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Harnessing the Power of Charitable Lead Trusts

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I. Charitable Lead Trusts (CLT)

a. Character – As it relates to the payout, a charitable lead trust works in an inverse fashion as the charitable remainder trust. For instance and in general, a CLT pays the lead interest to charity for a period of years or the life of an individual with the remainder either reverting back to the donor or to or for the benefit of another private individual.

b. Types

1. Non-Grantor - In a non-grantor CLT, the donor is not subject to income tax on the income and gain incurred by the CLT. Correspondingly, the donor is not entitled to an income tax deduction. The trust is a taxpaying entity, but receives a charitable income tax deduction for the lead payments to charity. The present value of the remainder interest in the CLT is treated as a gift for gift tax purposes.

2. Grantor - In a grantor CLT, the donor is subject to income tax on all income and gain incurred by the CLT. Correspondingly, the donor is entitled to a charitable income tax deduction. The present value of the lead charitable interest is the amount the donor will be entitled to as a charitable income tax deduction. This deduction, however, will have to be recaptured for income tax purposes on a pro rata basis if the donor dies during the term of a term-of-years CLT. The trust is a tax nothing and does not receive a charitable income tax deduction for the lead payments to charity.

3. Super-Grantor – The super-grantor CLT is a hybrid and special creature. It is essentially a defective grantor trust for income and estate and gift tax purposes. In other words, the donor is subject to all of the income and gain incurred by the trust (a grantor trust for income tax purposes), but the CLT assets are not includable in the gross estate of the donor. Thus, the donor can implement income and estate tax planning into his or her philanthropic planning.

4. Ghoul CLT – Don't Try This At Home! Several years back, the IRS informed us that a promoter was touting a CLT based upon the life of an individual who was seriously ill, but not "terminally ill" under the Section 7520 rules. Even worse, this sick individual would receive some type of payment in return for using his or her life as the measuring life in a CLT. A "terminally ill" person, under the technical rules, has a 50% probability of dying within one year, and if such person lives beyond 18 months, he or she is presumed not terminally ill. The potential for abuse was clear. If a CLT is created using the life expectancy (let's say 15 years) of someone who is very sick, but not "terminally ill", and the calculation of the lead interest for income, gift or estate tax charitable deduction purposes is based upon annual payments being made to charity for 15 years. But in reality, the individual lives for only 5 years – charity is only receiving 5 payments - and the balance is being distributed to the non-charitable remainder prematurely. The charitable deductions have been artificially inflated. Although there is no account of anyone actually creating such a CLT, Treasury heard about the abuse and reacted by amending the income, estate and gift tax Regulations. Basically, only one or more of the donor, the donor's spouse and lineal ancestors of all remainder beneficiaries may be used as the measuring life in a CLT. In other words, the distribution from a CLT should be, in essence, a substitute for a testamentary disposition. Thanks to a promoter of a ghoulish application of a legitimate planned giving vehicle, a donor cannot create a

CLT for the benefit of a step daughter, a partner in a common law marriage or a life partner, without violating these rules, which have been effective since April, 2000.

c. CLAT v CLUT (& GSTT)

1. A charitable lead annuity trust (CLAT) pays out an annuity amount to the charitable lead beneficiary. Thus, a specific dollar amount or a percentage of the net fair market value of the assets contributed to the CLAT determined on the date of contribution may represent the amount paid out to the charity. The annuity amount will be fixed on the date of creation and not change.

2. A charitable lead unitrust (CLUT) pays out a unitrust amount to the charitable lead beneficiary. Thus, a percentage of the net fair market value of the assets contributed to the CLAT determined on the date of contribution and revalued each year will represent the amount paid out to the charity. The unitrust amount is similar to the unitrust payout from a standard charitable remainder unitrust. The net income only payout (available to NIMCRUTs, for instance) is not available to CLTs.

