Some Recapture Considerations and Other Problems Relating to Charitable Lead Trusts

By Jonathan G. Blattmachr

EXECUTIVE SUMMARY

Although several articles have been recently published about charitable lead trusts, some focusing specifically on ones that are grantor trusts, they seem not to have discussed what may be several critical aspects of such arrangements. First, funding a charitable lead trust with a policy of life insurance other than one that is fully paid up may result in a complete disallowance of any tax deduction, including any gift or estate tax deduction, as well as potentially subjecting the trust to excise tax. Second, none seems to have commented on the virtual total recapture of any income tax deduction allowed in many cases under the specific provisions of the Internal Revenue Code ("Code"). Third, if the final charitable annuity payment is to be made when the grantor/insured dies, there almost certainly will be a significant recapture of the "upfront" income tax deduction allowed. Some of these "problems" may be overcome by cautious drafting and administration of the trust. But at least one problem almost certainly must await further guidance from the Internal Revenue Service ("IRS" or "Service").

FACTS

Section 170(f) of the Code, in general, disallows any income tax deduction for a transfer of an interest in property TO 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 unitrust payment (a fixed percentage of the annual fair market value of the trust assets) or annuity (a fixed dollar amount) from a trust. A trust that provides for such unitrust or annuity payments is called a "charitable lead trust." Unlike charitable remainder trusts, the term "charitable lead trust" is not used in either the Code or the Treasury Department Regulations. 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.

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Danger of a Lead Trust Holding Life Insurance. 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 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.

Recapture of Income Tax Deduction under the Code. The income tax deduction for the value (determined using standard IRS actuarial assumptions) of the interest committed to charity in a charitable lead trust is allowed only if the trust is a so-called "grantor trust" described in sections 671 to 679 in its entirety. In other words, in order for an income tax deduction to be allowed for the charitable interest in a lead trust, the trust must be structured so the grantor is treated as the trust's "owner" so all of the income, deductions and credits of the trust are attributed under section 671 to the trust's grantor. Even though the grantor typically is entitled to any income tax deduction the trust generates, section 170(f)(2)(B)(first sentence) provides that the grantor is not allowed any deduction for any amount paid to charity from the lead trust unless it is a grantor trust.

Hence, the grantor who creates a charitable lead trust that is a grantor trust in its entirety is entitled to an income tax deduction at the time the trust is created and the property transferred to it. However, the grantor is not entitled to any income tax deduction as the unitrust or annuity amounts are paid to charity even if consisting of the trust's gross income. Normally, a trust is entitled to an income tax deduction for gross income paid, pursuant to the terms of the governing instrument, to charity. See section 642(c).

The tax law provides that the upfront income tax deduction allowed when the taxpayer creates a charitable lead trust that is a grantor trust is recaptured, in whole or in part, in some cases when grantor trust status ends. Grantor trust status, of course, will end not later when the grantor dies. Unfortunately, the Code and regulatory provisions are so disparate that a taxpayer almost certainly should not create such a trust unless and until definitive guidance is obtained from the IRS. The recapture rules in the case of a so-called "shark fin CLAT" are so uncertain that it likely is unwise for anyone to create one that is a grantor trust—this problem does not seem to be present for one that is not a grantor trust.

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Another Recapture Problem for Shark Fin CLATs that End at Death. Recapture of the upfront income tax charitable deduction occurs under both the Code and the regulations when grantor trust status ceases, the regulatory recapture rule is nowhere near as draconian as under the Code itself. Nevertheless, an unexpected recapture may occur under the regulations if the last payment arises under the trust when the grantor dies unless, perhaps, the trust is structured in a special way.

COMMENT

Life Policy in a Lead Trust. Although not, perhaps, 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. 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 contain 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 charity may well be viewed as indirectly (if not directly) as 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 upon a charity described in section 170(c), which does not seem to include a charitable lead trust. The Treasury Department is directed to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of [section 170(f)(10)], including regulations to *prevent the avoidance of such purposes*." (Emphasis added.) It might not be surprising if the Treasury adopted regulations that made the section 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 simply to avoid the purpose of the section by creating a lead trust, where 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.

Different Recapture Rules under the Code and the Regs. When a taxpayer creates a charitable lead trust that is a grantor trust for income tax purposes, the taxpayer is trading an upfront income tax deduction for back end income without any further deduction and even

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though such income may be paid to charity. The taxpayer cannot obtain both an upfront income tax deduction for the value of the interest committed to charity and essentially avoid income tax on the trust's income that is used to fund the payments to charity. Section 170(f)(2)(C).

