Visual Planned Giving

(in color)

An Introduction to the Law & Taxation of Charitable Gift Planning

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An Introduction to the Law & Taxation of Charitable Gift Planning

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CONTENTS

PREFACE

This is not your father's law and tax book (Part I). The purpose of this text is to communicate to fundraisers and financial advisors the basic concepts of planned giving in a friendly, straightforward, and visually attractive format, while providing explanatory text that might be helpful where the visual elements are insufficient. The intended use is for the reader to flip through the images in the sections of interest until reaching an image that seems new or confusing, at which point the surrounding explanatory text may be helpful. The citations in the text are relatively sparse and for those desiring more technical texts with superior citations I recommend Thomas J. Ray, Jr.'s, *Charitable Gift Planning*, Catherine W. Wilkinson & Jean M. Baxley's, *Charitable Giving Answer Book*, Bruce R. Hopkins' *The Law of Fundraising*, and Bryan Clontz's *Charitable Gifts of Noncash Assets (2nd Edition)*.

This is not your father's law and tax book (Part II). This book is intentionally published in a print-on-demand format. This means that changes can be incorporated into the current version of the book within a matter of days. It also means that I would be most appreciative of any information related to errors, trivial or otherwise, because these are easily corrected. Please e-mail me at russell.james@ttu.edu if you happen to find such. (Special thanks to Jill Gary Hughes, Leo O'Connor, Jr., Peter Hayward, Robert Constantine, and Ray Tyler for their past guidance in this way.) Note, however, that some errors of omission are intentional as this is not intended to be an exhaustive treatment of every possible transaction type and option, but rather is intended to be a basic primer on charitable gift planning.

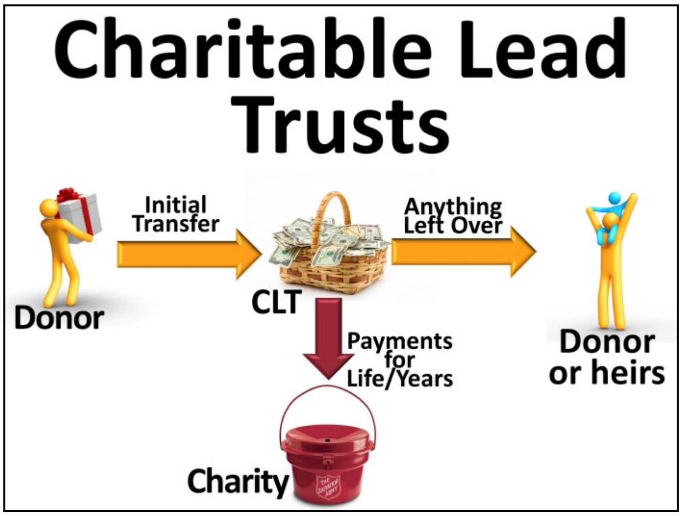
The slides used in this text are from the courses that I have taught for many years as part of the on-campus and online Graduate Certificate in Charitable Financial Planning and Master of Science in Personal Financial Planning both in the Department of Personal Financial Planning at Texas Tech University, as well as in my course in Charitable Gift Planning at the Texas Tech University School of Law. Information on the online Graduate Certificate in Charitable Financial Planning is available at www.EncourageGenerosity.com. Additionally, the PowerPoint or pdf version of many of the slides contained herein and audio of some related lectures are also available, for free, at the website.

And now, on to the disclaimers: *This notice is made in order to comply with applicable Treasury Department and other regulations (including but not limited to Circular 230): This book is not intended to provide personal legal, tax or financial advice. Consequently, I urge you to seek the advice of your own legal, tax, or financial professionals in connection with gift and planning matters. This text is not intended to be used and cannot be used for the purpose of avoiding tax-related penalties.*

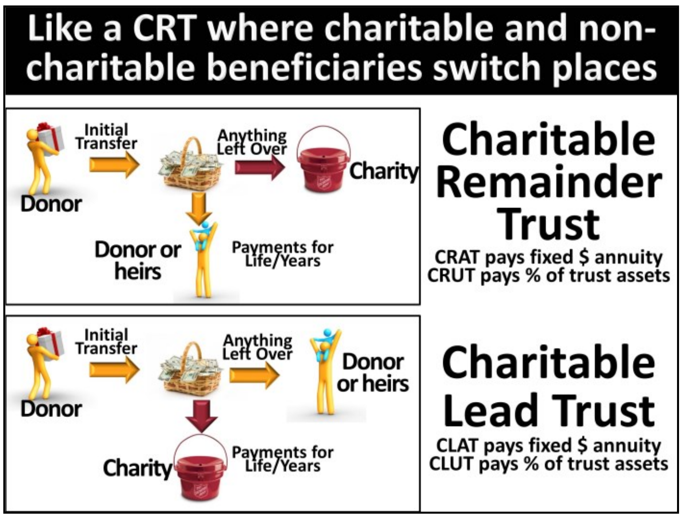
This document is for information and illustrative purposes only and does not purport to show actual transaction results applicable to your specific situation. It is not, and should not be regarded as, investment, legal, or tax advice or as a recommendation regarding any particular transaction or course of action. Opinions expressed herein are current opinions as of the date appearing in this material only and are subject to change without notice. Reasonable people may disagree about the opinions *expressed herein. All transactions and investments entail risks. There is no guarantee that investment or tax planning strategies will achieve the desired results under all market conditions.*

This book contains text and images representing charities including The Salvation Army (as an example of a public charity) and The Bill & Melinda Gates Foundation (as an example of a private foundation). These are used for illustrative purposes only and should in no way imply any support, endorsement, or affiliation of these organizations with this text or its author. The trademarks of these organizations are owned by their respective organizations. Images in this text were purchased from www.istockphoto.com and www.stockfresh.com. The image of Bill and Melinda Gates is from http://commons.wikimedia.org/wiki/File:Bill_og_Melinda_Gates_2009-06-03_(bilde_01).JPG and was taken by Kjetil Ree in 2009. The image of Bill Gates alone is from http://commons.wikimedia.org/wiki/File:Bill_Gates_in_Poland.jpg

13 CHARITABLE LEAD TRUSTS

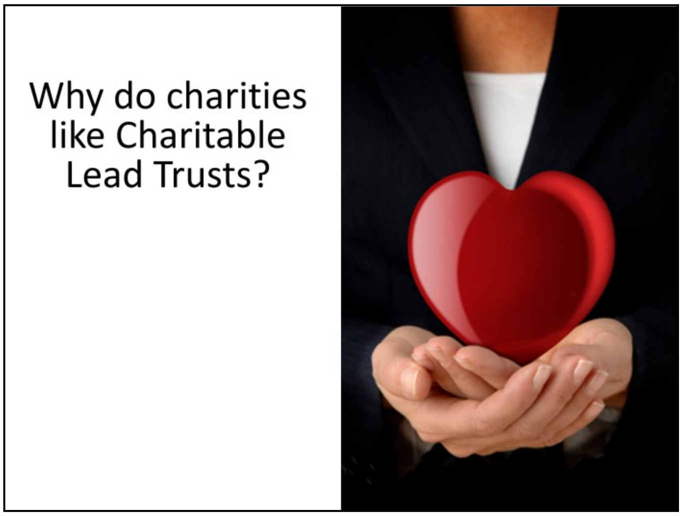


In both Charitable Remainder Trusts and Charitable Lead Trusts, the donor makes a gift to the trust, which then holds the asset, makes regular payments, and finally distributes the remaining amount at the end of the term of the trust. Unlike Charitable Remainder Trusts, which provide payments to the donor or another person followed by the remaining amount going to charity, the Charitable Lead Trust provides payments to charity followed by the remaining amount going to the donor or another person.



The Charitable Lead Trust is a mirror image of the Charitable Remainder Trust where the charitable and non-charitable beneficiaries change places. Just as with a Charitable Remainder Trust, there are two types of permitted payments from a Charitable Lead Trust, the fixed dollar annuity and the fixed percentage unitrust. If the Charitable Lead Trust pays a preset dollar amount to charity each year, it is a Charitable Lead Annuity Trust (CLAT). If the Charitable Lead Trust pays a set percentage of all trust assets each year, it is a Charitable Lead Unitrust (CLUT). The Charitable Remainder Trust also permitted variations that could lower the ongoing payments, such as a Net Income Charitable

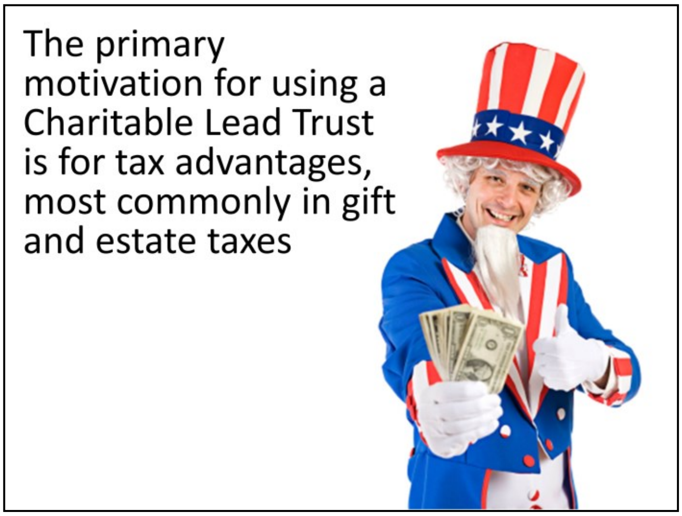
Remainder Trust (NICRUT), Net Income with Makeup Charitable Remainder Trust (NIMCRUT), or flip-Charitable Remainder Unitrust (flip-CRUT). None of these options are available with a Charitable Lead Trust because the ongoing payments in a Charitable Lead Trust go to the charity, and therefore may not be reduced.



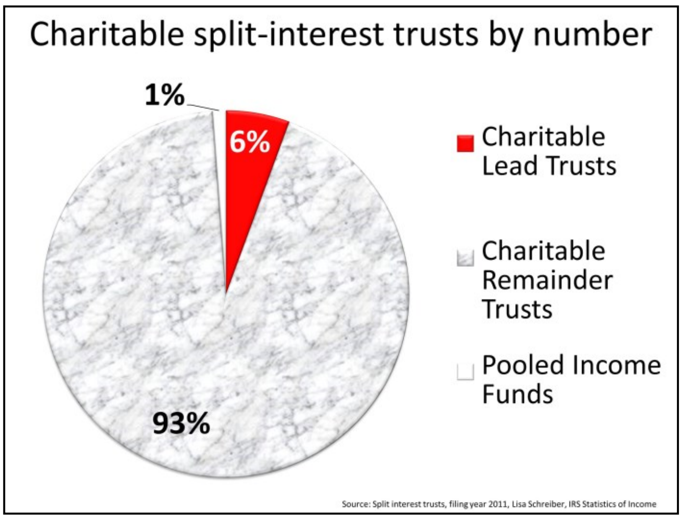
As a sophisticated charitable planning instrument, Charitable Lead Trusts can provide benefits to charities and to donors and their families. In general, charities like charitable planning because, ultimately, these plans are expected to benefit charities. Charitable Lead Trusts are particularly attractive to charities because they immediately generate income for the charity. In contrast, Charitable Remainder Trusts generate future benefit for charity, where that future may be delayed by many decades and, depending upon the longevity of the donor, may be significantly diminished compared with initial expectations.

Not only do Charitable Lead Trusts begin generating income for the charity immediately, but also that stream of gift income is secured. At least annually, payments must be made to the charity for the duration of the Charitable Lead Trust. Better still for the charity – and unlike a Charitable Remainder Trust – the donor typically may not retain the right to change the named charity in the most common form of the Charitable Lead Trust (called a non-grantor Charitable Lead Trust). Although it is possible for a trustee who is not the donor to decide how the ongoing payments will be divided among several listed charities (PLR 200240027), this is a rare provision. Thus, in the great majority of cases the charity is assured of receiving its ongoing payments, even if the relationship with the donor subsequently changes.

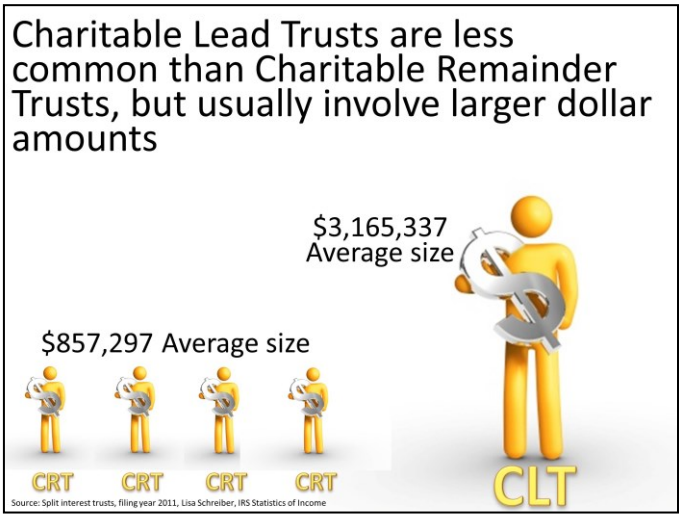
Charities enjoy Charitable Lead Trusts because of the immediate, secured payments coming to the charity. However, aside from tax benefits, there are no obvious reasons for donors to use a Charitable Lead Trust. Charitable Lead Trusts do not provide income to the donor, or donor's family, as Charitable Remainder Trusts or Charitable Gift Annuities can. Thus, they don't fit into typical planning for retirement or for planned educational expenses.



