Charitable Lead Trusts

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Types of Lead Trusts

<u>Non-Qualified</u>

1. Annual income to named or annually determined.
2. No income tax deduction.
3. No gift or estate tax deduction.

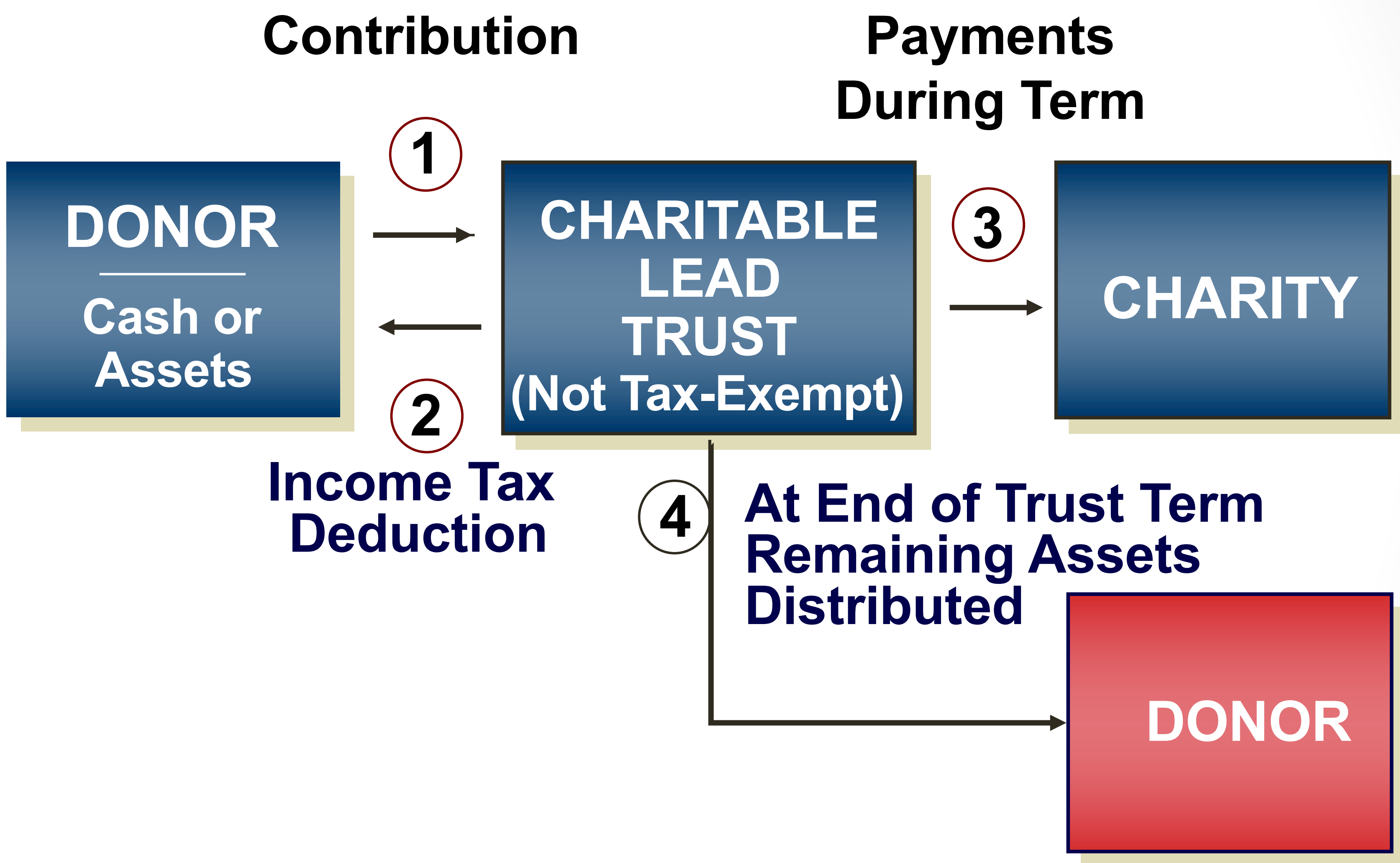
<u>Qualified</u>

1. Grantor – Income tax deduction.
2. Non-grantor – Gift/estate tax deduction.
3. Hybrid or Defective – Grantor for income tax deduction; non-grantor for gift/estate tax deduction.

Qualified Grantor Lead Trust

- Grantor trust: donor is the owner.
- Donor can claim a current income tax deduction on his/her tax return for payments to charity.
- Included in donor's estate for gift/estate purposes.

