Charitable Trusts and Insurance: Setting the Record Straight

Anticipated tax savings may be disallowed when a charitable lead trust is funded with a life insurance policy, creating the need to proceed with caution in this area.

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The several articles that have been published about charitable lead trusts, some focusing specifically on ones that are grantor trusts and funded with or that acquire life insurance policies, indicate that there is significant interest in such arrangements. In some cases, it may be possible to achieve superior results for property owners and charities using charitable lead trusts. However, there seems to be a significant lack of understanding of the consequences of trying to marry such a trust with life insurance. In fact, a non-adverse result is, in most cases, extremely difficult to achieve. In some cases, the structure will produce significantly more tax than the amount involved and, in at least one instance, the assets involved will be confiscated in their entirety by the IRS as an excise tax.

This article discusses these arrangements, pointing out the dangers and offering some limited solutions. Although in some circumstances it may be possible to combine life insurance and a charitable lead trust, any planning that attempts to do so must proceed with caution.

Background

Section 170(f),[1] in general, disallows any income tax deduction for a transfer of an interest in property to or for charity that represents less than the entire interest in the property. However, Section 170(f)(2)(B) allows a deduction for the value of certain partial interests, one of which is where charity is entitled at least yearly to an "upfront" or "lead" unitrust payment (i.e., a fixed percentage of the annual fair market value of the trust assets) or annuity (i.e., a fixed dollar amount) from a trust.[2] A trust that provides for such unitrust or annuity payments is called a "charitable lead trust."[3] Unlike charitable remainder trusts, the term "charitable lead trust" is not used in either the Code or the Treasury Regulations.[4] However, the regulations flesh out rules for charitable lead trusts.

Comparable provisions are contained in Sections 2055(a) and 2522(a) for estate and gift tax purposes, allowing a deduction for the interest committed to charity in a lead trust. However, there are limitations and other disallowances of the deduction for such an interest committed to charity.[5]

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A taxpayer who during lifetime creates a "qualified" charitable lead trust is entitled to a gift tax deduction for the value of the interest committed to charity in the trust.[6] The taxpayer also is entitled to an income tax deduction for the value of that interest if the trust is a "grantor trust," which is one the income, deductions, and credits against tax of which are attributed to the grantor (and in one circumstance to a trust beneficiary) pursuant to Section 671.

As a general rule, a charitable lead trust will be successful (at least in a wealth transfer tax sense) only if, at the end of the charitable lead term, adequate wealth is left in the trust for the remainder beneficiaries to have made the arrangement worthwhile.[7] If not, the taxpayer could have simply contributed the property to charity rather than funneling it through the lead trust. This means the trust must experience relatively high investment returns to achieve what will be viewed as success.

Consequence of grantor trust status or not

If the charitable lead trust is not a grantor trust, the taxpayer who funds the trust is not entitled to any income tax deduction for any portion of the value committed to charity in the trust. However, the trust itself is entitled to an income tax deduction under Section 642(c) against its otherwise taxable income for any part (including the whole) of its gross income paid for a charitable purpose pursuant to the terms of the trust's governing instrument.[8]

If the charitable lead trust is a grantor trust, the grantor, as mentioned above, is entitled to an income tax deduction for the present value of the interest committed to charity under the terms of the trust.[9] Hence, the income earned by the trust will be attributed to the grantor for income tax purposes but without any deduction (other than the "upfront" income tax deduction) to the grantor even to the extent the trust's income is paid to charity.

In addition, part (or possibly all) of the "upfront" income tax deduction allowed when creating a charitable lead trust that is a grantor trust is recaptured (that is, it must be included in the gross income of the taxpayer) when the trust's grantor trust status ends to the extent, if any, determined on a present-value basis, that the upfront deduction is greater than the trust income that has been attributed to the grantor under the grantor trust rules during the charitable term.[10]

Hence, in the typical case, the grantor has to weigh the benefit of the immediate income tax deduction by creating a charitable lead trust that is a grantor trust against the detriment of having all of the trust's entire taxable income, even the part paid to charity, during the entire charitable term, taxed to the grantor, as well as the possibility of recapture of a portion (or possibly all) of the income tax deduction if the trust ceases to be a grantor trust before the charitable term ends.