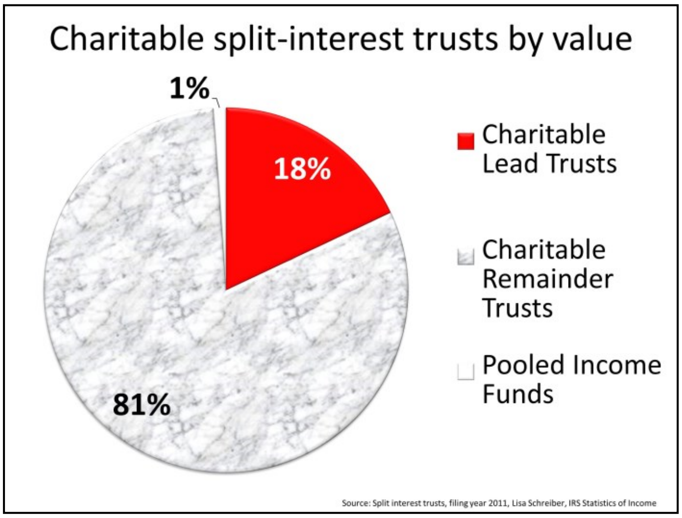
Instead, the use of Charitable Lead Trusts is primarily motivated by tax benefits. The most common type of Charitable Lead Trust, called a *non-grantor* Charitable Lead Trust, is used predominantly as a method for reducing gift and estate taxes. However, there are some circumstances where this trust can also be used for income tax benefits as well. The less common *grantor* Charitable Lead Trust is used to capture income tax benefits, but not gift and estate tax benefits.



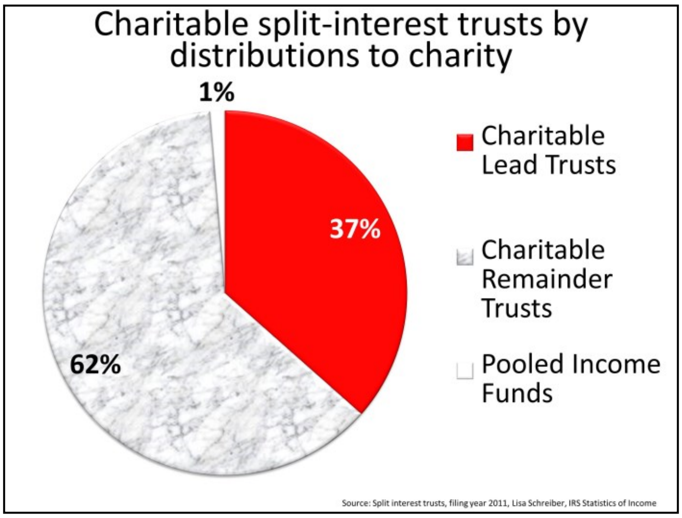
Charitable planners are more likely to work with Charitable Remainder Trusts than Charitable Lead Trusts simply because Charitable Remainder Trusts are much more common. Charitable Lead Trusts account for only 6% of all split-interest charitable trusts. (Split interest charitable trusts are Charitable Remainder Trusts, Charitable Lead Trusts, and Pooled Income Funds.) Seeing what a small fraction of total split interest charitable trusts that Charitable Lead Trusts represent might lead one to believe that Charitable Lead Trusts are insignificant in charitable planning. However, this idea is mistaken.



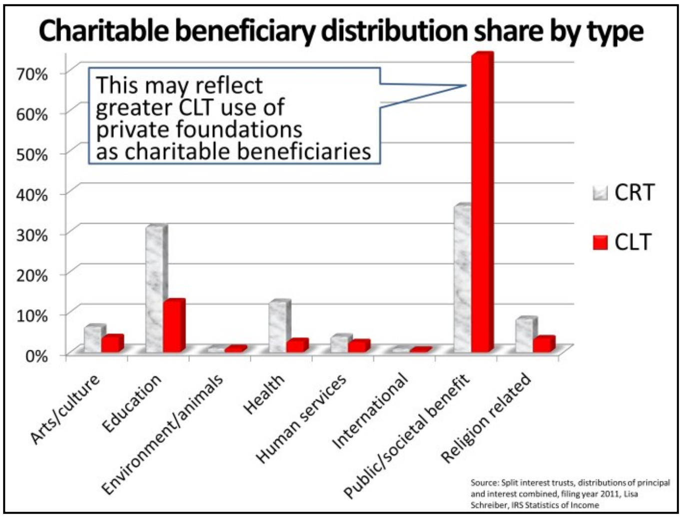
Although Charitable Lead Trusts are less numerous than Charitable Remainder Trusts, they are much larger. The typical Charitable Lead Trust holds more than 3½ times the assets of the typical Charitable Remainder Trust. Thus, although their numbers are relatively small, when they arise Charitable Lead Trusts often represent significant wealth.



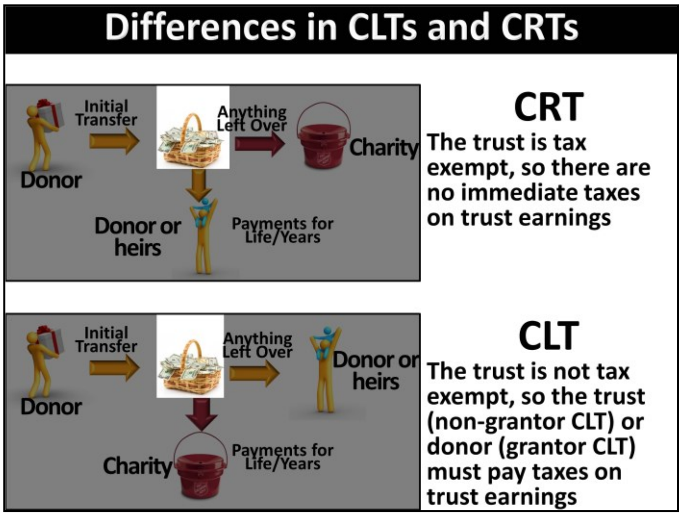
Because of their larger size, Charitable Lead Trusts hold 18% of all assets amongst split interest charitable trusts, even though they constitute only 6% of such trusts. Thus, while Charitable Lead Trusts are less common, they do represent an important segment of charitable planning.



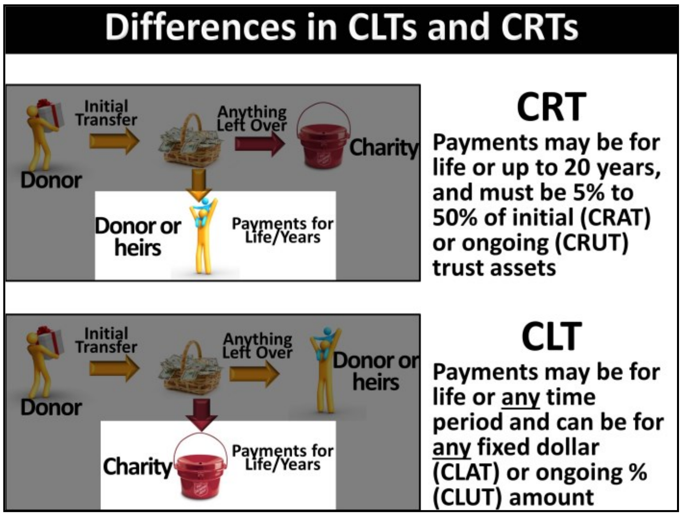
For those who represent charities, the most important figure may not be the frequency of the trusts, or even the assets held, but the actual dollars transferred to charity from split interest charitable trusts. In this category, Charitable Lead Trusts are quite significant, generating 37% of all transfers to charity. So, this infrequently used charitable planning vehicle, accounting for only 6% of all charitable split interest vehicles, results in charitable transfers of more than half the size of all Charitable Remainder Trusts. What accounts for this massive difference in actual charitable payouts? Where Charitable Remainder Trusts are annually paying out less than 2% of all their assets, Charitable Lead Trusts pay out more than 5.3%. As discussed in the chapter on Charitable Remainder Trusts, those charitable vehicles typically transfer assets to charity only after the death of the donor. The charitable deductions for Charitable Remainder Trusts are based upon donors living to their actuarial life expectancy. However, Charitable Remainder Trust donors, on average, live much longer than their actuarial life expectancy. This occurs for three reasons. First, those known to have shortened life expectancies for medical reasons do not typically establish new Charitable Remainder Trusts, or otherwise convert assets into annuity payments. Thus, one tail of the life expectancy distribution is essentially cut off. (This is why, for example, the insurance industry uses a different life expectancy table for those who purchase annuities than for the general population.) Next, greater wealth is associated with a longer life span. Those who establish Charitable Remainder Trusts tend to be at the highest end of the wealth spectrum, and thus live longer than their actuarial expectations. Finally, those with a charitable estate plan tend to live longer than others of their same wealth category do. (See James, R.N., III (2013) *American Charitable Bequest Demographics* for evidence on this). Taken together, these all point to Charitable Remainder Trust donors living far longer than the standard actuarial expectations would predict. When these donors serve as the measuring life prior to the charitable remainder payout, as is typically the case, this will result in far more non-charitable payments – and a much later and smaller charitable distribution – at the end. Charitable distributions from Charitable Lead Trusts do not suffer from these same longevity issues. The typical Charitable Lead Trust pays to charity for a fixed number of years, beginning immediately. These fixed term trusts are not affected by longevity expectations. Those Charitable Lead Trusts that exist for a donor's lifetime generate *more* charitable transfers when the donor lives beyond life expectancy, not less.



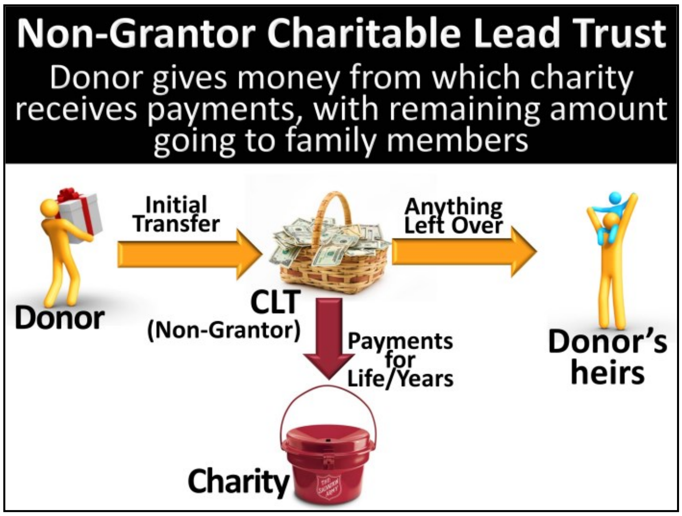
As shown in the accompanying chart, Charitable Remainder Trusts tend to most frequently benefit nonprofit organizations classified as "public/societal benefit," with substantial amounts also going to education and health related organizations. Charitable Lead Trusts have the same first and second most common beneficiary types as do Charitable Remainder Trusts. However, Charitable Lead Trusts are much more heavily concentrated in giving to nonprofit organizations classified as "public/societal benefit," as these receive over 70% of all charitable transfers from Charitable Lead Trusts. This might reflect a greater tendency for Charitable Lead Trusts to pay into private family foundations, which are most commonly classified as general "public/societal benefit" organizations rather than as topic-specific nonprofit organizations. As estate size increases among charitable estates, the tendency to leave money not to public charities but to private family foundations grows dramatically. Charitable Lead Trusts are predominantly used as an estate tax avoidance technique for the wealthy, making the association between Charitable Lead Trusts and private foundation beneficiaries plausible. Charitable Remainder Trusts, in contrast, hold fewer assets on average. They may be used for a variety of tax and financial reasons by those whose estates are too small to generate estate taxation.



Although it is convenient to think of Charitable Lead Trusts as simply a mirror image of Charitable Remainder Trusts where the charitable and non-charitable beneficiaries switch places, there are other differences. Unlike a Charitable Remainder Trust, a Charitable Lead Trust is *not* a tax-exempt entity. If a Charitable Remainder Trust sells a highly appreciated asset, it pays no capital gains tax, because it is a tax-exempt entity. If a Charitable Lead Trust sells the same asset, it must pay capital gains tax, because it is *not* a tax-exempt entity. However, just as with other taxpayers, a Charitable Lead Trust may reduce its taxable income by making transfers to charity, which results in charitable deductions. Unlike other taxpayers, a Charitable Lead Trust can typically deduct up to 100% of its income (other than unrelated business income) if it makes sufficient charitable gifts.

