MUST THE TRUSTEES BE SENSITIVE TO CERTAIN REQUIREMENTS?

To minimize the income taxes that a CLAT must pay, trustees should consider avoiding borrowing and debt-financed investments (mortgaged property, margined securities accounts, partnerships with debt-financed investments) as well as interests in a partnership or other pass-through entity that operates an active trade or business or holds debt-financed property. Such investments produce unrelated business taxable income or debt-financed income, and annuity payments made to charity will shelter only a portion (up to 50%) of such income from tax.

The CLAT is a taxable trust. It will be subject to income tax to the extent that its gross income exceeds its deductions. The trustees must file a federal fiduciary income tax return (Form 1041) and split-interest trust information return (Form 5227) with the Internal Revenue Service each year. The trust's Form 5227 (other than Schedule A) will be open to public inspection. The trustees may also need to file a state fiduciary income tax return depending on the situs of the trust.

The CLAT will be entitled to a charitable deduction each year for the gross income of the trust that is distributed to the Charitable Beneficiary when the annuity payment is made.

The trustees may need to register the trust and file annual reports depending on the situs of the trust. For example, the trustees of a New York CLAT are required to register the trust within six months of its funding and to file annual reports (Form CHAR004) within six months following the end of each taxable year of the trust with the Charities Bureau of the New York Attorney General's Office.

Annuity payments must be made each year in a timely manner and in accordance with the provisions in the trust document regarding frequency of payments. Failure to make the payments in a timely manner can give rise to private foundation excise (penalty) taxes.

CLATs are subject to the private foundation excise tax rules under Code section 4945 that prohibit the trustees from making taxable expenditures. If the charities are named in the trust and their shares are fixed by the terms of the trust, the trustees may simply distribute the annuity amount to the named charities in the shares stated in the trust.

If, however, the trustees have discretion to select the charities to receive the annuity amount or to determine their respective shares of the annuity amount, then the trustees must follow special procedures when making annuity payments in order to avoid incurring a penalty tax and having to try to recover the payments made. If the trustees document that the charities are 501(c)(3) tax-exempt organizations that have been classified by the IRS as "other than" private foundations because they are described in Internal Revenue Code section 509(a)(1) or (2) ("501(c)(3) publicly supported charities"), the trustees may simply pay the annuity amount to those charities. If, however, the trustees determine that a charity is not a 501(c)(3) publicly supported charity (for example, a 501(c)(3) charity that is classified as a private foundation, a private operating foundation, or a 509(a)(3) supporting organization), then the trustees must obtain certain additional documentation required by the IRS and/or use a grant agreement and require annual grant reports from the charity in connection with any annuity payments made to that charity.

The trustees may wish to prepare informal accountings and request that the beneficiaries release them from personal liability in connection with the trust's administration. The trust document describes the information to be provided in an informal account. The trustees may opt to instead file periodic court accountings, with notice to the appropriate state's Attorney General's office (which would represent all charitable beneficiaries), in order to ensure that the trustees are effectively released from personal liability in connection with their administration of the trust.