



The Charitable Lead Trust

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Would you like to support one or more charities at your death without reducing your children's or grandchildren's inheritance? Would you like to reduce the estate or gift tax on the transfer to your children to zero? Would you like to create a fund that can be available to benefit your family for generations to come — without ever being subject to the estate or gift tax?

The Charitable Lead Trust (CLT) might be right for you.

HOW DOES IT WORK?

The CLT is a split-interest trust. That is, the value of the trust is split into two components, income and remainder. During the term of the CLT the income is paid to a qualified charity and at the end of the term the remainder is paid to individual (non-charity) beneficiaries, generally your children or grandchildren. The gift of the remainder interest is a taxable gift by the donor to the individual (non-charity) beneficiaries. The value of the gift is determined by subtracting the net present value of the stream of cash flow payments made to the charity during the term of the trust from the amount initially contributed to the trust. The variables in the calculation are the amount paid to the charity each year, the number of years those payments are made, the Applicable Federal Rate (AFR) in effect at the time of the initial contribution to the CLT, and the structure of the CLT.

The CLT can be structured in one of two ways either as an “annuity” trust or as a “unitrust.” An annuity trust pays a fixed amount each year to the charity beneficiary based upon a percentage of the initial value of the contribution. A unitrust pays a fixed percentage each year of the then current value of the trust to the charity beneficiary. The structure selected greatly impacts the value of the remainder interest paid to the non-charity.

EXAMPLE:

Charitable Lead Annuity Trust (CLAT)

If you contribute \$1 million to a CLAT which by its terms will pay out 7% of the contribution each year to a charity for 20 years, the

remainder amount (the taxable gift amount) is \$65,304. If the assets in the trust grow at 10%, the actual remainder balance paid to your children is \$2,718,250. Your generosity also results in \$1,400,000 being paid to your favorite charity. If you extended the CLAT term to 23 years, the remainder value (taxable gift amount) is \$0 and the actual remainder value to your children is \$3,386,291, with \$1,610,000 going to charity. The zero remainder value would hold for any size gift (e.g., a \$10 million gift to a CLAT with a 7% payment to charity for 23 years will result in a zero remainder value).

Charitable Lead Unitrust (CLUT)

If you contribute \$1 million to a CLUT which by its terms will pay out 7% of the value of the CLUT each year to a charity for 20 years, the remainder amount (the taxable gift amount) is \$248,914. If the assets in the trust grow at 10%, the actual remainder balance paid to your children is \$1,806,111, with \$1,880,926 being paid to charity. If you extended the CLUT term to 30 years, the remainder value (taxable gift amount) is still \$124,207 and the actual remainder value to your children is \$2,427,262, with a whopping \$3,330,279 going to charity.

Thus, it is possible with a CLAT to transfer of any amount of assets to your children at a zero gift or estate tax cost with the right combination of annuity rate, term, and applicable federal rate.

It is not possible to reduce the transfer tax to zero using a CLUT because of the theoretical impossibility of reducing the remainder to zero. This outcome occurs because the most the trust can pay to a charity is a percentage of its holdings at the time of the payment. Since there will always be something left in the trust after every payment, the trust cannot be exhausted so there will always be a gift or estate tax associated with the gift to a CLUT.

CLAT OR CLUT?

Even though it is not possible to reduce the remainder value of a CLUT to zero, as is possible with the CLAT, the CLUT has a significant advantage over the CLAT if the intended beneficiaries are your grandchildren. Transfers to grandchildren are subject to a tax in addition to the gift or estate tax, called the Generation-Skipping Transfer Tax (GSTT). This tax is imposed at the highest marginal gift or estate tax rate (currently 45%). You have a lifetime credit (\$2 million in 2008, and \$3.5 million in 2009) that you can apply against the GSTT. You can apply your GSTT credit to a CLUT but not to a CLAT.

So in the above examples, you could apply \$248,914 of your GSTT credit to the CLUT at the time it is created and the trust would then be GSTT exempt. That is, it would not be subject to GSTT at the time it distributes its assets to your grandchildren, or even to subsequent generations. However, you cannot apply any amount of GSTT credit to the CLAT at the time it is created. In fact, you must

apply the GSTT credit at the time it terminates and is distributed to your grandchildren. In the above example, application of even your full \$2 million of GSTT credit to the CLAT in year 20 would not be enough to exempt the entire balance of \$2,718,250, so a portion of every distribution from the CLAT to your grandchildren is subject to an additional GSTT.