3. As a general rule, the CLUT will likely be used where a CLT is created with generation skipping planning, i.e., where a grandchild will be the recipient of the remainder interest at the termination of the CLT. This is so because under Section 2642 of the Internal Revenue Code of 1986, as amended ("Code", or simply referencing a "Section" of the Code, unless the context otherwise indicates), the amount of the GST tax imposed on distributions from a CLT is determined by the application of an "inclusion ratio" which takes into account the amount of the property transferred, the amount of the GST exemption allocated to the transfer, the death taxes paid, and any estate or gift tax charitable deduction allowed. The inclusion ratio is determined by subtracting the applicable fraction from 1. To prevent the avoidance of the GST tax by using a CLAT to zero out all gift tax and GST tax, Congress enacted Code Section 2642(e), which forces the applicable fraction to be determined at the end of the charitable term using the value of the assets then in the trust. Treas. Reg. Section 26.2642-3(a) further delineates that, in determining the applicable fraction with respect to a CLAT, the numerator is the adjusted GST exemption and the denominator is the value of the trust property immediately after the termination of the charitable lead interest. The adjusted GST exemption is the allocated GST exemption, increased by an amount equal to the interest that would accrue at the rate used to value the estate or gift tax charitable deduction, compounded annually, for the trust term. Under current law, it is impossible to have any assurance that a timely allocation of GST exemption at the creation of the CLAT will prevent the imposition of the GST tax. If the trust assets grow at a rate faster than is assumed in computing the value of the remainder interest, GST distributions from the trust will be subject to GST tax; if the trust assets grow at a slower rate, a portion of the GST exemption will be wasted. Suffice it to say, this area is very complex, and although there may be some saving actions that can be taken (like, make a late allocation of the GST exemption), a CLUT should be used where generation skipping planning is involved. A CLUT is not subject to Code Section 2642(e), and a GST exemption allocation made at the time of funding will be effective for the date of funding values.

d. Testamentary v Inter Vivos

1. A CLT may be created at the death of the donor or during the donor's life. A testamentary CLT is created upon the death of the donor; therefore, it is hard to advise the donor what the payout and the term of the trust should be to maximize the estate tax charitable deduction. The IRS has liberally permitted donors to provide flexibility in the establishment of the different terms of the CLT at such time when the donor passes. For instance, various private letter rulings indicate the flexibility that donors have to establish, based upon a formula, the CMFR, term, amount to be contributed and payout of

a CLT at death, *See*, PLRs 9118040, 9128051 and 9631021. In addition, if the assets remain a part of the donor's gross estate, they will be includable in his or her gross estate and subject to estate tax; however, those assets will receive a stepped-up basis at death and the appreciation during the donor's life will cause a larger estate tax charitable deduction.

2. A CLT may also be created during the donor's life. In that regard, the donor can experience the benefit of watching the charitable dollars at work during his or her life and take advantage of either estate tax planning and/or income tax planning (by the use of a grantor CLT). In the case of a nongrantor CLT, these assets will be removed from the donor's gross estate, if properly structured, at the price of a potential gift tax for the present value of the remainder interest at the creation of the CLT. Of course, the applicable exemption amount ($1.5 Million in 2004 and rising) can be reduced to reflect the present value of the remainder interest in the year of the gift.

II. Fundamental Concepts

a. Estate & Gift and Income Tax Regimes

1. The estate and gift tax regime is separate and apart from the income tax regime. The estate and gift tax regime taxes the transfer of wealth, whereas the income tax regime taxes the earning of income. Although the two regimes may overlap in the charitable gift planning arena, they remain separate and must be independently considered in structuring a CLT. For instance, a nongrantor CLT is generally created to minimize the estate and gift taxes on a transfer of a remainder interest to the donor's heirs. Whereas a grantor CLT is generally created to maximize the donor's income tax planning.

b. Present Value

1. The concept of present value is critical to the understanding of the benefits of creating a CLT. For instance, the present value of the income interest in a grantor CLT is the amount of the charitable income tax deduction, and the present value of the remainder interest in a nongrantor CLT is the gift to the donor's heirs on the date of the creation of the CLT. An understanding of present value is crucial. Conceptually, present value reflects the fact that receiving one dollar today is worth more than receiving one dollar ten years from today, because the negative impact of inflation reduces the dollar over time. Present value is calculated using special charitable gift planning software and the three basic elements are an amount (one dollar), timing (10 years from today) and an interest factor (Charitable Midterm Federal Rate - CMFR). For purposes of calculating the present value of the remainder interest in a CLT, the interest factor is a given – Treasury has accepted a floating rate, published monthly, based upon the applicable federal rate, called the CMFR. The donor can choose the CMFR from the month of the gift or for the last two months (whichever is most favorable), *See* the economic projections in IV below, for an analysis of the favorable impact of the current low CMFR.