The sought after "better" result

The best of all possible worlds, in the view of some, is to obtain the immediate deduction for creating a charitable lead trust that is a grantor trust while minimizing the taxable income the charitable lead trust generates during the charitable lead term and that will be included in the gross income of the grantor. Here are some ways that have been or might be considered to try to achieve that result.

Fund the charitable lead trust with municipal bonds. Although the charitable lead annuity trust (CLAT) or charitable lead unitrust (CLUT) might hold municipal bonds, the interest on which is not included in gross income,[11] the return on those bonds generally is so low that it is unlikely that the

1 Similar, although not identical, provisions apply for estate and gift tax purposes. See Sections 2055(e) and 2522(c).

2 The dollar amount (i.e., the annuity) may vary from year to year. See, e.g., Reg. 1.170A-6(c)(2)(i)(A) (last sentence) ("For example, *the amount to be paid* may be a stated sum for a term of years, or for the life of the donor, at the expiration of which it *may be changed by a specified amount*, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed in terms of a fraction or percentage of the cost of living index on the date of transfer.") (Emphasis added.)

3 Again, similar provisions apply for estate and gift tax purposes. See Sections 2055(e) and 2522(c).

4 There is a definition of charitable lead trust for generation-skipping transfer tax purposes under Section 2642(e)(3)(A).

5 See, e.g., Sections 170(a)(3), 170(f), 2055(e), and 2522(c).

6 See Sections 2522(a) and (c)(2)(B).

7 See, generally, Blattmachr, "A Primer on Charitable Lead Trusts: Basic Rules and Uses," 134 Tr. & Est. 48 (April 1995); and Zeydel "Estate Planning in a Low Interest Rate Environment," 36 ETPL 17 (July 2009).

8 Although there is no limit under Section 642(c) as to the amount a nongrantor trust may deduct for transfers of its gross income for charitable purposes pursuant to the terms of its governing instrument, Section 681 disallows any Section 642(c) deduction to the extent the income of the trust is unrelated business income (UBI) within the meaning of Section 681, which is essentially the same as unrelated business taxable income defined in Section 512, and which includes income generated by acquisition debt defined in Section 514. As a result, to the extent paid from UBI, the trust's deductions are the same as those for individuals under Section 170.

9 By having the annuity payments be large enough and for a sufficient duration, the charitable interest can be made equal to the entire value of the property contributed to the charitable lead trust. See, generally, Zeydel, *supra* note 7.

10 Section 170(f)(2)(B) (second and third sentences). The recapture provision under the Code is much harsher than it is under the regulations promulgated under it. See Reg. 1.170A-6(c). It is beyond the scope of this article to discuss the matter of this difference in detail but the difference is quite significant. That matter is discussed more extensively in Blattmachr, LISI Charitable Planning Newsletter #172 (2/7/2011).

11 See Section 103.

trust will be able to make the annuity or unitrust payments and have any property (or any significant property) left in the trust when the charitable term ends. Therefore, as a general rule, it will be hoped that the investment return experienced by the charitable lead trust will be well in excess of that provided from most municipal bonds.

Fund the charitable lead trust with a Roth IRA. One possibility is to fund the charitable lead trust with a Roth IRA, distributions from which produce no taxable income and which may well have returns in excess of those produced by municipal bonds.[12] Some commentators believe that, because it is the official position of the IRS that a grantor trust does not exist for income tax purposes and that its assets are treated for such purposes as held by the grantor,[13] the Roth IRA nature of the account continues while it is held by a grantor trust.[14] Whether or not the nature of the Roth IRA continues when it is contributed to a grantor trust is not certain in the mind of other commentators, and loss of Roth IRA status could mean all income earned after the contribution will be taxable to the grantor.[15]

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

Borrowings against the cash value of a policy that is an MEC, however, are included in gross income of the policy owner[16] to the extent the cash value has increased above premiums paid. A policy will be an MEC if its premiums are paid too rapidly. Although there are many ways to structure premiums to avoid MEC status, the premiums must be paid over a number of years. If the taxpayer who wishes to create a charitable lead trust that would be a grantor trust has a paid-up policy that is not an MEC, he or she could contribute the non-MEC policy to the charitable lead trust with a result that may appear attractive (an upfront income tax deduction with no taxable income imputed back to the grantor). Probably few taxpayers, however, have existing paid-up policies that are not MECs with sufficient cash value to make the creation of the lead trust worthwhile and who are willing to contribute such a policy to a lead trust.

