction that the family CLT receives. However, unlike a family CLT, the grantor must recognize the income tax generated by the super lead trust each year.

There have been a number of supporting private letter rulings concerning the "super lead trust" technique as applied to CLTs. [104] The potential benefits to the donor make this type of CLT an important estate and income tax planning tool. However, because private letter rulings are not legal precedent, clients should seek the guidance of their tax and legal advisors before implementing this strategy.

8. What types of assets should fund a CLT?

Once the donor has decided on the type of CLT that will be established, the next decision is the type of asset that should fund the CLT. A CLT may be funded with assets such as cash, appreciated stock, and real property. The types of assets that will be used to fund a CLT may also be determined by the type of CLT the donor will establish. For example, if the donor were to establish a grantor CLT, the donor would benefit if the CLT was funded with municipal bonds, preferably exempt from both state and federal income tax. Or, in the alternative, the donor could fund the CLT with cash or appreciated stock and the trustee could reinvest the funds in tax-exempt municipal bonds. Due to the fact that the grantor picks up the CLT's income tax each year, funding

[103] IRC Sec. 675(4)(c).
[104] See Priv. Ltr. Ruls. 200011012 (March 20, 2000), 200010036 (March 13, 2000), 199936031 (September 13, 1999), 199922007 (June 7, 1999), 199908002 (March 1, 1999), 9810019 (March 6, 1998), 9224029 (March 13, 1992).

the CLT with municipal bonds (that are not subject to state and federal income tax) would be advantageous.

Issues arise when funding a CLT with assets other than appreciated securities and cash. For example, when a donor establishes a family CLT, often the donor has a family business he or she would like to pass on to his or her heirs. When using business interests, like family limited partnership interests, the donor may reduce the gift to the CLT through the use of discounts.[105] However, a CLT is subject to several of the private foundation rules. When establishing a CLT, the donor must ensure that the trust agreement prohibits the violation of the private foundation rules against self dealing, excess business holdings, jeopardizing investments and taxable expenditures. Funding the CLT with specific types of assets may cause application of these rules. Furthermore, funding a CLT with certain assets may cause the trust to have UBTI.[106]

The existence of UBTI in a CLT does not have the same tax consequences as UBTI in a CRT. Should a non-grantor CLT be funded with an asset that creates UBTI, no deduction will be allowed for the payment to charity to the extent that the payment consists of UBTI.[107] However, IRC Section 512(b)(11) provides some relief in that the CLT may deduct payments of UBTI actually made to charity, subject to the percentage limitation rules applicable to individual taxpayers. Thus, careful consideration must be given when a donor is gifting any type of business interest or debt encumbered asset to a non-grantor CLT.

9. Can a CLT be funded with C-Corporation stock?

CLTs may be funded with C-Corporation stock, but there are a several issues that the donor should be aware of before transferring

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[105] If the donor gifts limited partnership interests to the CLT, these interests will lack marketability and control. Therefore, the value of these interests may be reduced or "discounted" to less than the fair market value.
[106] See note 11.
[107] Treas. Reg. Secs. 1.642(c)-3(d), 1.681(a)-2(b).

C-Corporation stock to a CLT. When funding a CLT with a business interest, such as closely-held C-Corporation stock, it may be necessary to declare dividends to fund the payout to the charitable beneficiaries. When a corporation issues dividends, the corporation will not receive a tax deduction. From an economic standpoint, this transfer should be examined by looking at the cost of nondeductible dividends to the corporation plus the tax, if any, on the transfer of the value of the remainder interest to the children. This cost should be compared to the cost of the estate or gift tax on the stock (plus any projected appreciation of the stock value) should it be gifted directly to the children at a later date.[108]

Alternatively, if for some reason no dividends are to be declared, then the CLT may be able to redeem some of the shares of the corporation for cash or notes in order to meet the required payout. An installment note for a stock redemption may be acceptable within the exception from the self-dealing rules for corporate redemptions.[109] The redemption must be offered to all shareholders owning the same class of stock.