c. Income Taxation of Trusts & CLTs

1. The administration of a CLT can be tricky, because the CLT is not a tax-exempt entity, like a CRT. The concept that applies to the income taxation of a CLT is "somebody's paying the taxes". For instance, in a non-grantor trust, if the trust earns $100 of taxable income and distributes $100 to the income beneficiary, the trust pays no tax and the beneficiary pays tax on the $100. If in the same scenario the trust earns $200 and distributes $100, the beneficiary again pays tax on its receipt of $100 and the trust pays tax on the $100 not distributed – someone is paying the taxes!

2. However, in the case of a grantor trust, no matter what the trust earns in taxable income and how much is distributed to the income beneficiary, the grantor will pay the taxes on the taxable income of the trust.

3. These rules are the same with a grantor and non-grantor CLT; however, a CLT is entitled to a charitable income tax deduction. Thus, a non-grantor CLT which incurs $100 of income and makes a charitable distribution of $100 will have a tax wash ($100 of income and a $100 charitable deduction). If the non-grantor CLT incurs more in income than the income payout to charity, though, the trust will be required to pay tax on the excess income – so, don't put in an appreciated asset that would be required to be sold and an immediate gain incurred during the term of the trust, *See* Section III, a, 2 below, relating to the impact of UBIT on a CLT.

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d. CLT v CRT

1. A CLT payout is the inverse of a CRT payout. The income beneficiary is a charitable organization and the remainder beneficiary is a non-charitable beneficiary. Since there is no approved form for a CLT, like the CRTs, many practitioners believe that portions of the CRT Regulations under Section 664 and governing instrument requirements relate to the drafting of a CLT document. It is good news that the IRS in Notice 2003-39 requested comments regarding the creation and publication of charitable lead trust sample forms. This program is very important to the planned giving community, because the publication of CLT forms by the IRS will further legitimize, and hopefully increase the use of, this valuable planned giving vehicle.

III. Technical Issues Relating to CLTs

a. Unrelated Business Income Tax ("UBIT")

1. Character of Tax - A public charity is generally not subject to income tax, *See*, Section 501(a). Likewise, a CRT is generally not subject to income tax, *See*, Section 664(c). However, a substantial exception to this "tax-exempt" status applies to both a charity and a CRT (and in effect, a CLT) where such entity has unrelated business income. UBIT will apply to the activities of a public charity if three (3) factors are present: (i) income is derived from a trade or business, (ii) which is regularly carried on by the charity and (iii) the conduct of which is not substantially related to the charity's performance of its tax-exempt function, *See*, Section 512(a) and Treas. Reg. Section 1.513-1(a). Section 513 specifically addresses unrelated trade or business activity and defines it as, "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501..." There are a variety of activities which can be conducted by a charity and not rise to the level of an "unrelated trade or business", such as where the charity's activity is "primarily for the convenience of its members, students, patients, officers, or employees....", *See*, Section 513 (*i.e.*, college cafeteria and book shop). Under Section 511(a), the amount of income subject to UBIT (which includes debt-financed income, as discussed below) will be taxed under the corporate rates under Section 11.

