

Summer 1997

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IS IT A GRANTOR CHARITABLE LEAD TRUST OR NOT? - HOW THE GRANTOR TRUST RULES INTERACT WITH THE CHARITABLE LEAD TRUST

JENNIFER I. LAST*

INTRODUCTION

There are two types of charitable lead trusts, the grantor charitable lead trust and the non-grantor charitable lead trust. Although very similar in character, the two types of charitable lead trusts result in very different income, estate and gift tax consequences. This article focuses on how to create and not create a charitable lead trust that is a grantor charitable lead trust. The following hypothetical illustrates the varying tax consequences of the two types of charitable lead trusts.

Jack and Jill Garcia (the "Grantors"), husband and wife, created a Charitable Lead Annuity Trust (the "Garcia CLAT") funded with income producing real property. The Garcias have four children. One of the Garcia children, Jerry, is the trustee of the Garcia CLAT. The lead term is paid to charity for a period of nine years. At the end of the nine year term, the assets are divided into four shares, one for each of the Grantors' four children. The shares are then distributed to asset trusts created for the benefit of each child and the child's family. The terms of the Garcia CLAT provide that an annuity amount will be paid to charity for the term of the Garcia CLAT. The annuity amount is equal to fifteen percent of the value of the trust assets determined as of the initial funding of the Garcia CLAT. The terms of the Garcia CLAT also provide that in a year in which the income generated by the Garcia CLAT exceeds the value of the annuity amount, the trustee has the discretion to add such excess to the principal or distribute such excess to the charity.

In order to reduce the size of their estate for estate tax pur-

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poses, the Grantors intended to create a non-grantor charitable lead trust. The issue for the Garcias is whether the fact that the trustee has the discretion to add income in excess of the annuity amount to principal, or distribute such excess income to charity, the Garcia CLAT is actually a grantor charitable lead trust.

ANALYSIS

No private letter ruling, revenue ruling or case addresses this question. The only authorities that discuss this issue are the CLT and grantor trust provisions of the Internal Revenue Code. Part I of this Article shall provide an overview of the charitable lead trust. Part II will review the grantor trust. Parts III and IV discuss the application of § 674 of the Internal Revenue Code to Charitable Lead Trusts. Finally, Part V explores why the retention of discretionary power over income in excess of the guaranteed annuity or unitrust payment should not cause a Charitable Lead Trust to be a Grantor Charitable Lead Trust.

I. OVERVIEW OF THE CHARITABLE LEAD TRUST

A Charitable Lead Trust (a "CLT") is a split interest trust. A split interest trust is one in which there are charitable and non-charitable beneficiaries.¹ A CLT is a trust where the lead term is paid to charity and the remainder is paid to non-charitable beneficiaries, typically the children and descendants of the grantors of the CLT. In order for gifts to qualify for the charitable gift tax deduction (for an *inter vivos* CLT) or estate tax deduction (for a testamentary CLT), a gift to a split interest trust where the charity is the lead beneficiary must be made to a qualified CLT.²

To create a qualified CLT, the charity must receive a guaranteed annuity or a unitrust payment.³ Receipt of a guaranteed annuity means that the charity will receive a sum certain which is established as of the creation of the CLT, or a fixed percentage of the value of the trust assets valued as of the initial funding of the CLT.⁴ This type is typically called a charitable lead annuity trust. Receipt

1. See Leo L. Schmolka, *Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism*, 40 N.Y.U. TAX L. REV. 1, 6 (1984), The split interest trust is a popular form of philanthropic support rewarded by our tax laws. See *id.* The donor in a split interest trust confers economic benefits upon both charitable and non-charitable institutions. *Id.* at 6. Section 4947(a)(2) of the Code defines a "split interest trust" as one that is not exempt from taxation under § 501(a), not all of the unexpired interests are contributed to charitable purposes, and for which a charitable allowance was made under a number of Code provision. *Id.* at 7.

2. I.R.C. §§ 2055(e)(2)(B) & 2522(c)(2)(B) (1994).

3. I.R.C. §§ 2055(e)(2)(B) & 2522(c)(2)(B) (1994).

4. Treas. Reg. § 25.2522(c)-(3) (as amended in 1994); Treas. Reg. § 1.170A-6(c) (as amended in 1994).

of an unitrust amount means that the charity will receive a fixed percentage of the value of the trust assets as valued annually.⁵ This is typically called a charitable lead unitrust.

