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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 term of years or for the life of an individual or individuals.

At the end of the term, the remainder interest passes to non-charitable beneficiaries, such as the grantor's family or a trust for their benefit. A grantor can establish the CLT during life or by will.

## TYPES OF CHARITABLE LEAD *Trusts...*

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- ◆ There are two CLT variations: the Charitable Lead Annuity Trust (CLAT) and the Charitable Lead Unitrust (CLUT). The primary difference between them is the method of calculating the payment to charity.
- ◆ A CLAT pays the charity a fixed sum each year, which can be a fixed dollar amount or a percentage of the initial gift to the trust.
- ◆ A CLUT pays the charity a percentage of the fair market value of the trust assets, recalculated annually.



## QUALIFICATION *Requirements...*

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- ◆ The charity's income interest must be either an annuity or a unitrust interest, and must be set for a specified term of years, the life of an individual(s), or for the life of an individual(s) plus a term of years—Treas. Reg. §§1.170A-6(c)(2)(i)(A); 1.170A-6(c)(2)(ii)(A); 20.2055-2(e)(2)(vi)(a); 20.2055-2(e)(2)(vii)(a); 25.2522(c)-3(c)(2)(vi)(a); 25.2522(c)-3(c)(2)(vii)(a). State 'Rule Against Perpetuities' statutes may also limit the trust term.
- ◆ The trust instrument can either designate a charitable beneficiary or can allow the trustee to make the selection. The charity must be a valid charitable organization under federal law. If the grantor retains the right to designate the charitable beneficiary, the trust assets will be included in the grantor's taxable estate—I.R.C. §2036(a)(2).
- ◆ Because the CLAT annuity payment must be determinable at the creation of the trust, CLATs must prohibit additional contributions—Treas. Reg. §§1.170A-6(c)(2)(i), 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a). However, a CLUT can accept additional contributions.



## INCOME TAX *Considerations...*


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- ◆ If the CLT is a grantor trust, the grantor can deduct the present value of the charity's income interest upon creation of the trust— I.R.C. §170(f)(2)(B); Treas. Reg. §1.170A-6(c)(1). (A grantor trust is one in which the grantor is treated as owner of the trust assets for income tax purposes.) As such, the grantor pays income tax on all taxable trust income. However, no deduction is received when the trust pays income to the charity. In general, therefore, grantor CLTs are only used when it is anticipated that the grantor's tax bracket will be much higher in the initial year than in subsequent years.
- ◆ If the CLT is not a grantor trust, the grantor does not take an income tax deduction, and trust income is taxed to the CLT (with a deduction for amounts it distributes to charity) not to the donor. This is the more common version.

## GIFT AND ESTATE TAX CHARITABLE *Deductions...*

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- ◆ If the CLT is created during the grantor's life, a gift tax charitable deduction is allowed for the present value of the charity's income




stream. If the grantor's will creates the CLT at death, the grantor's estate takes an estate tax charitable deduction. In either case, the computation is based on an interest rate issued monthly by the Treasury Department pursuant to Section 7520 of the Tax Code (known as the "Section 7520 rate")—I.R.C. §§2522(a), (c); 2055(a), (e). The grantor (or the estate) can select the current month's Section 7520 rate, or the rate from either of the two preceding months. The lower the rate used, the higher the charitable deduction. 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. This is the advantage that motivates most 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 *Issues...*

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- ◆ The generation skipping transfer tax (GSTT) is a tax on the transfer of assets to "skip persons" (in general, persons two or more generations younger than the transferor). GSTT is in addition to any gift or estate tax generated by the transfer. Each person can exempt a certain amount of assets transferred from the GSTT. In 2011, the exemption amount is \$5,000,000.

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- ◆ Any remainder amount in a CLT may be subject to GSTT if distributed to or held for the benefit of skip persons. In a CLAT, the grantor can generally allocate GSTT exemption only at the end of the charitable term—I.R.C. §2642(e). If the trust assets grow substantially, the remainder may be worth more than the available GSTT exemption, causing the trust to be only partially exempt from GSTT. This disadvantage does not exist with CLUTs.

## RESTRICTIONS ON THE TRUST'S *Activities...*

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- ◆ A CLT is subject to certain private foundation rules—I.R.C. §4947(a)(2). These rules impose penalty taxes on the trustee and any “disqualified person” who engages in acts of self-dealing with the trust—I.R.C. §4941(a). The penalties increase if the violation is not neutralized—I.R.C. §4941(b). Self-dealing includes sales, leases, and loans—I.R.C. §4941(d). The term “disqualified person” includes the grantor, certain members of the grantor’s family, and trusts established for their benefit—I.R.C. §4946(a).
- ◆ Another Tax Code provision creates a penalty tax for trusts with “excess business holdings”—I.R.C. §4943(a)(1). The tax increases if the trust does not disgorge the excess business holdings by the end of its taxable year—I.R.C. §4943(b). The term “excess business holdings” generally includes any interest in a corporation (or other business entity in excess of 20% of the voting stock or other equity



interest)—I.R.C. §4943(c)(1). Trusts receiving business holdings by gift or bequest generally have five years to dispose of them before the penalty is triggered—I.R.C. §4943(c)(6).

- ◆ A third set of rules imposes penalty taxes on the trust and the trustee if the trust invests in assets that can jeopardize the charitable purpose of the trust—I.R.C. §4944(a). The penalties increase if the trust does not rid itself of the jeopardizing assets—I.R.C. §4944(b). There is no fixed definition for “jeopardy investment.” Each investment is examined individually—Treas. Reg. §53.4944-1(a)(2).
- ◆ Additionally, there are penalty taxes imposed on the trust and trustee for “taxable expenditures,” which include expenses for lobbying, political campaigning, and certain grants—I.R.C. § 4945; Treas. Reg. §53.4945-4.

## CLAT *Versus* CLUT...

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- ◆ Given the same variables, gift tax on CLATs is considerably less than on CLUTs. Also, a CLAT may be preferable if the grantor expects the assets to increase in value, since appreciation favors the non-charitable beneficiaries. In contrast, CLUT appreciation favors both the charity and the remainder interest. However, a CLUT may be preferable if the trust will benefit skip persons, since the grantor can allocate GSTT exemption upon transfer instead of waiting until the end of the charitable term.



### Donor

Donor transfers assets to CLT and receives a gift or estate tax charitable deduction, and possibly an income tax deduction, for the present value of the income stream passing to charity.

The remainder interest is subject to gift tax



Transfers assets to trust



### Charitable Lead Trust (CLT)

Pays income stream to charity for donor's life or a specified number of years.

At end of the term, remaining trust assets pass to donor's heirs.



At expiration of the term, remaining assets pass to donor's heirs.



### Heirs

At the end of the term, assets remaining in the CLT pass to the designated beneficiaries.




Annual payout to charity



### Charity

Charity receives annual income for donor's life or a specified number of years.

A CLT provides an income stream to charity with the remaining trust assets passing to the donor's heirs at the expiration of the term.



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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act (“the Act”) was enacted on December 17, 2010. For 2011 and 2012, the Act provides for a \$5 million Federal gift, estate and generation skipping transfer tax exemption amount (indexed for inflation starting in 2012) and a top gift, estate and GST tax rate of 35%. On January 1, 2013, a \$1 million Federal gift, estate and GST exemption amount and a maximum gift, estate and GST tax rate of 55% is scheduled to go into effect. These considerations apply only to the Federal transfer taxes. Any state-level estate or inheritance tax should be evaluated separately. 436351 01/28/2013