2. Applications of Tax - It should be noted that the impact is different if a charity, a CRT or a CLT incurs UBIT. For instance, a charity will pay tax only on its unrelated business income, and the incurrence of UBIT will generally not otherwise adversely affect the charity. However, a charity may lose its tax-exempt status if the revenue generated from "unrelated" sources is substantial (one-half of the charity's annual

revenues, *See*, GCM 39108) or if the operation of the unrelated trade or business is not in furtherance of its tax-exempt purposes and the charity is operated for the primary purpose of carrying on a trade or business. Whereas a CRT will lose its tax-exempt status for all purposes in any taxable year in which it incurs UBIT, *See*, Sections 511 and 664(c). A non-grantor CLT loses, on a dollar for dollar basis, its charitable income tax deduction under Sections 642(c) and 681. A charity, CRT or CLT may incur UBIT even if it indirectly owns a business activity. For instance, a limited partner, member of an LLC, or member of another non-corporate entity will have attributed to it UBTI of the enterprise as if it were a direct recipient of its share of the entity's income which would be UBTI if it were itself carrying on the business of the entity, *See*, Section 512(c), Revenue Ruling 79-222, 1979-2 C.B. 236 and *Service Nut & Bolt Co. Profit Sharing Trust v. Commissioner*, 724 F.2d 519 (6th Cir. 1983). In addition, applying the aggregate view of partnerships, the IRS National Office in TAM 9651001 advised that an interest in a partnership that holds debt financed property is effectively an interest in the partnership's underlying assets and liabilities. Thus, the charity received debt financed income from the sale of its partnership interests, But *See*, PLR 9414002 where the charity's sale of stock in a subsidiary corporation whose real estate was leveraged did not incur debt financed income as a corporation was a separate taxpaying entity. The incurrence of any debt by a CLT generally is dangerous. For instance, no investments (even marketable securities) should be acquired through the incurrence of "margin" debt.

3. Debt Financed Income - Unrelated business income is not restricted to income from operations but also applies to gains from the disposition of debt financed property. Notwithstanding the exclusions for rent, capital gains and interest from UBTI discussed below, UBIT applies if debt financed income is generated. Under Section 514, certain income that would otherwise be excluded from the scope of UBIT must be included in UBIT because such income is incurred with respect to debt financed property. Section 514(b) defines "debt-financed property" as any property which is held to produce income and with respect to which there is "acquisition indebtedness" at any time during the year. Property held to produce a capital gain upon disposition, as well as property which produces a recurring income stream, is "held to produce income" for purposes of this definition, *See*, Treas. Reg. Section 1.514(c)-1(a)(1). The gain from the sale of such property is also subject to tax as UBIT. Keep in mind also that the sale of debt financed property within twelve (12) months of mortgage satisfaction will trigger this tax, *See*, Treas. Reg. Section 1.514(b)-1(a). In order to have a DFP, the property must be subject to "acquisition indebtedness". As stated in Treas. Reg. Section 1.514(a)-1(a)(1)(v), "acquisition indebtedness" means the outstanding amount of -- (i) the principal indebtedness incurred by the organization in acquiring or improving such property; (ii) the principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and (iii) the principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement. Treas. Reg. Section 1.514(a)-1(a)(1)(v) describes the method to calculate the taxable portion of the gain generated upon the sale of DFP, as follows: If debt-financed property is otherwise sold or disposed of, there shall be included in computing unrelated business taxable income an amount with respect to such gain (or loss) derived from such sale or other disposition as - (a) the highest acquisition indebtedness with respect to such property during the 12 month period, preceding the date of disposition, is of (b) the average adjusted basis of such property.

4. Exceptions to Tax - Aside from the type of activities excepted from UBIT, Congress has recognized that the nature of the income arising from certain activities should be considered in determining whether the income should be treated as unrelated business income and taxable.

A. 512(b) exceptions - For instance, dividends and interest (Section 512(b)(1)), royalties (Section 512(b)(2)) and certain rents from real property (Section 512(b)(3)) are all excepted from UBIT, because such income is passive in nature. However, great care must be exercised in considering these technical qualifications of each exception. For instance, “rents from real property” is a term of art and generally requires that the rental of real property be fixed in amount and on a triple net basis and the landlord is prohibited from providing substantial services (as is more explicitly described under the real estate investment trust rules). Another significant exception to UBIT is gains on the sale of property (Section 512(b)(5)), unless such property is "inventory" (as discussed below in III.g. under “Dealer Issues”) or is "debt-financed property" (as discussed above).

