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Early Termination of Charitable Lead Trusts

In our Spring 2015 edition, we considered how the early termination of a charitable remainder trust (CRT) can address evolving circumstances. This edition considers another type of split-interest charitable vehicle—the charitable lead trust (or CLT)—and why and how it might be terminated early to accommodate changing conditions.

Charitable Lead Trusts: An Overview

CLTs can be powerful estate-planning tools, particularly in a low-interest-rate environment. In this respect, a CLT is sometimes analogized to a grantor retained annuity trust (or GRAT) as a technique that enables families to make a bet, in effect, that investment performance in the trust will exceed the actuarial and market assumptions embedded in IRS valuation formulas.

A CLT can be seen as the converse of a CRT: the "lead" interest, which may take the form of a fixed annuity interest (for a charitable lead annuity trust or CLAT) or a unitrust interest (for a charitable lead unitrust or CLUT) for a term of years or measuring life, is payable to one or more charitable beneficiaries, and when the lead interest expires, the remainder interest passes to or for the benefit of one or more non-charitable beneficiaries (or may, in some cases, revert to the trust's donor). Because a CLT defers, sometimes for many years, any benefit to family members, it tends to be used by very wealthy families—those who have the wherewithal to hold property in trust for charity for a number of years before anything passes back into family hands and, indeed, those who can take the risk that the trust assets will be depleted, perhaps entirely distributed to charity, before the family's interest in the trust comes due.

But unlike a CRT, a CLT is not a tax-exempt trust. If a living donor creates a CLT, it may be designed either as a grantor trust (with all trust income taxable to the donor during his lifetime) or a non-grantor trust (with the trust being its own taxpayer) for income tax purposes. In addition, a CLT may be structured so the trust is includable in the donor's estate, or may be a com-

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pleted gift that is not included in the donor's estate. The specific tax characteristics associated with a CLT depend on which form is chosen:

- A so-called ***non-grantor CLT*** may be established during a donor's lifetime or at death. If the donor establishes the non-grantor CLT during life with a lead interest that qualifies for the estate and gift tax charitable deductions, he will generally relinquish all powers that cause estate tax inclusion, and his estate taxes may be reduced because the lifetime appreciation on trust assets allocable to the non-charitable remainder beneficiaries will be set aside for their benefit without further gift or estate taxes. If the CLT is established at death and has a lead interest that qualifies for the estate tax charitable deduction, the decedent's estate will receive an estate tax charitable deduction for the value of the lead interest and, to the extent the trust assets appreciate in excess of what is required to pay the lead interest to charity, the remainder will similarly pass to the non-charitable (i.e., remainder) beneficiaries without further gift or estate taxes.

  A non-grantor CLT is its own taxpayer (that is, trust income is generally taxable in the first instance at the trust level rather than to the donor), but the trust receives an income tax charitable deduction for income paid to the charitable lead beneficiary. This is the Code Section 642(c)[1] deduction, which is distinct from the individual and corporate income tax charitable deduction under Code Section 170. The Section 642(c) deduction differs from the Section 170 deduction in a variety of ways, including the absence of annual percentage limitations on the share of income that may be deducted. A CLT, in other words, may deduct 100 percent of its annual income, even though an individual donor's Section 170 deduction is capped at 50 percent of adjusted gross income for gifts to public charities. Some donors create non-grantor CLTs in part because they have exceeded (or expect to exceed) annual charitable deduction thresholds under Section 170 and wish to avoid incurring an income tax on income they desire to go to charity despite the unavailability of an individual charitable deduction.
- A so-called ***grantor CLT*** must be established during the donor's lifetime, and he will be entitled to an income tax charitable deduction upon the creation of the trust equal to the value of the charitable lead interest, provided the lead interest qualifies for purposes of the Code Section 170 income tax charitable deduction. However, the donor will be taxed on the trust's income during his lifetime (without a further Section 170 charitable deduction for the amounts paid out to the charitable lead beneficiary). In effect, because of this lack of a further charitable deduction, the donor's initial income tax charitable deduction is "recaptured" as the lead interest is paid to charity.