There are three types of qualified charitable lead annuity trusts and charitable lead unitrusts. The first type is an *intervivos* non-grantor CLT. The second type is a testamentary non-grantor CLT. The third type is a grantor CLT.

A. *Tax Attributes of the Intervivos Non-grantor CLT*

The *intervivos* non-grantor CLT is used for estate reduction purposes while also passing a substantial amount of property to descendants. This CLT is created during a grantor's life. The key is to fund a non-grantor CLT with assets that can generate income in excess of the required payment to charity. When funded this way, the trust will pay income tax on such excess. However, the value of the remainder interest will be higher than the present value of the remainder interest calculated at the outset due to the excess income allocated to principal.

For example, assume an *intervivos* non-grantor CLT trust is funded with \$1,000,000 of income producing real property and the term of the trust is fifteen years. The trust pays nine percent of the value of the trust assets (valued as of the initial funding, i.e. \$90,000) to charity. The present value of the charitable lead interest is \$793,080.⁶ The present value of the non-charitable remainder interest is \$206,920, and the grantor would pay gift tax on this amount at the creation of the trust.⁷ Further, assume that the assets in the trust generate ten percent of income annually, and that there is one percent of annual capital unrealized appreciation. In year fifteen, which is the end of the trust term, the value of the trust assets passing to the grantor's descendants will be \$1,426,909. As well, the trust will have paid a total of \$143,189 in income tax on the excess income over the term of the trust.⁸

The *intervivos* non-grantor CLT has the following tax attributes:

- 1) In every year, the trust pays the income tax on the income of the trust. However, every year the trust receives a corresponding charitable income tax deduction on payments to charity. The trust pays income tax on any accumulated excess income.⁹

5. Treas. Reg. § 25.2522(c)-(3) (as amended in 1994); Treas. Reg. § 1.170A-6(c) (as amended in 1994).

6. See the attached charts which were computed and produced using the *Planned Giving Manager*, a software program for planned giving management from PG Calc Inc.

7. *Id.*

8. *Id.*

9. I.R.C. §§ 641 & 642(c) (1994).

- 2) At the creation of the non-grantor CLT, the grantor does not receive a charitable income tax deduction for the present value of the property passing to charity. Instead, the trust receives an unlimited charitable income tax deduction as each payment is made to charity during the lead term.¹⁰
- 3) The grantor pays gift tax on the present value of the noncharitable remainder interest.¹¹
- 4) The value of the CLT assets at the death of the grantor are not included in the grantor's estate for estate tax purposes. Thus, the appreciation in the assets is also excluded from the grantor's estate.¹²
- 5) If the remainder beneficiaries are grandchildren or those in lower generations than grandchildren, the generation skipping tax (the "GST") exemption must be allocated to avoid the GST tax.¹³

B. The Testamentary Non-grantor CLT

The testamentary non-grantor CLT is very similar to the *intervivos* non-grantor CLT except that it is created at the death of the grantor pursuant to the grantor's will. Grantors also use this CLT for estate reduction purposes, while also passing a substantial amount of property to descendants. It has the same tax attributes as the *intervivos* version except that no gift tax is paid. Instead, estate tax is paid on the present value of the remainder interest.¹⁴

C. Tax Attributes of the Grantor CLT

The grantor CLT is typically used when a taxpayer has a particularly large amount of income in one year and needs a large charitable income tax deduction to offset that income. However, such charitable income tax deduction is recaptured over time. The grantor CLT is a grantor trust with the following tax attributes:

- 1) The grantor receives an immediate charitable income tax deduction based on the present value of the property passing to charity over the term of lead interest.¹⁵
- 2) The grantor is "treated as the owner of . . . [the annuity of the unitrust] interest for purposes of applying § 671." In other words, the grantor is taxed on the income of the trust.¹⁶