Another issue to consider when funding a CLT with C-Corporation stock is the excess business holdings rule. The CLT's corporate interests should not exceed 20 percent of the corporation's voting stock. This 20 percent will be reduced by the percentage of voting stock that is owned by all other disqualified persons.[110] However, if the effective control of the corporation is in the hands of a third party (i.e. not a disqualified person), then the holdings will not be excessive if the CLT combined with disqualified persons do not own more than 35 percent of the voting stock.[111] If the CLT is determined to have excess business holdings, the trustee is allowed

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108 *Supra* note 6 at 21.
109 IRC Sec. 4941(d).
110 IRC Sec. 4943(c)(2). Disqualified persons include: a substantial contributor to the foundation, a foundation manager, an owner of more than 20 percent of a substantial contributor to the foundation, certain family members, related business entities, government officials, an others who may hold a fiduciary capacity with regard to the foundation. IRC Sec. 4946.
111 IRC Sec. 4943(c)(2)(B).

five years to dispose of the holdings prior to the imposition of tax.[112] If the CLT fails to dispose of the excess business holdings, the trust will be subject to an initial excise tax of five percent of the holdings amount.[113]

One way to avoid the excess business holding tax is the passive source exception. If 95 percent or more of the gross income of a business enterprise is "passive," the entity will not be deemed to be a business enterprise.[114] The definition of what is passive is a term of art and can include: dividends, interest, annuities, and rents from real property (unless taxable as UBTI).[115] Therefore, if the C-Corporation is not considered a business enterprise, then the excess business holdings rule should not apply.

The last issue to consider is whether or not the C-Corporation stock is a jeopardizing investment. A CLT is subject to the rules prohibiting jeopardizing investments if the present value of the charitable income interest at the creation of the CLT exceeds 60 percent of the aggregate fair market value of the trust's assets, or if a portion of the income interest is not paid to the charitable beneficiary.[116] No specific category of investment is considered jeopardizing; however, certain types of investments such as trading securities on margin, commodity futures, and selling securities short will be closely scrutinized by the Internal Revenue Service (IRS).[117]

Therefore, while a donor may fund a CLT with C-Corporation stock, the donor must make certain that the transfer of the C-Corporation stock will not violate any of the private foundation rules that a CLT is subject to.

10. Can a CLT be funded with S-Corporation stock?

[112] IRC Sec. 4943.
[113] *Id.*
[114] IRC Sec. 4943(d)(3)(B), Treas. Reg. Sec. 53.4943-10(c)(1).
[115] Treas. Reg. Sec. 53.4943-10(c)(2), Priv. Ltr. Rul. 8135040 (June 3, 1981).
[116] IRC Sec. 4947(b)(3)(A).
[117] Treas. Reg. Sec. 53.4944-1(a)(2)(i).

Generally, a non-grantor lead trust is not a permissible S-Corporation shareholder. However, Treasury Regulations finalized in 2002 indicate that a non-grantor CLT may own S-Corporation stock by qualifying as an electing small business trust (EBST).[118] To become an EBST, the CLT must meet the following requirements: (1) all beneficiaries must be individuals, estates or charities; (2) the S-Corporation stock in the trust may not be acquired by purchase (i.e. must be received by gift or bequest); (3) it cannot be an electing qualified Subchapter S trust, and (4) each potential and current beneficiary of the CLT will be treated as a shareholder for the purpose of S-Corporation eligibility rules.[119]

While qualifying as an EBST will allow the CLT to hold S-Corporation stock, there are significant income tax disadvantages. First, an EBST pays income tax at the highest trust income tax rates. Second, an EBST may not deduct payments made to the charitable beneficiary each year. Therefore, all of the CLT's income will be subject to the highest income tax rates each year even if all the income is distributed to charity. These two consequences combined, could cause a great amount of income tax liability to the CLT, thereby decreasing the overall value of the trust.

