

THE Good Advisor

Understanding and Using Charitable Lead Trusts

In April 2007, the IRS issued new model forms for the charitable lead annuity trust. Because of this new development and continuing low interest rates, a review of charitable lead trusts is warranted.

The historically low interest rates in recent times have led to a resurgence of the charitable lead trust. For example, the number of reported charitable lead trusts increased from 4,571 in 2001 to 6,168 in 2005. Choosing the lowest federal interest rate available tends to boost the amount of the gift tax or estate tax charitable deduction (and the income tax charitable deduction, too, when permitted by law), assuming all other factors are held constant.

Charitable lead trusts pay an annual income, consisting of a specified percentage of trust assets, to one or more charitable organizations, usually for a certain number of years but sometimes for an individual's life. At the end of the trust term, the principal passes back to the grantor or to other individual beneficiaries (often children, grandchildren and/or great-grandchildren of the grantor). The charity's income interest "leads" the noncharitable remainder interest, thus giving the trust its name. In a sense, the charitable lead trust is the mirror image of a charitable remainder trust, but with several important differences as we shall see.

This newsletter describes the features of charitable lead trusts (CLTs) and highlights some of the ways in which they can be used in tax, estate and philanthropic planning.

WHY CHARITABLE LEAD TRUSTS?

In addition to satisfying philanthropic motives, CLT grantors generally hope to accomplish one or both of the following planning objectives:

- To utilize the gift tax or estate tax charitable deduction available for the charity's interest to reduce the tax cost of passing property to heirs (it is possible to zero out tax liability with a CLT)

- To "collapse" a planned series of future charitable gifts into a single gift that will create a large, immediate income tax deduction in the current year.

UNDERSTANDING CHARITABLE LEAD TRUSTS

Charitable lead trusts can be categorized according to four sets of criteria:

- Whether the trust is "qualified" under federal tax law or "nonqualified"
- Whether the income payout to the charity is an annuity interest, unitrust interest, or some other type of (nonqualified) interest
- Whether the grantor is considered the owner of the trust for federal income tax purposes, and
- Whether the trust is set up by inter vivos or testamentary transfer.

QUALIFIED VS. NONQUALIFIED CLTs

A qualified CLT is one that meets the tax law requirements to qualify for a gift tax or estate tax charitable deduction. As we shall see, a CLT may also qualify for an income tax charitable deduction if the trust is deemed a "grantor trust" for federal income tax purposes. Nonqualified CLTs are those that fail to qualify for a charitable deduction.

It's important to note that even a qualified CLT (unlike a qualified charitable remainder trust) is not income tax-exempt. Trust income will be taxed either to the grantor or to the trust. If the trust is the taxpayer, it is taxed as a complex trust.

To be "qualified," a CLT must meet several requirements:

- The trust must be irrevocable
- The term of the trust generally must be measured by a fixed term of years or by the life or lives of one or more

persons living when it is created. Most CLTs are created for a fixed term of years

- Income payments must be made to charity either in the form of a guaranteed annuity interest or a unitrust interest (defined below)
- Generally, payments to noncharitable beneficiaries are not allowed during the term of the trust
- The trust agreement must contain language that forbids certain kinds of prohibited dealings and activities.

ANNUITY VS. UNITRUST PAYOUT

A guaranteed annuity interest is a fixed percentage of the initial value of the trust principal. This establishes at the outset a fixed dollar amount that must be paid to charity each year regardless of trust performance.

A unitrust interest is a fixed percentage of the annually revalued trust principal, and results in an annual payout that fluctuates in dollar amount with trust performance.

There is no 5 percent minimum payout for CLTs as required for charitable remainder trusts (applicable to both types of qualified payouts). There is no minimum charitable interest as required for charitable remainder trusts (10 percent). There is no “net-income CLT,” under which the trustee would distribute only the trust’s net income if that were less than the regular percentage payout. There is no such thing as a “flip CLT,” under which the trustee would switch from one type of payout to another upon the occurrence of some contingency. To be qualified, a CLT must select one of the two authorized payout methods and stick with it for the entire term of the trust – any other payout method makes the trust nonqualified.

GRANTOR VS. NON-GRANTOR CLTS

The grantor can take only an income tax charitable deduction upon the creation of an inter vivos CLT if the trust is considered a grantor trust for federal income tax purposes [IRC Sec.170(f)(2)(B)]. While the net income of the trust is included in the grantor’s gross income each year, the grantor can deduct the present value of the charity’s income interest in the year of the gift (subject to the percentage limitations).