10. I.R.C. §§ 170(f)(2)(B), 641 & 642(c) (1994).

11. I.R.C. § 2522(c)(2)(B) (1994).

12. I.R.C. § 2055(e)(2)(B) (1994).

13. I.R.C. § 2642(e) (1994).

14. I.R.C. § 2055(e)(2)(B).

15. I.R.C. § 170(f)(2)(B).

16. *Id.*

- 3) The grantor receives no additional charitable income tax deduction as the lead payments are made to charity since the grantor received a deduction at the outset. As a result, the charitable income tax deduction received at the outset is recaptured over time.¹⁷
- 4) The grantor CLT must be an *intervivos* trust.
- 5) Since the trust is a grantor trust, the value of the CLT assets at the grantor's death will be included in the grantor's estate.¹⁸
- 6) As long as the grantor CLT is a qualified CLT, the grantor pays gift tax on the present value of the remainder interest passing to the non-charitable beneficiaries.¹⁹ Therefore, the higher the payment to charity, the less gift tax will be paid. If it is not a qualified CLT, the grantor will pay gift tax on the value of all the assets in the trust.²⁰

D. Comparison of Non-grantor CLT and Grantor CLT

Determining whether to use a grantor CLT or a non-grantor CLT depends upon the goal of the particular taxpayer. A non-grantor CLT is purely an estate reduction tool for estate tax purposes, but the assets are returned to individuals, typically the family members of the grantor, at a value which can be greater than the remainder interest computed at the outset.

The grantor CLT is not an estate reduction tool. Instead, it yields a charitable income tax deduction in the year of the funding of the CLT. Considering the grantor is taxed on the income of the CLT, the income tax deduction is recaptured over the term of the trust. The value of the assets in the grantor CLT at the death of the grantor will be included in the grantor's estate without a corresponding charitable estate tax deduction.

Since these two types of CLTs result in differing income, estate and gift tax treatments, it is imperative not to accidentally create a grantor CLT when the client's tax requirements actually call for the creation of a non-grantor CLT, and *vice versa*.

II. OVERVIEW OF THE GRANTOR TRUST

Sections 671 through 679 of the Code set forth a number of ways in which a trust will be treated as a "grantor trust."²¹ When the trust is a grantor trust, the grantor is taxed on the income of the trust instead of the trust being taxed on such income.²² For example,

17. I.R.C. §§ 671-79 (1994).

18. I.R.C. §§ 2035-36 & 2038 (1994).

19. I.R.C. § 2522(c)(2) (1994).

20. *Id.*

21. I.R.C. §§ 671-79.

22. *Id.*

when the grantor of a trust retains the power to revoke the trust, the trust is a grantor trust and thus, the grantor pays the income tax on the income generated by the assets in the trust.²³ However, the grantor trust provisions, which describe the various ways in which a trust can be a grantor trust, provide that the grantor is taxed only on that portion of the trust income over which the grantor has one of the specified powers.²⁴ For example, if a grantor retained the power to revoke only a certain portion of the trust, the grantor would be taxed only on the income only attributable to that portion.²⁵ The remainder of the income would be taxed to the trust.²⁶

Pursuant to § 674(a) of the Code, the ability to control the enjoyment of all or a portion of trust assets will result in the grantor being taxed on the income from all or a portion of a trust.²⁷ This is the section that could cause the Garcia CLAT to be a grantor charitable lead trust since the trustee of the Garcia CLAT has the discretion to allocate excess income to principal or distribute the excess income to charity.

The general rule promulgated by § 674(a) of the Code provides as follows:

The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.²⁸

Section 674(a) applies if the grantor or a non-adverse party has the power to direct enjoyment of income or corpus without the approval of an adverse party.²⁹ An adverse party "means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust."³⁰ Furthermore, there are many

23. I.R.C. § 676(a) (1994).

24. I.R.C. §§ 671-79.

25. I.R.C. § 676(a).

26. I.R.C. § 671 (1994) provides as follows:

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person, those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D

I.R.C. § 671. Subparts A through D provide for income taxation of the trust.
Id.

27. I.R.C. § 674(a) (1994).

28. I.R.C. § 674(a).

29. *Id.*

30. I.R.C. § 672(a) (1994).

specified exceptions in § 674.³¹

III. WHETHER § 674(a) APPLIES TO THE GARCIA TRUST DUE TO THE TRUSTEE'S DISCRETION TO ALLOCATE OR DISTRIBUTE EXCESS INCOME?