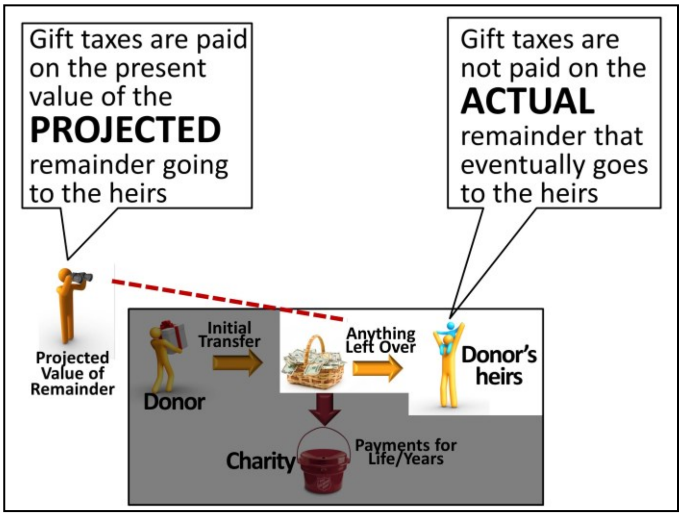


Because a Charitable Lead Trust is not a tax-exempt entity, some guidelines are more flexible than with a Charitable Remainder Trust. For example, Charitable Remainder Trusts can make payments for life or for up to 20 years. In contrast, Charitable Lead Trusts can make payments for life or for up to an unlimited number of years. The annual payments in a Charitable Remainder Annuity Trust must be between 5% and 50% of the initial trust assets. Annual payments in a Charitable Lead Annuity Trust can be as small or as large as desired. Further, Charitable Lead Annuity Trusts, unlike Charitable Remainder Annuity Trusts, do not have to be concerned with the risk of exhaustion being greater than 5%. A Charitable Remainder Unitrust must pay between 5% and 50% of all trust assets each year, whereas a Charitable Lead Unitrust can payout any desired percentage. There is no requirement for a minimum of a 10% charitable deduction (present value of projected amount going to charity) as with Charitable Remainder Trusts. In fact, the most common type of Charitable Lead Trust (the non-grantor Charitable Lead Trust) generates no charitable income tax deduction to the grantor regardless of its terms. This freedom in options comes because a Charitable Lead Trust, unlike a Charitable Remainder Trust, is not a tax-exempt entity.

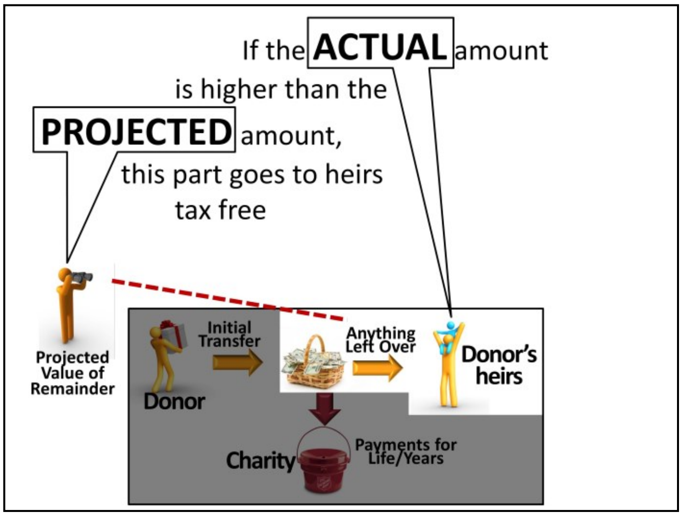


The most common type of Charitable Lead Trust is a *non-grantor* Charitable Lead Trust. The term *non-grantor* means that the Charitable Lead Trust is not owned or controlled by the donor (a.k.a. the grantor). Although the donor typically establishes all the rules for the Charitable Lead Trust, once established the trust is irrevocable. Because this trust is usually an estate tax avoidance mechanism, it is critical for the intended tax result that transfers to a non-grantor Charitable Lead Trust stay outside of the donor's estate. Once these assets are outside of the donor's estate, none of them should return to – or be controlled by – the donor, so that the trust and all its assets stay outside of the donor's estate. The assets in a Charitable Lead Trust fund annual payments to a charity and then, at the end of the term of the trust, are paid to the heirs or other beneficiaries selected by the donor. The payments to charity (either predetermined dollar amounts or a predetermined percentage of trust assets) typically occur for a fixed number of years but can continue for a life or multiple lives.

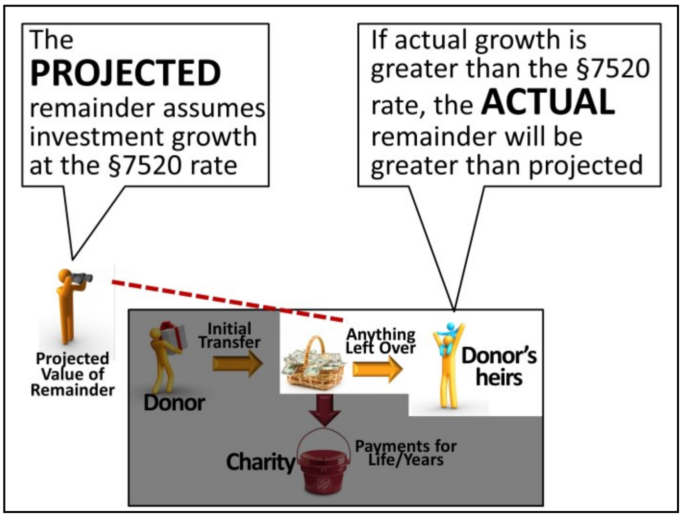
The primary purpose of non-grantor Charitable Lead Trusts is to reduce gift and estate taxes. Anything placed into a non-grantor Charitable Lead Trust is no longer owned or controlled by the donor. Although the donor typically creates the rules for the trust, the donor cannot change those rules once the trust is created. Unlike a Charitable Remainder Trust, the donor should not directly manage or control the assets of a non-grantor Charitable Lead Trust. This is avoided to ensure that all assets are excluded from the donor's estate. This focus on excluding the assets from the donor's estate is not typically a concern with standard Charitable Remainder Trusts. Why not? If a donor receives income from a Charitable Remainder Trust for her life with the remainder going to charity at her death, the fact that the remaining assets are going to charity means that the inclusion of the assets in her estate is irrelevant. The assets come into the estate and then the assets are exempted from taxation because they are transferred to a charity. This is not the case with a non-grantor Charitable Lead Trust. Here the assets are distributed to family members, or other non-charitable beneficiaries, at the termination of the trust. If any assets are *included* in the donor's estate, perhaps because the donor exercised too much control over the assets, then the assets are *taxed* in the donor's estate.



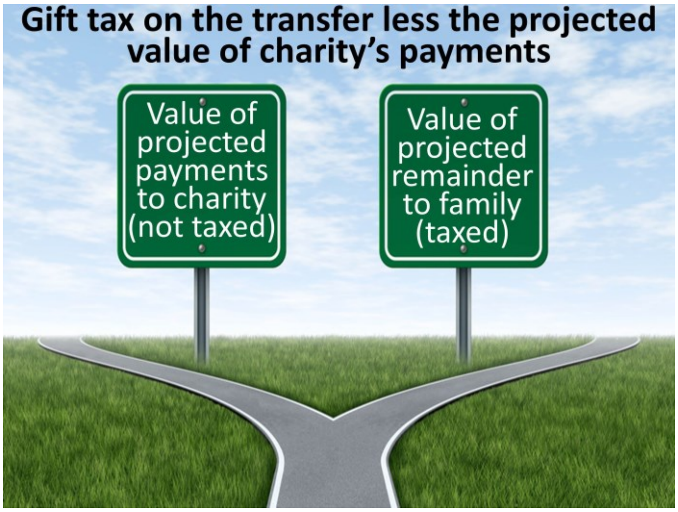
The fundamental tax advantage gained from a non-grantor Charitable Lead Trust is that when a donor makes transfers to the trust, he or she pays gift taxes on the *projected* amount of the ultimate transfer to the heirs (i.e., any non-charitable beneficiaries), not on the *actual* amount of the transfer to heirs. The actual amount transferred to heirs at the termination of a non-grantor Charitable Lead Trust is not subject to gift or estate taxation. This difference between the projected amount and the actual amount transferred to heirs creates an opportunity for tax-reduced transfers.



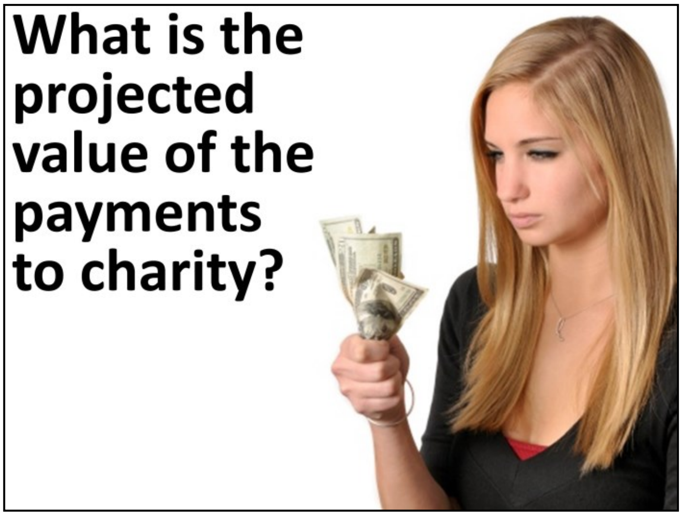
The key benefit for gift and estate tax planning purposes is that if the actual amount transferred to family members is higher than the projected amount, the difference between these two numbers is transferred without any gift or estate taxation. This part of the transfer to children, or others, is made free of estate and gift taxation.



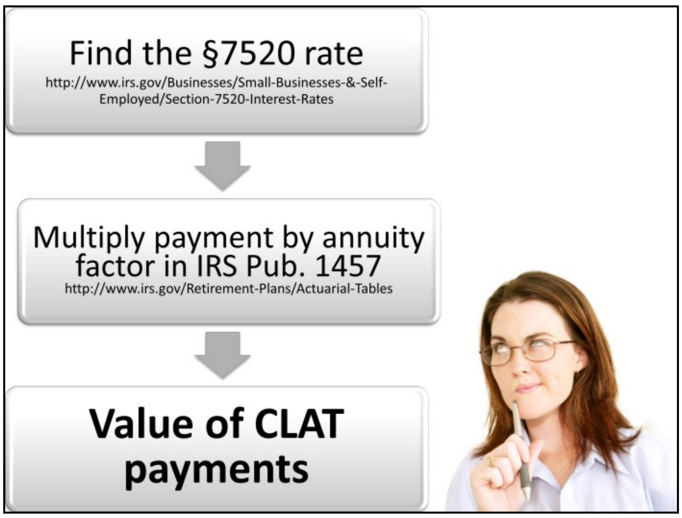
Gift taxes must be paid on the projected remainder that will be transferred to heirs (i.e., any non-charitable beneficiaries). This projection assumes that the assets in a Charitable Lead Trust will grow at the initial §7520 interest rate for the life of the trust. Any growth that occurs above the §7520 interest rate is therefore transferred free from gift or estate taxes. Of course, if the investments in the trust return less than the §7520 interest rate, then this advantage could become a disadvantage because the initial gift tax would have been based upon a projected transfer larger than the actual transfer ultimately made to the heirs (unless the projected transfer was $0).



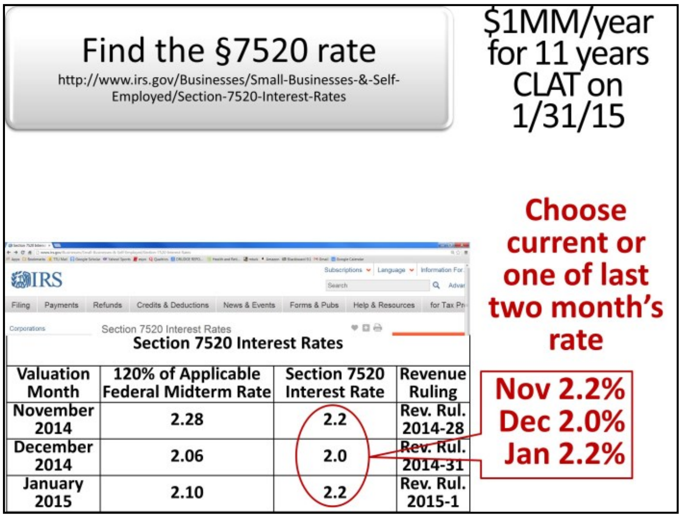
At the time of the transfer to a non-grantor Charitable Lead Trust, the donor must pay gift taxes on the value of the transfer less the present value of the payments projected to go to charity. The projected value of the amount going to charity is not taxed. The rest, which is the present value of the projected amount going to heirs or other people, is taxed. Thus, calculating the taxable part of the transfer can be determined by estimating the non-taxable part of the transfer, i.e., the present value of the projected payments to charity.



