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Comments by the American Council on Gift Annuities (ACGA) and the National Committee on Planned Giving (NCPG) on the Proposed Charitable Lead Trust Regulation that requires the payments to the charity beneficiary consist of different classes of income determined on a pro rata basis.

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Submission. In addition to this signed original and eight copies of our comments, the comments have been submitted in electronic form.

About the American Council on Gift Annuities (formerly the Committee on Gift Annuities). ACGA, formed in 1927, is an IRC §501(c)(3) organization described in IRC §170(b)(1)(A)(vi). ACGA's board of directors and its legal counsel are all unpaid volunteers. ACGA is sponsored by over 1200 social welfare charities, health organizations, environmental organizations, colleges, universities, religious organizations and other charities.

About the National Committee on Planned Giving. NCPG is an IRC §501(c)(3) organization described in IRC §170(b)(1)(A)(vi). Its board members are all unpaid volunteers. NCPG is an association for professionals in the charitable gift planning field. Its members are: planned and major gifts officers for charities, fundraising consultants, attorneys, accountants, financial planners and donor advisors. NCPG has a network of more than 130 local planned giving councils that provide community-based education. NCPG represents over 10,000 individual and council members.

SUMMARY. A specific provision in a non-grantor charitable lead trust's governing instrument (or a provision of local law) that identifies the source of the amounts to be paid to the charity beneficiary (often referred to herein as an income-ordering provision) should be respected by the Service, and a deemed distribution to the charity beneficiary on a pro rata basis of each class of income (often referred to herein as a deemed pro-rata-basis requirement) should not be imposed for these reasons:

I. An income-ordering provision has an economic effect in a charitable lead trust independent of income tax consequences. Not respecting that

provision and imposing a deemed pro-rata-basis requirement could reduce the annual payments to the charity beneficiary and/or result in the trust being depleted before the end of the trust term. Further, a deemed pro-rata-basis requirement could jeopardize matching funds to be paid to the charity beneficiary. Finally, imposition of a deemed pro-rata-basis requirement may cause a trustee to delay diversifying trust assets in order to protect the trust from tax liabilities created by a deemed pro-rata-basis requirement.

II. Whether or not an income-ordering provision has an economic effect independent of income tax consequences, section 642(c) of the Code authorizes an income-ordering provision and does not require an economic effect apart from income tax consequences. The proposed regulation is contrary to the clear language of the Code, and its promulgation would exceed the authority of the Treasury and the Service to prescribe all needful rules and regulations.

III. The federal government's long-standing policy is to encourage charitable gifts and benefit and protect charities; the proposed regulation is contrary to the Code and public policy.

IV. A sampling of existing charitable lead trusts shows how charities nationwide are benefitting; the proposed regulation would reduce the benefits to charities from lead trusts and discourage their use, to the detriment of charities.

V. The final regulations should recognize income-ordering provisions of non-grantor charitable lead trusts in all cases. The Service's current revenue procedures that provide safe-harbor charitable lead trust agreements should be modified and supplemented to specifically state that income-ordering provisions of non-grantor lead trusts will be respected by the Service and safe-harbor income-ordering language should be provided.

I. AN INCOME-ORDERING PROVISION HAS AN ECONOMIC EFFECT INDEPENDENT OF INCOME TAX CONSEQUENCES.

A. For non-grantor charitable lead unitrusts. A charitable lead unitrust pays the charity beneficiary a unitrust amount equal to a fixed percentage of the fair market value of the trust assets, as redetermined each year. An income-ordering provision enables the trustee to minimize the trust's income tax liability, and thereby preserve the corpus of the trust. Not respecting an income-ordering provision (and imposing a deemed pro-rata-basis requirement) will increase the taxes that must be paid from the trust, thereby reducing the value of the lead trust's corpus and the annual percentage payments to the charity beneficiary over the term of the trust.