The power to allocate or distribute income is a power to direct the enjoyment of trust income.³² Therefore, § 674(a) would apply unless the trustee of the Garcia CLAT is an adverse party or unless one of the specified exceptions apply. The power to allocate the excess income of the Garcia CLAT directly affects how much money the charity and remainder beneficiaries will ultimately receive. No specified exception applies.³³ The question remains whether the trustee is an adverse party. The trustee of the Garcia CLAT is only adverse as to his one-fourth remainder interest in the trust, but he is a non-adverse party as to the remaining three-fourths interest ultimately passing to his siblings.³⁴

A beneficiary is an adverse party but if the beneficiary has a right to share in the income or corpus of a trust, he is adverse only as to that part. For example, if there are four equal income beneficiaries and the grantor can revoke only with the consent of one of the income beneficiary's consent, that income beneficiary is adverse only as to his one-fourth interest in the trust.³⁵

Therefore, § 674(a) applies to the Garcia CLAT.

31. See I.R.C. § 674(b)-(d) (1994). Subsection (a) does not apply where the grantor or non-adverse party has the authority to use the income from the trust to support a dependent. *Id.* § 674(b)(1). Nor does the section apply where the grantor or non-adverse party has the power to affect the beneficial enjoyment of the income only after the occurrence of an event. *See id.* § 674(b)(2). Subsection (b) also provides that subsection (a) will not apply where the grantor or non-adverse party only has the power to affect the disposition of the income through the use of a will. *See id.* § 674(b)(3). The remaining subsections of § 674 all create exceptions to subsection (a). *See generally* I.R.C. § 674(b)-(d).

32. Section 674(d) provides as follows:

POWER TO ALLOCATE INCOME IF LIMITED BY A STANDARD

Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, . . . if such power is limited by a reasonably definite external standard which is set forth in the trust instrument.

I.R.C. § 674(d). Thus, since the trustee's power to allocate excess income is not limited by any reasonable definite external standard, subsection (a) does apply causing the grantor to be taxed on the income as to that portion over which the trustee, if a non-adverse party, has such discretion.

33. I.R.C. § 674(b)-(d).

34. Treas. Reg. § 1.672(a)-1(b) (1960).

35. *Id.*

IV. WHAT IS THE EFFECT OF THE APPLICATION OF § 674(a) TO A CHARITABLE LEAD TRUST?

Until now, this analysis has been relatively straightforward. Section 674(a) applies to the three-fourths interest in the trust. It is not clear, however, whether all the trust income is subject to taxation or whether only the excess trust income is taxed to the grantor. Pursuant to § 674(a), the Grantors of the Garcia CLAT will only be taxed on three-fourths of the excess income of the trust.³⁶ Section 671 of the Code specifically indicates that a grantor is taxed on the income only as to portions over which the grantor has one of the delineated powers. Any remaining portions of the trust shall be taxed to the trust.³⁷

Another question is whether the Garcia CLAT is really a grantor CLT causing estate inclusion and income taxation to the Grantors of the Garcia CLAT. The difficulty in answering this question derives from the application of the grantor trust rules to charitable lead trusts. Generally, one determines that either a trust is a grantor trust or is not a grantor trust— meaning that all the income is taxed to the grantor or that none of the income is taxed to the grantor.³⁸ However, that is not the case here. The grantor trust rules provide that the grantor is taxed on the income of a trust only as to that portion over which the grantor or non-adverse party has one of the delineated powers.³⁹

However, the CLT rules appear to provide that if the CLT is a grantor CLT, the grantor receives an immediate charitable income tax deduction and estate inclusion. If a CLT is a non-grantor CLT, the grantor receives no immediate charitable income tax deduction but does receive estate exclusion. So what kind of CLT has one created when the grantor is only taxed on the income as to a portion of the trust?

Section 170(f)(2)(B) provides that a grantor of a grantor CLT receives an immediate charitable income tax deduction. This section also states that a grantor receives an immediate charitable income tax deduction for transfers into CLTs only if the charitable lead interest is in the form of a guaranteed annuity or unitrust payment. "[T]he grantor is treated as the owner of such interest for purposes of applying section 671."⁴⁰ If a grantor must retain, over the guaranteed annuity or the unitrust payment, one of the powers delineated in §§ 671-79, then the retention of a discretionary power over income in excess of the guaranteed annuity or unitrust payment should not cause a CLT to be a grantor CLT.