On the other hand, a grantor lead trust is a permissible S-Corporation shareholder.[120] As long as the grantor is a permissible S-Corporation shareholder, a grantor CLT may own S-Corporation stock.[121] This is allowable because a grantor lead trust has no identity separate from its grantor. The donor will still receive an income tax deduction for the fair market value of stock subject to reductions and limitations.[122] If the grantor should die during the

[118] Treas. Reg. Sec. 1.641(c)-1(k), Example (4).
[119] IRC Sec. 1361(e)(1)(A).
[120] IRC Sec. 1361(c)(2)(A)(i).
[121] Priv. Ltr. Ruls. 199936031 (September 13, 1999), 199908002 (March 1, 1999).
[122] The deduction of S-Corporation stock is reduced and limited below fair market value in two ways: (1) the fair market value must be reduced by any ordinary income element

term of the trust, the CLT ceases to be a grantor trust.[123] Accordingly, the CLT should be drafted to include provisions in the trust that will convert it to a permissible S-Corporation holder (EBST) at the grantor's death, so that the S-Corporation will not be disqualified.

Furthermore, the same excess business holdings, jeopardizing investment and UBTI rules regarding C-Corporation stock also apply to S-Corporation stock. Please see discussion under "*Can a CLT be Funded with C-Corporation Stock?*"

11. Can a CLT be funded with partnership or limited liability company (LLC) interests?

As previously mentioned, partnership interests are an ideal asset to fund a non-grantor/family lead trust because the donor may take advantage of valuation discounts. Gifting partnership interests subject to valuation discounts to a family CLT will allow the donor to transfer a larger amount to his or her heirs at a reduced gift tax cost. Due to the initial value of the partnership interest being reduced by the valuation discounts, the reduced amount is used in determining the charitable distribution and gift tax deduction, thereby allowing more to pass to the CLT remaindermen.

In the case of a grantor CLT, reducing the value of the partnership interests gifted to the CLT will decrease the donor's charitable income tax deduction. Although the donor may not want to reduce his income tax deduction, this approach may be preferable, as compared to the partnership interests being included in his or her estate. Additionally, if the partnership does not produce enough income to satisfy the annual income stream to charity, the CLT would have to distribute partnership interests to satisfy the payout amount. If those partnership interests are discounted, then that discounted value would be used for the payout amount. Thus, more

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attributable to the stock and (2) the deduction is limited by the donor's basis in the S-Corporation. IRC Secs. 170(e)(1), 1366(d).

[123] IRC Sec. 1361(c)(2)(A)(v) & (e).

partnership interests would have to be used to make the required payment to charity.

Like the other business interests discussed above, partnership and LLC interests are subject to the same excess business holdings and jeopardizing investment issues. If 95 percent or more of the gross income of the partnership or LLC is passive income, the entity will not be deemed a "business entity," and therefore not subject to the excess business holdings restrictions.[124]

In addition, because partnerships and LLCs are pass-through entities for income tax purposes, the activity of the partnership is attributed to the partners for purposes of UBTI.[125] Therefore, if the partnership or LLC is engaged in a business or trade that produces non-passive income, the CLT may have UBTI. As mentioned above, the tax consequences of a non-grantor CLT having UBTI, is that amount paid to charity which consists of UBTI will only be deductible up to the limits prescribed to individual taxpayers.[126]

12. Can a CLT be funded with real property?

A CLT can be funded with real property and there are different types of real property that may be transferred into a CLT. Issues may arise depending on the type of real property transferred. For example, if the donor transferred a personal residence into a CLT, the self-dealing rules would apply and the donor would not be able to live in the property. However, if the property was investment property that would generate rent to maintain the CLT payout, this asset may be suitable for a family lead trust that would transfer the property to the donor's heirs at the end of the CLT term.

Passive investment property, such as apartment buildings or office buildings that are producing enough rental income to sustain the CLT payout, may be an appropriate asset to transfer to a CLT. If the property is sold, the non-grantor CLT will pay tax on the gain

[124] *Supra* note 21.
[125] IRC Sec. 512(c).
[126] IRC Sec. 512(b)(11).

or if structured as a grantor CLT, the grantor will recognize the gain on the property.