B. Holding Rule DFP Exception - An exception to the DFP rule is provided under Section 514(c)(2)(B) where, among other things, the encumbrance is placed on the property more than 5 years before the date of the gift.

C. Special School DFP Exception for Real Property - A substantial exception to the DFP acquisition indebtedness rules is described in Section 514(c)(9). Debt which is incurred in the acquisition of property by certain "qualified organizations" will not be treated as acquisition indebtedness, so long as such organizations do not violate certain statutory prohibitions. This exception applies only to schools (and their affiliated supporting organizations) and Section 501(c)(25) organizations.

b. Excess Business Holdings Tax

1. Character of Tax – In order to discourage private foundations from holding investments in business enterprises, Congress enacted Section 4943, which basically subjects a private foundation to a two-tier excise tax for its "excess business holdings". In enacting this Section, Congress was concerned that private foundation managers would focus their attention on the success of a business enterprise and away from the charitable purposes for which the private foundation was created. In addition, such enterprise, as owned by a tax-exempt entity, could unfairly compete with another similarly situated enterprise which was owned by a taxable entity. The excise tax imposed under Section 4943 is 5% of the highest value of the holdings in a business enterprise in excess of the "permitted holdings". A harsh second-tier excise tax equal to 200% of such excess business holdings may apply if (i) the 5% tax is imposed and (ii) the private foundation still has excess business holdings at the close of the earlier to occur of (A) the date of mailing of a notice of deficiency by the IRS relating to such holdings or (B) the date on which the 5% tax is assessed by the IRS, *See*, Sections 4943(b) and (d)(2), *Also See*, Section 6684 for a possible third-tier tax. "Permitted holdings" means 20% of the voting stock in an incorporated business enterprise, or 20% of the profits or beneficial interest in a non–incorporated enterprise, reduced by the percentage such interests owned by all disqualified persons (as defined in Section 4946(a)) (“Disqualified Persons”, who are generally substantial contributors to, and trustees of, the private foundation, and any person related by family to such individuals and entities significantly owned by such individuals), *See*, Section 4943(a)(1) and (2). Once the permitted holdings have been determined, the permitted holdings are subtracted from the percentage held by the foundation to determine the amount of "excess business holdings", *See*, Treas. Reg. Section 53.4943-3(d). The net effect of these formulas is to assure that the combined holdings of all Disqualified Persons and the private foundation in a business enterprise are not more than 20%. Any readjustment of the assets (*e.g.*, a recapitalization, redemption, merger) may also impact the excess business holdings rules, *See*, Treas. Reg. Section 53.4943-7(d).

2. Exceptions to Tax - If the excess business holdings tax applies, there are several methods by which the “private foundation” (a CLT, in this case) can limit the impact of, or altogether avoid, such tax.

A. Five-year period - The private foundation is given a five-year period beyond the date of the gift to dispose of the business holdings in excess of the combined 20% permitted holdings, *See*, Section 4943(c)(6). The law treats the business holdings as being held by Disqualified Persons for such five-year period. Thus, the private foundation is not deemed to own any business holdings for such period. There are, however, exceptions to this favorable rule. These exceptions basically attempt to prohibit an end run around this rule, *i.e.*, transfer from the private foundation to another commonly controlled or related private foundation, a purchase by an entity effectively controlled by a Disqualified Person or the private foundation or a Disqualified Person's plan to purchase during the five-year period additional holdings in the same business enterprise held by the private foundation, *See*, Treas. Reg. Section 53.5953-6(c).

B. Effective control exception - Under certain circumstances, the permitted holdings may be increased from 20% to 35%, *See*, Section 4943(c)(2)(B). Such an increase is permitted if (i) persons other than the private foundation and Disqualified Persons have "effective control" of the enterprise and (ii) the private foundation establishes to the satisfaction of the Commissioner that effective control is in one or more persons (other than the private foundation itself) who are not Disqualified Persons. Effective control means the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise. For example, the effective control test is met if individuals holding a minority interest, none of whom is a Disqualified Person, have historically elected a minority of the corporation's directors. The key is to prove that another person or group of persons do control the company, not that the Disqualified Persons don't control the company, *See*, Revenue Ruling 81-111, 81-1 CB 509.