A grantor is treated as the owner of a trust if, among other things, the present value of the grantor’s reversionary interest in the trust exceeds 5 percent of the trust’s value [IRC Sec. 673(a)]. Unless the grantor creates a CLT with a very

high payout percentage and/or a very long term – so that the present value of the charity’s interest is 95 percent or more of the trust’s value – the donor’s retention of a reversionary interest will make the CLT a grantor trust for income tax purposes.

In order to qualify a trust as a non-grantor CLT, the grantor cannot have any of the following rights or powers:

- A reversionary interest exceeding 5 percent
- A power to revoke the trust
- A power to control its beneficial enjoyment
- A right to receive trust income or to have trust income applied in certain ways for the grantor’s benefit (e.g., to discharge the grantor’s support obligations, or to pay life insurance premiums on a policy on the life of the grantor or the grantor’s spouse), or
- Certain administrative powers over the trust, e.g., a power to borrow from the trust on “sweetheart” terms.

No income tax charitable deduction is allowable for the creation of a non-grantor CLT, although the trust itself can deduct its annual payouts to charity during the trust term.

If a grantor provides that the principal of a CLT will pass to a third party upon expiration of the trust term rather than reverting to the grantor, no reversionary interest exists in the grantor. The grantor would neither be taxed on trust income, nor be allowed an income tax charitable deduction. But the federal gift tax may become a factor because a future-interest gift is made to the noncharitable third party. Only the present value of the charitable portion is sheltered by the gift tax charitable deduction.

INTER VIVOS VS. TESTAMENTARY CLTS

CLTs may be set up during the grantor’s life or at the grantor’s death. When the primary motive is current income tax savings, the CLT must be set up during life. When the primary motive is transfer tax savings, the grantor may choose to establish a testamentary CLT. This will have the important side benefit of passing a tax basis to beneficiaries (when the CLT ends) that is stepped-up to the estate tax value of the trust property.

An increased gift tax charitable deduction available for an inter vivos CLT reduces the value of the ultimate gift to the noncharitable remaindermen in the case of a non-grantor CLT. However, the grantor’s basis in the trust property

carries over to the remaindermen when an inter vivos CLT ends.

If remaining payments are to be made to charity at the grantor's death, the present value of these payments is estate-tax deductible if the CLT is included in the grantor's gross estate.

Finally, the appreciation in value of the trust principal after the trust is created would escape transfer tax entirely (unless the generation-skipping tax is triggered upon trust termination).

TWO POPULAR TYPES OF CHARITABLE LEAD TRUSTS

While a CLT can be arranged in different ways, let's examine the two most popular types: the qualified grantor CLT and the qualified non-grantor CLT.

Qualified Grantor CLT

The qualified grantor CLT is (1) established during the grantor's lifetime, (2) makes annual payments for a designated period, (3) after which the principal reverts to the grantor (or, possibly, to family members).

If the grantor's reversionary interest exceeds 5 percent, as it usually will, the trust is a grantor trust for federal income tax purposes. The grantor secures an immediate income tax charitable deduction for the present value of the charity's income interest. The grantor is taxed on the trust income, but if the CLT is funded with tax-exempt bonds, the adverse impact of having trust income taxed to the grantor can be neutralized. Of course, a major reason that individuals employ a non-grantor CLT is to "freeze" the value of the assets entering the trust so that the assets appreciate at a faster rate than the Sec. 7520 rate – which tax-exempt bonds likely cannot do.

The qualified grantor CLT is especially useful for the grantor who intends to make annual gifts to the charity anyway. The CLT can accelerate the deductions for these future gifts into one large deduction for the current year (with a carryover of up to 5 years for any excess deduction if the percentage limitations place a ceiling on the current year's deduction).

The grantor who has had an extraordinary income year (for example, large realized capital gains, income from taxable stock options, or receipt of large commissions or a large performance bonus) may be eager to accelerate future income

tax charitable deductions into the current tax year with a qualified grantor CLT.

Qualified Non-grantor CLT

The qualified non-grantor CLT is probably the most commonly used CLT. It can be established during the grantor's life or testamentarily at the grantor's death. Because this is not a grantor trust, the trust income is not taxed to the grantor and no income tax charitable deduction is available to the grantor in the year the trust is established or in any subsequent year.

However, the trust itself can take income tax charitable deductions each year as payments are made to the charity (a CLT is not income tax-exempt, so these deductions will help offset its tax liability).