Commercial property, such as farmland, may result in possible UBTI as a result of the operation of property. In that case, the UBTI rules discussed above would apply and limit a non-grantor CLT's charitable deduction each year.

Real property acquired with debt will be debt-financed property which will cause the CLT to have UBTI. However, there is a "five-and-five" exception. If the CLT acquires the encumbered property by gift, the debt secured by the mortgage will not be treated as an "acquisition of indebtedness" during the ten years following the date of acquisition as long as: the mortgage was placed on the property more than five years prior to the gift; and the property was held by the donor/grantor for more than five years prior to the gift. [127] This exception is not applicable if the CLT assumes any part of the debt.[128] Thus, the donor should be the party responsible for the debt even after the transfer to the CLT.

Furthermore, a prohibited act of self-dealing will occur if the debt-encumbered property is transferred to a CLT by a disqualified person within a ten year period ending on the date of transfer. In effect, this increases the five-and-five exception discussed above to ten years.[129] This means that the mortgage must have been placed on the property more than ten years prior to the gift and was held by the donor/grantor for more than ten years prior to the gift.

Therefore, real property may be a suitable asset to transfer into a CLT. However, if the property is encumbered or generates UBTI, the donor may want to use other assets to fund the CLT.

13. Can life insurance be purchased inside a CLT?

[127] IRC Sec. 514(c)(2)(B).
[128] *Id.*, Priv. Ltr. Rul 9241064 (July 16, 1992).
[129] IRC Sec. 4941(d)(2)(A).

Life insurance can be purchased inside a CLT, but the trustee of the CLT has to make sure that he or she is fulfilling the fiduciary duty to both the charity and the remainder beneficiaries. A CLT must pay out either an annuity or unitrust amount to a charitable beneficiary for the term of the trust. In order to make these income payouts, the CLT should hold and invest in assets that produce income at least equal to the amount of those payouts. If life insurance is to be purchased inside of a CLT, there should be sufficient income from other trust assets to not only pay the annual income payouts to charity, but also the premiums needed for the life insurance policy. In addition, it is important to remember that CLTs are subject to IRS rules designed to prevent exempt organizations from jeopardizing the carrying out of their exempt purpose. No particular action is per se a jeopardizing event, but the trustee needs to manage the trust assets in a way that benefits both the charitable income beneficiary and the remainder beneficiaries. If the donor would like to make additional contributions to the CLT to assist the premium payments then the donor should create a CLUT. Purchasing life insurance inside a CLAT may be more difficult because the donor cannot make any additional contributions.

The advantage of purchasing a life insurance policy inside a family lead trust is that the death benefit is outside of the donor’s estate. In addition, upon the donor/insured’s death, the death benefit will increase the value that the heirs receive in addition to the assets already in the CLT. The disadvantage is that the assets may not produce enough income and appreciation to pay both the annual income stream to charity and the premiums for the life insurance policy. If the CLT does not generate enough income and appreciation, the premiums may not get paid and the life insurance policy may lapse. Additionally, if principal is being used for the annual income payouts to charity, assets inside the CLT may be depleted, leaving nothing for the remainder beneficiaries at the end of the trust term.

Therefore, while ownership of a life insurance policy by a CLT is not an uncommon strategy, there is not much legal authority that discusses the concept.

14. Are there additional strategies that can utilize both life insurance and a CLT?

Even if donors decide not to purchase life insurance inside their CLT, there are many other strategies that they may implement that involve both life insurance and CLTs.

A. Life Insurance to Replace Income to Charity

Life insurance may be used to continue the charity's income from the CLT. The charity only receives an income stream from the CLT for the term of the trust, thus the income stream is only temporary. A possible solution for this temporary income stream is to have the charity use a small portion of each year's CLT payout to purchase life insurance on the life of the donor and/or the donor's spouse.[130] At the death of the insured(s), the charity receives the death benefit proceeds to replace all or a portion of the income stream it had been receiving from the CLT.