  In addition, if the donor dies during the charitable lead term, an additional amount of income will be recaptured on his final income tax return based on the present value of the remaining charitable lead payments. If a grantor CLT has income in excess of its annual obligation to make the lead payments to charity, this excess income accumulates in the trust without bearing any of the resulting tax liability; the donor, instead, picks up that liability, which is (in effect) a tax-free gift to the CLT's remainder beneficiaries (usually family members). A grantor CLT may be structured to be includable or not includable in the donor's taxable estate.
- Finally, a third, less common category of CLT is sometimes called a ***non-qualifying CLT***. These CLTs do not have a charitable lead interest that is a qualifying interest for purposes of the income, gift, and estate tax charitable deductions. This type of CLT is, nonetheless, structured to be a separate taxpayer and may receive an income tax charitable deduction under Section 642(c) for income paid to the charitable lead beneficiary.

This edition focuses on grantor and non-grantor CLTs, which are sometimes referred to as ***qualifying CLTs*** to distinguish them from non-qualifying CLTs. For more information on what makes the charitable lead interest a qualifying interest for purposes of various income tax deductions, see the October 2008 edition of *Professional Notes*.

Although CLTs are not used nearly as often as CRTs, CLTs tend to attract the attention of planners in periods of relatively low Code Section 7520 rates (that is, the interest rates that are used to value the respective charitable and non-charitable interests). When interest rate assumptions are low, CLTs have a greater likelihood of passing value to the non-charitable remainder beneficiaries with gift and estate tax savings. CLATs that are "zeroed-out"—that is, those where the non-charitable remainder interest is assigned a zero value for gift or estate tax purposes—have been particularly popular as an estate planning tool, at

1 All "Code Section" or "Section" references are to the Internal Revenue Code of 1986, as amended.

least for those who wish to benefit charity and are prepared for the risk that the trust will not appreciate in excess of what is required to be paid to the charitable lead beneficiary. (CLUTs cannot be "zeroed out" because their payout is always a percentage of asset value.)

Reasons for Terminating CLTs Early

Interested parties to a CLT might wish to terminate the trust before the expiration of the charitable lead interest for a variety of reasons. For example, the motivation could be purely economic: to accelerate the remainder beneficiaries' receipt of their interests or to eliminate the administration costs of having a trust at all (costs that may be disproportionate to the value of the assets held in the trust).

There also could be economic motivations arising from tax concerns. For example, it may be advantageous for income earned on trust assets to be taxable to the remainder beneficiaries rather than to the donor (in the case of a grantor CLT) or the trust itself (in the case of a non-grantor CLT).

Or there could be motivations driven by tax rules applicable to the specific property used to fund the CLT. For example, it is ordinarily permissible for a grantor CLT to hold shares of a Subchapter S corporation. But if the donor were to die during the lead term, or if a CLT were to receive S corporation stock under the donor's will, the CLT would need to either divest itself of its S corporation stock within the 2-year grace period allowed under Section 1361 or become an electing small business trust (or ESBT). If neither of those options is possible, early termination may be necessary to avoid adversely affecting the corporation's S election.

Ironically, some of the rules applicable *because* the trust is a CLT may be the reasons the creators of CLTs, their families and advisors may conclude it would be advantageous to terminate a CLT before its stated term. These include the self-dealing and the excess business holdings rules.

- ***Self-dealing (Code Section 4941)***—Qualifying CLTs will generally be subject to the self-dealing rules of Section 4941, with the result that certain "acts of self-dealing" between the CLT and "disqualified persons" (e.g., the donor, his family, and certain family-owned trusts and businesses) would result in prohibitive excise taxes (10 percent a year of the amount involved plus 200 percent if the act of self-dealing is not timely corrected). The sale of CLT assets to the donor or other disqualified persons with respect to the CLT (or use of those assets by those persons) would ordinarily constitute an act of self-dealing, even if the sale is on fair and reasonable terms. Therefore, if illiquid assets, such as interests in a limited liability company or other closely held entity, were used to fund the CLT, the existence of Section 4941 may sharply limit the already-constrained market for those assets during the charitable lead term.