An income-ordering provision enables the trustee to pay otherwise taxable income to the charity beneficiary, and that beneficiary, being tax-exempt, pays no tax on the income distributed to it. Conversely, if an income-ordering provision is not respected, the lead trust itself will be taxed on the income the trust is deemed under the pro-rata-basis requirement to have retained. As a result, the value of the trust corpus will be reduced, as will the amount of the annual percentage payments to the charity beneficiary.

Consequently, an income-ordering provision always has an economic effect for the charity beneficiary of a charitable lead unitrust independent of its income tax consequences for the trust. The Service recognized the economic effects of distributions that reduce the value of a charitable lead unitrust's assets in Revenue Ruling 78-183, 1978-1 C.B. 302, in which it ruled that a unitrust that was to pay the charity beneficiary the greater of (1) 2 percent of the net fair market value of the trust property determined annually, or (2) the income of the trust, resulted in a smaller charitable contribution value than a unitrust that paid only 2 percent of the value of the trust property annually. The Service ruled that payments from the trust in excess of the percentage amount would reduce the principal value, thereby reducing future percentage payments to charity and the value of the charity's interest in the trust. Similar economic consequences will occur if the value of a trust is reduced by the payment of taxes that could otherwise have been avoided if an income-ordering provision had been given effect.

B. **For non-grantor charitable lead annuity trusts.** Not respecting an income-ordering provision (and imposing a deemed pro-rata-basis requirement) increases the risk that the trust's assets will be depleted before the end of the trust term by payment of taxes that could otherwise have been avoided if the income-ordering provision had been given effect. This is an economic effect independent of income tax consequences, and one that Treasury's own regulations recognize as a long-standing concern for annuities. See Treas. Regs. § 1.7520-3(b)(2)(i).

C. **Matching funds jeopardized.** As stated above, a deemed pro-rata-basis requirement reduces the payments to the charity beneficiary of a charitable lead unitrust and may deplete the assets of a charitable lead annuity trust before the scheduled end of the trust term. When lead trust payments made to a charity beneficiary are matched by other donors, the economic effect of any reduction in the amount paid by the trust to the charity beneficiary will be magnified when matching fund gifts that are contingent upon the amount paid by the trust are similarly reduced or are not made as a consequence. This is an additional economic effect independent of income tax consequences.

D. **Diversification.** The proposed regulation would create a Catch 22 situation for trustees of charitable lead trusts under prudent investor laws in virtually all states. Trustees have a fiduciary duty to manage and preserve trust assets. Prudent investor laws require trustees to diversify trust investments except in unusual circumstances. In making investment decisions, trustees are required to consider the purpose of the trust. Many state prudent investor statutes also list “the expected tax consequences” of contemplated investments as an important factor to be considered by trustees.

Imposition of a deemed pro-rata-basis requirement may cause a trustee to delay diversifying trust assets in order to protect the trust from tax liabilities created by a deemed pro-rata-basis requirement. For example, if a trustee needs to diversify the assets of a charitable lead trust funded with appreciated securities and tax-exempt bonds, a deemed pro-rata-basis requirement will allocate a portion of the section 642(c) deduction to the trust’s tax-exempt interest, thereby limiting the amount of gain the trust can recognize without incurring a tax liability that must be paid from the corpus of the trust. An income-ordering provision would direct that the payment to charity be satisfied first from the trust’s taxable income before making payment from the tax-exempt interest of the trust. An income-ordering provision thereby allows the trustee to diversify the trust assets more quickly by minimizing the tax consequences to the trust from the sale of appreciated securities. Accordingly, an income-ordering provision has an economic effect apart from income tax consequences because it enables a trustee to reduce investment risk to the charity beneficiary while minimizing the risk to the charity’s interest in the trust that arises when taxes are paid from the trust.