C. Passive source exception - The third possible method of avoiding the Section 4943 tax is the passive source exception. The definition of a "business enterprise" includes the active conduct of a trade or business, including any activity which is regularly carried on for the production of income from the sale of goods or the performance of services, *See*, Section 4943(d)(3)(B). If 95% or more of the gross income of a business enterprise is "passive", the entity will not be deemed to be a business enterprise. The definition of what is passive is a term of art and basically includes dividends, interest, payments with respect to securities loans, annuities, royalties measured by production of income from the property, rents from real property (unless taxable as unrelated business income) and gains or losses on sales and exchanges of property (other than inventory and property held for the sale to customers), *See*, Section 4943(d)(3). This concept is consistent with the Congressional intent in attempting to discourage foundation managers from spending too much time on the business enterprise, *See*, PLR 9211067. If the activity is passive, by definition, the managers would not be spending time on the business enterprise.

D. Extension of initial five-year period - The IRS has the statutory power to extend the initial five-year period (discussed in (i) above), for unusually large gifts or bequests of diverse holdings or holdings with complex corporate structures, for up to an additional five years, Section 4943(c)(7). The private foundation must prove to the Secretary of the Treasury that it has made diligent efforts to dispose of such holdings during the initial period, and a disposition of such holdings within the initial period has not been possible (except at a price substantially below fair market value) due to the size and complexity or diversity of such holdings. The private foundation must submit a plan with the Secretary and the state official having the authority over the foundation's affairs (usually the Attorney General's Office) for disposing of the excess during the extended period. This plan may be accepted by the Secretary if it can be reasonably expected to be carried out during the extension period.

E. De minimis rule **-** A de minimis rule is provided in which Disqualified Persons may retain any percentage of holdings, so long as the private foundation holds no more than 2% of the voting stock (or profits or beneficial interest) or 2% by value of all outstanding shares, *See*, Section 4943(c)(2)(C).

F. 90-day grace period **-** A private foundation will have at least 90 days from the date of the gift to dispose of the excess business holdings without incurring this excise tax, *See*, Treas. Reg. Section 53.4943-2(a)(1)(ii). This 90-day period is extended to include the period during which a private foundation is prevented by federal or state securities laws from disposing of such excess business holdings, *See*, Treas. Reg. Section 53.4943-2(a)(1)(iii).

3. Applications of Tax – Although Section 4943 deals with a private foundation and not a CLT, Section 4947(a)(2) and (b)(3)(A) cause the excess business holdings tax to apply to a CLT where the aggregate value of the charitable lead interest exceeds 60% of the fair market value of the property contributed to such trust.

c. Jeopardy Investment Tax

1. Character of Tax - Section 4944 subjects a private foundation and a manager of the private foundation (*i.e.*, a trustee) to a two-tier excise tax for *making investments* in such a manner as to jeopardize the carrying out of the private foundation's exempt purposes. If such a jeopardizing investment is made, Section 4944(a)(1) imposes on the private foundation a tax of 5% of the amount of the investment for each year or part thereof in the "taxable period" (defined below), and Section 4944(a)(2) imposes a similar 5% tax on any foundation manager who knowingly and willfully participated in making such investment. However, the tax on the foundation manager is limited to $5,000 per investment. The second tier tax of 25% of the investment is imposed whenever (i) an initial tax is imposed pursuant to Section 4944(a)(1) on the making of a jeopardy investment and (ii) the investment is not removed from jeopardy within the "taxable period", Section 4944(b)(1). The "taxable period" is the earlier to occur of (A) the date of mailing of the deficiency notice by the IRS, (B) the date on which the 4944(a)(1) tax is imposed or (C) the date on which the amount so invested is removed from jeopardy, Section 4944(e)(1). A foundation manager is liable for an additional tax equal to 5% of the amount invested, only if an additional tax has been imposed on the foundation and the manager has refused to agree to part or all of the removal from jeopardy of such investment. This second-tier tax on the foundation manager is likewise limited to $10,000 per investment (Also *See*, Section 6684 for a possible "third-tier" tax where the private foundation or manager had been liable for the Section 4944 tax in a prior year and became liable for the same tax in a subsequent year or where the act or failure to act giving rise to the excise tax is both willful and flagrant).

