WHAT MOTIVATES A CLIENT TO CREATE A CHARITABLE LEAD TRUST?

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Introduction

- Charitable lead trusts (CLT) are becoming increasingly popular because the trust allows an individual to provide benefits to both charitable and noncharitable beneficiaries.

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- CLTs can be created during lifetime (*inter vivos*) or at death in a will or trust (testamentary).

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- In each year of the trust, the trustees will distribute an annuity or unitrust amount to charitable organizations either selected by the donor or by the trustees.
- Upon termination of the trust, all of the property remaining in the trust will be distributed to the remainder beneficiaries, typically children.

Introduction

- The initial term is known as the lead term. Thus, at the outset, the trust has two interests – a annuity or unitrust interest to a charity or charities, and an eventual remainder gift to individuals or a trust for individuals. The value of the individual's remainder interest is reduced by the value of the charity's lead interest.

Charitable Lead Annuity Trust (CLAT)

- An irrevocable trust in which the trustee pays an annuity amount (the lead) to a charity or charities for a specified term. At the termination of that term, the trust property passes to individual (noncharitable) remainder beneficiaries, typically the donor's children.

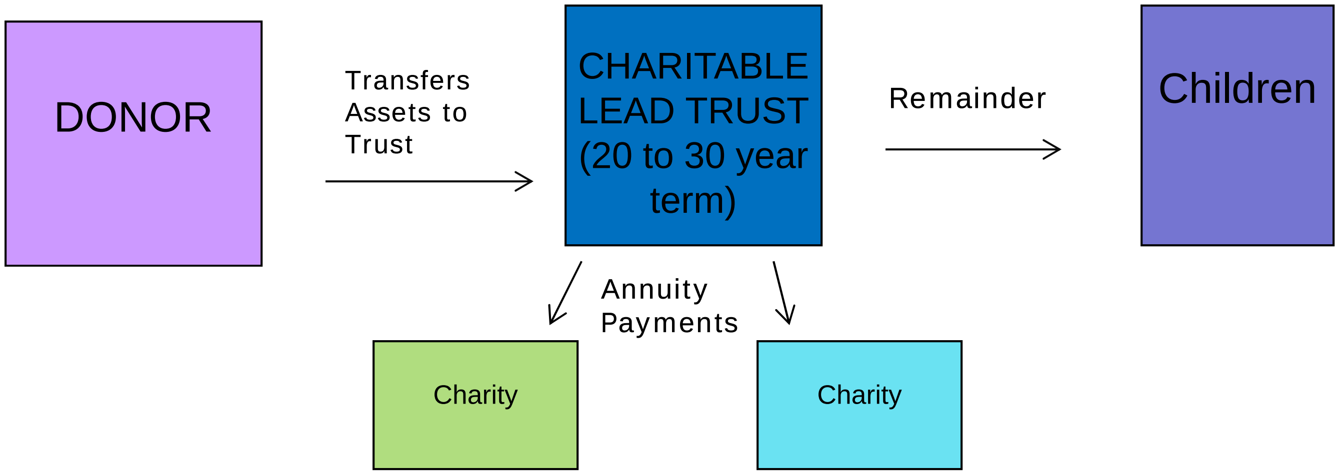
Charitable Lead Annuity Trust (CLAT)

- Ex: A $1 million transfer to a 6% CLAT for 10 years would provide charity with an annual income stream of $60,000 per year for the 10-year term.

Charitable Lead Annuity Trust (CLAT)

- Alternatively, the governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded.

Charitable Lead Trust Illustration



Benefits:

- CLATs are generally created for a longer term (20-30 years) to “lock in” a low interest rate at inception.
- CLATs work well in a low interest rate environment because if the trust’s investment performance exceeds the AFR rate, then the excess earnings and growth at the end of the term pass to the remainder beneficiaries tax free. The lower the AFR, the larger the potential gift to the family.

Example:

- Contribution of $1,000,000 to a CLAT that lasts for 15 years and pays 5% (or $50,000) annually to charity. With an AFR Rate of 2%, and assuming 7% growth of the assets, the result would be as follows:

Charity receives $750,000 ($50,000 per year for 15 years).
Remainder to family members (or a trust for their benefit) is $1,502,580.