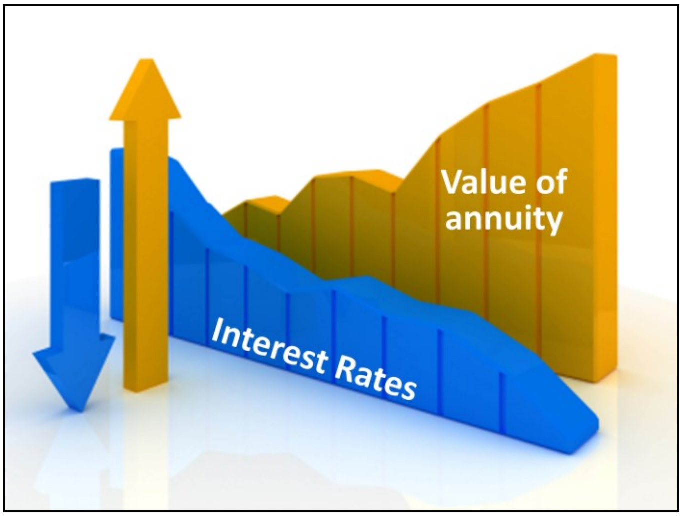
What is the process for estimating the present value of the projected payments to charity? It is identical to the process for estimating the present value of the projected payments to the non-charitable beneficiaries in a Charitable Remainder Trust. This makes sense because the charitable and non-charitable beneficiaries switch places in a Charitable Lead Trust as compared with a Charitable Remainder Trust. The value of an annuity (or unitrust payment) in a Charitable Remainder Trust is the same as the value of the same annuity (or unitrust payment) in a Charitable Lead Trust, only the recipient changes.



Determining the value of the annuity payments in a Charitable Lead Annuity Trust (i.e., the part not subject to gift or estate taxes) requires (1) finding the §7520 interest rate and (2) multiplying the annuity payment by the annuity factor in IRS Publication 1457 for that §7520 interest rate.

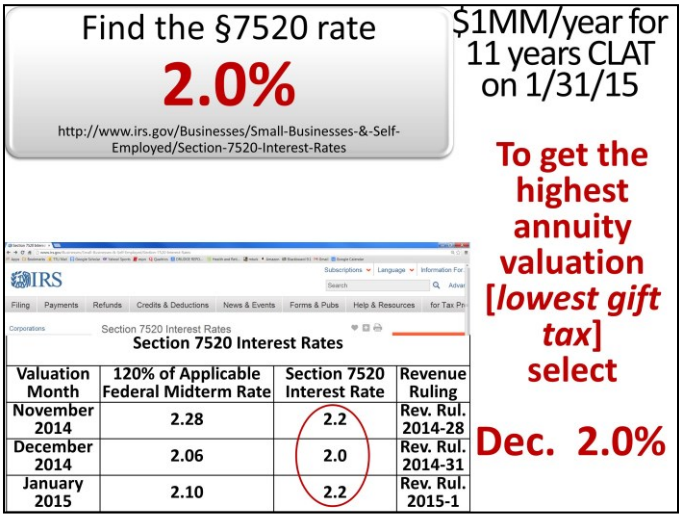


Consider the example of a non-grantor Charitable Lead Annuity Trust created on January 31, 2015, paying $1 million per year to charity for 11 years. What is the present value of these charitable annuity payments (i.e., the part not subject to gift taxes)? Calculating this first requires finding the §7520 interest rate. These rates are issued monthly and can be found on the IRS website at https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates, or on other planned giving websites. The donor may use the §7520 interest rate for the month of the transaction or either of the two previous months. Thus, the donor in this case may use the interest rates for January, December, or November. (Of course, by late in January the future rates for February would also have been posted so the donor could have delayed the transaction into February to take advantage of the February rates if desired.) For a transaction completed on January 31, 2015, the donor would need to choose between a 2.2% and a 2.0% §7520 interest rate. Which one is better for the donor?

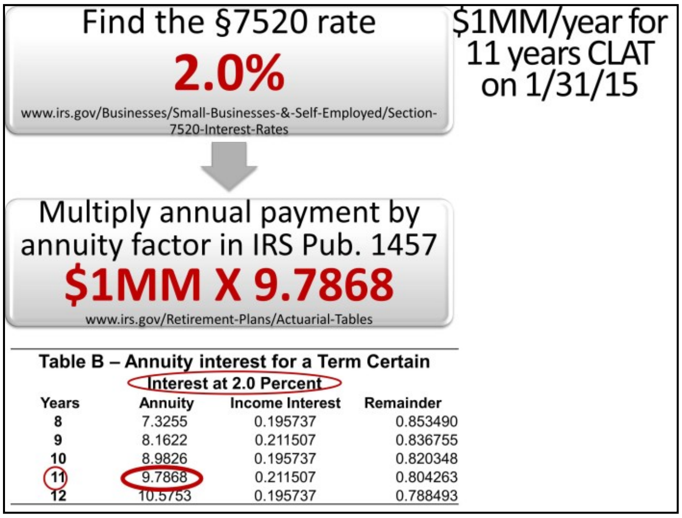


As interest rates rise, the value of a fixed dollar annuity decreases. Consider the value of an annuity that paid $1,000 per year when interest rates were 1%. An investor would have to invest $100,000 to generate that same income stream at 1%. However, if interest rates were 10% an investor would have to invest only $10,000 to generate the same income stream. Thus, the value of the income stream (the annuity) is higher when interest rates are low and lower when interest rates are high.

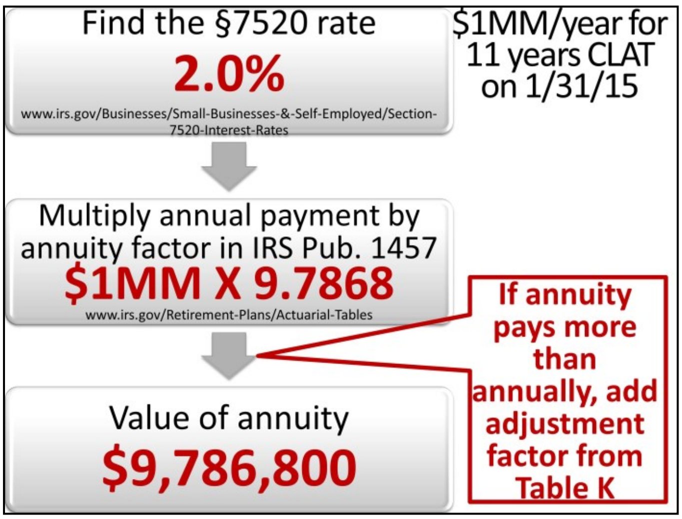
Is the donor better off having the annuity valued higher or lower? In a Charitable Lead Annuity Trust, the annuity is the part that goes to charity. The value of the portion that goes to charity is *not* subject to gift or estate taxes in a non-grantor Charitable Lead Trust. So, the donor is better off having a higher valuation for this charitable portion (meaning a higher valuation for the annuity).



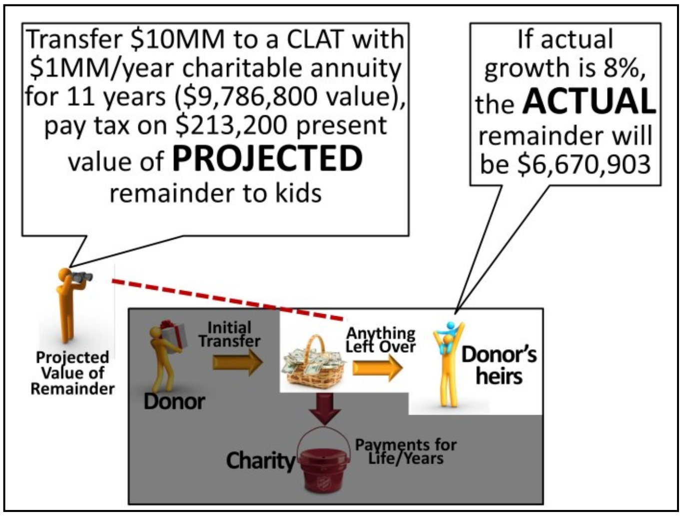
Returning to the two options for the §7520 interest rate of 2.0% or 2.2%, the donor is better off choosing the lowest rate. Thus, for this calculation the donor should choose the 2.0% rate to get the highest annuity valuation, and therefore the lowest gift tax. This 2.0% interest rate will be used for all calculations for this transaction even though during the life of the trust the interest rates may fluctuate greatly. Only the initial §7520 interest rate is relevant to the tax calculation.



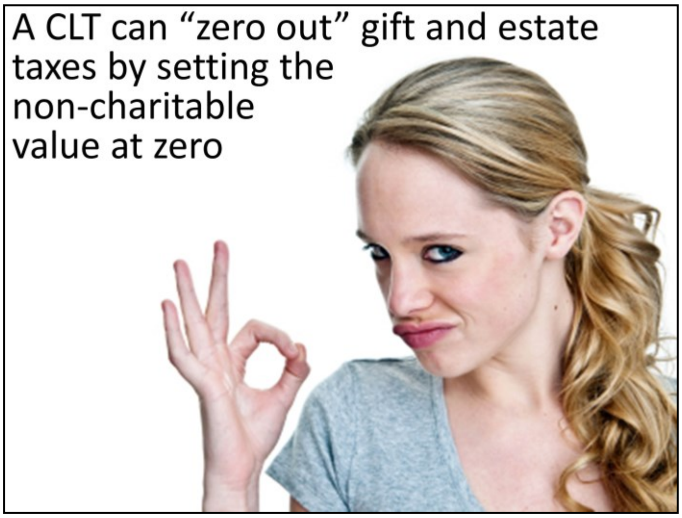
Once the appropriate §7520 interest rate is identified, the value of the annuity can be determined from the table associated with IRS Publication 1457 which can be found on the web at http://www.irs.gov/Retirement-Plans/Actuarial-Tables. In this case, the annuity will be paid for a fixed number of years, so we select Table B "Term Certain Factors." If instead the annuity were to be paid for life, we would select Table S for a single life or Table R(2) for two lives. These tables are also found on the same webpage. Examining Table B under the 2.0 percent interest rate heading shows that the annuity factor for an 11-year fixed term at that interest rate is 9.7868.



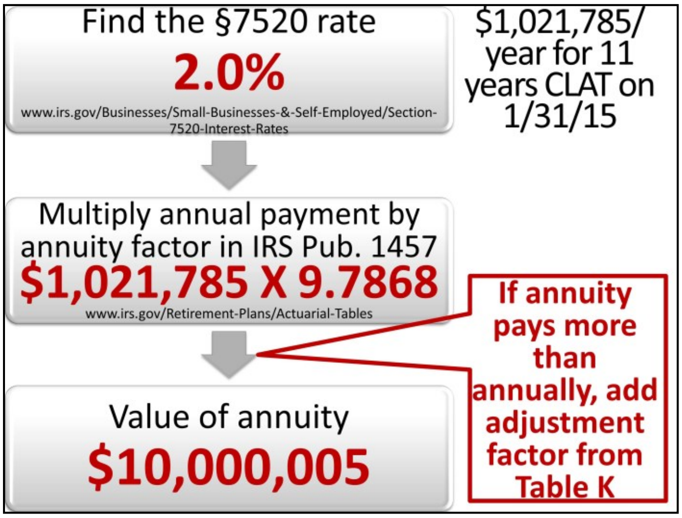
If the annuity pays annually, the value of the annuity is simply this annuity factor (9.7868) multiplied by the annual annuity payment ($1 million). Thus, the value of this annuity is $9,786,800. If the annuity paid more frequently than at the end of each year, then it would be slightly more valuable. (It is more valuable because the recipient gets the money slightly earlier.) For example, if the annuity were paid monthly (still with an initial §7520 interest rate of 2.0%) the value of the annuity would be $9,786,800 X 1.0091, or $9,875,859.88. This adjustment factor of 1.0091 comes from Table K on the previous website and varies with payment frequency and the §7520 rate.