In addition, the upfront income tax deduction is recaptured (that is, it must be included in the gross income of the taxpayer) when the trust's grantor trust status ends to the extent, IF ANY, determined on a present value basis, that the upfront deduction is greater than the amount of trust income that has been attributed to the grantor under the grantor trust rules. Section 170(f)(2)(b)(second and third sentences).

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

Apparently to ameliorate that draconian result, the Treasury Regulations provide a different recapture rule. Reg. § 1.170A-6(c) provides, in part, "(4) *Recapture upon termination of treatment as owner*. If for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be treated as the owner of such interest for purposes of applying section 671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under section 170 for the contribution of such interest reduced by (ii) the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest."

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In other words, recapture of the upfront deduction occurs under the regulation: (1) only if grantor trust status ends *before* the charitable lead term ends and (2) only to the extent (based upon present value calculations) charity has received less than the donor's income tax deduction, and not to the extent that the grantor had to include trust income in gross income. Hence, under the regulation, in the foregoing example where the taxpayer created a $1 million two year charitable lead trust paying $524,137 each year to charity, there would be no recapture because the present value of the payments made to charity during the charitable term would equal the upfront deduction. NOTE THAT [In fact], no recapture would occur even if the trust's income exceeded 3.2 percent each year.

Therefore, the recapture rules under the Code are starkly different than under the regulation. Which rule prevails? It seems appropriate to note that the Congress apparently intended the literal result dictated under the Code. The General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation (December 2, 1970), at p. 88, provides, in part, in discussing the recapture rule, "This is accomplished by treating the donor at the time he ceases to be taxable on the trust income as having received income to the extent the deduction he previously was allowed exceeds the value of the income previously earned by the trust and taxable to him."

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

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

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

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> *to the donor and the amount paid to the charity.* Thus, for example, the trust might earn $10,000 annually (all taxable to the donor) and pay $1,000 annually to the charity.
>
> "Accordingly, the proposed regulation adopts the position that the amount recapturable is to be measured by subtracting from the amount of the charitable contributions deduction previously allowed to the donor the discounted value of only those amounts which were taxable to the donor and paid by the trust to the charity. It is recognized that this approach is not clearly supportable under the language of section 170 (f) (2) (B). Paragraph (c) (4) also adopts the position that, for purposes of applying this recapture rule, trust income of which the donor is treated [*33] as the owner shall be treated as income taxable to him even though it is excluded from his gross income by reason of an exclusion provision of the Code. This appears consistent with the allowance of a charitable contributions deduction to a donor for amounts paid to a charitable organization from amounts as a gift or as exempt income." (Emphasis added.)[ii]

The regulation is so explicit that one might conclude that the IRS would accept it as the recapture rule. However, [in] Rev. Proc. 2007-45, promulgated by the IRS to provide sample charitable lead trust provisions, essentially recites the same recapture rule contained in the Code. Specifically, Rev. Proc. 2007-45 § 8.01(5) provides, "If at any time the donor ceases to be treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code, the donor shall be considered to have received an amount of income equal to the amount of any deduction the donor received under § 170(a) for the contribution to the trust, reduced by the discounted value (as of the date of the contribution to the trust) of all amounts of income earned by the trust and taxable to the donor before the time that the donor ceased to be treated as the owner of the trust under subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Section 170(f)(2)(B)."

It is not at all certain that the Service would be bound by the regulation. Indeed, it is questionable whether a government agency may ignore the law. For a discussion of this interesting issue, see Gans, "Deference and the End of Tax Practice," 36 Real Prop. Prob. & Tr. J. 731 (Winter 2002), pp. 795-800.

Therefore, in the absence of clarification by the IRS, a taxpayer must consider that recapture will occur under the provisions of the Code. The recapture rule under the Code is so adverse that it seems few, if any, informed taxpayers likely would create a charitable lead trust that is a grantor trust.

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Recapture Potential When the Lead Trust Ends at the Grantor's Death. Some charitable lead trusts provide that the unitrust or annuity payments to charity shall cease upon the grantor's death with the last payment arising at that time. It seems such a lead trust is valid. The income, estate and gift tax regulations cited above all provide "A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term of years or *for the life or lives of certain individuals*, each of whom must be living at the date of the gift and can be ascertained at such date." (Emphasis added.) See, e.g., Treas. Reg. §1.170A-6(c)(2)(i)(A)(second sentence); cf. Treas. Reg. §20.2055-2(e)(2)(vi)(a).