36. I.R.C. §§ 671 & 674(a) (1994).

37. I.R.C. § 671 (1994); See *supra* note 26 for the text of § 671.

38. Generally, practitioners speak in terms of a trust being a grantor trust or not being a grantor trust.

39. I.R.C. §§ 671-79 (1994).

40. I.R.C. § 170(f)(2)(B) (1994).

V. REASON WHY RETENTION OF A DISCRETIONARY POWER OVER INCOME IN EXCESS OF THE GUARANTEED ANNUITY OR UNITRUST PAYMENT SHOULD NOT CAUSE A CLT TO BE A GRANTOR CLT

Retention of a discretionary power over excess income should not cause a CLT to be a grantor CLT. The reason why such a power will not cause a CLT to be a grantor trust is how the grantor trust rules, themselves, apply.

A. Grantor is Owner Only as to Portions of Trust

The grantor trust rules provide that a grantor is treated as the owner of the trust, but only as to portions over which the grantor or a non-adverse party has delineated powers.⁴¹ If a non-adverse party of a CLT, as in the Garcia situation, only has a power as to a specific portion of the CLT assets, the grantor is treated as owner only as to that specific portion. If a grantor of a CLT is treated as an owner as to only a portion of the CLT assets, then what effect does that have on obtention of an immediate charitable tax deduction?

B. Grantor is Owner Only When Problematic Asset is Held in CLT

One common power which causes a trust to be a grantor trust is the "swap power" under § 675(4)(C).⁴² This power permits the assets of a trust to be reacquired and substituted (or swapped) for other assets with like value. Obviously, if this power is included, it applies to all assets and the grantor is treated as the owner of all the assets in the trust. As a result, the owner is taxed on all of the income of the trust.⁴³ This is the case regardless of whether the power is utilized. The existence of the power itself causes the entire trust to be a grantor trust. On the other hand, what if a power was included which permitted the swap of real estate only. Further, what if there was no real estate in the trust in a given year? In that year, the trust would not be a grantor trust.⁴⁴ However, in a year when the

41. I.R.C. §§ 671-79.

42. I.R.C. § 675(4)(c) provides:

A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: . . . (c) a power to reacquire the trust corpus by substituting other property of an equivalent value.

Id.

43. I.R.C. § 675(4)(C) (1994).

44. *Id.* See also Priv. Ltr. Rul. 88-39-008 (June 23, 1988). In this Private Letter Ruling, the taxpayer sought an opinion regarding the continued qualification of a Charitable Remainder Trust (a "CRT") which was created in 1982. *Id.* A CRT is a backwards CLT where the lead interest is paid to a non-charitable beneficiary, typically the grantor, and the remainder interest is paid to charity. Unlike a CLT, the CRT is a tax exempt entity and thus cannot be a grantor trust. If a CRT is found to be a grantor trust, it loses its tax

trust held real estate, the trust would be a grantor trust and this is true regardless of the utilization of the power.⁴⁵ Furthermore, the grantor would only be taxed on the income with respect to the real estate.⁴⁶ This is further evidence that when a trustee has discretion over excess income in a trust, that trust is a grantor trust only when the trust has excess income, and then, only as to that excess income.

C. Reconciliation of the Grantor Trust Rules with the CLT Charitable Deduction Rules

Assume the Garcia CLT has no excess income in year one but the trustee has discretion over such excess income. Is it a grantor CLT? Assume the Garcia CLAT in year two has a small amount of excess income. Is the Garcia CLAT now converted into a grantor CLT and how is the charitable income tax deduction of the grantor claimed in year two?