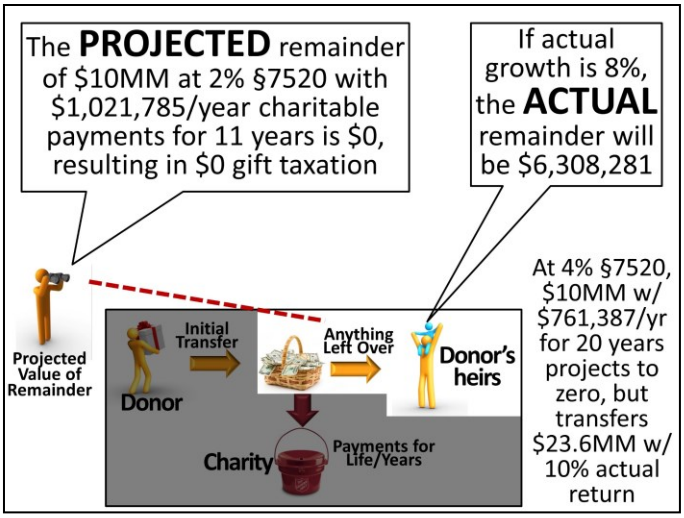
Suppose that the donor transferred $10 million to this non-grantor Charitable Lead Annuity Trust on January 31, 2015. The projected value of the charitable share, based upon 11 years of $1 million payments would be $9,786,800 as described above. This leaves a projected gift to the donor's heirs (or whomever the donor names to receive the remaining amount) with a present value of $10,000,000 less $9,786,800. Thus, the present value of the projected taxable gift to the heirs would be $213,200. If, during the life of the trust, the assets in the trust grow at a rate of 2.0% (equal to the initial §7520 interest rate) this projection will be accurate. However, if the assets in the trust grow at a rate faster than 2.0% this *extra* growth will go to the heirs without additional gift or estate taxation. For example, if the assets in the trust grew at a rate of 8%, the actual amount transferred to the heirs would be $6,670,902.51. This demonstrates the power of the non-grantor Charitable Lead Trust. The donor would transfer over $6.6 million in value to heirs but pay gift taxes on only $213,200.



In the previous example, the present value of the amount projected to go to heirs based on the §7520 interest rate was only $213,200. However, the donor could easily set the payments to charity such that the projected amount going to the heirs would be $0. This zeroed-out non-grantor Charitable Lead Trust results in no gift or estate taxation, regardless of the size of the *actual* transfer going to the heirs. Using a zeroed-out Charitable Lead Trust also eliminates the risk of paying unnecessary taxes if the trust assets *underperform* the initial §7520 interest rate. If the trust assets ultimately grew at a rate lower than the initial §7520 interest rate, then the trust would simply exhaust earlier than its intended term with no payments to non-charitable beneficiaries. But, since no gift taxes were paid, the donor does not risk overpaying gift taxes due to the underperformance.

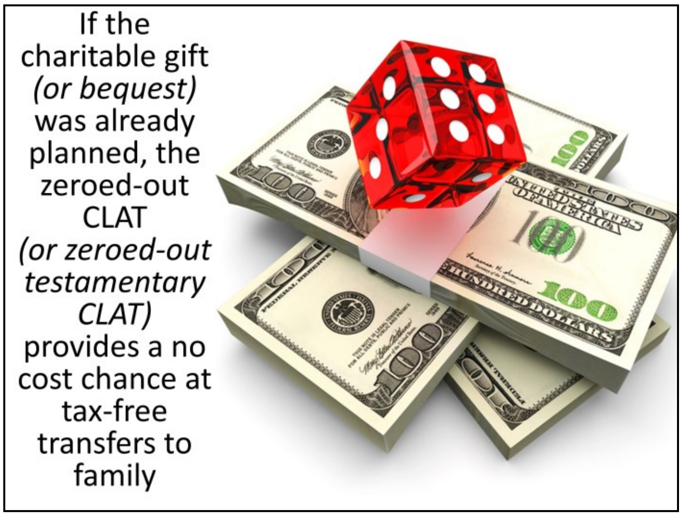


The calculation process for a zeroed-out Charitable Lead Annuity Trust is the same as before. In this case, the donor transfers $10 million into a non-grantor Charitable Lead Annuity Trust that pays $1,021,785 per year to charity for 11 years. The present value of this series of annual payments, at a 2.0% §7520 interest rate, is $10,000,005. This exceeds the value of the trust assets of $10,000,000. Thus, if the trust assets return exactly 2.0% during the life of the trust, there will be nothing left after the final charitable payment is made. If, however, the trust assets grow faster than 2.0%, any excess growth is transferred to the heirs (or other non-charitable beneficiaries). This transfer of extra growth occurs without any gift or estate taxation.



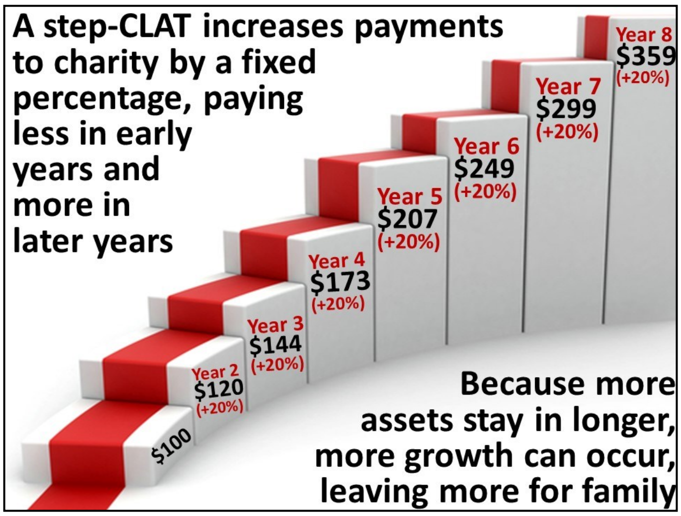
As before, the donor must pay gift taxes on the present value of the amount *projected* to go to the heirs. But, because $0 is *projected* to go to the heirs, there are no gift taxes. Any amount that *actually* goes to heirs – due to growth above the initial §7520 rate – also avoids taxation because the gift tax (of $0) has already been paid.

Conceptually, this might seem to be a lot of effort to go through just to be able to transfer the "extra" growth above the §7520 rate. But consider that in the previous example if the $10 million transfer grew at 8% instead of the §7520 rate of 2%, this transaction results in $6,308,281 being transferred to heirs with no gift taxes. For a donor at top tax rates, gifting that much after-tax money to heirs would otherwise have come at a cost of over $2.5 million in gift taxes or $4.2 million in estate taxes. (The estate tax cost is higher because estate taxes are tax "inclusive.") For those subject to estate and gift taxes, this benefit is well worth the planning, even for smaller transactions. For example, a $500,000 zeroed-out non-grantor Charitable Lead Annuity Trust earning 8% could transfer $315,414 to heirs after tax, which otherwise would have cost $210,276 in estate taxes. This can work at higher interest rates as well, as long as there is some chance that the investments will outperform the initial §7520. Consider, for example if the initial §7520 rate was 4% instead of 2%, but the value of the assets grew at 10%. In that case, a $10 million transfer with 20 years of annual payments to charity of $761,387 projects to a $0 remainder, resulting in no gift or estate taxes. However, if assets grew at 10%, the actual remainder would be $23,666,559, all of it transferring to heirs entirely gift and estate tax free.

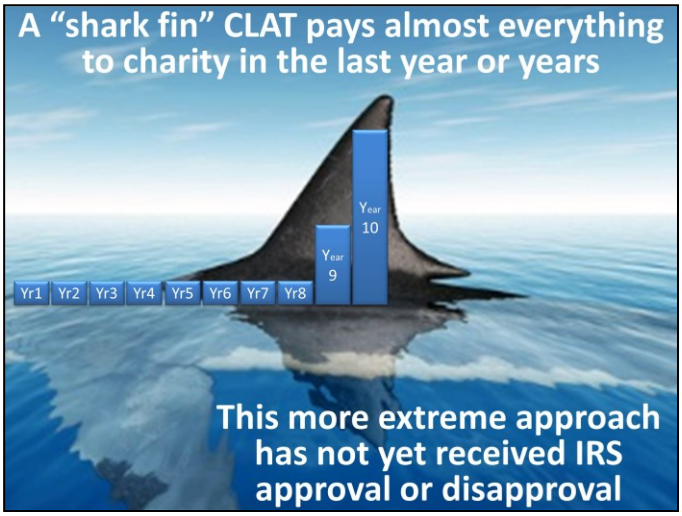


This tax savings is especially attractive to a donor who was already planning to make these charitable transfers. In that case, the ability to gift the extra growth to heirs with no gift or estate tax is a "free" benefit available simply by using the non-grantor Charitable Lead Trust as the charitable gifting mechanism. This is one of the reasons why *testamentary* zeroed-out non-grantor Charitable Lead Trusts are so attractive. For any taxable estate where the donor has already planned a substantial charitable estate gift, transferring the gift in the form of a testamentary zeroed-out non-grantor Charitable Lead Trust provides the opportunity for tax-free transfers to heirs with no downside risk to the heirs.

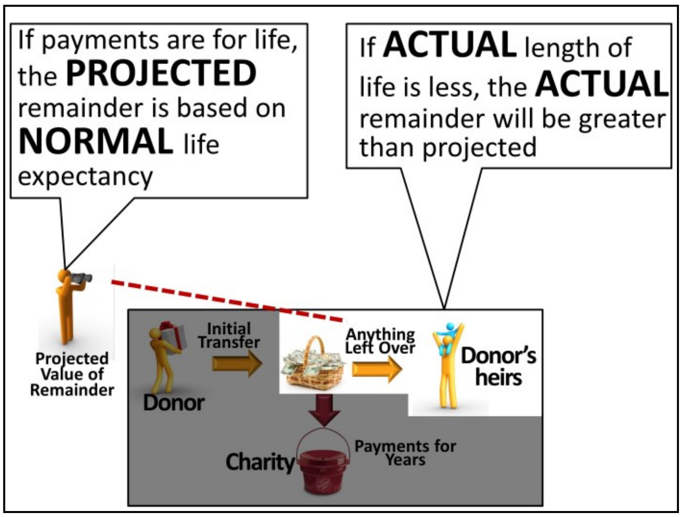
Because the non-grantor Charitable Lead Trust provides the opportunity to transfer extra growth, above the §7520 rate, free from estate and gift taxes, the value of this technique depends upon the growth rate of assets in the trust. If clients have assets that they anticipate will grow more rapidly in future years these are the assets most suited for a non-grantor Charitable Lead Trust.



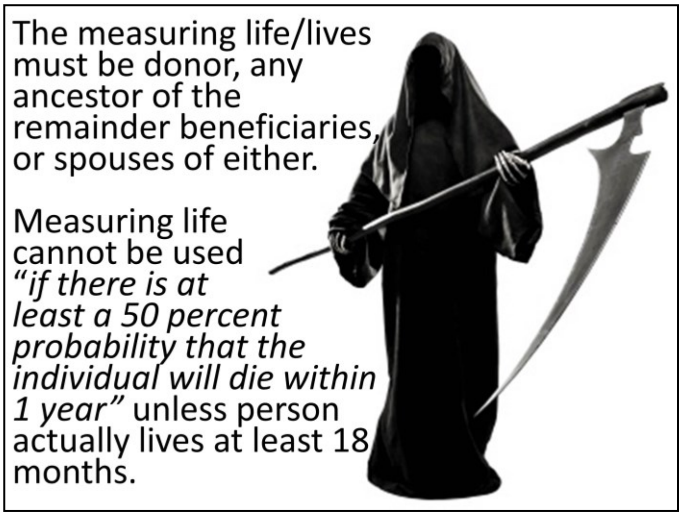
A step-CLAT (non-grantor Charitable Lead Annuity Trust) provides for steadily increasing payments to the charity during the fixed term of the trust. The payments are not flat, but they are known in advance. The motivation for pushing more of the charitable payments to the later stages of the trust term is that this allows more assets to stay in the trust longer. For assets that outperform the initial §7520 rate, the longer they stay in the trust the more excess growth they will generate. For example, the IRS has approved using annual 20% increases in the charitable payment amounts. Returning to the previous example, a zeroed out Charitable Lead Annuity Trust with a $10 million initial transfer could be generated by 11 annual payments starting at $362,000 and increasing by 20% each year. Taking this approach instead of paying the flat annuity rate (i.e., $1,021,785 per year) means that the charity receives lower payments at the start of the trust, but larger payments at the end of the trust. For instance, the first annual payment would be $362,000, but the final annual payment would be $2,241,409. If trust assets grew at 8% annually (instead of the 2.0% initial §7520 rate) the standard flat payout annuity in a zeroed-out non-grantor Charitable Lead Trust would leave $6,308,281 for the heirs. But the 20% annual increasing step annuity in a zeroed-out non-grantor Charitable Lead Trust would leave $7,936,082. This extra $1.6 million in tax-free transfer results from keeping the faster growing assets in the trust longer. If, however, the assets underperformed the 2.0% initial §7520 rate both the traditional annuity and the step annuity would exhaust the trust and the heirs would receive nothing.



