Charitable Lead Trusts

A charitable lead trust ("CLT") is an estate planning strategy generally used by someone looking to provide a current income stream to a charity for a lifetime or a certain number of years, and then leaving any remaining assets of the trust to individual beneficiaries either outright or in trust. There is the potential for a charitable deduction for the amount paid to the charity, but certain requirements must be met. It is possible, but rare, that the creator of the trust can also be the remainder beneficiary. Here we will discuss the most common CLT which involves you leaving assets to other individuals after the charitable income stream ends.

Creating a CLT

If you are interested in creating a CLT it is recommended that you work with a competent estate planning attorney to create your trust. The trust is an irrevocable trust, and once created the trust will pay an income stream to the charity (ies) you select. The income stream must either be a "unitrust" amount (the payment is a percentage of the fair market value of the trust with the fair market value recalculated annually) or an "annuity" amount (the payment is a fixed value based on a percentage of the initial value of the trust).

The Charitable Lead Unitrust is commonly called a "CLUT" and the Charitable Lead Annuity Trust is commonly called a "CLAT." The primary distinctions are that the CLUT payment will fluctuate depending on the value of the trust throughout the years, while the annuity payment will generate a fixed amount paid to the charity. The CLAT is a more commonly used payment method. The charity's income stream can last either during the term of someone's lifetime, or for a term of years not to exceed twenty years. Typically, the term of years approach is most common.

At the end of the term of the charity's income stream your named beneficiaries will receive whatever is remaining in the trust. There are complex generation-skipping tax issues if your remainder beneficiary is a grandchild or more remote descendant, so be sure to consult with your tax and legal professionals should you wish to create a CLT for such beneficiaries.

Tax Consequences of a CLT

When you create a CLT and you name individuals that will receive the assets after the end of the charitable income stream you are making a taxable gift to those remainder beneficiaries. Moreover, because the gift isn't a "present interest gift" you cannot apply the annual exclusion gift amount (currently $16,000). The value of the gift is an actuarial calculation of the present value of the income stream to the charity and the estimated present value of the remainder

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interest to the beneficiary. The gift value depends on the amount of the annual payout to charity (generally the higher the charitable income payout, the lower the taxable gift), the term of the trust and the published IRS interest rate for the month.

After the calculation, the assets estimated to remain for your beneficiary will likely require a gift tax return (form 709) be filed and either the use of your lifetime exclusion amount or the payment of gift/estate tax for the transfer amount.

It is possible to "zero out" a CLT. In other words, you can stipulate the charitable income stream at such a level that the actuarial calculation results in no assets to be left to your beneficiaries. Consequently, no taxable gift is made.

Charitable Deduction Opportunities

Creating a CLT does not immediately create a charitable deduction for you. However, if you are willing to make the CLT a "grantor trust" for income tax purposes, you may be able to receive a charitable deduction. There are several legal techniques and consequences for creating a "grantor trust" and you should work with your tax and legal advisors should you consider this technique.

Generally, in a "grantor trust" you, as grantor, are liable for all income tax consequences of the trust during the trust's existence. What that means is that you would be responsible for the tax liability of the trust's investments while the charity receives the income stream even though you do not receive any assets from the trust. Therefore, if the CLT has ordinary income and/or capital gains greater than the income stream to the charity during the trust term you are responsible for paying those taxes.

Gift Tax Calculation Example

Hypothetically you gift $100,000 to a CLT with your child as the remainder beneficiary. Let's assume that the actuarial calculation resolves that the charitable interest has a present value of $80,000 and the remainder interest has a present value of $20,000. In this scenario, you have made a $20,000 gift to your child and consequently used $20,000 of your federal gift tax exclusion amount, if applicable; otherwise you owe gift tax.

For example, let's assume you create a CLAT that pays the charity $5,000 each year. If the trust were to have $6,000 of taxable income, you would be able to deduct the $5,000 payment to the charity but would owe tax on the remaining $1,000 of income at your prevailing tax rates. Because of this ongoing and unknown liability, consider whether to elect or forego the charitable deduction option for a CLT in consultation with your tax and legal advisors.

Strategic Considerations for a CLT

The most important driver for creating a CLT should be that you intend to make present charitable gifts. There are also some other strategic benefits to CLTs:

- You can witness the good your philanthropy can bring to your favorite charities as you have created an immediate income stream for the charity's benefit. Using a charitable

remainder trust or making gifts at your death, while philanthropic, do not allow you the opportunity to witness the benefit of your giving.

- In a low interest rate environment CLTs offer potential transfer tax opportunities. Simply, if the interest rate used in the actuarial calculation of the gift to the beneficiaries is low, and the trust's investments can outperform those rates, it is possible to a have "transfer tax free" assets pass to your remainder beneficiaries.

  Applying our example above, ($100,000 trust with an 80/20 present value split), let's assume the investments outperform the actuarial calculation and at the end of the trust $30,000 remains and is passed to your beneficiaries. The IRS does not require a review of this transfer, and therefore the $10,000 increase passes to your remainder beneficiaries transfer tax free. Of course, the opposite may also be true. If the trust underperforms and only $10,000 remains at its termination, you've transferred $10,000 in assets using $20,000 in gift tax costs.

- The "grantor trust" rules can provide other transfer tax benefits as well. If you have a "grantor trust" your tax liability is not considered a gift to anyone; rather it's you paying your tax bill. Because of this you essentially are passing a tax-free benefit to your remainder beneficiaries because the assets held and invested inside of the CLT have not borne any income tax liability. Moreover, by paying the tax you're lowering the value of your estate for estate tax purposes, meaning any potential estate tax liability may be less. Traditionally income tax rates are less than estate tax rates, so "choosing" to pay income taxes in lieu of estate taxes may net more to your beneficiaries in the end.

Conclusion

If you are charitably inclined and you would like to provide an income stream to a charity today, consider implementing a CLT. Consult with your tax and legal advisors, along with your financial advisor, to see if a CLT fits in your specific situation. We are happy to work with your team of professionals to help implement a plan that's appropriate for you. ■

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