

The Charitable Lead Trust: A Closer Look, © 2008 Sarah Ruef-Lindquist, JD, CTFA

Last month, we brought to light the favorable dynamic – for donors and charities – created by historically low interest rates and declining stock market values. It makes sense to provide a little more insight into how these marvelous vehicles can work, the various types of charitable lead trusts and related tax-treatment nuances that can affect a donor's choices in creating a charitable lead trust.

In general terms, a charitable lead trust (“CLT”) allows a donor to place into trust assets that will generate an “income” interest to charity for a period of time, and then pass those assets (often at an appreciated value) on to heirs at a reduced cost, if gift tax is involved.

The CLT may be either an annuity trust (paying a fixed sum each year to charity) or a unitrust (paying a fixed percentage of the fluctuating value of the trust each year).

The “lead” interest is what is paid to charity

The remainder, after the lead interest has terminated, passes to heirs

From a donor's perspective, CLT's are attractive because they allow the Donor to not only accomplish significant charitable gifting during the term of the trust, but they also allow assets to pass to heirs with potentially substantial transfer tax savings. In most cases, the gift tax a donor will pay on creating the trust is less – much less - than the gift tax would be if the donor waited and passed the assets to heirs without using a CLT.

From a charities perspective, the CLT can provide one or more injections of funds into endowment funds, often time realizing the value of a planned gift in the year the trust is created, rather than at the time of its termination.

The **income tax treatment** for donors creating these types of trusts, depends upon whether the trust is a “grantor” or “non-grantor” trust. Whether the CLT is “qualifying” or “non-qualifying” will impact the potential for the assets of the trust to be included in the **grantor's estate** or subject to the gift **tax charitable deduction**.

Qualified vs non-qualified

- A qualified CLT allows a donor to receive a gift tax deduction and, in some cases, an income tax deduction, upon creation of the trust. The value of the lead interest to be paid to charity is the measure of the income tax deduction. The donor may not use assets that violate any of the Private Foundation rules, and if the gift is considered a completed gift (the donor retains no control over the disposition or management of the assets) then the assets may be excluded from the donor's estate if the donor dies during the term of the trust.

- A qualified CLT may involve an annuity or unitrust interest, payable at least annually. An annuity may provide either a specific dollar amount or percentage of the initial value of the trust assets upon establishment.
- A qualified CLT may be payable for a term of years or may be payable for a specific lifetime – the donor, their spouse, or a common lineal ancestor of the remainder beneficiaries or a spouse of the same.

#### Grantor vs. non-grantor

During a trust’s existence, its income must be reported, and whether or not the income is taxable to the person who created the trust – the grantor – is an important planning consideration.

- When a trust is not a grantor trust - a non-grantor trust - then the trust will pay income tax, and receive a deduction for the lead interest it pays to charity every year. The donor does not get to use that deduction. This type of CLT may be attractive for a donor who has little or no need for the charitable income tax deduction during the term of the trust, or upon creation of the trust.
- When a CLT is a grantor trust, then the grantor recognizes all of the trust’s gain, loss, deductions and credits on his or her personal income tax return, and upon establishment of the trust, receives an immediate income tax deduction for the value of the charitable lead payments. The trust essentially “passes on” the tax issues to the grantor.

Here’s a summary:

CLT Type	Income tax deduction on establishment for Donor/Grantor?	Who recognizes trust’s gain, loss, income, deductions each year?	Who pays trust’s taxes each year?	Gift or Estate Tax Charitable deduction for lead interest to charity?
GRANTOR QUALIFIED	Yes, for Grantor	Grantor	Grantor	Yes
GRANTOR NON-QUALIFIED	None	Grantor	Grantor	No
NON-GRANTOR, QUALIFIED	None	Trust	Trust	Yes
NON-GRANTOR NON-QUALIFIED	None	Trust	Trust	No

So, depending upon a grantor's specific goals in creating the CLT, they may choose to create a trust that favors their income tax situation, or one that favors their gift or estate tax situation.

A great example of a technical approach to achieving planning goals using CLT's was described in a recent article in *Probate & Property*, a publication of the Real Property, Trust and Estate Law Section of the American Bar Association. The article, entitled 'The Leveraged Family Business CLAT' by Douglas W. Stein, September/October 2007, described the ability of a donor to create a testamentary trust arrangement that would create an annuity stream for charity (using a Charitable Lead Annuity Trust) and pass the donor's interest in a closely-held or family business on to heirs at a reduced tax cost, through the remainder interest of the CLAT.

The technique also involves the use of a debt instrument to fund the payments by the CLAT. The article carefully describes the various key issues, including self-dealing rules, that a planner must consider and anticipate in drafting the documents to create this type of gift and what would be required of heirs – presumably children – who wish to inherit and/or continue the operation of a family business. It is a terrific example of the variety of planning goals that can be met – including those of charitably-minded family-business owners – when using charitable lead trusts.