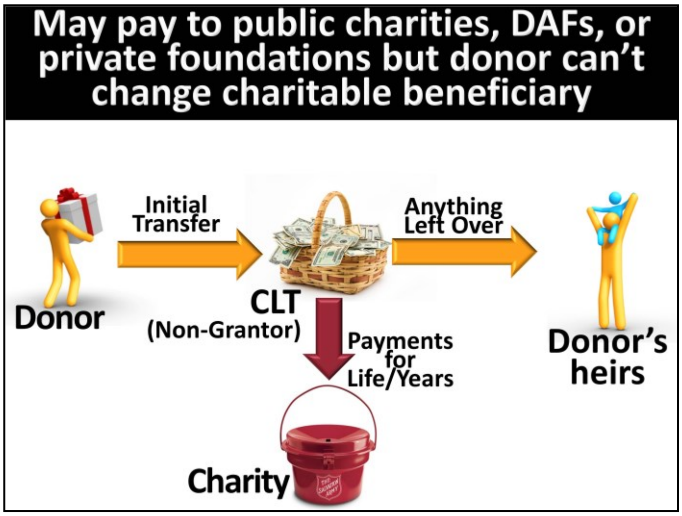
The extreme version of keeping assets inside the Charitable Lead Annuity Trust is known as a "shark fin" Charitable Lead Annuity Trust. The name comes from a visualization of the payment amounts on a graph where the large charitable payments all come in the last year or two of the trust, forming a steep shark-fin like graph. The benefit of such a payout scheme is the same as with a step-CLAT (Charitable Lead Annuity Trust). The longer the assets are kept inside the Charitable Lead Trust, the more excess growth they will be able to generate, assuming that they outperform the §7520 rate. Using these more extreme payouts is a more aggressive approach because it has not been approved (or disapproved) by the IRS (although Rev. Proc 2007-45 seems to allow any payments). Some argue that 20% annual increases, which have been specifically allowed (PLR 201216045), should be treated as a maximum. The argument is that 20% increasing annuities is the maximum allowed for Grantor Retained Annuity Trusts, and so perhaps the IRS will dispute Charitable Lead Annuity Trusts that exceed this level.



For Charitable Lead Trusts paying to a charity for a lifetime, the actual amount left for the non-charitable beneficiary depends not only on the rate of growth of the assets, but also on the length of the measuring life. For example, if a Charitable Lead Trust pays $100,000 per year for the life of a person whose age suggests a life expectancy of 30 years, the present value of that charitable payment would be $100,000 x 22.3965, or $2,239,650 (at a 2.0% §7520 rate). However, if the person lived for only two years, the actual payments to charity would total only $200,000. Just as before, gift tax is paid based upon the *projected* transfer to the non-charitable beneficiaries, not the *actual* transfer. Consequently, if a donor transferred $2.2 million to the previous Charitable Lead Trust with projected distributions to charity having a present value over $2.2 million, there would be no gift or estate tax on the transfer. This remains true even though the shortened life, in reality, would have resulted in $2 million being transferred to the heirs with no gift or estate taxes. Recognizing this reality led to the practice of creating "viatical" Charitable Lead Trusts (a.k.a. "vulture" Charitable Lead Trusts), where the measuring life for the charity's payments would be a younger person with a terminal disease. In response, the law was changed to limit the people who can be named as the measuring life for a Charitable Lead Trust.

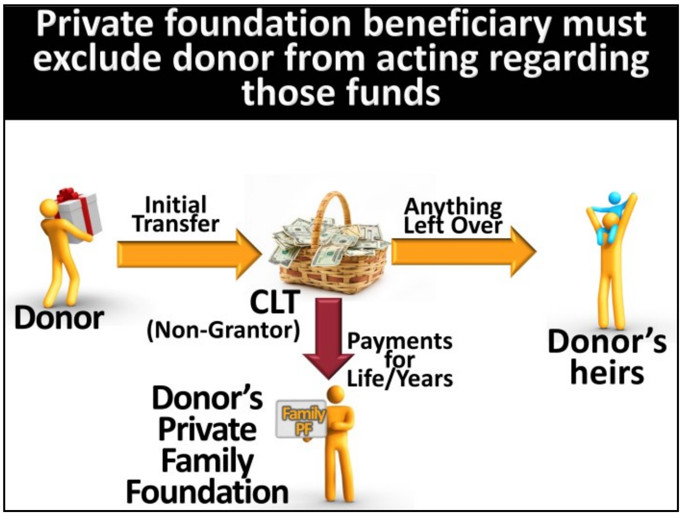


To prevent widespread viatical shopping, the measuring life for a Charitable Lead Trust is now limited to the donor, any ancestor of the remainder beneficiaries, or the spouse of either of these. Thus, taking advantage of a terminal diagnosis for tax planning purposes is still theoretically possible, but only within the much smaller close family group. Additionally, a person may not be used as the measuring life for a Charitable Lead Trust if there is at least a 50% probability that the individual will die within one year. Such a probability would be an issue of fact and subject to expert testimony. However, if the person who is the measuring life actually lives for at least 18 months after being named, then there is no requirement to meet the 50% probability test.



In Charitable Remainder Trusts, it is quite common for the donor to retain the right to change the charitable beneficiary of the trust. So long as the trust requires that some charity will ultimately receive the funds, this retention of power creates no problems. In contrast, if the donor retains this power in a non-grantor Charitable Lead Trust the gift and estate tax advantages of the trust will be lost. Why? Retaining the power to change charitable beneficiaries causes the assets to remain in the donor's estate. Because the assets have not left the donor's estate, they are still subject to estate taxes at the donor's death. This same reality does not create tax problems for the Charitable Remainder Trust. The Charitable Remainder Trust assets may be included in the donor's estate, but when those assets are all transferred to charity at death, they are not subject to estate taxation because of the unlimited charitable estate tax deduction. In contrast, the Charitable Lead Trust passes its assets to non-charitable beneficiaries at termination. Thus, inclusion of the Charitable Lead Trust assets in the donor's estate at death can result in estate taxation. Although the donor may not have this power, it is acceptable for the donor's spouse or some other family member to have the power to change charitable beneficiaries. Because the donor is not the one who holds the power, the trust assets will not be included in the donor's estate. (Note, however, that if the Charitable Lead Trust will pay to a "skip person" such as a grandchild with living parents, it is important that no one retain the right to change the charitable beneficiary. This is discussed briefly below in the section on generation skipping transfer taxes.)

It is also acceptable if the donor has the power to "request but not direct" an independent trustee to change the charitable beneficiary. Because the donor does not have the legal right to change the charitable beneficiary, keeping this right does not create estate tax problems. Along the same lines, it is perfectly acceptable for the Charitable Lead Trust to pay to a donor advised fund, even if the donor has the right to advise the charity regarding the timing and recipients of subsequent charitable transfers (see PLR 9633027). This right is only the right to give "advice." It is not a legal right to force a particular charitable transfer. Because it is not an enforceable legal right, it does not result in inclusion of the assets in the donor's estate.

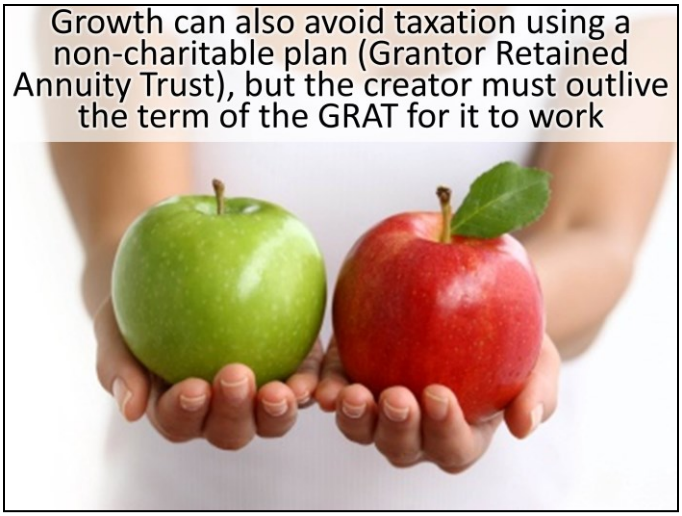


The non-grantor Charitable Lead Trust may name the donor's donor advised fund as the charitable beneficiary because the donor has no legal right to control the distributions out of those funds (only a right to "advise" regarding distributions). Similarly, if the donor's private family foundation is named as a charitable beneficiary, it is important to show that the donor has no legal right to control the ultimate charitable grant recipients through his control of the private foundation. If the donor had this right, then the Charitable Lead Trust assets would still be included in the donor's estate. In order to prove that the donor has no ability to direct the ultimate distribution of those assets paid to the donor's private foundation, the terms of the gift should prohibit the donor from acting with regard to funds coming from Charitable Lead Trust. Further, such funds should be maintained by the private foundation in a separate account. There are no problems with inclusion in the donor's estate if the donor's spouse, children, or friends can control these separate funds in their role as foundation trustees, but the donor must be excluded. (Allowing another person to change the charitable beneficiary of the non-grantor Charitable Lead Trust creates negative consequences for purposes of generation skipping transfer taxes, but allowing others to keep the right to control distributions made from the private foundation that is the recipient of Charitable Lead Trust funds does not create any such problems.)

The IRS has allowed early termination of a fixed term Charitable Lead Annuity Trust. However, it has not allowed the division to be based upon the present value of the relative income and remainder rights (as has sometimes been allowed with a Charitable Remainder Trust). Instead, the charity must be paid all of the scheduled payments at the time of termination, without discounting for receiving the payments early. Thus, if 10 years remained in a fixed term Charitable Lead Trust where the charity received $1,000,000 per year, an early termination would require the immediate payment to the charity of $10,000,000, rather than the present value of the right to receive these payments over the next ten years. Charitable Lead Unitrusts, in contrast, may not be terminated early.

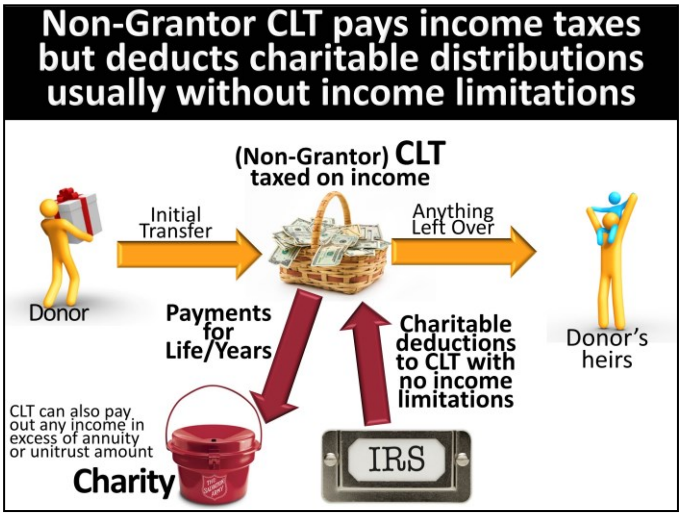
The primary estate and gift tax advantage to be gained with a non-grantor Charitable Lead Trust comes from the taxation of the *projected* transfer to heirs rather than the *actual* transfer to heirs. This same advantage arises for generation skipping transfer taxes only with a Charitable Lead Unitrust (CLUT), but not with a Charitable Lead Annuity Trust (CLAT). With a Charitable Lead Annuity Trust, the generation skipping transfer tax is based upon both the *projected* and the *actual* transfers to the "skip person" (e.g., a grandchild whose parents are still alive). For both Charitable Lead Trust types, the donor can initially allocate generation skipping transfer tax exemption equal to the present value of the projected transfer to be made to "skip persons," just as with the gift tax. However, if a Charitable Lead Annuity Trust grows faster than the §7520 rate, then additional Generation Skipping Transfer Tax will be due at the termination of the Charitable Lead Annuity Trust. Worse, if a Charitable Lead Annuity Trust grows slower than the §7520 rate, ultimately leaving less to the "skip person" than projected, there is no refund of the allocated generation skipping transfer tax exemption. In contrast, the ultimate amount of the transfer is irrelevant to the calculation of generation skipping transfer tax for a Charitable Lead Unitrust. However, the Charitable Lead Unitrust is not an ideal mechanism for transferring the growth above the §7520 rate, because such growth must be shared with the charity. A Charitable Lead Unitrust pays a fixed percentage of trust assets to charity each year. Thus, more rapid growth results in higher payments to charity.