B. CLT as an Exit Strategy for Gift Reduction Techniques

A second strategy to be considered is using a CLT in conjunction with a gift reduction technique. Gift reduction arrangements, such as premium financing, split-dollar or IRC Section 7872 loans, are usually used to reduce the gifts to fund an irrevocable life insurance trust (ILIT) to purchase life insurance. The disadvantage of these techniques is that, while they work well reducing gifts to fund the ILIT in the early years, over time they become less efficient because of increasing loan interest or reportable economic

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[130] To purchase life insurance on the lives of their donors charities must have an insurable interest. Most states have enacted laws giving charitable organizations an insurable interest in a donor. Before creating a charitable insurance plan, state law should be consulted.

benefit (REB) costs. Once the loan interest or REB costs start to become extremely large or surpass the actual life insurance premium, the donor will want to terminate the gift reduction technique. This termination will require the ILIT to repay the borrowed funds. Without advanced planning, the ILIT may not have enough assets to terminate the gift reduction arrangement, thus causing a large gift tax dilemma for the donor. For a charitably inclined individual with highly appreciating and income producing assets, a gift reduction arrangement used in tandem with a CLT may help fund the ILIT's termination of the gift reduction arrangement and perhaps fund additional premiums.

Accordingly, a CLT will be established at the same time or soon after the ILIT enters into the gift reduction arrangement. The remainder beneficiary of the CLT will be the ILIT. At the end of the term of the CLT, any remaining assets in the trust will then pass to the ILIT without imposition of additional gift tax.[131] The ILIT may then use these assets to assist in the termination of the gift reduction arrangement by paying back the amount owed. Additionally, if there are any assets remaining after the termination, those assets may be used to fund additional life insurance premiums, if any. Keep in mind that for this technique to work, the assets in the CLT need to be income producing and highly appreciating. Should the assets fail to produce sufficient income and appreciation, there may not be enough assets to pour over into the ILIT to assist in the termination of the gift reduction arrangement. Therefore, it is important that the donor have income producing and highly appreciating assets to ensure that this strategy will be successful.

C. Life Insurance for Estate Tax Liquidity

[131] As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation). The generation-skipping transfer (GST) tax exemption cannot be allocated to the initial transfer of assets to a CLT. If the ILIT will benefit grandchildren, the donor cannot allocate the GST exemption until the end of the CLT term. If a CLT is going to be used as an exit strategy, donors should consult with their legal and tax advisors.

If the donor is a high net worth individual, transferring property into a CLT may reduce the estate, but the donor may still have an estate tax[132] liquidity problem. The donor may want to purchase life insurance outside of the estate in an ILIT to help solve any estate tax[133] liquidity concerns. When the donor establishes the CLT, he or she will also establish an ILIT. The ILIT will then purchase life insurance on the donor and/or the donor spouse's life. At the death of the insured(s), the death benefit proceeds may then be used to purchase assets from the decedent's estate to provide liquidity to satisfy the estate tax. The combination of these strategies will help the donor achieve his charitable giving goals, reduce the overall estate, and provide liquidity for any additional estate taxes.

15. Are additional contributions to a CLT allowed?

Additional contributions may be allowed to a CLT, depending on if the trust is structured as a CLAT or a CLUT. Unlike the rules governing charitable remainder annuity trusts, there is no clear prohibition against making additional contributions to a CLAT. In one 1997 Private Letter Ruling the IRS initially concluded that additions to a CLAT should be prohibited.[134] However, a Technical Advice Memorandum issued *after* that Private Letter Ruling indicated that post-creation additions to a CLAT were permissible.[135] Even if additions to a CLAT were allowed, it is unclear how the annuity amount paid to charity would be adjusted to take such additions into account. Furthermore, additional contributions may not be desirable because they would not

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[132] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

[133] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

[134] Priv. Ltr. Rul. 9304020 (November 2, 1992).