Although a taxpayer certainly could acquire such a non-MEC policy with an eye to contributing it to a charitable lead trust in a future year, it seems few taxpayers will be willing to pay significant premiums over a number of years to make the policy a paid-up non-MEC, which could then be contributed to the trust (then generating the income tax deduction if the trust is a grantor trust) so the annuity payments could be funded by income tax free borrowings against the policy's cash value.

Fund a shark-fin CLAT with large life policy and a little cash. Another suggestion has been to create what is called a "shark fin CLAT,"[17] funding it with a small amount of cash

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12 No citation is needed to establish that municipal bonds produce a lower yield than otherwise taxable counterpart investments. And, because the income of an IRA (whether a Roth or traditional IRA) is not taxed as earned in the account, it makes no sense, as a general matter, for an IRA to acquire municipal bonds.

13 See, e.g., Rev. Rul. 85-13, 1985-1 CB 184.

14 See, e.g., Horwitz and Damicone, "A Decent Proposal," 150 Tr. & Est. 46 (November 2011).

15 See, e.g., Choate, seminar outline, "The 201 Best & Worst Planning Ideas for Your Client's Retirement Benefits," 2014 edition, published electronically as a Special Report by Ataxplan Publications, www.ataxplan.com. See, also, Ltr. Rul. 201129045 (stating without analysis or citation that an IRA will lose its status as such if contributed to a grantor trust); but, cf. CCA 201334021 (which seems critical of the statement in the private letter ruling). Neither a private letter ruling nor a chief counsel advisory (CCA) may be cited or used as precedent.

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

17 It is beyond the scope of this article to discuss the matter in detail but it almost never is preferable to create a charitable lead unitrust rather than a charitable lead annuity trust. See Blattmachr "A Primer on Charitable Lead Trusts: Basic Rules and Uses," 134 Tr. & Est. 48 (April 1995).

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

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

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

21 See Fox and Teitelbaum,"Validity of Shark-Fin CLATs Remain in Doubt Despite IRS Guidance," LISI Charitable Planning Newsletter #162 (October 2010).

22 Pratt, Goldberger, and Lee, "Biting Back: Responding to the Attack on Shark-Fin CLATs," LISI Charitable Planning Newsletter #163 (October 2010).

23 See Reg. 1.170A-6(c)(2)(i)(A) (second sentence); cf. Reg. 20.2055-2(e)(2)(vi)(a).

and a significant paid-up life insurance policy.[18] Under the trust terms, small annuity payments would be made each year until the insured dies, at which time a sufficient payment would arise under the trust to pay the charity in full and be paid from the income tax free life insurance proceeds paid on the death of the insured when the charitable term of the trust will end.[19]

The reason the annuity payments are kept so small until the insured[20] dies is because a recently acquired policy likely will be an MEC, so that borrowings against its cash value will be included in gross income as ordinary income to the extent the cash value has appreciated above premiums paid. Some have suggested that a small "side fund" of cash (or some assets that have a stable value and that can be readily converted to cash) could be contributed to the trust, which can be used to make these small initial payments and make borrowing against the cash value of the contributed policy unnecessary. There may well be some challenges in using that structure.

At least one set of commentators has contended that a trust that provides for increasing annuity payments may not be a "qualified" charitable lead trust.[21] Others contend to the contrary.[22]

In any event, even assuming (which may be reasonable based on the explicit regulation that indicates that annuity payments may vary from year to year as long as the amounts are essentially determinable from the inception of the trust)[23] that small initial payments may be provided for from a lead trust, there is a significant potential for income tax recapture with respect to the final "big" payment to be made from the income tax free insurance proceeds when the insured dies.

Recapture occurs under the regulation:

1. Only if grantor trust status ends *before* the charitable lead term ends.
2. Only to the extent (based on present value calculations) that the charity has received less, on a present-value basis, than the donor's income tax deduction.