With an income-ordering provision, a trustee of a charitable lead trust can better fulfill both its fiduciary obligation to diversity the trust assets and its duty to preserve the trust assets because the trust will not be required to pay tax on taxable income that it distributed to the charity beneficiary. If a deemed pro-rata-basis requirement is imposed, it will be more difficult for a trustee to meet its diversification obligations under the prudent investor rule and its duty to manage and preserve trust assets because a deemed pro-rata-basis requirement, by its terms, forces a trustee to either pay taxes from the trust or diversify the trust more slowly, thereby increasing the risk to the charity beneficiary’s interest in the trust. A deemed pro-rata-basis requirement places a trustee between Scylla and Charybdis when determining how to fulfill its fiduciary duties to the trust and the trust’s beneficiaries. Diversifying to protect the value of the trust could result in taxes that decrease the value of the trust to the detriment of the charity beneficiary. When the purpose of a trust is to provide an annuity or unitrust interest to a charity beneficiary for a term set by the trust instrument, how can the trustee fulfill that purpose when the term of the trust may be cut short or the payment to charity reduced by the payment of income taxes that could have been reduced or avoided entirely if an income-ordering provision had been given effect?

II. WHETHER OR NOT AN INCOME-ORDERING PROVISION HAS AN ECONOMIC EFFECT INDEPENDENT OF TAX CONSEQUENCES, SECTION 642(c) OF THE CODE ALLOWS AN INCOME-ORDERING PROVISION AND DOES NOT REQUIRE THAT IT HAVE AN ECONOMIC EFFECT INDEPENDENT OF INCOME TAX CONSEQUENCES. THERE MAY BE POLICY REASONS UNDER SECTIONS 661 AND 662 OF THE CODE TO IMPOSE A PRO-RATA-BASIS REQUIREMENT, BUT AN INCOME-ORDERING PROVISION IN A CHARITABLE LEAD TRUST TO WHICH SECTIONS 661 AND 662 OF THE CODE DO NOT APPLY SHOULD BE RESPECTED BY THE SERVICE.

The proposed regulation is contrary to the language of the Code and exceeds the regulatory authority of the Treasury and the Service.

No income tax deduction is allowed under section 170(a) of the Code to the individual who funds a non-grantor charitable lead trust, and the trust itself is a taxable trust. It is, however, entitled to its own income tax deduction under section 642(c)(1) of the Code for income it pays or distributes to charity. Section 642(c)(1) of the Code provides that a trust shall be allowed a deduction in computing its taxable income for “any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c)” of the Code.

There is no provision in the Code governing the determination of the income character of the amounts paid by the trust to charity for purposes of section 642(c)(1) of the Code. Instead, Code section 642(c)(1) provides an unlimited deduction for the gross income “*which pursuant to the terms of the governing instrument is*” paid to charity. Treasury Regulations sections 1.642(c)-3(b)(1) and 1.642(c)-3(d) provide that no deduction is allowed under section 642(c)(1) for amounts paid to charity from a trust’s tax-exempt income or its unrelated business income. Treasury Regulations section 1.642(c)-3(b)(2) provides that (a) in determining whether the amounts paid for charitable purposes include particular items of income of a trust that are not included in the trust’s gross income, the specific provision of the governing instrument controls if it “specifically provides as to the source out of which amounts are to be paid” to charity, and (b) in the absence of specific provisions in the governing instrument, an amount to which section 642(c)(1) applies is deemed to consist of a pro rata share of each class of the items of income of the trust.

By contrast, sections 661 and 662 of the Code, with respect to taxable trusts, and section 664 of the Code, with respect to tax-exempt charitable remainder trusts, contain statutory provisions for determining the income character of the amounts distributed to the non-charitable beneficiaries of a trust. Code sections 661(b) and 662(b) also specifically authorize Treasury to prescribe regulations for determining how "the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income." Those regulations provide that in the absence of specific provisions in the trust, amounts paid for charitable purposes "are first ratably apportioned among each class of items of income entering into the computation of the distributable net income" of the trust "in accordance with the rules set out in paragraph (b) of section 1.643(a)-5." Treas. Regs, §§ 1.661(b)-2 and 1.662(b)-2. Treasury Regulations section 1.662(b)-2 contains a similar provision for determining the income character of the distributable net income (the "DNI") that the non-charitable beneficiaries of the trust are deemed to have received. Treasury Regulations section 1.643(a)-5(b) provides that the tax-exempt interest that a DNI beneficiary is deemed to receive is reduced by the portion of the trust's tax-exempt interest that is deemed to be included in the income paid to charity, but also provides that if the governing instrument provides as to the source out of which amounts are paid to charity, those specific provisions will control.