As discussed above, the donor may not retain the right to change the charitable beneficiary of a Charitable Lead Trust. Otherwise, the assets of the Charitable Lead Trust will still be included, and taxed, in the donor's estate. However, allowing another person, such as a family member, to have this right to change charities does not create estate tax problems for the donor. However, it does create a potential negative result for generation skipping transfer tax if the trust will be paid to a "skip person." In that case, leaving open the option to change the charitable beneficiary means that the transfer to the skip person is a "taxable distribution" rather than a "taxable termination." Under the generation skipping transfer tax rules, taxes from a "taxable distribution" are owed by the recipient "skip person" (I.R.C. §2603(a)(1)), but taxes from a "taxable termination" are owed by the trust itself (I.R.C. §2603(a)). For example, if $1,000,000 in generation skipping transfer taxes were due in a "taxable termination" the trust could pay those taxes with no negative consequences to the recipient. But, if the trust paid the $1,000,000 in generation skipping transfer taxes in a "taxable distribution," the trust would be paying an obligation of the recipient, meaning that the recipient would have received an additional $1,000,000 gift that would itself be subject to the generation skipping transfer tax.

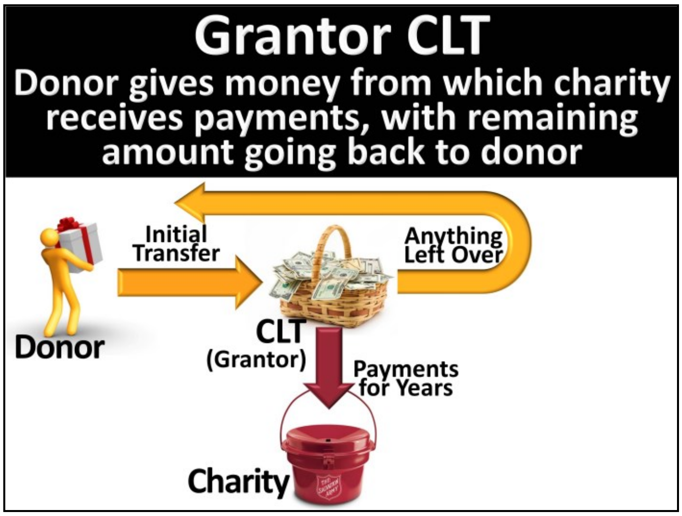


Although a non-grantor Charitable Lead Trust can create significant potential tax advantages, as with other charitable planning techniques it is important to limit those techniques to clients with charitable interests. There are other ways to reduce estate taxes that do not involve making gifts to charity. For the non-charitable client, these techniques will inevitably be more appropriate. For example, a client may transfer excess growth to the next generation with similar results using a grantor retained annuity trust. Although this is not a perfect match for a Charitable Lead Trust (e.g., the client must outlive the term of the grantor retained annuity trust in order for the estate to receive the tax benefit), such techniques will typically be more appropriate than charitable strategies for the client who does not desire to make gifts to charity.

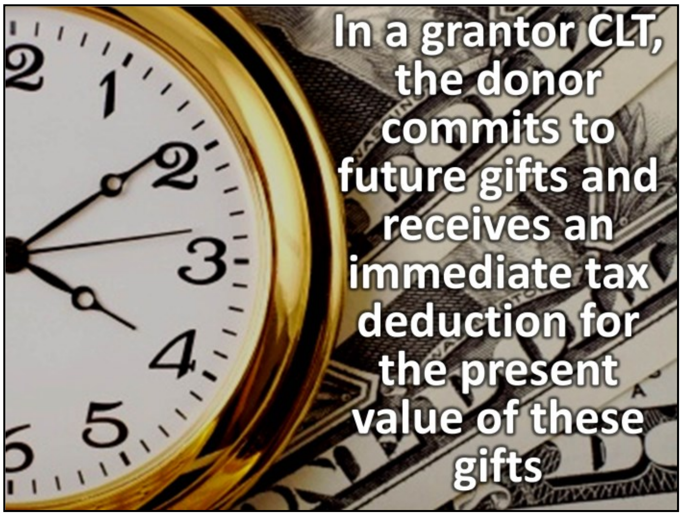
The primary role of non-grantor Charitable Lead Trusts is to aid in reducing gift and estate taxation. However, there is also a less well-known role for these trusts in reducing income taxation. This opportunity arises when a donor's gifts no longer generate income tax deductions because of the income limitations on charitable deductions. In this scenario a donor might earn, e.g., $1,000,000 in interest and dividends on certain assets, donate the entire $1,000,000 to charity, but still be required to pay income taxes on the $1,000,000 with no usable charitable income tax deduction. The non-grantor Charitable Lead Trust can provide a solution to this income tax problem.



By transferring the income earning assets to a non-grantor Charitable Lead Trust, the donor no longer reports future earnings as income. Instead, the trust itself reports these earnings, and pays taxes on them. Normally, this would not be considered a tax benefit because trusts have a compressed tax schedule (i.e., they pay the highest tax rate at a much lower level of income). However, a non-grantor Charitable Lead Trust can normally deduct payments to charity with no income limitations. Returning to the previous example, the donor owns assets generating $1,000,000 in interest and dividends annually. The donor would still have to pay taxes on that income even if she donated the entire amount to charity because the donor's other (or previous) gifts have already exceeded the income limitations on charitable deductions. However, if the donor transferred these assets to a non-grantor Charitable Lead Trust, the trust could deduct all gifts, up to 100% of income. Additionally, a Charitable Lead Trust may be written to allow distribution of any income in excess of the required annuity or unitrust amount, so that the trust would pay no income taxes regardless of the investment returns. This plan works well when a donor who is already over the income limitations for deductible gifts wishes to make gifts out of income earned from assets, has no plans to consume the assets personally, but does desire to keep the underlying assets in the family.

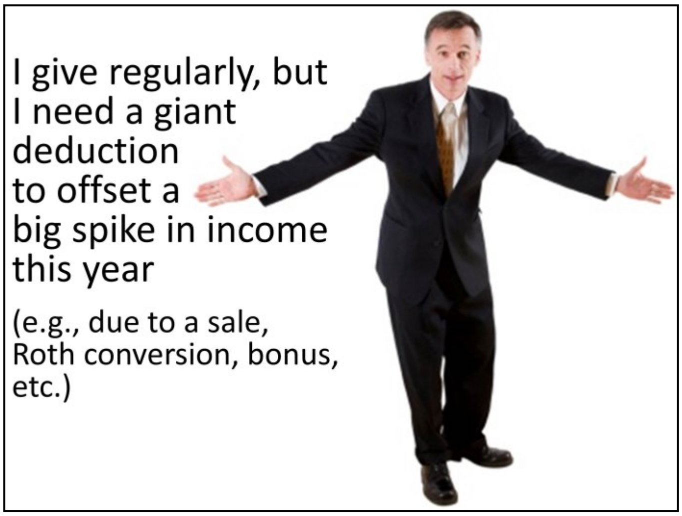


To this point, the focus of the chapter has been on non-grantor Charitable Lead Trusts. A less common type of Charitable Lead Trust is a grantor Charitable Lead Trust. In a typical grantor Charitable Lead Trust, the donor receives the remaining interest at the termination of the trust. Because of this, the trust is always considered to be owned by the donor. A grantor Charitable Lead Trust is not even a separate tax paying entity; it is simply an extension of the donor. If the trust earns income, the donor is treated as having earned the income. This trust is not used for estate and gift tax planning because the donor hasn't transferred anything out of his or her estate.



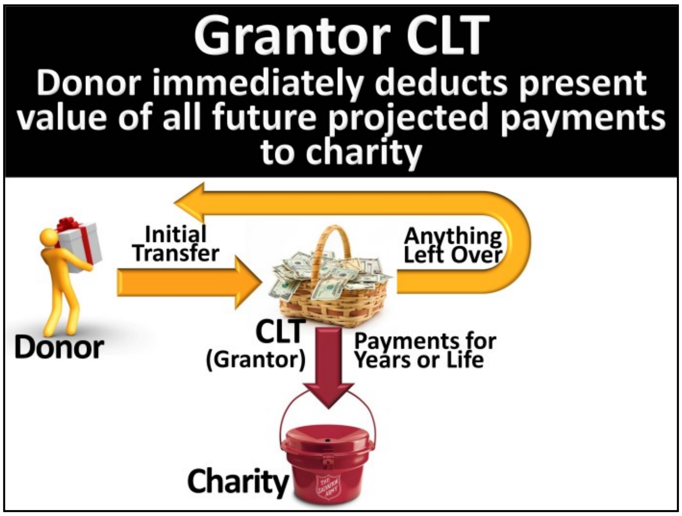
Instead, this trust is used for income tax planning purposes. Specifically, the donor is allowed to immediately deduct the present value of the future charitable gifts funded by the trust assets. This allows the donor to "pull forward" future charitable gifts and to deduct them today (so long as the donor transfers sufficient assets into the trust to fund these gifts).

The tax deduction for transfers to grantor Charitable Lead Trusts is limited to 30% of adjusted gross income, or 20% if funded with long-term capital gain property, because the gift is considered to be "for the use of" charity rather than "to" charity. This is because the Charitable Lead Trust itself is not a tax-exempt entity (unlike the Charitable Remainder Trust). Additionally, Regulation 1.170A-10(a)(1) and PLR 8824039 indicate that excess gifts "for the use of" charity cannot be carried forward, but IRS publication 526 and PLR 200010036 indicate that they can be.



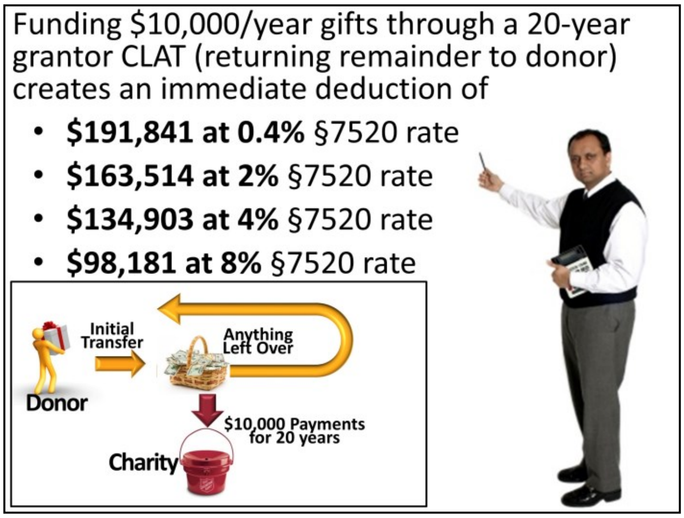
Pulling forward tax deductions for future charitable gifts is particularly useful when the donor's tax rates are high now but will be lower later. A grantor Charitable Lead Trust allows the donor to take the deductions now, when they are more valuable, rather than later. This temporarily higher tax rate may result from a spike in income, perhaps due to the sale of an appreciated asset, a Roth conversion, or some other temporary income. Additionally, this difference in tax rates may occur as the result of a planned retirement where future income, and thus future tax rates, will be substantially lower after the retirement date.

Of course, the donor could simply make a large charitable gift during the year when income is high. Or, if the donor wishes to spread out the transfers to charity over many years, he or she could make a large transfer to a donor advised fund. Both of these approaches would also generate a large immediate income tax deduction. However, the grantor Charitable Lead Trust allows the donor to get the asset back after the expiration of the trust (or at least what remains of the asset after making the required payments to charity). Suppose the donor owns a large income-producing investment that generates $100,000 per year. Using a grantor Charitable Lead Trust, the donor could transfer the asset, use the income to pay for $100,000 annual charitable gifts, take an immediate tax deduction for all of the future $100,000 annual gifts, and then receive the asset back at the close of the trust. This could work especially well if the asset was desired to produce income in the future, for example in retirement planning, but would be better used to generate charitable tax deductions today. The other methods do not allow the donor to both keep the underlying asset and take an immediate deduction for the future years of gifting.

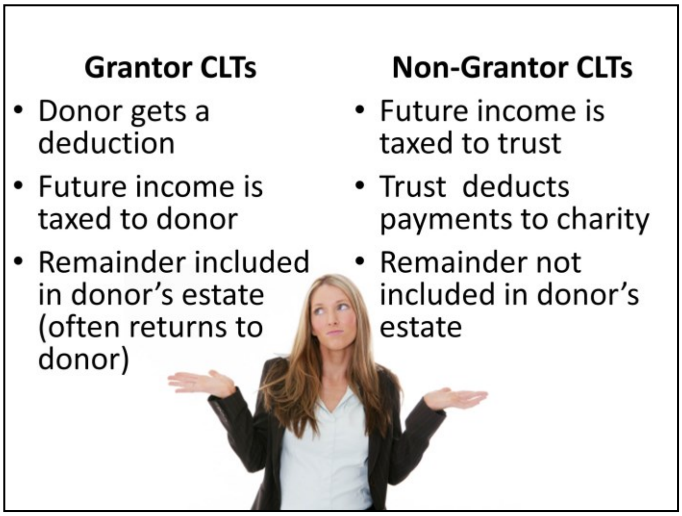


A typical grantor Charitable Lead Trust follows the plan of the accompanying diagram because the donor retains the reversion rights. There are other rights that will also trigger this grantor trust treatment, but many violate other Charitable Lead Trust rules (such as rules against self-dealing) and therefore eliminate Charitable Lead Trust treatment and the tax deduction.

