

Charitable Lead Trusts for Advisors

Charitable lead trusts (CLTs) are designed to provide income payments to at least one qualified charitable organization for a period measured by a fixed term of years, the lives of one or more individuals or a combination of the two; after which, trust assets are paid to either the grantor or to one or more noncharitable beneficiaries named in the trust instrument. Also referred to as a "charitable income trust," the term "charitable lead trust" is used more commonly because the payment of the income interest to charity precedes or leads the payment of the remainder interest.

Historically, the charitable lead trust has been used not only to make very substantial charitable gifts, but also to pass wealth partially or entirely free of estate and gift taxes to family members.

The lead trust can likewise be helpful when a person wants to make a charitable gift over several years, but then would like to have the trust assets returned.

For the individual concerned with retirement planning as well as estate planning, therefore, the lead trust can be a powerful tool. This section provides for the planner an overview of the tax and financial considerations that go into the design of a lead trust.

To aid planners, the Internal Revenue Service has issued sample forms for drafting inter vivos and testamentary charitable lead trusts. See Rev. Proc. 2007-45 and 2007-46.

Basic Tax Law Rules

Payout: In order for the charitable interest in a lead trust to qualify for income, gift or estate tax charitable deductions, the payout must take the form of a "guaranteed annuity interest" or a "unitrust interest." See IRC section 170(f)(2)(B).

A guaranteed annuity interest is basically the right to receive a fixed dollar payment at least annually (for example, \$50,000 a year, regardless of trust income). A unitrust interest is the right to receive each year a fixed percentage of the annually determined value of trust assets (for example, 5% of the determined value of trust assets).

The regulations do not allow for a "net income" lead unitrust—i.e., a lead unitrust that pays out the lesser of its net income for the year or the specified unitrust percentage amount. By way of contrast, such a variation is permissible with a charitable remainder unitrust. Unlike charitable remainder trusts, however, lead trusts are not subject to minimum or maximum payout rates or to a time limit of 20 years if they are for a term of years rather than for the lifetime of one or more persons.

Tax status of the trust: Income not distributed to charity but accumulated by a lead trust is taxed to the trust at normal trust rates except in the case of a grantor lead trust, as discussed below. (Lead trusts can be divided into two categories: grantor and non-grantor trusts.) In other words, the lead trust is not exempt from federal income tax. It pays tax on its undistributed capital gains, as well as on its undistributed ordinary income.

Non-grantor lead trusts: A non-grantor trust is treated for federal income tax purposes as a separate taxpayer, as discussed in the preceding paragraph. An individual who establishes a non-grantor trust is not considered the owner of trust assets or income. Therefore, income distributed by the trust to a charity is effectively shifted from the individual to the charity (a tax-exempt entity, which pays no tax on the income it receives).

Under IRC section 170(f)(2)(B), an individual receives no federal income tax charitable deduction for the gift of an "income" interest in a charitable lead trust unless he or she is considered owner of the interest under the grantor trust rules. In the case of a non-grantor trust, the donor is not considered the owner of the charitable "income" interest and is thus not entitled to an income tax charitable deduction with respect to the charitable interest.

Grantor lead trusts: It is possible to set up a lead trust as a grantor trust—for example, by the donor's retaining a reversionary interest in the trust. In this case, the income tax consequences to the donor are basically the opposite of those resulting from the creation of a non-grantor lead trust.

The donor receives an up-front federal income tax charitable deduction for the initial present value of the payments to be made by the trust to charity. The computation of this present value is discussed below.

The donor, not the trust, reports and pays tax on all trust income, even the income distributed to charity, with no offsetting yearly charitable deduction for this income. It should be noted that if the trustee voluntarily holds just tax-exempt bonds, there will be no taxable income for the donor to report with respect to the trust.

Effect of higher marginal income tax rates on grantor and non-grantor lead trusts: Higher marginal income tax rates tend to make the non-grantor lead trust more attractive because, as the donor shifts income to charity with such a trust, it costs the donor less after tax to do so.

In the case of a grantor lead trust, higher marginal income tax rates have historically increased the tax benefits from the donor's income tax charitable deduction. But, at least to the extent a grantor lead trust has ordinary income (income which the donor must include on his or her income tax return), higher marginal income tax rates tend to detract from the attractiveness of the grantor lead trust.

The "best of both worlds," insofar as the grantor lead trust is concerned, is for the donor to create the trust in a year when facing a high marginal tax rate (against which the donor can make good use of his or her income tax charitable deduction) and for the donor to drop into a relatively low tax bracket for subsequent years when any income of the trust must be reported.

Determining the Present Value of the Charitable Payout

The initial present value of the payout to charity from a lead trust is the amount of the donor's gift to charity for income, gift and estate tax purposes.

AFMR: This present value is determined using IRS tables based on the adjusted applicable federal midterm rate (AFMR) in effect for the month the trust is created or, at the donor's election, for either of the two preceding months. See IRC section 7520(a).