While Treasury is authorized to promulgate regulations regarding the effect of a trust's section 642(c) deduction on its section 661 DNI deduction and on the deemed allocation of the trust's income among the beneficiaries of the trust's DNI, it is not authorized to restrict a trust's section 642(c) deduction outside the context of sections 661 and 662 of the Code. Treasury's problem in adopting regulations that are effective to ensure that a trust cannot use section 642(c) to direct its taxable income to charity and its tax-exempt income and principal distributions to its non-charitable beneficiaries lies in section 663 of the Code, which provides that amounts qualifying as charitable deductions under section 642(c) of the Code are not included in a trust's DNI. United California Bank v. U.S., 439 U.S. 180, 191 (1978). Accordingly, in order to prevent taxpayers from creating trusts that benefit both charitable and non-charitable beneficiaries currently, and that, by including an income-ordering provision in the governing instrument, shelter the non-charitable beneficiaries from income tax on the amounts distributed to them, Treasury must find a way to equalize the treatment of all current beneficiaries of the trust. The proposed regulations do this by requiring that both the amounts distributed to charity that are deductible under section 642(c) of the Code and the amounts distributed to the DNI beneficiaries that are deductible under section 661 of the Code will be deemed to have been paid pro rata from each item of income of the trust.

The effect of the proposed regulation is to limit the charitable deduction that Congress provided to trusts "without limitation" under section 642(c)(1) of the Code and to "indirectly offend the exemption extended to charities by section 501." United California Bank v. U.S., 439 U.S. at 195. While there may be valid policy reasons and sufficient authority under sections 661 and 662 of the Code for Treasury to take such an action, there is no policy reason and no statutory authority for Treasury to override section 642(c) with a regulation limiting a charitable lead trust's deduction under section 642(c) of the Code when the sole current beneficiaries of the lead trust are charities. In such a case, there is no DNI deduction and no DNI beneficiary, and, therefore, no policy and no statutory authority for a regulation that restricts the unlimited deduction provided by Congress, and such an action violates established government policies favoring charities. See United California Bank, 439 U.S. at 194 - 96.

Helping a charitable lead trust minimize the taxes paid from the trust will protect and, in the case of a unitrust, will enhance the value of the charitable beneficiary's interest in the trust. It also respects Congress's intent in providing an unlimited deduction to trusts under Code section 642(c) for the income they distribute to charity and an unlimited deduction to charities under Code section 501(a) for the income they receive.

If regulations are needed to address income tax abuses in trusts that benefit both non-charitable and charitable beneficiaries, Treasury has the authority and the means to address those valid concerns without putting charitable interests at risk. It can adopt regulations that provide that income-ordering provisions will be deemed to have an economic effect independent of income tax consequences when a trust has no current beneficiary other than charity.

III. THE FEDERAL GOVERNMENT'S LONG-STANDING POLICY IS TO ENCOURAGE CHARITABLE GIFTS AND BENEFIT AND PROTECT CHARITABLE ORGANIZATIONS. THE PROPOSED REGULATION IS CONTRARY TO THAT POLICY.

The provisions of the Code dealing with charitable organizations and charitable contributions to them should be broadly construed in favor of charitable organizations and their donors.