  In such a case, it may become desirable for the CLT to be terminated early so that CLT assets can be distributed outright to the charitable lead beneficiary (if it is not itself a private foundation with the same disqualified persons and the same self-dealing problem) and/or the non-charitable remainder beneficiaries, clearing the path for a sale of the illiquid assets to those who would have been disqualified persons with respect to the CLT. (For a variety of reasons, illiquid assets may not be an ideal choice for the CLT in the first place. Exit strategies should be contemplated at the outset if a CLT is to be funded in this manner.) Similarly, a qualifying CLT could not buy assets from its disqualified persons without triggering the Section 4941 excise tax, so early termination also may be necessary if purchase of assets from a disqualified person is contemplated.

  Note: In cases where a potential Section 4941 issue is being addressed through early termination of a CLT, it will generally be necessary that the charitable beneficiary upon termination be a public charity, including a community foundation, such as The New York Community Trust.
- ***Excess business holdings and jeopardizing investments (Code Sections 4943 and 4944)***—If the actuarial value of the charitable lead interest is greater than 60 percent of the value of all beneficial interests at the time of the donor's transfer to a qualifying CLT, the CLT will generally be subject to Sections 4943 and 4944, which impose excise taxes on certain "excess business holdings" and "jeopardizing investments," and its governing instrument will be required to prohibit the trustees from becoming subject to these taxes. All "zeroed-out" CLTs—and other CLTs structured to have minimal gift or estate tax consequences upon creation—will therefore be subject to these rules. Under the excess business holdings rules and subject to a *de minimis* rule described below, a CLT in which charity's interest exceeds the 60 percent threshold when the CLT is funded will have excess business holdings if at any time it (on its own or in combination with its disqualified persons and certain related private foundations, donor-advised funds, and non-functionally integrated Type III supporting organizations) owns more than 20 percent of the voting stock of a business enterprise. The threshold is raised to 35 per-

CLT Morphing into a Disqualified Person.

It is possible for a split-interest trust such as a CLT to *itself* be a disqualified person. In other words, a partially charitable vehicle such as a CLT may be treated *both* as if it is a private foundation for purposes of self-dealing, excess business holdings rules, and jeopardizing investment rules *and* as if it is a disqualified person with respect to wholly charitable vehicles, such as a private foundation. How can this dual character be possible? It is because of a rule that treats a trust as a "disqualified person" (see Code Sections 4946 and 4958) if more than 35 percent of the beneficial interest of the trust is owned by certain disqualified persons.

For example: A donor creates a CLT with a remainder to pass to his children and grandchildren who are living when the CLT terminates. The donor's children and grandchildren are disqualified persons with respect not only to the CLT (while it is in existence), but also with respect to any private foundation to which the donor is a substantial contributor. Once the interest in the CLT of the donor's children and grandchildren passes the 35 percent mark, the CLT becomes a disqualified person with respect to the private foundation. At that point, most transactions between the CLT and the private foundation are effectively barred by the onerous excise taxes that would be imposed. In other words, simply due to the passage of time and the steady increase in the share of the CLT's beneficial interests deemed held for the benefit of family members, new tax risks (and new constraints on flexibility) are presented. Early termination of the CLT may solve the problem if the terms of the termination enable a charity to be the counterparty in the contemplated purchase, sale or other transaction with the private foundation.

Matters may become more complex if excess business holdings are involved. There, thanks to the Pension Protection Act of 2006, a CLT also may become a disqualified person with respect to certain donor-advised funds and certain non-functionally integrated Type III supporting organizations.

cent if non-disqualified persons have effective control over the business. However, a *de minimis* exception applies (and holdings will <u>not</u> be deemed excess business holdings) if the CLT (again, together with certain related private foundations, donor-advised funds and non-functionally integrated Type III supporting organizations) owns 2 percent or less of the voting stock and 2 percent or less of all classes of stock of a business enterprise. This is true without regard to the size of the holdings of disqualified persons.

A CLT that receives excess business holdings by gift or bequest usually will have five years to bring its holdings (together with those of its disqualified persons and certain related private foundations, donor-advised funds and non-functionally integrated Type III supporting organizations) below the excess business holdings threshold. If it becomes clear that the initial five-year grace period will not be long enough and if there is a risk that the CLT will not be eligible for a discretionary IRS additional grace period, early termination of the CLT could cure the problem.