Grantor Charitable Lead Trust



Grantor Trust Rules

- IRC Section 671.
- Grantor or spouse has more than a 5% reversionary interest or more than 5% income interest from the trust assets.
- Grantor, spouse or nonadverse party (Trustee) has powers over the beneficial interest, e.g.: change charity or direct payments to different charities annually.

Income Tax Savings: Grantor Lead Trust

- Significant income tax deduction for year of gift plus carry-over.
- Trust income reported on donor's income tax return.
- Consider investment in tax-free investments such as municipal bonds
- Or investment in stocks to pay income as needed to realize minimum gain or use stocks with unrealized losses

Qualified Grantor Trust: Potential Uses

1. Trust invested in only tax-exempt income assets.
2. Trust funded in an unusually high income year and donor can use the income tax deduction.
3. Established during same tax year as an IRA Roth conversion to reduce income tax liability

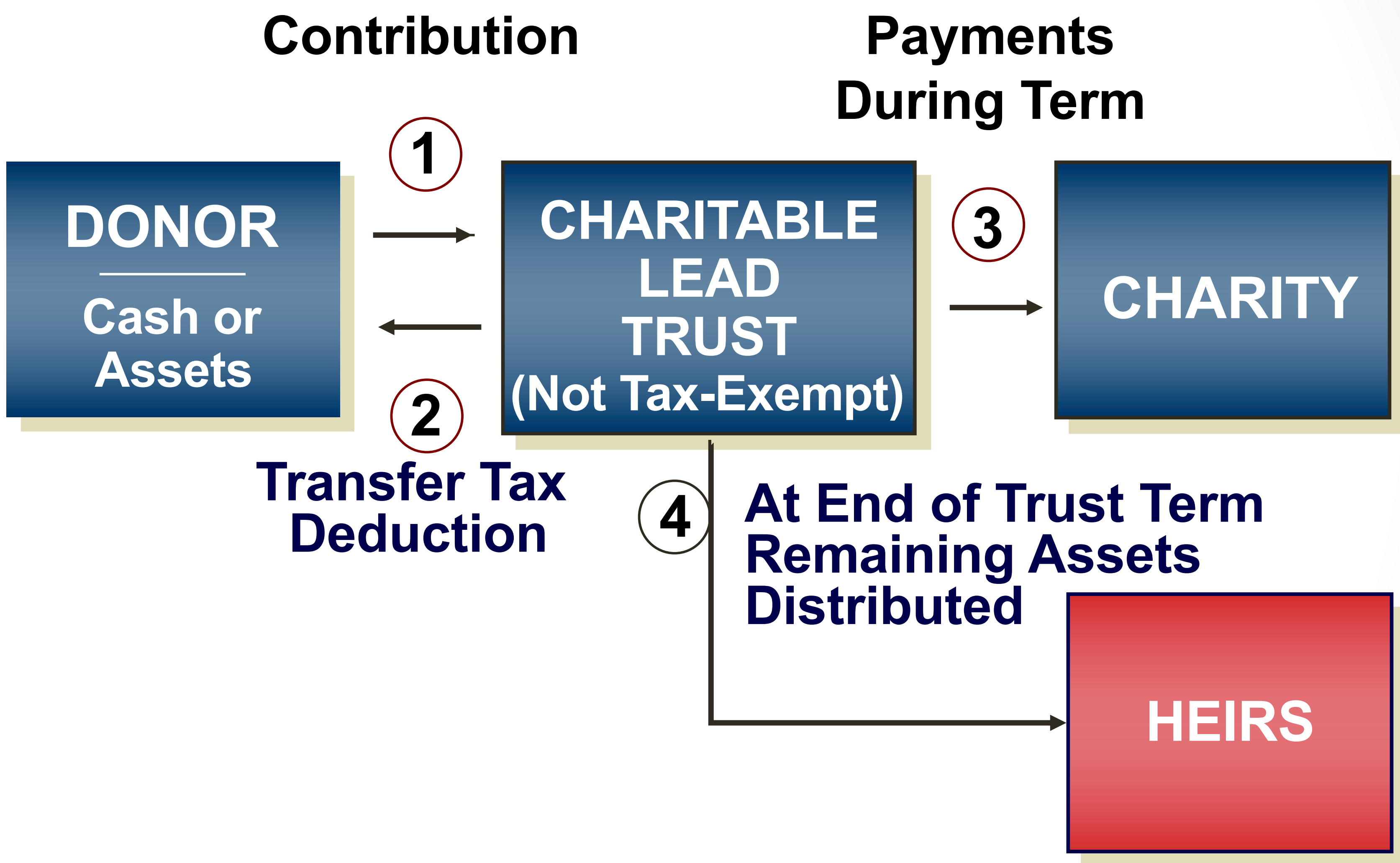
Example

- **$1,000,000 donated to 20-year grantor charitable lead annuity trust**
- **5% payout; 7% total return on assets**
- **5.0% Adjusted Federal Mid-term rate (April 2025) <u>$634,700 income tax charitable deduction</u>**
- **$1,819,910 calculated to return to donor at end of trust term**
- **$1 million paid to charity during term**