Effect of the AFMR on annuity and unitrust payouts: Because the present value of any fixed annuity varies inversely with the interest rate used to determine the present value (the interest rate in the case of a lead trust being the AFMR), the lower the AFMR, the higher the present value of the payout from a charitable lead annuity trust and vice versa.

Thus in a climate of low interest rates, the charitable lead annuity trust gains in attractiveness. The charitable lead unitrust also tends to gain in attractiveness in a climate of low interest rates, but only slightly because the present value of a unitrust type of payout is basically independent of any assumed discount rate.

Example: Assume that a donor establishes a \$500,000 charitable lead annuity trust that is to pay 6% or \$30,000 a year to a charitable organization for 20 years. The present value of the annuity payout is equal to \$463,000, assuming a 2.6% AFMR. If the AFMR is assumed to be 4%, the present value of the annuity payout is approximately \$407,000.

It should be noted that if the lead trust in question is a grantor lead trust, the donor can claim the \$463,000, or \$407,000 present value as a charitable contribution for federal income tax purposes, subject to the percentage limitations on the income tax charitable deduction. The donor will, however, be subject to income tax on the amount of the payments to charity as they are received unless they are tax-exempt or paid from principal.

The same amount also qualifies for the federal gift tax charitable deduction.

Estate and Gift Tax Considerations

A closer look at the federal gift tax charitable deduction. The gift to charity of a "guaranteed annuity interest" or a "unitrust interest" in a lead trust qualifies for the gift tax charitable deduction.

To put the gift tax charitable deduction in perspective, consider a lead annuity trust funded with \$500,000 that is to pay \$25,000 a year to charity for 20 years. The gift tax charitable deduction for such a trust is approximately \$386,000, assuming a 2.6% AFMR.

If the lead trust provides an irrevocably vested remainder interest to the donor's daughter, upon creating the trust the donor is deemed to make a gift to her equal to \$114,000: \$500,000 minus \$386,000.

This gift does not qualify to any extent for the annual gift exclusion (\$15,000 as of 2018) under IRC section 2503(b), because the gift is of a future interest. Federal gift tax on the gift, however, may be avoided to the extent the donor has any remaining gift tax exemption amount.

When trust assets appreciate: To take this example one step further, assume that over the course of the 20-

year trust term, the value of the trust assets increases from \$500,000 to \$750,000 due to capital appreciation, reinvestment of after-tax income or both.

The \$250,000 of growth in the value of trust assets passes to the donor's daughter without being subject to federal gift or estate taxes. In this way, the lead trust has served to accomplish an "estate freeze."

The donor's daughter will take the trust's "basis" in the assets she receives from the trust. If the basis is relatively low, the daughter will face a sizable capital gain if/when she sells the assets. To put this capital gain in perspective, however, one must compare the capital gains tax rate the daughter is likely to pay with the estate tax rate that would have been applicable to the appreciation had the lead trust not been created. The most favorable federal capital gains tax rates are a fraction of the highest estate tax rates, thereby adding to the attractiveness of the lead trust as a planning tool in certain circumstances.

Expanded Gift Tax Exemptions

Tax legislation enacted in 2011 set the lifetime gift tax exemption amount at \$5 million per person, indexed for inflation beginning in 2012. In 2017 Congress acted to double this amount. The exemption adjusts to an estimated \$11.18 million per person for 2018. Check for current exemption amounts.

The charitable lead trust can be an excellent way to make charitable gifts while maximizing the benefit of lifetime exemptions currently available.

For example, assuming a 2.6% AFMR, a charitable lead annuity trust funded with \$20 million that makes fixed charitable gifts of 5.1% per year for 10 years results in a charitable gift tax deduction of \$8.9 million, leaving a \$11.1 million taxable gift. If the donor has the full \$11.18 million exemption available it will serve to completely shield that the gift amount from gift tax, while he will have made charitable gifts totaling over \$10 million, while effectively transferring \$20 million or whatever other amount remains in the trust in 10 years. This plan nearly doubles the amount of an \$11.18 million gift tax exemption while making a very substantial charitable gift. A couple could transfer up to \$40 million tax free using the assumptions of this example.

The Non-Reversionary Grantor Lead Trust

In the wake of earlier tax legislation, many planners believed that the only permissible way to create a grantor lead trust was to have the trust assets revert to the donor at the end of the trust term. Such a trust may be consistent with the donor's objectives, but it does not serve to pass wealth to children or other family members.

The IRS has ruled privately, however, that it is possible to establish a qualified non-reversionary grantor lead trust: a trust that both provides the donor with an income tax charitable deduction and serves to pass wealth at reduced gift and estate tax costs to family members.