The ability to obtain the charitable income tax deduction is an all or nothing proposition.⁴⁷ Furthermore, the immediate charitable income tax deduction is only available in the taxable year of the contribution (upon the initial funding of the grantor CLT).⁴⁸ The grantor trust rules, on the other hand, can cause the grantor to be taxed

exempt status. Section 677(3) of the Code provides that a grantor will be treated as the owner of any portion of a trust of which income can be used for the payment of premiums on a life insurance policy on the life of the grantor or the grantor's spouse. The terms of the CRT prohibited the trustee of the CRT to use trust income for the payment of premiums on such a policy. *Id.* Until 1982, the CRT owned no such life insurance. *Id.* However, in 1987 the trust purchased a life insurance policy on the life of the grantor. *Id.* The Internal Revenue Service ruled that the trustee was able to use tax accounting income (capital gains) for the purchase of the policy. *Id.* Thus, the trust became a grantor trust in 1987 because § 677(a)(3) disallows the use of tax accounting income for such purchase. Until 1982, the trust was not a grantor trust since the trust did not own the problematic asset. *Id.* However, upon owning the problematic asset, the trust became a grantor trust. *Id.*

45. I.R.C. § 674(4)(C).

46. I.R.C. §§ 671 & 675(4)(c) (1994).

47. I.R.C. § 170(f)(2)(B) (1994). This section provides:

No deduction shall be allowed under this section for the value of any interest in property . . . transferred in trust unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property . . . and the grantor is treated as the owner of such interest for purposes of applying section 671. If the donor ceases to be treated as the owner of such an interest for purposes of applying section 671, at the time the donor ceases to be so treated, the donor shall for purposes of this chapter be considered as having received an amount of income equal to the amount of any deduction he received under this section for the contribution reduced by the discounted value of all amounts of income earned by the trust and taxable to him before the time at which he ceases to be treated as the owner of the interest.

48. I.R.C. § 170(a)(1) (1994).

on income only as to parts of trusts.⁴⁹ Furthermore, a trust can be a non-grantor trust in one year and then in another year, be a grantor trust.⁵⁰

How can these two seemingly opposing rules be reconciled? A close reading of § 170(f)(2)(B) of the Code does clarify the application of these two rules. This section provides that the charitable income tax deduction is permitted if the grantor is treated as the owner of "such interest," meaning if the grantor is treated as the owner of the guaranteed annuity interest or unitrust interest.⁵¹ Thus, a power over any other interest in a CLT would not result in grantor trust status for purposes of determining if a CLT is a grantor trust for charitable income tax purposes. Even though a discretionary power over excess income causes practitioners to commonly refer to this trust as a grantor trust, the trust is not a grantor trust for CLT charitable income tax deduction purposes since the power is not one which relates to a payment to charity.⁵²

CONCLUSION

If a non-adverse trustee of a CLT has the discretion to allocate the excess income to principal or to distribute the excess income to charity, such discretionary power will not cause the CLT to be a grantor CLT. Instead, such CLT is a non-grantor CLT.

To avoid any risk of confusion, an attorney might simply suggest that the trustee of a CLT should not be given the discretion to allocate or distribute excess income. If the trustee were required to either accumulate the excess income or distribute the excess income, the grantor would not be taxed on any portion of the trust. The trust would not be a grantor trust as to any portions since the trustee has no discretionary powers. However, most clients want flexibility especially when dealing with an irrevocable trust, which a CLT must be.

In some years, the grantors may prefer to have the excess income accumulated, and in other years the grantors may prefer to have the excess income distributed. In years in which it is accumulated, the grantor will have to pay income tax on the excess income

49. I.R.C. §§ 671-79 (1994).

50. Priv. Ltr. Rul. 88-39-009 (June 24, 1988).

51. I.R.C. § 170(f)(2)(B).

52. See, Charitable Income Trusts, 442 2d T.M. A-36. This portfolio addresses the use of excess income to pay premiums on life insurance policies covering the lives of grantors. The author points out that if this were done "the grantor would be taxed under § 677 only on such excess income. *Id.* Given that the grantor is not taxed on all the trust's income, the grantor would not be entitled to the income tax charitable deduction in the year of the trust's creation." *Id.* The most common and dependable means of creating a grantor CLT is to provide that the grantor or the grantor's spouse has a reversionary interest equal to at least five percent of the value of the trust assets as of the date of the initial funding of the CLT. I.R.C. § 673 (1994).