The Supreme Court of the United States, in the 1937 landmark case, Old Colony Trust Co. v. Commissioner of Internal Revenue, 301 U.S. 379, involving charitable contributions by a trust estate, stated that the statute in question "should be construed with the view of carrying out the purpose of Congress — evidently the encouragement of donations by trust estates." Id. at 384. Thus, section 642(c) of the Code, which is plain on its face, should not be interpreted narrowly.

The U.S. Supreme Court concluded its opinion in Old Colony Trust Co. in favor of the trust estate as follows:

> "Capital and income accounts in the conduct of the business of estates are well understood. Congress sought to encourage donations out of gross income, and we find no reason for saying that it intended to limit the exemption to sums which the trust could show were actually paid out of receipts during a particular tax year. **The design was to forego some possible revenue in order to promote aid to charity** [emphasis supplied]**.** Here the trustee responded to an implied invitation and the estate ought not be burdened in consequence."

A long line of cases consistently hold that it is public policy to promote aid to Charity: "The exemption of income devoted to charity . . . [is] not to be narrowly construed." Helvering v. Bliss, 293 U.S. 144 (1934). See also Kibbe v. City of Rochester, 57 F.2d 542, Roche's Beach, Inc., v. Commissioner, 96 F.2d 776, Faulkner v. Commissioner, 112 F.2d 987, Schoellkopf v. U.S., 36 F.Supp. 617 (D.C.N.Y. 1941), aff'd. 124 F.2d 982 (2d Cir. 1942).

"The public policy behind section 642(c) is to encourage private donations to charities." Hartwick College v. U.S., 611 F. Supp. 400, 405 (N.D.N.Y. 1985), aff'd. 801 F.2d 608 (2nd Cir. 1986).

While public policy considerations are not directly mentioned, they are at the heart of the U.S. Supreme Court's ruling in United California Bank v. U.S., 439 U.S. 180 (1978). There, the Court held that long-term capital gains that were paid or permanently set aside for charitable purposes within the meaning of Code section 642(c) under the terms of Walt Disney's Will should be excluded from the total net long-term capital gains for the purposes of calculating the capital gains tax due. The effect of including such gains in the tax base for the purposes of determining the income tax would have been to subject the estate to a higher income tax than if the same portion of long-term capital gains had been distributed to non-charitable beneficiaries, thereby reducing the residuary estate. The additional tax burden would have been borne by either the charitable beneficiaries or the non-charitable beneficiaries and, as the Court correctly noted, neither result could have been intended by Congress. Allocating the burden of the additional tax upon the property passing to the charitable beneficiaries would, in the words of the Court, "contravene the statutory provision for the deduction of charitable set-asides — §642(c) provides for their deductibility "without limitation" — and would indirectly offend the exemption extended to charities by § 501." United California Bank v. U.S., 439 U.S. at 195.

IV. SAMPLING FROM A SPOT CHECK OF ACGA'S AND NCPG'S MEMBERS ON HOW INDIVIDUAL CHARITIES ARE CURRENTLY RECEIVING PAYMENTS FROM CHARITABLE LEAD TRUSTS AND THOSE BENEFITS WILL BE DECREASED IF AN INCOME-ORDERING PROVISION IS NOT RESPECTED.

Imposing a deemed pro-rata-basis requirement, which, by its terms, is less tax-efficient for a trust than an income-ordering provision, risks reducing or cutting short the payments to the charity beneficiaries. That is an economic effect independent of income tax consequences. The consequences are magnified when a lead trust is part of a matching gift campaign. The $1 million lead trust for a University (described immediately below) tells about matching State funds to be contributed to the University based on the lead trust's distributions to the University. An income-ordering provision minimizes the taxes to be paid from a lead trust, thereby protecting the value of the charity beneficiary's interest in the trust and the matching gifts that are based on that interest.

Sampling of existing charitable lead trusts:

- This $1 million CLT is especially beneficial to our University in that the trust income to the University (total of which will be $600,000) will be matched by the State with $400,000 to create a $1 million endowed chair.