2. Exceptions to Tax

A. Gratuitous Transfer - The tax under Section 4944(a)(1) is imposed on the private foundation if it "invests" any amount in such a manner as to jeopardize its tax-exempt purpose, *See*, Treas. Reg. Section 53.4944-1(a).

Although neither the Code nor the legislative history address the application of this tax to gifted property, Treas. Reg. Section 53.4944-1(a)(2)(ii)(a) provides that Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. This Regulation Section further provides that, if such foundation furnishes any consideration to such person upon the transfer, the foundation shall be treated as having made an "investment" in the amount of such consideration. One commentator describes this Regulation Section as follows, "Property received as a gift or bequest is not a jeopardizing investment regardless of how imprudent it might be if purchased by the foundation", Bittker & Lokken, *Federal Taxation of Income Estates and Gifts*, Second Edition, 1993, ¶101.7.3, p.101-111. Thus, it appears clear that the *receipt* by way of gift of a speculative asset by a private foundation cannot be described as an "investment", causing the private foundation to be subject to the tax under Section 4944. However, what is less clear is the ability of the foundation to *retain* such asset without incurring the jeopardy investment tax. In fact, another commentator has indicated that an implied duty to dispose of highly speculative property, even if acquired by gift, can arguably be read into Section 4944, *See*, Chiechi and Maloy, 338-3rd T.M., *Private Foundations - Section 4940 and Section 4944*, p.A-17 ("Chiechi"). However, two private letter rulings which relate directly to CLTs, and as recognized by Chiechi, indicate a contrary and favorable taxpayer result, *See*, PLRs 8125038 and 8038180, *Also See*, PLR 8135040 and 9320052. The IRS, however, adds the following qualification to that conclusion: the trust does not change the form or terms of such investment. Treas. Reg. Section 53.4944-1(a)(2)(iii) provides in effect that if a private foundation changes the form or terms of an investment (including property gratuitously transferred to a private foundation), the trust will be considered to have entered into a new investment which will be judged at the time of such change as to whether that investment carries out the organization's exempt purposes. Thus, a change in the form or terms of an investment triggers a reapplication of the jeopardy investment standard.

3. Applications of Tax – Although Section 4944 deals with a private foundation and not a CLT, Section 4947(a)(2) and (b)(3)(A) cause the jeopardy investment tax to apply to a CLT where the aggregate value of the charitable lead interest exceeds 60% of the fair market value of the property contributed to such trust.

A. Jeopardy Investment Defined - Treas. Reg. Section 1.4944-1(a) states the general trustee standard to be applied in determining when an investment is a "jeopardy investment" under Section 4944, as follows: when the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investments, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. This standard as established in the legislative history has been described as a "prudent trustee" approach, *See*, S. Rep. No. 91-552, 91st Cong., 1st Sess. 45 (1969), 1969-3 C.B. 423, 453, and reaffirmed as such by the IRS in Revenue Ruling 74-316, 1974-2 C.B. 389. As provided in Treas. Reg. Section 53.4944-1(a), the managers may, in the exercise of the requisite standard of care and prudence, take into account the expected return (including both the income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). In addition, the determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of the foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. Such Regulation Section also provides that no category of investments shall be treated as a *per se* violation of Section 4944. However, this Regulation does cite certain investments which will be closely scrutinized, as follows: trading on margin, trading in commodity futures, investments in working interests in oil and gas wells, purchase of puts, calls and straddles, purchase of warrants and selling short. The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of such purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though as a result of such investment, the foundation subsequently realizes a loss, *See*, Treas. Reg. Section 53.4944-1(a)(2).