Note: Although early termination of a CLT in favor of a donor-advised fund may not solve a potential Section 4943 problem due to the 2006 expansion of the excess business holdings rules, termination in favor of an unrestricted or "field of interest" fund (e.g., limited to arts, hunger, or the environment) at a community foundation would provide a solution.

Early Termination by Prepaying the Charitable Lead Interest

Unlike in the case of early CRT terminations, there is not a substantial body of guidance regarding early CLT terminations. Nonetheless, there are some IRS private letter rulings (which, of course, are non-precedential) that may be helpful to taxpayers who wish to terminate a CLT early by prepaying or "commuting" the lead interest of the charitable beneficiary. These rulings all involve term-of-years CLATs. However, because CLTs may be formed with varying income, gift, and estate tax properties, it is important for practitioners to think broadly about the potential tax consequences of any proposed early termination of a CLT.

State-Law Threshold Issue: Varying the Trust Terms to Allow Prepayment

CLT governing instruments generally will not include an express power for the trustee to prepay the charitable lead interest and terminate the trust early, because the IRS has stated (in both a revenue ruling and the annotations to its sample CLAT and CLUT forms) that such a power in the governing instrument will disqualify the annuity or unitrust interest from charitable deductions. Therefore, it will likely be necessary for the parties to resort to a state law remedy, such as judicial modification (including equitable deviation) or modification on consent of the interested parties (if allowed under state law), to obtain the appropriate authority for the trustee to vary the terms of the trust and prepay the charitable lead interest.

In all three of the private letter rulings in which the IRS has approved prepayment of a charitable lead interest, it was contemplated that a *judicial* proceeding would be commenced in order to vary the trust terms and effect the termination. The IRS does not appear to have considered situations in which the charitable lead interest would be prepaid by varying the trust terms under N.Y. EPTL 7-1.9[2]

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or another *non-judicial* method that may be available. For a trust that is governed by the law of a state that permits a non-judicial modification method for trusts with charitable interests, such a method might be a simple alternative approach, though one that has not yet been tested in private letter rulings.

In one of the favorable private letter rulings, it was stipulated that the charitable lead annuity interest would be prepaid, but that the trust would continue until its original expiration date. When engaging in a modification of the CLT's terms in accordance with state trust law, the practitioner may wish to confirm that prepayment of the charitable interest also will have the effect of accelerating the remainder under applicable state law if the goal is for the non-charitable beneficiaries to receive their interests immediately. If the trust must continue in existence until the expiration of the original term, even though the charitable lead interest has been prepaid, the trust may nonetheless cease to be subject to private foundation excise taxes because it would no longer have unexpired charitable interests (though it could still be a disqualified person with respect to private foundations and certain other charities).

Determining the Value of the Lead Interest

In all three of the private letter rulings in which the IRS approved prepayment of a charitable lead annuity interest, it was stipulated that the prepaid annuity payments would be made to the charitable beneficiary on an *undiscounted* basis, that is, without any reduction for the fact that the annuity payments would not have ordinarily become payable until years into the future. This is inconsistent with Code Section 7520 valuation principles that ordinarily apply to split-interest trusts, but may have been a limitation imposed by the IRS as a condition for the issuance of a favorable ruling.

Prepayment on an undiscounted basis may undermine the gift and estate tax goals the donor had when establishing the CLT. The donor's gift tax (and, if applicable, income tax) charitable deductions upon the establishment of the CLT are valued on a discounted basis using Section 7520 principles. When the charitable annuity interest is prepaid without such a discount, a proportionately larger share of the trust's principal will need to be used to satisfy the prepaid annuity, particularly where the initial CLT term would otherwise last for several more years.