[135] TAM 9506001 (February 10, 1995).

generate any further estate or gift tax[136] deductions to the grantor because the amount of the annual guaranteed annuity payment must be determinable at the inception of the CLAT.[137] Therefore, it is generally assumed that additional contributions to a CLAT are prohibited and that a separate CLT would need to be established to hold those additional contributions.[138]

The CLT regulations are silent as to whether additional contributions are permissible in a CLUT. The regulations governing charitable remainder unitrusts (CRUT) do permit additional contributions and even provide how to calculate the resulting charitable deduction. This is relevant because there have been private letter rulings that have approved CLUTs that allowed additional contributions. Furthermore, these rulings provided the calculation for additional charitable deductions in a manner consistent with the CRUT regulations. [139] Therefore, it seems that the IRS will treat additional contributions to a CLUT the same as additional contributions to a CRUT. Keep in mind, however, that these are only private letter rulings and are only binding to the individual taxpayer to which the ruling was issued.

16. Can the donor's private foundation be the income beneficiary of a CLT?

If the donor has established a private foundation, he or she may also want to benefit the private foundation by creating a CLT. By naming the private foundation the income beneficiary of the CLT, the donor is able to leave a legacy for the heirs by having them involved in the operation of the private foundation and perpetuating the wealth of the foundation through the CLT. However, to ensure that the CLT will be excluded from the donor's estate when naming the private foundation as beneficiary, the

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[136] As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).

[137] Treas. Reg. Secs. 1.170A-6(c)(2)(i)(A), 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a).

[138] Priv. Ltr. Rul, 8034093 (May 29, 1980).

[139] Priv. Ltr. Ruls. 8052068 (September 30, 1980), 8043077 (July 29, 1980), 7938099 (June 22, 1979).

donor must take some precautions. If the donor, in the capacity as member, director and/or president of the private foundation, has the power to direct the disposition of funds for charitable purposes, the value of the property transferred to the foundation would be includable in the donor's estate under IRC Section 2036.[140]

A simple solution to the estate inclusion problem would be to have the donor refrain from sitting on the private foundation's board. However, even if the donor(s) did sit on the private foundation's board, there have been several private letter rulings where the IRS ruled there would be no estate inclusion when the donor's private foundation was named as the income beneficiary. In one ruling, the donor and the donor's spouse remained directors on the board of the private foundation, but were prohibited from acting on matters concerning funds coming to the private foundation from the CLT.[141] In that case, the IRS found that there was no estate inclusion because the donors could not participate in any vote concerning the funds received from the CLT. In another ruling, the donor was an officer of the private foundation that was the lead beneficiary, but the funds received by the CLT were to be held in a segregated account in which the donor had no vote.[142] Again, the IRS found that the donor did not retain any interest that would cause estate inclusion.

Additional rulings follow the same logic, where segregated accounts are used for funds received by the CLT and where the private foundation by-laws prohibit the donor from participating in grant making decisions pertaining to those funds, there will be no estate inclusion.[143] Thus, a donor's private foundation may be an income beneficiary of the CLT. Furthermore, the donor may continue to sit on the board of the private foundation as long as the

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[140] Rifkind v. U.S. 5 Cl. Ct. 362 (1984), Rev. Rul. 72-552, 1972 2 C.B. 525.
[141] Priv. Ltr. Rul 200138018 (September 24, 2001).
[142] Priv. Ltr. Rul. 199908002 (March 1, 1999).
[143] Priv. Ltr. Ruls. 9319022 (February 9, 1993), 9320008 (February 3, 1993), 9317039 (February 2, 1993).

donor does not retain any voting rights or power over the funds received from the CLT by the private foundation.

17. Can a donor advised fund be an income beneficiary of a CLT?

A donor advised fund can be an income beneficiary of a CLT, but the same issues that apply to private foundations with regard to estate inclusion would be present. Therefore, the donor may make recommendations regarding the charitable grants from the donor advised fund. However, to avoid the donor from having any retained interest that would cause estate inclusion, the donor's recommendations may be accepted or rejected by the other directors.