WHAT CHARITIES CAN YOU CHOOSE?

You can choose any qualified 501(c)(3) charitable organization you like. You can choose more than one charity. Most commonly though, the charity is a family foundation run and managed by the family to support a variety of the family's charitable goals.

PLANNING OPTIONS

Commonly, CLTs are put in place at your death. These are called Testamentary CLTs. They operate in the same way as CLTs you set up during your life, but defer the gifts to your children and grandchildren for many years after your death. Often, a grantor will obtain life insurance and hold it in a life insurance trust for the benefit of children or grandchildren, so that the children or grandchildren receive an inheritance at the death of the grantor with no need to wait an extended time to receive the benefits of the CLT.

Many times a grantor will contribute interests in Limited Partnerships or Limited Liability Companies to a CLT because these interests may be subject to valuation discounts. The discounts have the effect of increasing the potential annuity or unitrust payout rate, resulting in a shorter term for the CLT and earlier distribution to children or grandchildren.

If you prefer a CLUT, it often makes sense to establish the CLUT in a state which has abolished the Rule against Perpetuities so that the CLUT can benefit not just your children and grandchildren, but subsequent generations as well.

SUMMARY

The Charitable Lead Trust (CLT) is one of the most powerful tools in the estate planner's arsenal for estate or gift tax planning and for providing large contributions to one or more charities. Properly drafted and implemented, this strategy can reduce estate or gift taxes to zero for any size gift. A CLT can also provide the means to create and preserve multi-generational family wealth.

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Charitable Trusts Compared

	CHARITABLE LEAD TRUST	CHARITABLE REMAINDER TRUST	POOLED-INCOME FUND
Purpose	Property is transferred to a trust that distributes income to a charitable beneficiary for a period of time or for the life or lives of designated individuals. Remainder interest reverts back to donor or some other noncharitable beneficiary.	Split interest gift in which donor receives either a fixed or variable annuity for a period of time not to exceed 20 years or for the life or lives of designated individuals and remainder goes to charity.	Investment fund created and maintained by target charity. Pools property from all contributors and pays a pro rata share of income earned by commingled trust assets.
Income Tax Consequences	Grantor trust: If created during life, grantor claims income and receives charitable deduction for the present value of the total anticipated income during the lead period. Nongrantor trust with remainder beneficiaries other than grantor: Grantor does not claim income and cannot receive charitable deduction.	If created during life, donor receives immediate charitable contribution deduction for FMV less present value of retained interest. Annual income is taxable to the income beneficiary.	If created during life, donor receives immediate charitable contribution deduction for FMV less present value of retained interest. Annual income is taxable to the income beneficiary.
Estate Tax Consequences	Grantor trust: If created during life, the value of the asset is generally out of the estate. Nongrantor: The value of the asset is out of the estate.	Value of property is included in gross estate, but an equivalent charitable deduction reduces the taxable estate amount to zero.	Value of property is included in gross estate, but an equivalent charitable deduction reduces the taxable estate amount to zero.
Planning Opportunities	Noncharitable beneficiary can be grantor, spouse, child, or other person. Good for clients who have a large amount of highly appreciating assets and can forgo the income from these assets. When interest rates are low, this increases the valuation of the deductible interest donation.	Contributions allowed only at setup for CRAT. CRUT allows contributions after initial setup. While CRAT provides a fixed annuity, CRUT can provide a hedge against inflation. When interest rates go up, the deductible charitable remainder interest goes up.	No tax-free securities can be contributed. A good choice for those who do not want to set up and maintain a trust. Many colleges and universities maintain these.

Retirement Savings Vehicles: Charitable Remainder Trusts vs. Qualified Plans

	CHARITABLE REMAINDER TRUST	QUALIFIED PLAN
Subject to ERISA.		X
Subject to Internal Revenue Code rules on coverage and contribution requirements.		X
Contributions are fully deductible within prescribed limits.		X
Full amount of assets is available at retirement.		X
All or a portion of the distributions may consist of tax-free income.	X	
Borrowing funds from the account is not subject to an excise tax on self-dealing.		X
Distributions prior to age 59 ½ are not subject to the 10% excise tax.	X	
Upon death, remaining balances passes to the beneficiaries of the participant.		X