THE NAUTILUS GROUP®

GUIDEPOST

Charitable Lead Trusts

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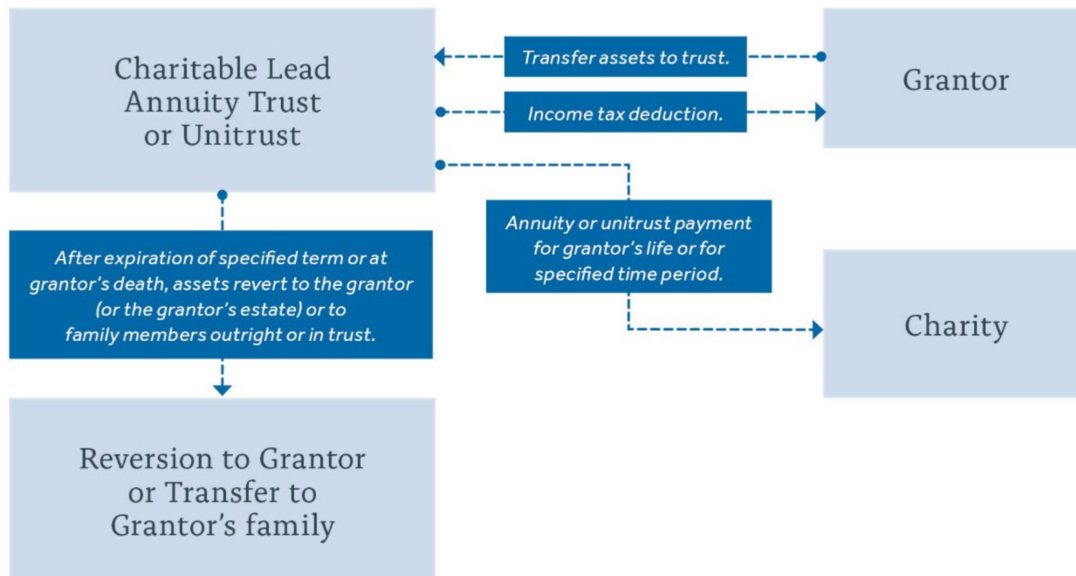
A charitable lead trust (CLT) can be an attractive tool for making gifts to family members with little or no transfer tax. The grantor designates a charitable beneficiary to receive annual payments for a period of time with the remainder interest either reverting back to the grantor or passing to other non-charitable beneficiaries, such as the grantor's heirs, directly or in trust. A grantor can establish a CLT during life or at death through a will. Transfers to a CLT may provide income, gift, or estate tax benefits.



Description and operation

A CLT may be appropriate where:

- A charitable intent exists;
- There exists property that a donor would like to retain, but the donor does not require the current income from the property;
- A grantor would like to pass property to heirs in the future at reduced gift or estate tax; and/or
- A grantor would like to create an immediate income tax deduction to offset unusually high taxable income in a particular year.

Two types of CLTs exist: charitable lead annuity trust (CLAT) and charitable lead unitrust (CLUT). The primary difference between them is the method of calculating the payment to charity, as detailed below. Unlike CRTs, CLTs do not have a minimum or maximum payout requirement.

The charity's income interest must be a specified term of years, the life of an individual(s), the life of an individual(s) plus a term of years, or the lesser of a term of years or the life of an individual(s). Also, individual state "rule against perpetuities" statutes may further limit the trust term.

The trust instrument can either designate a charitable beneficiary or can allow the trustee to make the selection. The charity selected must be a valid charitable organization under federal law. If the grantor retains a continuing right to designate the charitable beneficiary after the trust is established, the trust assets will be included in the grantor's taxable estate.

CLAT versus CLUT

- A CLAT pays the charity a fixed annuity amount each year, which can be a fixed dollar amount or a percentage of the initial gift to the trust. The payment is determined at the creation of the trust; therefore, additional contributions cannot be made to a CLAT. A CLAT may be preferable if the grantor expects the assets to increase in value, since appreciation favors the non-charitable beneficiaries.
- A CLUT pays the charity a percentage of the fair market value of the trust assets, re-calculated annually. With a CLUT, additional contributions can be made after the CLUT's creation since the payments are recalculated each year. With a CLUT, appreciation of the assets in a CLUT favors both the charity and the remainder interest. The CLUT must be revalued each year, which is costly.

Life insurance in a CLT

A question that often arises from grantors is whether a CLT can purchase an insurance policy on the grantor's life to leverage the amount of assets ultimately passing to the grantor's heirs. However, the charitable split dollar rules of Internal Revenue Code (IRC) §170(f)(10) disallow a charitable income tax deduction for amounts transferred to a charitable organization that are used directly or indirectly to purchase life insurance that will benefit the grantor or his/her family. While there has been no formal determination that a CLT is a "charitable organization" that falls under these split dollar rules, there is a risk that the IRS will determine that it is. If it is desired that a CLT should hold life insurance on the grantor, the more conservative, but untested, approach may be for the grantor to contribute a paid-up policy on his/her life in addition to the cash or other assets that could be used to service the lead interest payments.