As mentioned above, recapture occurs under the regulation: (1) only if grantor trust status ends *before* the charitable lead term ends and (2) only to the extent (based upon present value calculations) that charity has received less than the donor's income tax deduction, not to the extent that the grantor has not had to include trust income into gross income.

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. Before we turn to a case where both the charitable interest and grantor trust status arguably terminate simultaneously at and by reason of the grantor's death, let's take another hypothetical.

Assume an individual taxpayer creates a charitable lead annuity trust on January 1, 2011, providing for charity to receive $100,000 at the end of each calendar year through 2020. Hence, on December 31, 2011 through 2020, charity will receive $100,000, for a total of $1 million. A person who is not "disqualified" within the meaning of section 4946 is authorized to substitute property of equivalent value up until December 31, 2020 which will make the trust a grantor trust under section 675(4)(C) during the period the person holds that power. The taxpayer will receive an income tax deduction for the value of the interest committed to charity. The value will turn on the section 7520 rate used to value the interest. Let's assume the $100,000 annuity payable for ten years is worth $900,000.

By the time the charitable interest ends on December 31, 2020 charity will have become entitled to ten $100,000 payments which have a present value of $900,000. In any case, it seems grantor trust status ends at the same time that the charitable interest ends. Should there be recapture? When grantor trust status ends, on December 31, 2020, charity will have become entitled to exactly $900,000 worth of the present value payments. It seems that the purpose of the regulatory recapture rule is met: charity will have been entitled to receive an amount equal to the

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grantor's income tax deduction and during the entire time the grantor will have been taxed on all trust income up until the charity's interest ends.

However, when the charitable term ends has grantor trust status already ended? It seems not. It seems they ended simultaneously. However, the charity will likely not have received its final payment on December 31, 2020 when its entitlement to the final payment arose and grantor trust status ends. It is possible that the regulation means the grantor trust status cannot end before charity, in fact, receives the final payment.

Why should the IRS care? It seems that the regulation wants all tax 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 December 31, 2020, it might be paid with income earned after that date and, because grantor trust status ended in 2020, this income will not be taxed to the grantor. Hence, there is at least some risk that there will be recapture to the extent of the final payment.

This problem for a term of years CLAT can be ameliorated by providing 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 would not expire until sometime after the final payment to charity is made.

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 no matter what.

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

Blattmachr Formula[iii]. In Atkinson v. Commissioner, 115 TC 26 (2000), aff'd, 309 F 3d 1290 (11th Cir. 2002), 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. The IRS in audits has been contending that, if a GRAT does not make annuity payments timely (including not made within the 105 day

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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, the Wealth Transfer Planning[sm] forms provide, in effect, that if the annuity from a GRAT is not made on time, the donor-annuitant will become vested absolute in a portion of the trust's assets so that the annuity will be deemed paid in full. The language (reprinted here with the permission of Interactive Legal, LLC the publisher of Wealth Transfer Planning[sm]) 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

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> 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.

It will be noted that all property is either owned by the trust or by the donor, not both. Obviously, this language would need to be revised to refer to the charitable annuitant rather than the Grantor and the Grantor's estate. Also, to ensure there is no co-ownership of property which might give rise to an act of self-dealing[iv] 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 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).

SUMMARY AND CONCLUSIONS

Charitable lead trusts can be excellent planning tools for some circumstances. However, funding such a trust with a policy of life insurance may result in the disallowance of all charitable deductions, including any gift tax deduction, unless the policy is "paid up." 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. Under the Code, the recapture appears to be draconian. Under the regulations, it is less severe and likely might be avoided in its entirety if the grantor does not die before the charitable term ends. However, even under the regulatory recapture rule, having the charitable term end when the grantor trust status ends (as may occur with a shark fin CLAT) may result in significant recapture unless the trust is structured so that the annuity is effectively paid at that same time.

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CITATIONS

Internal Revenue Code Sections 170(a), 170(f), 170(f)(2)(B) and (C), 170(f)(10), 642(c), 664, 675(4)(C), 671-679, 2055, 2522, 2702, 4941, 4946, 7520; Rev. Proc. 2007-45, 2007-29 I.R.B. 89; Treas. Reg. §1.170A-6(c)(2)(i)(A); Treas. Reg. §20.2055-2(e)(2)(vi)(a); Treas. Reg. § 1.170A-6(c); Atkinson v. Commissioner, 115 TC 26 (2000), aff'd, 309 F 3d 1290 (11th Cir. 2002); General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation (December 2, 1970)

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