regardless of whether it is distributed. However, in deciding to accumulate such excess income, the grantor has made a gift to the remainder beneficiaries for the price of the income tax associated with such excess income. For example, assume a grantor funded a non-grantor nine percent CLAT with \$1,000,000 in property. Further assume that the trustee has the discretion to accumulate or distribute excess income. The grantor will be taxed on the excess income in years in which there is excess income. In year one, the trust earns ten percent or \$100,000 in income. The trustee will distribute the nine percent or \$90,000 to charity. If the excess income is accumulated, the grantor will pay \$3960 (39.6%) in income tax on the excess income of \$10,000 but will have made a future gift of \$6040 (\$10,000 - \$3960) in addition to any appreciation thereon to the remainder beneficiaries without the payment of any gift tax. However, what if in year two, the trust again earns ten percent in income but the grantor decides not to pay the income tax on the excess income due to other demands on his or her finances. The trustee would then distribute the excess income of \$10,000 to charity and the grantor would be entitled to a corresponding charitable income tax deduction of \$10,000.

It is imperative to understand how the grantor trust rules interact with the CLT so that when this issue arises in other contexts, and with other powers, an attorney can create the kind of CLT that will respond to the needs of the particular taxpayer.

**Deduction Calculations
Summary of Benefits
9% Non-Grantor Lead Annuity Trust**

ASSUMPTIONS:

Fixed Term	15
Trust Principal	\$1,000,000.00
Cost Basis of Property	\$1,000,000.00
Pay-out Rate	9%
Payment Schedule	quarterly at end

BENEFITS:

Gift Tax Deduction	\$793,080.00
Annual Payment to Charity	\$90,000.00
Taxable Portion of Principal	\$206,920.00
	\$0.00
Donor Prior Taxable Gifts	

**January 18, 1997
Discount Rate is 8%**

Deduction Calculations
Actuarial Calculations
9% Non-Grantor Lead Annuity Trust

ASSUMPTIONS:

[1] Fixed Term	15
[2] Trust Principal	\$1,000,000.00
Cost Basis of Property	\$1,000,000.00
[3] Pay-out Rate	9%
[4] Payment Schedule	quarterly at end
[5] Discount Rate Under IRC Section 7520(a) for 12/96	8%

CALCULATIONS:

[6] Value of \$1 for measuring lives/term on [1] (Table B in IRS Publication 1457)	8.5595
[a] Adjustment factor for payment schedule on [4] (Table K in IRS Publication 1457)	1.0295
[b] Adjusted value of \$1 ([6] x [6a]) (Reg. 20.2031-7(b)(3))	8.8120
[7] Annual Payment to Charity ([2] x [3])	\$90,000.00
[8] Gift Tax Deduction ([6b] x [7])	\$793,080.00
[9] Taxable Portion of Principal ([2] - [8])	\$206,920.00
[10] Donor Prior Taxable Gifts	\$0.00

January 18, 1997

Inter Vivos Lead Trust Projections**Detailed Cash Flow Analysis****Assumptions:****Trust Established in 1997 for 15 years****Lead Trust Makes annual, end of period payments to Charity****Original Principal of 1,000,000 has a cost basis of 0%****9% Charitable Lead Annuity Trust**

YR	Capital Apprec. (1%)	Income (10%)	Payout to Charity	Mgmt Fees	Income Taxes	Year-End Principal
97						\$1,000,000
98	\$10,000	\$100,000	\$90,000	\$0	\$3,064	1,016,936
99	10,169	101,694	90,000	0	3,734	1,035,065
00	10,351	103,507	90,000	0	4,452	1,054,470
01	10,545	105,447	90,000	0	5,221	1,075,241
02	10,752	107,524	90,000	0	6,043	1,097,475
03	10,975	109,747	90,000	0	6,924	1,121,273
04	11,213	112,127	90,000	0	7,866	1,146,747
05	11,467	114,675	90,000	0	8,875	1,174,015
06	11,740	117,401	90,000	0	9,955	1,203,202
07	12,032	120,320	90,000	0	11,110	1,234,443
08	12,344	123,444	90,000	0	12,348	1,267,885
09	12,679	126,788	90,000	0	13,672	1,303,680
10	13,037	130,368	90,000	0	15,089	1,341,996
11	13,420	134,200	90,000	0	16,607	1,383,009
12	13,830	138,301	90,000	0	18,231	1,426,909
TOT	\$174,554	\$1,745,544	\$1,350,000	0	\$143,189	\$1,426,909

January 18, 1997
Discount Rate is 7.4%