Charitable Lead Unitrust (CLUT)

- The required annual (or more frequent) payout to a charity or charities in a CLUT is based upon a fixed percentage of the trust value determined on the annual valuation date set forth in the trust document. Thus, the annual payout percentage remains constant but the required payout would change annually depending upon the value of the trust on the annual valuation date.

Charitable Lead Unitrust (CLUT)

- Alternately, the governing instrument may provide for a unitrust payment that is initially stated as a fixed percentage amount but increases or decreases during the lead period. Payments made during the lead term of a CLUT may be made for a specified term of years or for the life or lives of individuals.

History of CLTs

- Following the 1969 Tax Reform Act, an income, estate or gift tax deduction is not allowed for a contribution of property to a trust that pays income to a charity with the remainder to individuals or a trust for individuals, unless the governing instrument qualifies as a charitable lead trust (sometimes called a charitable income trust).

Comparison to Charitable Remainder Trusts

- A CLT is sometimes described as the opposite of a charitable remainder trust (CRT). A CRT is a trust that provides payments to noncharitable beneficiaries during an initial term, followed by payment to a charity at the end of the initial term.

Comparison to Charitable Remainder Trusts

- Although charitable lead trusts are sometimes described as the "mirror image" or the opposite of charitable remainder trusts, there are significant differences between the two types of trust, including the following:
  - No minimum or maximum payout requirements.
  - No 20-year limit on the term of years alternative. There is no restriction on the length of the lead term of a CLT.

Comparison to Other Charitable Vehicles

- Pooled income funds. A pooled income fund is a trust that is established and maintained by a public charity. The pooled income fund receives contributions from individual donors that are commingled for investment purposes within the fund.

Comparison to Other Charitable Vehicles

- Charitable gift annuities. A charitable gift annuity is a contract under which a charity, in return for a transfer of assets, agrees to pay a fixed amount of money to one or two individuals, for their lifetime.

Technical Requirements

- The IRS has issued Revenue Procedures containing sample forms and annotations for both inter vivos and testamentary CLUTs and CLATs, both grantor and nongrantor CLUTs and CLATS.

IRS Sample Forms

- In Revenue Procedures 2007-45, 2007-46, 2008-45, 2008-46, the IRS issued sample forms for testamentary CLATs and CLUTs and inter vivos grantor and nongrantor CLATs and CLUTS. Obviously, you could not have a grantor testamentary trust.

IRS Sample Forms

- The Revenue Procedures also include useful annotations for the forms provisions and alternative provisions that the drafter can include in the trust.

IRS Sample Forms

- Safe Harbor – the IRS will recognize either a CLAT or a CLUT as a "qualified CLT" if it is substantially similar to an IRS sample form. Trusts that omit, substitute, or add to the forms are not necessarily disqualified, but the careful drafter will think carefully about omissions, substitutions, or additions.

IRS Sample Forms

Trust	**Revenue Procedure**	
	CLAT	CLUT
Inter Vivos Nongrantor CLT for a Term of Years	2007-45	2008-45
Inter Vivos Grantor CLT For a Term of Yeas	2007-45	2008-45
Testamentary CLT For a Term of Years	2007-46	2008-46

Governing Instrument Requirements

- Trust must provide for annual or more frequent distributions to a charity or charities designated in the trust document itself or chosen by the trustees.
- Ex: "to one or more organizations described in sections 170(c), 2055(a), and 2522(a) of the Code selected by the trustees from time to time."

Governing Instrument Requirements

- If the donor is serving as a trustee, the trustee's power to select the charitable beneficiaries could cause the gift to be incomplete for gift tax purposes, and could cause some or all of the trust property to be included in the donor's gross estate.
- Therefore, prohibit donor from being a trustee.

Governing Instrument Requirements

- Also, if the charitable beneficiary is a private foundation and the donor is an officer or director of the private foundation, the trust property could be includible in the donor's estate.
- The funds should be segregated, administered, and distributed by a group of officers and directors other than the grantor.

Governing Instrument Requirements

- The charitable beneficiary's interest must be a guaranteed annuity or unitrust interest.
- There are no minimum or maximum limitation on payments.
- A trust that provides a charity with an income interest that is not stated as a guaranteed annual annuity will not qualify for the estate and gift tax deductions.