B. Self-Dealing Tax

1. Character of Tax - Section 4941 imposes an excise tax (from 5% to 200%) on a private foundation for direct or indirect acts of "self-dealing" between a private foundation and a Disqualified Person, including any direct or indirect: sale or exchange, or leasing, of property; and lending of money or other extension of credit; and furnishing of goods, services, or facilities; and payment of compensation (or reimbursement of expenses); and transfer to, or use by or for the benefit of, a Disqualified Person of the income or assets of a private foundation. Note that the definition of a Disqualified Person does not include a charity defined under Section 509(a)(1), (2) or (3).

2. Application of Tax - There are two persons upon whom the Section 4941self-dealing excise tax can be imposed, the Disqualified Person and the foundation manager (*i.e.*, Trustee). The self-dealing excise tax has two tiers, the (a)(1) and (2) tier and the (b)(1) and (2) tier. Each tier's tax is imposed during the taxable period, *See* Sections 4941(a) and (b). The taxable period begins upon the act of self-dealing and ends upon the earlier of (i) the date of the mailing of the notice of deficiency, (ii) the date on which the tax imposed under (a)(1) is assessed, or (iii) the date on which the correction of the act of self-dealing is completed, *See*, Section 4941(e)(1). The taxable period may otherwise close on any particular act of self-dealing if the statute of limitations for the assessment of the excise tax arising thereunder expires. These self-dealing rules apply to a CLT as if such trust was a private foundation, *See*, Section 4947(a)(2), *Also See*, Section 6884 for a possible third tier tax.

3. Exceptions to Tax - Even if a transaction would constitute self-dealing, no excise tax will be imposed if the transaction satisfies one of the following overall exceptions.

A. Furnishing of Goods, Services or Facilities on Same Basis as to Public - The furnishing of goods, services, or facilities by a private foundation to a Disqualified Person where such goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the Disqualified Person is exempt from the self-dealing tax, Section 4941(d)(2)(D).

B. Compensation for Certain Personal Services - The payment of compensation (or the payment or reimbursement of expenses) by a private foundation to a Disqualified Person (other than a government official) for the performance of personal services which are reasonable and necessary to carry out the exempt purposes of the private foundation is not self-dealing, as long as such compensation (or payment or reimbursement) is not excessive, Section 4941(d)(2)(E).

C. Corporate Transactions - A transaction between a private foundation and a corporation which is a disqualified person and which is pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization is not self-dealing so long as all of the securities of the same class as that held (prior to such transaction) by the foundation are subject to the same terms and such terms provide that the foundation will receive no less than fair market value, *See*, Treas. Reg. Section 4941(d)(2)(F).

D. Self-Dealing Corrective Act - The correction of a previous act of self-dealing is not self-dealing, *See*, Treas. Reg. Section 53.4941(e)-1(c)(1).

E. Initiation of Disqualified Person Status - A transaction between a private foundation and Disqualified Person where the Disqualified Person's status arises only as a result of the transaction at issue is not self-dealing, *See*, Treas. Reg. Section 53.4941(d)-1(a).

F. Certain Indirect Transactions - Certain specific transactions, not directly involving a private foundation as a party but involving an organization, estate, or trust in which the private foundation owns an interest are excluded from self-dealing. For example, indirect self-dealing does not include certain transactions with respect to a foundation's interest or expectancy in property held by an estate (or revocable trust) where the transaction is approved by the probate court having jurisdiction over the estate or trust, *See*, Treas. Reg. Section 53.4941(d)-1(b)(3). The IRS has approved the use of this exception to self-dealing in several instances, including a disqualified person's purchase of a private foundation's interest in corporate stock (PLR 8901039), a private foundation's interest in a deed of trust and the related note receivable (PLR 9127052) and a private foundation's remainder interest in nonresidential real property (PLR 9112012).

IV. Economic Illustrations of a CLT

a. Impact of the current CMFR – the lower the CMFR, the larger the charitable income, estate and gift tax deduction upon the creation of a CLT, *See* the illustration attached as Exhibit A (#'s 1 – 4).

b. Impact of using discountable assets in CLT – by using assets whose fair market values are discounted, such as FLP or LLC interests or a promissory note, a higher stated payout rate can be used, causing a CLT to terminate earlier and distribute the assets to the donor's heirs sooner, *See* the illustration attached as Exhibit A (#'s 5 – 9).

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