Qualified Non-Grantor Trusts

- Donor is not owner: No income tax deduction.
- Gift/estate tax charitable deduction for the present value of lead interest to be paid to charity.
- Substantial gift or estate tax savings!

Nongrantor Charitable Lead Trust



Example

- $1,000,000 donated to 20-year nongrantor charitable lead annuity trust
- 5% payout; 6% total return on assets
- 5.0% Adjusted Federal Mid-term rate (April 2025). Note: As AFR decreases, charitable value increases.
- $1,819,624 calculated to family at end of trust
- $1,000,000 paid to charity during term
- <u>$365,300 taxable gift to heirs</u>
- Potential to "zero out" transfer tax by increasing number of years and/or payout rate

IRS Safe Harbor Template Forms

- **Rev. Proc. 2007-45 and 2007-46: sample forms, annotations and alternate provisions for inter vivos and testamentary grantor and nongrantor charitable lead <u>annuity trusts</u>.**
- **Rev Proc 2008-45 and 2008-46: Inter vivos and testamentary grantor and nongrantor charitable lead <u>unitrusts</u>.**

Planning Pointers 1

- Irrevocable
- CLT is a complex taxable trust that receives an income tax deduction for payments to charity.
- No minimum or maximum payout percentages as with charitable remainder trust (CRT)
- No minimum or maximum term of years for a term CLT as with a CRT.
- Testamentary lead trust permits step-up in basis when assets are inherited by heirs. No step-up for assets inherited from an inter vivos lead trust

Planning Pointers 2

- Payments must be to a “qualified” charity or charitable purpose pursuant to IRC Sec. 501(c)(3) and regulations. No specific charity need be named. Trustee may choose from year to year.
- Annual income tax deduction ceilings only apply to grantor lead trust. Deemed a gift “for the use of” charity: 30% AGI ceiling with five years of carry-over.

Private Foundation Rules Apply to CLTs

1. No self-dealing between donor (and other disqualified persons) and CLT such as payments for pledges, meals, benefits
2. No taxable expenditures by making grants for non-charitable purposes.
3. No excess business holdings such as holing more than 20% of a corporation's voting stock.
4. No jeopardizing investments that violate the prudent investment standard.

Annuity or Unitrust Payout

- <u>Annuity trust</u> pays an annual fixed dollar amount calculated by multiplication of stated percentage to value of initial donation. <u>Unitrust</u> pays an annual variable amount calculated by multiplication of stated percentage to annually revalued principal.
- With the potential for growth because the annuity is fixed and the corpus can compound, it is possible to move very substantial assets through to family with modest use of the gift exemption.
- Annuity trust leverages better tax savings for assets returning to donor or children.
- Unitrust format leverages better generation skipping transfer tax savings for assets returning to grandchildren (skip generation).

Unitrust Payout: CLT for Grandchildren

- Possible to pass 2 to 7 times the exemption amount to grandchildren with a testamentary lead trust and still have zero Generation Skipping Transfer Tax.
- Unlike the CLAT, the CLUT is permitted to calculate the applicable fraction as of the testator's date of death.
- Enables the trust to use a formula or other allocation method to zero the GSTT.

Unitrust Payout: CLT for Grandchildren

With a unitrust lead trust, the applicable fraction equals the allocated exemption divided by the fair market value of the property minus the charitable deduction. If the allocated exemption is equal to the present value of the taxable gift, the applicable fraction equals one/one. Since the inclusion ratio equals one minus one, or zero, the lead unitrust is exempt from generation-skipping transfer tax.

Advanced Applications of Charitable Lead Trusts

Funding CLT with FLPs

- Family limited partnership (FLP) has valuation discounts of 15% - 40% due to lack of marketability and lack of control.
- The CLT provides another discount due to the reduction in transfer tax resulting from the charitable payments.