In one of these rulings, a charitable lead unitrust was made a grantor trust through the donor's retaining the right to reacquire trust property by substituting other property of equivalent value. See Letter Ruling 9224029. In a subsequent ruling, someone other than the donor who was not an "adverse party" with respect to the donor had such a power (again, the trust was a charitable lead unitrust). See Letter Ruling 9247024.

In both rulings, the IRS took the position that (1) nothing in the trust agreement would cause the trust assets to be included in the donor's gross estate for federal estate tax purposes if the donor died during the trust term and (2) the charitable interest in the trust qualified for the federal gift tax charitable deduction.

The first ruling is difficult to understand because if the donor exercised his or her power to exchange property with the lead trust, the donor and the trustee would violate the self-dealing prohibition. The second ruling makes more sense because such an exchange, if between the trust and a party who is not a "disqualified person" with respect to the trust, would not be self-dealing.

Another interesting ruling is Letter Ruling 199922007.

Miscellaneous Planning Considerations and Questions

Generation-Skipping Transfer (GST) Tax considerations: If a lead trust, upon termination, distributes its assets to one or more "skip persons," the distribution is considered a taxable termination for federal (and possibly state) GST tax purposes. The federal GST tax rate applicable to the amount distributed depends on whether the trust is a lead annuity trust or a lead unitrust.

If a lead unitrust, the GST tax rate (under current law) is basically equal to:

$$TR (1 - E/[FMV - CD])$$

“FMV” is the value of the assets transferred to the trust, determined as of the date of transfer. “CD” is the gift or estate tax charitable deduction allowed with respect to the trust. “E” is the amount of the donor’s GST tax exemption allocated to the trust. “TR” is the highest applicable federal estate tax rate in effect.

In the case of a lead annuity trust, the GST tax rate (under current law) is equal to:

$$TR (1 - [(E \times F)/fmv])$$

“E” is the amount of GST tax exemption allocated to the trust. “F” is the compound interest factor corresponding to the length of the trust term and the IRS discount rate applicable to the trust at the time the trust is created. The quantity “fmv” is the fair market value of the assets passing from the trust at the time of its termination. One possible disadvantage of a lead annuity trust from a planning standpoint is that because “fmv” is not known until the trust terminates, there is no way to know the GST tax rate applicable to the trust until the trust terminates.

“Recapture” of federal income tax charitable deduction: The income tax charitable deduction allowed with respect to a grantor lead trust is “recaptured” in part if the donor dies during the trust term. The amount recaptured—that is, the amount that has to be reported as income on the donor’s final income tax return—is equal to the charitable deduction allowed minus the discounted value of the payments made by the trust to charity before the donor’s death. See Treas. Reg. section 1.170A-6(c)(4).

Ordering of payout: Attorneys who draft lead trust agreements commonly provide that the trust payout shall consist first of ordinary income, second of capital gain, third of tax-free income and fourth of corpus. The purpose of this type of provision is to “flush out” of the trust as much taxable income as possible.

The IRS, however, disregards such ordering provisions and takes the position that the payout consists of a proportionate amount of each category of income making up the trust’s distributable net income.

Unrelated business income: One of the significant limitations on a charitable lead trust is that the trust (that is, a non-grantor lead trust) cannot take an income tax charitable deduction for unrelated business income (UBI) that it distributes to charity. See IRC section 681.

This problem can arise, for example, if a lead trust is funded with a parking lot—the income from which is UBI.

Commutation of the payout: Sometimes an individual who creates a lead trust wants to be able to “pay off” the charitable interest “early” by having the trust distribute to the charitable recipient in a lump sum an amount equal to the present value of the charitable interest over the balance of the trust term.

The IRS, however, takes the position that such a commutation of the charitable interest may not be carried out and that a commutation provision may not be included in a lead trust agreement, unless the commuted payout is equal to the total amount remaining to be paid to charity not discounted for time value.

Lead trusts for life: Effective January 2001, IRS requirements provide that for a lead trust established to run for an individual’s life, the individual must be the trust’s donor, the donor’s spouse, a lineal ancestor of all the trust’s remainder beneficiaries or the spouse of a lineal ancestor of all the trust’s remainder beneficiaries.

The description here of tax and financial considerations inherent in the design of a lead trust is intended as a starting point to identify some of the issues a professional planner may wish to explore in advising a client on the potential benefits and risks of creating a lead trust. Donors and their advisors should always check for the latest legislation and regulations prior to completion of a charitable lead trust or similar charitable gift.

For further reading, see also from the Planned Giving Design Center:

Technical Reports:

- Charitable Lead Trusts

Case Studies:

- Creating a Temporary Private Foundation using a Charitable Lead Trust

Articles:

- Charitable Lead Trusts: A Primer

- Combining Life Insurance and Annuity Policies to Create a Financial Engine for a Nongrantor CLAT
- Charitable Estate Planning: A Reverse Charitable Bucket
- The Charitable Lead Trust: Don't Forget The Donor!
- The Coming Boom In Charitable Trusts

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