- A private school has a $5 million lead trust (20-year term) that pays 7.36% which is unrestricted.

- A religious organization is the beneficiary of a $300,000 lead trust funded with cash last December. It is paying out an annual annuity of $60,000 for a term of five years to a church. Any remaining funds after the term will go to the donor's child.

- A family came into sudden wealth following the sale of a business. The parents had never shared the potential wealth of their family with their two children — then "starving" college students in their early 20's. The parents felt overwhelmed by the sudden wealth distribution they received, and were searching both for effective tax strategies and for a vehicle that would help their children become acclimated to the wealth they would one day be responsible for stewarding. One of the first strategies they employed was a charitable lead trust that since 2002 has distributed its total annual distribution each year to a community foundation. The parents named the two children as the sole advisors to the fund, so they would bear the responsibility for making charitable recommendation decisions. The parents felt that the best way to prepare their children for the ultimate responsibility of the wealth that would come to them would be to give them 20 years of experience (the term of the trust) as charitable stewards, with the guidance and expertise of the community foundation to support them. This strategy has proven to be a huge success in meeting the goals of this family. The children have steadily grown in their comfort and sophistication as philanthropists, and with the community foundation's support they have together granted nearly $300,000 over the past 6 years to a variety of worthy organizations across the country.

- A small college in the past 4½ years has received $119,315 from a lead trust — a $5,000,000 trust that includes a number of other beneficiaries. The payments support diverse religious education and activities on the campus.

- The gift was from an alumnus from the Class of 1924 of a secondary school. Having no direct heirs, after his death in 1984, most of his estate went into a lead trust with three charitable beneficiaries. The current value of the trust is approximately $18 million and annual income to the school has ranged between $375,000 and $800,000 over the years. The trust ends when the last of the donor's direct nieces and nephews passes away. Most of these descendants are in their 60s now. The managers of the trust (a local bank and trust company) have been very positive advocates for the school. They provide quality and timely financial statements and the performance under the trust has been adequate to good.

- A zoo and botanical garden has three lead trusts. The amounts placed in trust: $131,587, $133,757, $200,000 and the payout percentages: 16.6%, 16.6%, 13.08% respectively. The trust income is being used for first education capital, an endowed fund for programs, and an education endowment for programs.

- A humanitarian organization is the beneficiary of 12 lead trusts and uses the substantial annual payments for its mission dedicated to working with children, families, and their communities worldwide to reach their full potential by tackling the causes of poverty and injustice.

- A $2.5 million trust, 7.7% payout, benefits the College of Medicine. And a $150,000 trust, 6.7% payout, benefits the University Library.

- A $1 million (8%) lead trust supports medical research at a medical school.

- A health clinic receives 10% of the payout of a lead trust that it uses for delivery of its services.

- A group of 4 trusts pays out approximately $44,000 per trust annually to support a palliative care center for children with terminal cancer.

- Two trusts support a wide variety of organizations, ranging from a church to the local symphony to breast cancer research to the Boys and Girls Club.

- Another trust distributes over $210,000 annually to support literacy, food banks, the homeless and hospice care.

- A small community foundation is the beneficiary of a charitable lead annuity trust that will pay out $1.5 million over 15 years ($100,000 per year). The first five years of funds are for a specific program; the remainder is unrestricted.

- A small university has seven lead trusts established by one donor. Each was funded with approximately $75,000 in 2000. Each is meant to eventually benefit minor children and have staggered distribution dates going to 2018. The payout rate is 8%. Trust income is going to benefit a research fund for the sciences.

- A state university has five lead trusts with a total value of $5,659,674 (three with 7% payout and two with 8% payout). The annual payments provide scholarship support, support for the performing arts, faculty awards, support for the Alumni Center, the National Kidney Foundation and a local church.

- A small community foundation has one charitable lead trust. The amount placed in trust was $126,594. The payout percentage is 5%. The trust income is being used to provide grants to nonprofit organizations recommended by the donor and approved by the board of trustees.