UBTI Concerns

- If there were debt in the partnership, then under IRC Sec. 512 and Sec. 514, the presence of debt could give rise to unrelated business taxable income (UBTI).
- If the business is involved in an active business, there also could be UBTI.
- Per IRC Sec. 681, if there is UBTI the CLT no longer receives a full deduction for all distributions to charity.
- CLTs normally are able deduct 100% of income under Sec. 642(c) when the income is transferred to charity, but CLTs with UBTI are subject to the 30% appreciated and 50% cash limits of Sec. 170.

Multi-Layered Lead Trust

- Layers 1 and 2: CLAT, with distributions to children. Not subject to generation-skipping transfer tax.
- Layers 3 and 4: CLUT for grandchildren with formula clauses or trust funding plans, designed to be exempt from generation-skipping transfer tax.
- CLUT remainders may be distributed to a dynasty trust in a state without a rule against perpetuities.

“ER” or Ghoul CLAT

- Format: Link payout from CLAT to a “recruited” (for a fee?) young person with a nominally long life expectancy who, in reality, is not well.
- Gift tax paid at much reduced rate than if an older person (e.g., parent) had been the measuring life.
- Prohibited by Treasury Decision 8923.

Defective/Hybrid/"Super" CLT

- An income and gift tax deduction in the same trust.
- The trust must qualify as a grantor trust and therefore permit the income tax deduction, and also qualify as a complete gift.
- The combination of both tax benefits produces even greater leverage for the lead trust.

Background

- **Prior to 1969, it was possible to receive income, gift and estate tax deductions for creation of lead trusts. In some circumstances, the total tax benefits derived exceeded the value transferred to the trust.**
- **For this reason, the Code was changed to require the donor to recognize income if the grantor lead trust qualified for an initial charitable deduction. Sec. 170(f)(2).**

Hybrid Design

1. Create a trust that is not included in the taxable estate. For this reason, the grantor may not retain a reversion or control over the distribution of income. Sec. 2036(a).
2. Grantor retains a power that does not cause estate inclusion but does cause the trust to be a grantor trust.
3. The preferred retained power is usually held by a non-adverse party to reacquire trust assets in a non-fiduciary role. Sec. 675(4).

Retained Power

- In some circumstances, the trust grantor has retained that power. Unlikely that the grantor would exercise that power, since that could be construed to be a violation of the self-dealing rules under Sec. 4941, it is still a potential power that does require grantor trust status. The grantor retaining such a power could maintain that this exercise would be permitted under the "incidental exception" to the self-dealing rules. Reg. 53.4941(b)-3.
- A sibling of the donor may hold the Sec. 675(4) power to reacquire assets. Since the Sec. 4941 disqualified persons category does not include siblings, this provision does not violate self-dealing. Sec. 4946(d). The sibling would also need to be able to exercise this power in a non-fiduciary capacity to cause the lead trust to be a grantor trust. PLR 200010036.

Example

- $5 million donated to 20 year "hybrid" CLT
- 5% payout; 7% total return on assets
- 5.0% Adjusted Federal Mid-term rate
- $5 million paid to charity during term
- <u>$3,173,500.00 income tax charitable deduction</u>
- $9,099,508 calculated to family at end of trust
- <u>$1,826,500 taxable gift to heirs</u>
- Potential to "zero out" transfer tax by increasing number of years and/or payout rate

Step Lead Trust

- Differs from a standard charitable lead annuity trust in the pattern of its payments to charity.
- Step lead trust makes payments to charity that increase in steps during the trust term, such as 10% per year.

Legal Support of Step Lead Trust

Revenue Procedure 2007-45 provides that the "step" type of payment schedule meets the requirements of a charitable lead annuity trust.

The IRS reaffirmed its position with an affirmative ruling regarding a 10-year testamentary lead annuity trust with payments that will increase 20% each year (PLR 201216045).

Shark Fin CLAT

- Extreme form of step CLT with nominal early payments.
- Back-Loaded large balloon payments.
- Maximize early growth to allow for more to heirs.
- Zero-out gift/estate tax.
- Life insurance investment to pay balloon.

Legal Support of Shark-Fin CLAT

- IRS form annotations allow variable payments - but no specific guidance.
- The notion of having payments increase by no more than 20% each year is considered a “safe harbor” by some practitioners.
- Derives from a ruling relating to the grantor retained annuity trust (GRAT). See Treas. Reg. §25.2702-3(b)(1)(ii)).
- Potential self-dealing if charity’s payments are at risk by back loading investments. Estate Planning Journal, October 2010.