Governing Instrument Requirements

- The charitable lead income interest must be paid for a period measurable by a life or lives in being at the time the trust was created, or for a fixed term of years.

Governing Instrument Requirements

- If the lead interest is for the life or lives of individuals, all of the individuals must be alive and ascertainable on the date of the transfer of assets to the trust.
- Only the following individuals can be used as measuring lives: the donor, the donor's spouse, and an individual who, for all remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries.

Governing Instrument Requirements

- No payments to noncharitable beneficiaries during the term.
- Charities can be public charities or private foundations.

Governing Instrument Requirements

- A CLT is subject to the private foundation prohibited transaction rules.
- Neither an annuity trust nor a unitrust are permitted to prepay the charitable lead interest.
- No additional contributions can be made to a CLAT.
- Taxable year of the trust is the calendar year.

Governing Instrument Requirements

- Provisions not required, but recommended:
  - Provision allowing amendment to achieve or maintain qualification.
  - Others

Tax Consequences: Income Tax

- There are two types of inter vivos CLTs:
  - Grantor
  - Non-Grantor

Tax Consequences: Income Tax

- An income tax deduction is only available for grantor trusts.
- No income tax deduction is generated by a contribution to a lead trust unless the trust is a grantor trust, in which event all income of the trust will be taxed to the grantor as earned, without any further charitable income tax deduction for the annual payments from the trust to the charity or charities.

Tax Consequences: Income Tax

- To make a trust a grantor trust, must use a provision that triggers grantor-trust status.
- Conversely, if you don't want a grantor trust, be careful not to inadvertently include a grantor trust provision.

Tax Consequences: Income Tax

- Although the grantor of a grantor CLT obtains an income tax deduction, the deduction comes with a price: the income tax charitable deduction is "recaptured" over time by recognition of taxable income earned by the CLT.
- Because of this tax treatment, most CLTs are nongrantor.

Tax Consequences: Income Tax

- Unlike CRTs, a CLT is not exempt from income tax.
- Because all of its income is not required to be distributed currently, a nongrantor trust is a complex trust for income tax purposes.
- The trust has its own taxpayer identification number.
- If the trust is a nongrantor trust, the trust is allowed an unlimited charitable deduction for amounts paid to charity (other than unrelated business taxable income).

Tax Consequences: Income Tax

- The tiered system of income distributions applicable to charitable remainder trusts does not apply to lead trusts.
- Income paid to charity is made on a pro rata basis from trust income.

Tax Consequences: Gift Tax

- If the trust is created during the lifetime of the donor, the present value of the intervening charitable interest qualifies for the gift tax charitable deduction.
- The value of the noncharitable future interest is a taxable gift, unless retained by the donor or the donor's spouse.

Tax Consequences: Estate Tax

- Because both the charitable and noncharitable gifts are completed at the time the trust is created, if the grantor retains no interest in an *inter vivos* trust, the value of the trust property is not included in the donor's estate for federal estate tax purposes.
- If a testamentary trust is created, the property funding the trust will be includable in the donor's estate for estate tax purposes, and the present value of the charitable interest will qualify for the estate tax charitable deduction.

Tax Consequences: GST Tax

- The GST tax consequences of a CLT depend on whether the trust is a CLAT or CLUT.
- If the trust is a CLAT, the inclusion ratio is not determined until the charitable lead interest terminates and the value of the actual non-charitable interest is known.
- Thus, CLATs are not considered a good option if the remainder beneficiaries are grandchildren.
- If the trust is a unitrust, the inclusion ratio is determined at the inception of the trust.

Motivational Factors

- A CLAT can be especially useful for clients who have charitable goals, and want to blend their philanthropic goals with their wealth transfer goals. The low AFR rate reduces annuity payments to the charities, and increases the potential wealth transfer to the children.

Motivational Factors

- Donors can increase charitable gifts without regard to percentage limitations application to donor’s personal gifts to charity.

Motivational Factors

- Donor can “zero-out” the value of the remainder interest passing to children and subject to gift or estate tax for a CLAT.

Motivational Factors

- Interest rate assumptions: CLATs are more attractive in a low interest rate environment.
- Mortality assumptions.
- Gifts of assets with high appreciation potential.
- Funding trusts in a down market.
- Gifts to foreign charities.