Identity of Charitable Lead Beneficiary

In two of the three favorable rulings regarding prepayment of a CLAT's annuity interest, the charitable beneficiary that would receive the prepaid annuity payments was a private foundation. The IRS ruled that the prepayment was not an act of self-dealing because the recipient private foundation was not a disqualified person with respect to the CLAT, and that the prepayment was also not a taxable expenditure (under Code Section 4945) by the CLAT because the terminating payment, even though made to a private foundation, was in fulfilling the governing instrument's mandate to pay out the annuity. Obviously, designation of a public charity beneficiary, such as a fund at a community foundation, to receive the terminating lead interest would simplify matters further by removing concern about those issues altogether.

Can a CLUT be prepaid?
What about a CLT measured by a life term?

The fact that the favorable CLAT rulings appear to require that the charitable annuity interest be prepaid on an undiscounted dollar-for-dollar basis—and not by reference to Section 7520 valuation principles—may suggest that a unitrust interest in a CLUT cannot be prepaid without adverse tax consequences because the value of the unitrust interest cannot be determined with certainty prior to the year in which it becomes payable. Indeed, the IRS has ruled that the prepayment of a unitrust interest in a testamentary CLUT, where the prepayment was approved by a state court and the amount was based on Section 7520 valuation principles, would nonetheless result in the disallowance of the estate tax charitable deduction for the charitable lead interest. This ruling was issued prior to the three favorable CLAT rulings discussed above, and whether this history suggests a progression in the IRS's position toward prepayments or the existence of some distinction between CLATs and CLUTs is not clear.

A related question: Where will the IRS come out on the issue of the early termination of a CLT—CLAT or CLUT—that is measured by a life term rather than a term of years? Under Section 7520 valuation principles and assuming the good health of the measuring life or lives, the value of charity's interest is, in theory, ascertainable, and the IRS has certainly granted rulings where CRTs were terminated early despite the existence of a unitrust structure or a measuring life or both. The lack of rulings may mean the IRS has not been asked the question—or that the IRS has told taxpayers it would not rule (or would not rule favorably) with respect to any CLT early termination unless there is no element of discounting and no actuarial calculation involved in establishing the length of the charitable term.

Other Options for Early Termination of a CLT

It also may be possible to effect an early termination of a CLT in one of the same ways a CRT may be terminated. Some of these methods are explained in our Spring 2015 *Professional Notes*. For example, the non-charitable beneficiary might be able to assign or sell the remainder interest to the charitable lead beneficiary. There is no sufficient body of guidance setting forth the IRS's position regarding the tax issues that might be involved. However, the same issues that arise in the context of CRTs are likely to be relevant: the transferability of the non-charitable beneficiary's interest under state law, whether self-dealing is implicated by the proposed termination, and how gain might be recognized by the non-charitable beneficiary. In addition, the private letter rulings described above regarding prepayment of CLAT annuity interests suggest the valuation of a remainder interest in any such assignment or sale might present a difficult hurdle. Unlike in the case of early terminations of CRTs, the IRS has not expressly declared that it will not issue private letter rulings with respect to early CLT terminations.

Given the low-interest rate environment that has prevailed for many years and the fact that CLTs appear to have increased in popularity, we may see more interest in early termination of CLTs in the years ahead. This area may, therefore, attract further private letter rulings or other IRS guidance.

For further reference, see:

Treas. Reg. §§ 20.2055-2(e)(2) and 25.2522(c)-3(c)(2): Definitions of guaranteed annuity interests and unitrust interests for qualified CLTs.

Code § 642(c): Income tax deduction applicable to non-grantor CLTs.

Code § 4941: Excise tax on acts of self-dealing.

Code § 4947(a)(2) and 4947(b)(3); Treas. Reg. §§ 53.4947-1(c) and 53.4947-2(b): Application of private foundation excise taxes to certain non-exempt split-interest charitable trusts.

Rev. Rul. 88-27; Rev. Proc. 2007-45, Rev. Proc. 2008-45 (discussing prohibition on clauses in a CLT permitting the prepayment or commutation of the charitable lead interest).

PLR 9734057 (disallowance of charitable estate tax deduction if charitable interest in a testamentary CLUT will be prepaid).

PLR 9844027 (prepayment of charitable interest in a term-of-years CLAT to a public charity where the trust remains in existence for its initial term).

PLRs 199952093, 200225045 (prepayment of charitable interest in a term-of-years CLAT to a private foundation).

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