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

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

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

This problem for a term-of-years CLAT might be ameliorated by providing language in the trust document so that grantor trust status cannot end (other than by the grantor's death) before all unitrust or annuity payments, in fact, are made to charity. For example, the trust could be drafted so that the power of substitution, making the trust a grantor trust pursuant to Section 675(4)(C), would not expire until sometime after the final payment to charity is made. But there is a risk that the grantor will die prior to the end of the term of years and, of course, grantor trust status automatically will end when the grantor dies.

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

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

Is there a solution? There may well be. To understand it, we have to look at charitable remainder trusts (CRTs) and grantor retained annuity trusts (GRATs).[24]

In *Atkinson*,[25] the Tax Court and the United States Court of Appeals for the Eleventh Circuit held that a trust was not a qualified charitable remainder trust because the annuity payments required under the trust were not made "on time." The IRS, in audits, has been contending that, if a GRAT does not make annuity payments timely (including not made within the 105-day regulatory grace period), there is no qualified annuity interest under Section 2702 from inception causing the entire amount transferred to the GRAT to be treated as a taxable gift.

To avoid that problem, some GRAT forms provide, in effect, that, if the annuity from a GRAT is not made on time, the donor-annuitant will become vested absolutely in a portion of the trust's assets so that the annuity will be deemed paid in full. An example of this type of language[26] is:

> **Payments to Vest.** If any portion of the annuity payable to the Grantor or the Grantor's estate, as the case may be, on a particular date is not distributed in its entirety by the Trustee to the Grantor or the Grantor's estate, as the case may be, by the end of the last day (the "Annuity Amount due date") on which it must be paid in order for the Annuity Amount to be treated as a qualified annuity for purposes of Section 2702 of the Internal Revenue Code, including any applicable grace period (such unpaid portion of the Annuity Amount being hereinafter sometimes referred to as the "undistributed Annuity Amount"), then, at the end of the Annuity Amount due date, the Annuity Property (as hereinafter defined) held by the trustee shall vest absolutely in the Grantor or the Grantor's estate, as the case may be. The trust shall immediately terminate as to the Annuity Property, and the Trustee, in the Trustee's capacity as Trustee, shall have no further duties, power, authority or discretion to administer the Annuity Property notwithstanding any provision of applicable law or this Agreement to the contrary. If the Annuity Property shall remain in the hands of the Trustee after the Annuity Amount due date, the Trustee shall hold such property exclusively as nominee and agent for the Grantor or the Grantor's estate, as the case may be. The Grantor hereby authorizes the Trustee, but only as nominee and agent for the Grantor or the Grantor's estate, as the case may be, to invest the Annuity Property on the Grantor's behalf or on behalf of the Grantor's estate, as the case may be, with the same authority as the Grantor or the Grantor's estate, as the case may be, could individually. The Trustee, both as Trustee and as such nominee and agent, is hereby relieved of any liability for commingling assets that have vested absolutely in the Grantor or the Grantor's estate, as the case may be, with assets that remain part of the trust estate under this Article. Any Annuity Property that shall have vested in the Grantor as hereinbefore provided shall, upon the Grantor's subsequent death, vest in the Grantor's estate. For purposes of this Article, the term "Annuity Property" shall mean that portion of the trust estate having a fair market value as finally determined for Federal gift tax purposes equal to the lesser of (x) all property held by the Trustee, in the Trustee's capacity as Trustee, at the end of the Annuity Amount due date or (y) the undistributed Annuity Amount. If the fair market value as finally determined for Federal gift tax purposes of the property then held by the Trustee is greater than the undistributed Annuity Amount at the end of the Annuity Amount due date, the Annuity Property shall consist of those assets having the lowest income tax basis as finally determined for Federal income tax purposes compared to their current fair market values as finally determined for Federal income tax purposes, and if more than one asset has the lowest basis for Federal income tax purpose, the Annuity Property shall consist of a proportionate share of each such asset. The Annuity Property shall include all income, appreciation and depreciation on all assets that are used to fund the Annuity Property, and all other incidents of ownership attributed thereto.

All property is either owned by the trust or by the donor, not both. Obviously, this language would need to be revised to refer to the charitable annuitant rather than the Grantor and the Grantor's estate. Also, to ensure there is no co-ownership of property that might give rise to an act of self-dealing[27] between a private foundation entitled to the payments from the charitable lead trust and the lead trust (which may itself be considered a disqualified person with respect to the foundation), the formula should

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

25 115 TC 26 (2000), *aff'd* 309 F.3d 1290, 90 AFTR2d 2002-6845 (CA-11, 2002).