- A university has a $1 million lead trust with a payout for 10 years at $100,000 per year. The income is being used for its new science building.

- A university benefits from a $200,000, 7% lead trust with the payout used to support library collections and athletics.

- A major university benefits from seven lead trusts. The beneficiaries are: the school of business; the Children’s Hospital, student scholarships, the history department and the school of education.

- A state university has an 8%, $1,705,308 lead trust that is used for scholarships.

Imposing a deemed pro-rata-basis requirement in the above trusts could reduce the payments to the charity beneficiaries and possibly cause the trusts to be depleted. That has an economic effect independent of income tax consequences.

V. CONCLUSION.

A. The final regulations should recognize income-ordering provisions in non-grantor charitable lead annuity trusts and unitrusts in all cases or, at a minimum, in all cases in which distributable net income under sections 661 and 662 of the Code is not involved.

B. Rev. Proc. 2007-45 and 2007-46 (providing safe-harbor charitable lead annuity trust agreements) and Rev. Proc. 2008-45 and Rev. Proc. 2008-46 (providing safe-harbor charitable lead unitrusts agreements) should be modified and supplemented to provide that an income-ordering provision will be respected by the Service.

A suggested safe-harbor income-ordering provision for a lead unitrust follows:

Charitable lead unitrust — manner of payment. It is my intention that the unitrust amount be paid in a manner that will secure the largest charitable deduction allowable in determining the taxable income of the trust to ensure that the lead trust will have sufficient assets to pay the unitrust amount in full throughout the entire trust term and that the value of the trust for determining the annual unitrust amount won't be unnecessarily decreased by the tax payments that reduce the trust corpus. Accordingly, I direct that the unitrust amount shall be paid from the taxable income and gains of the lead trust (as determined before allowance of any charitable deductions under sections 642(c)(1) and 512(b)(11) of the Code) as follows: first, from the ordinary taxable income of the lead trust (including short term capital gains) which is not unrelated business income (as defined in section 681 of the Code) and, to the extent the unitrust amount is not so satisfied, then from (i) fifty percent (50%) of the unrelated business income if the charity beneficiary is described in section 170(b)(1)(A) of the Code, or from thirty percent (30%) thereof if it is not so described, (ii) the capital gains of the lead trust other than short term capital gains (and first from those categories of capital gains which would otherwise be taxed at higher rates pursuant to section 1(h) of the Code), (iii) the balance of the unrelated business income, (iv) the tax-exempt income, and (v) the principal of the lead trust, in that order. Any net income of the lead trust for a taxable year not paid to the charity beneficiary shall be added to principal.

A suggested safe-harbor income-ordering provision for a lead annuity trust follows:

Charitable lead annuity trust — manner of payment. It is my intention that the annuity amount be paid in a manner that will secure the largest charitable deduction allowable in determining the taxable income of the trust to ensure that the lead trust will have sufficient assets to pay the annuity amount in full throughout the entire trust term. Accordingly, I direct that the annuity amount shall be paid from the taxable income and gains of the lead trust (as determined before allowance of any charitable deductions under sections 642(c)(1) and 512(b)(11) of the Code) as follows: first, from the ordinary taxable income of the lead trust (including short term capital gains) which is not unrelated business income (as defined in section 681 of the Code) and, to the extent the annuity amount is not so satisfied, then from (i) fifty percent (50%) of the unrelated business income if the charity beneficiary is described in section 170(b)(1)(A) of the Code, or from thirty percent (30%) thereof if it is not so described, (ii) the capital gains of the lead trust other than short term capital gains (and first from those categories of capital gains which would otherwise be taxed at higher rates pursuant to section 1(h) of the Code), (iii) the balance of the unrelated business income, (iv) the tax-exempt income, and (v) the principal of the lead trust, in that order. Any net income of the lead trust for a taxable year not paid to the charity beneficiary shall be added to principal.

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