The main purpose of the qualified non-grantor CLT is to reduce transfer taxes on property that ultimately will pass to descendants. This is accomplished by naming descendants as the remaindermen, and utilizing the gift tax and estate tax charitable deductions for the charitable interest to minimize transfer tax costs.

Example: Consider a testamentary charitable lead annuity trust that is to pay \$45,000 (5 percent of its initial principal of \$900,000) to charity each year for eight years. The trust has a steady annual return of 10 percent, or \$90,000. Let's assume that taxes and expenses consume 33.3 percent of each year's excess annual income (over the charitable payout amount).

When the trust terminates in eight years, the grantor's beneficiary will receive, under these assumptions, a distribution in excess of \$1,350,000. This will substantially exceed the value of the beneficiary's remainder interest that was taxed at the time of the grantor's death. The estate tax charitable deduction for the charity's lead interest in the trust effectively sheltered part of the principal that the beneficiary(ies) eventually will receive. Equally important, all post-death appreciation in the trust corpus avoids transfer tax.

NEW CHARITABLE LEAD ANNUITY TRUST SAMPLE FORMS AVAILABLE AT IRS.GOV – SEE REV. PROC. 2007-45 AND 2007-46.

New Tax Developments

Early Termination of a NIMCRUT Permitted

Several recent Private Letter Rulings (PLRs 200304025, 200403051, 200408031, 200441024) have permitted the early termination of a charitable remainder unitrust (CRUT) without the peril of self-dealing penalties. In PLR 200725044 (published in late June) the IRS again allows the taxpayer to terminate a net income makeup CRUT, but with a twist.

The taxpayer set up a NIMCRUT that would pay him the lesser of the net trust earnings or 10% of the trust assets. Later, the taxpayer decided to change the charitable beneficiary from a single charity to a set of twelve charities. The taxpayer wanted to then terminate the trust and to sell his income interest in the CRUT to the charities. The sale of the income interest would be valued according to the discount rate in effect on the date of sale under IRC Sec. 7520 and the method outlined in Reg. Sec. 1.664-4. The taxpayer sought a PLR to answer to whether the act would be considered self-dealing.

The IRS agreed to allow the termination of the CRUT. However, the payout of the NIMCRUT is contingent, so the standard valuation would not do. Instead, the IRS based the valuation of the income interest on either the stated 10% or the IRC Sec. 7520 rate when the trust was terminated (whichever was less) so not to "inappropriately inflate the income beneficiary's interest to the detriment of the charitable remaindermen."

The "twist" on the valuation of the CRUT income interest has drawn criticism (see Steve Leimberg's Charitable

Planning Newsletter #123 (June 27, 2007). The termination of a charitable remainder unitrust (especially with a net-income makeup provision) still requires close attention.

IRS Issues Revised Publication 950 Introduction to Estate and Gift Taxes

The IRS publishes many guides that outline the basic federal tax laws pertinent to a certain area. These guides are written for the layperson and can be a resource for educating your clients. Publications relevant to charitable giving include:

- * Claiming a deduction for charitable contributions (Publication 526)
- * Substantiating charitable contributions (Publication 1771)
- * Making a charitable gift of a vehicle (Publication 4303)
- * Valuing property donated to charity (Publication 561).

The IRS periodically updates the publications, usually to account for changes in the law. The newly revised Publication 950 Introduction to Estate and Gift Taxes explains:

- * When tax is not owed because of the unified credit
- * When the gift tax does and does not apply
- * When the estate tax does and does not apply
- * When to file a return for the gift tax or the estate tax
- * When the generation-skipping transfer tax may apply.

This newsletter is only for professional advisors and only for their information and discussion. It is intended only to provide general information about charitable gifts and charitable-gift planning. This newsletter is not (1) legal, tax, accounting, or financial advice, (2) any solicitation of legal, tax, accounting, or financial services, (3) any securities or investment advice, or (4) any solicitation of securities or investment advisory services. Each professional must evaluate the tax and financial consequences of each individual situation.

Although The Catholic Foundation has been diligent in attempting to provide accurate information, the accuracy of the information in this newsletter cannot be guaranteed. Laws and regulations change frequently and are subject to differing legal interpretations. Accordingly, The Catholic Foundation shall not be liable for any loss or damage caused or alleged to have been caused by the use or reliance upon the information in this newsletter.

T H E
CATHOLIC
F O U N D A T I O N