18. Can grandchildren be remainder beneficiaries of a CLT?

Grandchildren may be remainder beneficiaries of a CLT; however, when the charity's interest terminates, any assets passing to a skip person[144] are subject to generation skipping transfer (GST) tax[145] unless the CLT is GST tax exempt. For example, if the donor of a CLT creates a remainder interest in favor of his or her grandchildren, a GST tax might be imposed upon the termination of the charitable lead interest, unless the CLT is GST tax exempt. The question is how does the donor allocate the GST tax exemption if the tax is imposed at the termination of the CLT? The answer depends on if the donor created a CLUT or a CLAT.

GST Tax Exemption Allocation and the CLUT

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[144] A "skip person" is a person who is more than one generation younger than the transferor of the property (i.e. grandchildren) or a trust for the benefit of such person(s). IRC Secs. 2613(a), 2651.

[145] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

The GST tax can be determined with certainty when a CLUT is created and the donor can therefore allocate the correct amount of GST exemption[146] at the creation of the trust, making the CLUT GST tax exempt. In the simplest terms, the donor will allocate the GST tax exemption to the CLUT equal to the gift tax value of the remainder interest. The CLUT should then be exempt from GST tax regardless of the amount of property remaining in the CLUT at the termination of the trust. In a Private Letter Ruling, the IRS approved the use of a formula funding clause for a testamentary CLUT, designed to ensure the value of the remainder interest is equal to the donor's available GST tax exemption.[147]

GST Tax Exemption Allocation and the CLAT

The donor cannot allocate the GST tax exemption to a CLAT upon creation and know for certain whether or not the CLAT will be exempt from GST tax at the termination of the charitable interest. The reason for this is that the CLAT GST tax calculation is done at the termination of the trust, while the CLUT calculation is done at the inception of the trust. The CLAT uses an "adjusted GST tax exemption" formula.[148] Accordingly, any GST tax exemption allocated at the creation of the CLAT will appreciate at the IRC Section 7520 rate used to value the charitable gift at the time the CLAT is created. As a result, if the trust assets appreciate at a rate greater than the 7520 rate, the CLAT will be required to pay a GST tax at the termination of the charitable interest. If the assets grow at a rate less than the 7520 rate, then the amount of GST tax exemption allocated will be greater than the value of the CLAT and the excess exemption may not be credited back to the donor.[149] Thus, in order to ensure that no GST tax will be due upon termination of the CLAT, the donor must wait until the end of the charitable interest to allocate the GST tax exemption.

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146 *Id.*
147 Priv. Ltr. Rul. 9532007 (May 4, 1995).
148 IRC Sec. 2642(e).
149 Treas. Reg. Sec. 26.2642-3(c).

Conclusion

CLTs offer many different planning opportunities for donors looking for charitable planning, in addition to income tax planning, estate planning or perhaps both. Although a CLT may seem like a simple planning tool to implement, careful consideration must be given to the types of assets that will fund the CLT, and who will be the charitable and the remainder beneficiaries. Using a CLT in conjunction with life insurance may help the donor realize his or her charitable planning goals, help to reduce their overall estate, and maximize the wealth transferred to both the heirs and to charity.

Appendix A – CRT

John and Jane Doe support several charities with donations and involvement in the charities' activities. They are considering a donation of one of their highly appreciated assets to a charity but desire a steady income stream. John and Jane are interested in providing for their children after their deaths. Selling the asset and contributing a portion of the sales proceeds to a charity is not attractive to John and Jane because the amount of large capital gains tax due would be significant. To achieve their goals, John and Jane consider establishing a Charitable Remainder Trust ("CRT"), along with a Wealth Replacement Trust.[150] The CRT may sell the asset and re-invest the proceeds without the impact of capital gains tax. The CRT will provide John and Jane with an income stream for life and the remainder of the assets will be distributed to a charity. With a portion of the income stream from the CRT, Joe and Jane can fund a Wealth Replacement Trust that owns life insurance on their lives.

John and Jane are 69 and 67 respectively. Their combined life expectancy is approximately 23.6 years. The asset to be contributed to the CRT has a fair market value of $1,000,000 with a cost basis of $150,000. John and Jane are in a 30% tax bracket with a combined federal and state capital gains rate of 20%. They are assuming an 8% return on the trust assets, and would like a 6% annual income payout.