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27 Section 4941 imposes significant excise taxes on acts of self-dealing as defined in that section.

be revised so that the phrase "if more than one asset has the lowest basis for Federal income tax purpose, the Annuity Property shall consist of a proportionate share of each such asset" to state, "if more than one asset has the lowest basis for Federal income tax purpose, the Annuity Property shall consist of that asset which has or those assets which have a fair market value at the time of distribution in satisfaction of the undistributed Annuity Amount greater than the undistributed Annuity Amount but as close to the undistributed Annuity Amount as possible." (Comingling does not itself appear to be an act of self-dealing under Section 4941).

Unfortunately, it does not seem certain that the foregoing formula "works" to avoid recapture in the case of a shark-fin CLAT.[28]

Fund the CLAT with cash and a policy that is* not *paid up. Another suggestion is to contribute a policy that is not paid-up and also contribute sufficient cash to continue to pay premiums until it is no longer an MEC. Despite being fairly widely promoted, including by one of the country's largest life insurance companies, the strategy runs directly into Section 170(f)(10), which potentially causes doomsday results.

Section 170(f)(10) disallows any charitable deduction if any charity "directly or indirectly" pays (or has paid) any premium on any "personal benefit contract" or there is an understanding or expectation that "any person" will, directly or indirectly, pay any premium on any personal benefit contract. A personal benefit contract is any life insurance, annuity or endowment contract if any "direct or indirect" beneficiary is the transferor, any member of the transferor's family or anyone (other than a charity) designated by the transferor. (It seems nearly certain that the remainder beneficiaries of a lead trust who would succeed to any life insurance proceeds not paid to charity would be designated by the trust's grantor.) In addition, a 100% excise tax is imposed on any charity equal to the premiums it pays on such a personal benefit contract. As a consequence, where Section 170(f)(10) applies, the taxpayer receives no income tax charitable deduction, receives no gift tax charitable deduction (and, therefore, must pay gift tax on the value of what has been committed to charity in the trust), and the assets essentially will be confiscated by the IRS.

Although not certain, it seems that Section 170(f)(10) may apply to a charitable lead trust and, if so, no income, estate, or gift tax deduction would be allowed for creating one where the section applies. If the section can apply to a lead trust, it would seem to apply where a policy of insurance is transferred to it if the policy of life insurance is not "paid up" so that the lead trust or some other person must or is expected to pay premiums on it. One logical reason that the IRS may well contend that the section applies to a charitable lead trust in such a case is because the section applies if charity "directly or indirectly" pays a premium. Because a portion (if not all) of the interests in the lead trust is committed to charity (indeed, the taxpayer will seek at least a gift tax deduction for the value of that interest), it seems the charity may well be viewed as indirectly (if not directly) paying all or part of any premium paid by the lead trust.

It is less certain that the lead trust, if it paid any premium, would be subject to the excise tax imposed by the section. The tax is imposed on a charity described in Section 170(c), which does not seem to include a charitable lead trust. The Treasury Department is directed to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of [section 170(f)(10)], including regulations to *prevent the avoidance of such purposes*." (Emphasis added.) It might not be surprising if the Treasury adopted regulations that made the section applicable to lead trusts.

Section 170(f)(10)(C) provides (subject to an exception) that the section applies to charitable remainder trusts. One can argue that, because charitable remainder trusts are mentioned and lead trusts are not, that lead trusts were not intended to be covered by Section 170(f)(10); alternatively, one can argue that, because it would be so simple to avoid the purpose of the section by creating a lead trust, under which the entire actuarial interests are committed to charity, that lead trusts were intended to be covered. Although it seems uncertain which argument would prevail, it seems "risky" to proceed on the basis that the section does not apply to charitable lead trusts.

In any case, the application of Section 170(f)(10) may cause such tremendously adverse results that it seems unwise even to consider going forward with a charitable lead trust plan expecting to be able to establish that the section cannot apply.

Fund the CLAT with cash and later substitute a non-MEC policy. It has been suggested that one way to avoid the problem is to currently fund the grantor lead trust with

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

[29] See, e.g., Clark, 489 U.S. 726, 63 AFTR2d 89-860 (1989).

cash, acquire a policy and hold it until it is fully paid up and sufficient premiums are paid over time that the policy is a not an MEC, and then to "exchange" the policy for the cash in the lead trust.