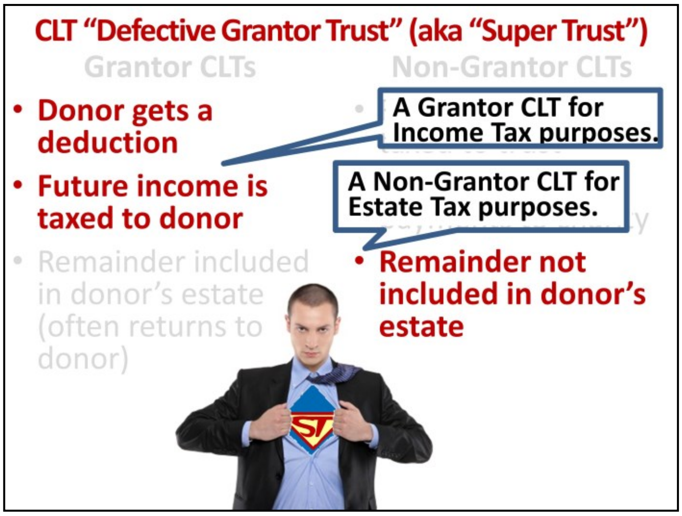
In rare cases, a grantor Charitable Lead Trust may continue to exist beyond the death of the donor. (This might occur where the trust is set to run for, say, 10 years, but the donor dies before the end of the 10-year period.) This creates a problem because the donor can no longer be treated as the owner of the trust and taxed with the trust's income. In such cases, a grantor Charitable Lead Trust becomes its own separate tax paying entity (i.e., a complex trust) just like a non-grantor Charitable Lead Trust. This means that the trust is taxed with any income earned, but it can also deduct subsequent transfers to charity. However, to offset the fact that these anticipated gifts were *already* deducted by the donor, the deductions are recaptured on the donor's final income tax return. In other words, the donor's original deduction, less the value of the amounts already paid to charity discounted to the year of the deduction, is treated as income in the year of recapture. This same result also occurs if the donor gives up his or her reversion rights (although the recapture will occur on the donor's tax return in the year that the rights were given up rather than on the donor's final tax return).



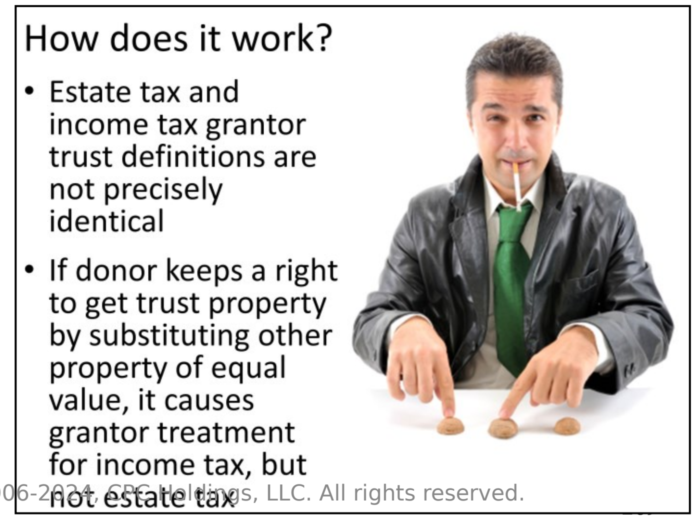
Because the grantor Charitable Lead Trust allows for a deduction today for transfers to be made to charity in the future, the value of the deduction depends upon the prevailing §7520 interest rate. The size of the deduction is much larger during lower interest rate periods than during higher interest rate periods. For example, a Charitable Lead Trust funded to support $10,000 annual charitable gifts for the subsequent 20 years will generate a $163,514 deduction if the §7520 rate is 2.0%. (The annuity factor for a 20-year term certain annuity at a 2.0% interest rate on Table B "Term Certain Factors" found on the web at http://www.irs.gov/retirement-plans/actuarial-tables is 16.3514.) But, if the §7520 rate is 8.0%, the same transaction generates a deduction of only $98,181.



Grantor Charitable Lead Trusts and non-grantor Charitable Lead Trusts have opposing tax characteristics. A grantor Charitable Lead Trust is treated as if the donor still owns it. Thus, the donor receives the charitable income tax deduction but is taxed with the income earned by the trust. Also, the assets in the trust are considered to be owned by the donor for gift and estate tax purposes. In contrast, a non-grantor Charitable Lead Trust is treated as a separate taxpayer. Transfers to a non-grantor Charitable Lead Trust do not generate income tax deductions. The trust pays taxes on any income it earns, and it takes deductions for any transfers it makes to charity. Most importantly for gift and estate tax planning purposes, any assets in a non-grantor Charitable Lead Trust are outside of the donor's estate. Thus, the choice of the trust type will depend upon the tax goals of the donor.



There is, however, a type of Charitable Lead Trust that proposes to combine the characteristics of a grantor and non-grantor trust. A "defective grantor trust" or "super grantor trust" or "super trust" purports to create a Charitable Lead Trust where the donor may take an immediate tax deduction for future charitable gifts from the trust, pay taxes on any income earned by the trust, but the trust assets will not be included in the donor's estate. Thus, the estate and gift tax results are the same as with any *non-grantor* Charitable Lead Trust, but the donor is actually able to take a personal income tax deduction as if it were a *grantor* Charitable Lead Trust.



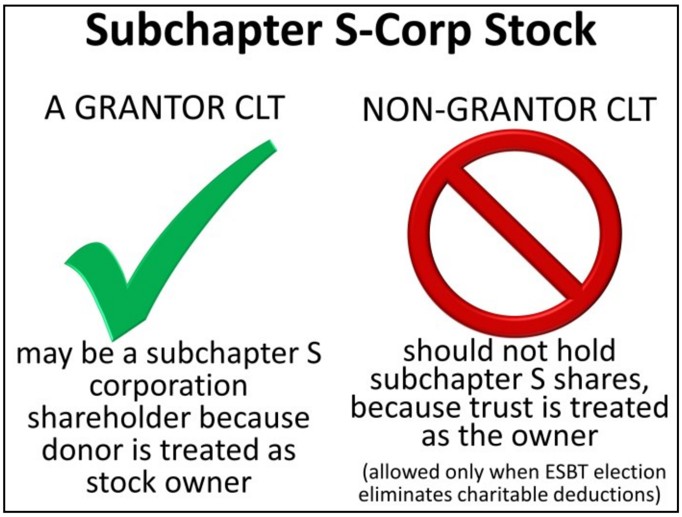
The explanation for this result relates to a slight inconsistency in the tax code. The income tax rules defining grantor and non-grantor trusts are *almost* identical to the gift and estate tax rules defining grantor and non-grantor trusts. But they are not perfectly identical. If a donor keeps the right to get trust property by substituting other property of equal value, this will trigger grantor treatment of the trust for income tax purposes. However, it does not trigger grantor treatment of the trust for gift and estate tax purposes. Thus, an otherwise normal non-grantor Charitable Lead Trust can be converted into a "super grantor trust" by simply inserting this one right. This hybrid trust has not received clear approval from the IRS but does appear to comply with the language of the tax code.

Charitable Lead Trusts are commonly funded with simple assets such as cash and publicly traded stocks and bonds. However, some assets can create complications or difficulties when transferred to a Charitable Lead Trust.

Although Charitable Lead Trusts are not private foundations, they are required to follow the private foundation rules against self-dealing, taxable expenditures, jeopardizing investments, and excess business holdings. Failing to follow these rules will result in the trust being disqualified as a Charitable Lead Trust. For example, the trust may not indefinitely hold too much ownership in a single business entity (no more than 20% ownership by the trust and all disqualified persons combined unless trust ownership is 2% or less). However, the trust may hold unlimited ownership in a business gifted to the trust for up to 5 years before it must sell the asset. Consequently, if a Charitable Lead Trust is established for a term of 5 years or less, it will not violate this rule. Another rule is that the donor may not transfer property to the trust with debt that is less than 10 years old because such transfer constitutes self-dealing. Also, the trust may not hold assets that are so risky as to jeopardize the charitable purposes of the trust. These rules are covered in detail in the chapter on private foundations.

Unrelated business income arises when a trust owns business interests in a form that generates ordinary income such as a sole proprietorship, a partnership, or a limited partnership interest where the limited partnership is actively managing a business operation and not simply collecting passive income from investments. In a Charitable Remainder Trust, unrelated business income results in a harsh 100% excise tax. No such excise tax applies to Charitable Lead Trusts, allowing them to receive unrelated business income. When the trust is a *grantor* Charitable Lead Trust, any such income is simply attributed to the donor and treated as if the donor had directly received it. However, special rules apply if a *non-grantor* Charitable Lead Trust receives unrelated business income. In this case, a non-grantor Charitable Lead Trust may deduct only 50% of this income when it is given to a public charity or 30% when it is given to a private foundation. This means that the trust cannot escape paying at least 50% or 70% of the unrelated business income tax, regardless of its charitable distributions.

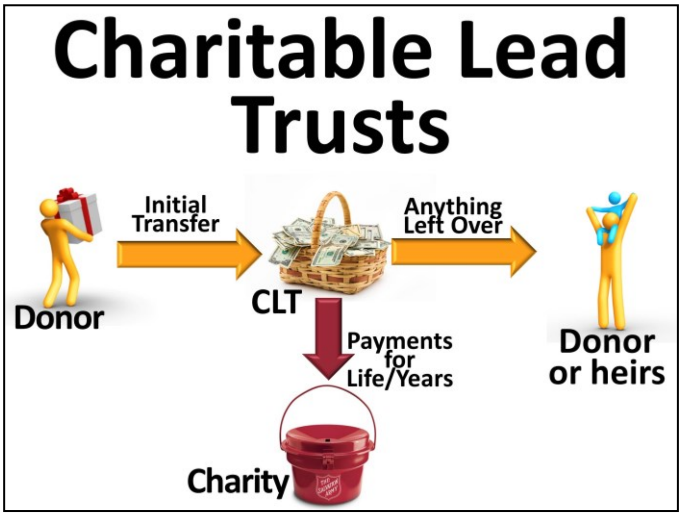
Why should such a rule exist? The idea of having an unrelated business income tax is that nonprofits should not be able to outcompete for-profits in non-charitable commercial enterprises simply because nonprofits pay no taxes. This would be unfair for regular businesses and would have a negative effect on tax revenues based upon regular commercial activity. If a non-grantor Charitable Lead Trust were allowed to operate a business and pay no tax on the earnings (because earnings were 100% distributed to a charity and resulted in a 100% tax deduction), the result would be the same as charging no unrelated business income tax. To avoid this result, contributions of unrelated business income are not fully deductible. As a result, a non-grantor Charitable Lead Trust must pay some unrelated business income tax, even if all unrelated business income is donated to charity. (Note that the trust's ownership of a limited partnership interest will not generate unrelated business income if the limited partnership does not engage in the active management of a business, but simply holds passive investments and collects income from them. Thus, if a donor was using a limited partnership holding passive investments for the purpose of obtaining a valuation discount for estate tax purposes, such interests could be gifted to a Charitable Lead Trust.)



Subchapter S-corporation shares are most commonly held by people. Another corporation, a partnership, or a Charitable Remainder Trust may not hold these shares. (Doing so will cause the corporation to lose its subchapter S status and instead become a subchapter C-corporation.)

It is perfectly acceptable for a grantor Charitable Lead Trust to hold such shares because the trust is treated, for tax purposes, as being owned by the donor. Similarly, the hybrid "super grantor" trust is also treated as a grantor trust for income tax purposes and could hold subchapter S corporation shares. This is not the case, however, if a non-grantor

Charitable Lead Trust holds the shares. The non-grantor Charitable Lead Trust is a separate taxpayer from the donor. Because the trust is not a person, its ownership of subchapter S-corporation shares is not permitted under the subchapter S-corporation rules. One exception permits a non-grantor Charitable Lead Trust to own such shares. This arises if the trust chooses to make an ESBT (Electing Small Business Trusts) election. Such an election is usually undesirable for the non-grantor Charitable Lead Trust as any income earned from the shares may not be deducted as a charitable gift when transferred to charity.



Charitable Lead Trusts can be complex vehicles (certainly much more complex than presented in this brief chapter), but this complexity should not prevent advisors and fundraisers from being familiar with their, potentially dramatic, tax benefits. Although relatively rare, these trusts represent a significant share of assets held in split interest charitable trusts and an even larger share of actual charitable distributions made from such trusts.