If John and Jane decided to sell the asset, they would recognize capital gains tax of $170,000. Assuming an 8% growth on the asset for approximately 23.6 years, the net proceeds from the sale should grow to approximately $3,004,005. However, estate taxes[151] of

[150] Commonly known as an irrevocable life insurance trust.

[151] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

45% will reduce the net amount to the heirs to approximately $1,652,802.

By establishing a CRT and combining it with a Wealth Replacement Trust, the capital gains tax may be avoided, income is provided and wealth may be distributed to their heirs.

From the CRT, Joe and Jane receive:
- An annual income stream of approximately 6% or $60,000 a year;
- Income paid over 23.6 years;
- Total income of $1,250,558.

Next, Joe and Jane:
- Create a Wealth Replacement Trust by using an irrevocable life insurance trust (ILIT);
- Have the ILIT's trustee purchase a $1,000,000 survivorship policy;
- Use a portion of the income from the CRT as a gift to the ILIT in an amount equal to or greater than the life insurance premium;
- Have the ILIT's trustee use the gift to pay the premium on the life insurance in the ILIT.

Following the deaths of Joe and Jane:
- Life insurance death benefit proceeds of $1,000,000 are paid to the ILIT;
- ILIT assets are distributed to the trust beneficiaries;
- The combined benefit paid to Joe, Jane and trust beneficiaries is $2,250,558;
- Charity receives the remainder of the CRT of $1,595,822.

Appendix B – CLT

Mr. Smith has a family construction business worth $5,000,000. He would like to pass the business on to his heirs, who are also active members in the business, with reduced estate and gift tax consequences. Mr. Smith considered establishing a Grantor Retained Annuity Trust (GRAT) but does not need the income from the GRAT, and is concerned about the inclusion of the business in his estate should he die before the end of the GRAT term. Mr. Smith has also been an active donor to his alma mater throughout his life and would like to continue his charitable giving.

To accomplish his charitable and estate planning goals, Mr. Smith's tax advisors suggest creating a non-grantor/family CLAT for a 10-year term. Mr. Smith will fund the CLT with the family business, which is generating a 10% return. The charitable income beneficiary of the CLT will be his alma mater, which will receive an 8% payout for the 10 years, and his children will be the remainder beneficiaries. Mr. Smith will receive no immediate income tax deduction for the transfer to the CLT, but the CLT will receive an income tax deduction each year for the income stream paid to the charity.

The transfer of the family business to the CLT is a completed gift for gift tax[152] purposes. In essence, Mr. Smith is making two gifts: the gift of the income interest to his alma mater, and a gift of the remainder interest to his children. If the CLT is properly structured and using an IRC Section 7520 rate of 4.6%, a charitable gift tax deduction will be allowed for the present value of the interest passing to the alma mater. However, the present value of the remainder interest passing to Mr. Smith's heirs is a gift subject to gift taxation. In this case, Mr. Smith's gift tax deduction of $3,149,600 will reduce his taxable gift from $5,000,000 to

[152] As of January 1, 2013, the annual gift tax exclusion is $14,000 per donee (indexed for inflation).

$1,850,400. Using his and his spouse's lifetime exemption[153] amounts, no gift tax should be due upon the transfer of the business to the CLT. Also, because the remainder interest in the CLT is a completed gift while Mr. Smith is living, the value of the CLT will not be included in his estate at death.

Mr. Smith has essentially met his estate planning goals with regard to the family business. Through the charitable gift tax deduction, Mr. Smith was able to pass the business, plus additional growth of $1,593,742 to his children at a reduced gift tax cost, and benefit his favorite charity with a total of $4,000,000 in income stream payments. Furthermore, the business is now outside of his estate at his death, thereby reducing his overall estate for estate tax purposes.

[153] According to the American Taxpayer Relief Act of 2012, the federal estate, gift and generation skipping transfer (GST) tax exemption amounts are all $5,000,000 (indexed for inflation effective for tax years after 2011); the maximum estate, gift and GST tax rates are 40%.

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