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

First, there is at least some risk that the Service could argue successfully that Section 170(f)(10) applies by reason of the application of the step-transaction doctrine.[29] It is beyond the scope of this article to discuss that doctrine in detail, but there is probably some risk it could be applied where it was understood from inception that the policy would be substituted in for the trust's cash. And, as stated above, the results of the application of the section are so adverse that it just does not seem wise to take the risk that the grantor of the lead trust can successfully argue against the application of the doctrine. Recall that, if the section applies, no income tax deduction or gift tax deduction is allowed, and the assets in the trust may be taken by the IRS as an excise tax. It seems unlikely that any informed taxpayer would engage in such a plan even if the risk of the application of the section applying is only, for example, 10%. It certainly seems to be at least that great.

Another potential adverse consequence also needs to be considered, so any informed taxpayer probably would not go forward with the substitution plan. Specifically, Rev. Proc. 2007-45[30] provides in part: "The donor to a CLAT may claim an income tax charitable deduction under § 170(a) if the donor is treated as the owner of the entire CLAT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Paragraph 11, Retained Powers and Interests, of the sample trust in section 7 creates a grantor CLAT through the use of a power to substitute trust assets under § 675(4) that is held by a person *other than the donor, the trustee, or a disqualified person* as defined in § 4946(a)(1), and is exercisable only in a nonfiduciary capacity." (Emphasis added.)

The Procedure expressly states that the power of substitution is held by someone other than the donor (the grantor of the lead trust), the trustee, or a disqualified person. The grantor and the trustee are also disqualified persons. The reason they are excluded from holding the power of substitution is that virtually any economic transaction between a charitable lead trust and a disqualified person will be an act of self-dealing under Section 4941 and thereby subject the disqualified person to an excise tax of up to 200%.[31]

Even the mere authorization for the grantor to substitute almost certainly causes the trust to fail to be a "qualified" charitable lead trust.[32] And it seems to be as certain as a legal proposition can be that the actual exercise of the power of substitution by the grantor will be an act of self-dealing subjecting the grantor to tax under Section 4941.[33]

As mentioned above, even if an advisor concludes that the risk of the substitution plan not working is very low (e.g., only 5%), the result of the application of the self-dealing taxes and possibly Section 170(f)(10) would be so adverse that it seems few, if any, well-informed taxpayers would adopt such an arrangement.

Conclusion

Charitable lead trusts can be excellent planning tools for some circumstances. However, funding such a trust with a policy of life insurance may result, under Section 170(f)(10), in the disallowance of all charitable deductions, including any gift tax deduction, and confiscation of the assets unless the policy is "paid up" when it is contributed to the trust. Moreover, any individual who wishes to obtain an income tax deduction for the value of the interest in a lead trust committed to charity must structure it to be a grantor trust. Even if the trust is so structured, recapture of the income tax deduction may occur. Many other plans to avoid Section 170(f)(10) by the exercise of powers of substitution raise significant self-dealing tax risks and may not, in fact, avoid Section 170(f)(10). ■

30 2007-2 CB 89.

31 Section 4941 imposes a tax on virtually all economic transactions (e.g., sale or exchange) between a private foundation and a disqualified person equal to 10% of the amount involved which, if not "corrected" within the meaning of the section, results in an additional tax of 200%. The tax is made applicable to such economic transactions between a disqualified person and a charitable remainder trust (described in Section 664) and a charitable lead trust pursuant to Section 4947(a)(2). Disqualified person is defined in Section 4946.

32 See Rev. Proc. 2008-45, 2008-30 IRB 224, section 8.09.1 (last sentence) ("Note, that the exercise of a § 675(4) power may result in an act of self-dealing under § 4941").

33 Sections 4941(a)(2) and (b)(2) also impose an excise tax on any foundation manager (subject to certain dollar limitations specified under Section 4941(c)) who knowingly engages in the act of self-dealing. Agreeing to act as trustee of a charitable lead trust that expressly authorizes an act of self-dealing would seem to foreclose the trustee from successfully arguing that the act of self-dealing was not done knowingly.