Tax considerations

Income tax – General

Unlike CRTs, the CLT is a taxable entity. The type of CLT determines which party will be liable for income tax generated by trust assets and if an income tax deduction will be available.

If the CLT is a **grantor** trust, the grantor is treated as the owner of the trust for income tax purposes. The grantor can claim an income tax deduction at trust inception for the present value of the charity's income interest. Since the charitable lead interest is a gift "for the use of" charity rather than a gift "to" charity, the grantor's deduction will be limited to 30% of AGI (20% for gifts of appreciated property), with a 5-year carry over. The deduction could be further limited to the grantor's cost basis if the charitable beneficiary is a private foundation. The grantor is taxed personally on all trust income. No additional income tax deduction is allowed as the grantor CLT makes payments to the charitable income beneficiary. As such, grantor CLTs are used when it is anticipated that the grantor's tax savings at inception exceed the present value of the tax attributable to the trust's income over the trust term.

If the CLT is a **non-grantor** trust, the grantor is *not* entitled to an income tax deduction and is *not* taxed on trust income. Instead, the trust is taxed as a complex trust and the trust receives an income tax deduction for trust income paid to the charitable lead beneficiary. All trust income above the annuity or unitrust lead interest paid to charity is taxed to the trust. The non-grantor CLT is commonly used when reduction of transfer tax (rather than mitigation of income tax) is desired.

Note that if the CLT ceases to be a grantor trust (due to the grantor's death or otherwise), the charitable income tax deduction will be recaptured. The amount of the recapture is the initial deduction taken less the discounted amounts that were actually paid out to the charitable recipient.

Income tax – Charitable deduction limits

Contributions to a grantor CLT are subject to the reduced deduction limits of 30% of AGI (20% of AGI for long term capital gain property) since the gift is "for the use of" a charity rather than "to" a charity. In addition, the deduction may be further reduced by the grantor's cost basis if the charitable recipient is a private foundation.

While many commentators agree that the 5-year carryover of unused deduction applies to contributions to a CLT, the IRS took the position in PLR 8824039[1] that, at least in the context of a CLT benefitting private foundations, the carryover was not available. It also is possible that the IRS could take the position that the carryover is not available for contributions to any CLT (regardless of the charitable beneficiary) since contributions are "for the use of" a charity rather than "to" charity.

Gift and estate tax

Gift tax: If the CLT is created during the grantor's life, the value of the gift to the remainder beneficiaries is reduced by the present value of the income stream passing to the charity.

Estate tax: If the grantor's last will and testament creates the CLT at death, the grantor's estate may claim an estate tax charitable deduction for the present value of the interest passing to charity. A CRT created during life can be included in the grantor's estate when he/she retains the right to name the charitable beneficiary after the trust is established, or when the trust assets can revert back to the grantor.

Valuations of the charitable interest: In either case, the computation is based on an interest rate issued monthly by the Treasury Department pursuant to IRC §7520 (known as the "Section 7520 rate"). The grantor (or the estate) can select the current month's Section 7520 rate, or the rate from either of the two preceding months. Bear in mind that the lower the Section 7520 rate used, the greater any charitable deduction will be.

If the grantor sets the payout to charity high enough, the charitable deduction can equal the total current value of the assets transferred. As a result, the arrangement would result in no gift or estate tax, even though family members would receive the trust remainder at some point. The fact that CLTs can be "zeroed out" is the advantage that motivates many CLT transfers. To the extent that trust assets grow faster than the Section 7520 rate, the amount passing to remainder beneficiaries increases.

Generation skipping transfer tax

Generation skipping transfer (GST) tax exemption cannot be allocated to transfers during any estate tax inclusion period (ETIP). The annuity term of a CLAT is an ETIP, meaning the grantor cannot allocate GST tax exemption to the trust until the earlier of the end of the annuity term or upon the grantor's death. A CLUT may be preferable if the trust will benefit skip persons since the grantor can allocate GST exemption more efficiently on the initial transfer.

Income tax compliance

CLTs must file IRS Form 5227, Split-Interest Trust Information Return annually.

[1] A private letter ruling (PLR) is issued by the IRS National Office in response to a specific request from a taxpayer as to the tax consequences of a proposed transaction. A PLR applies tax laws to specific facts only, is solely for the taxpayer who requested it, and should not be relied upon as authority by other taxpayers. Additionally, PLRs may later be revoked by the IRS. As such, PLRs do not carry the stamp of law, but they do give an indication of the IRS's current thinking towards a specific type of transaction. Reference to the PLR herein is for informational purposes only.

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