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Charitable Lead Trusts: The Basics, Tips, & Traps for the Unwary

Northern California Planned Giving Council

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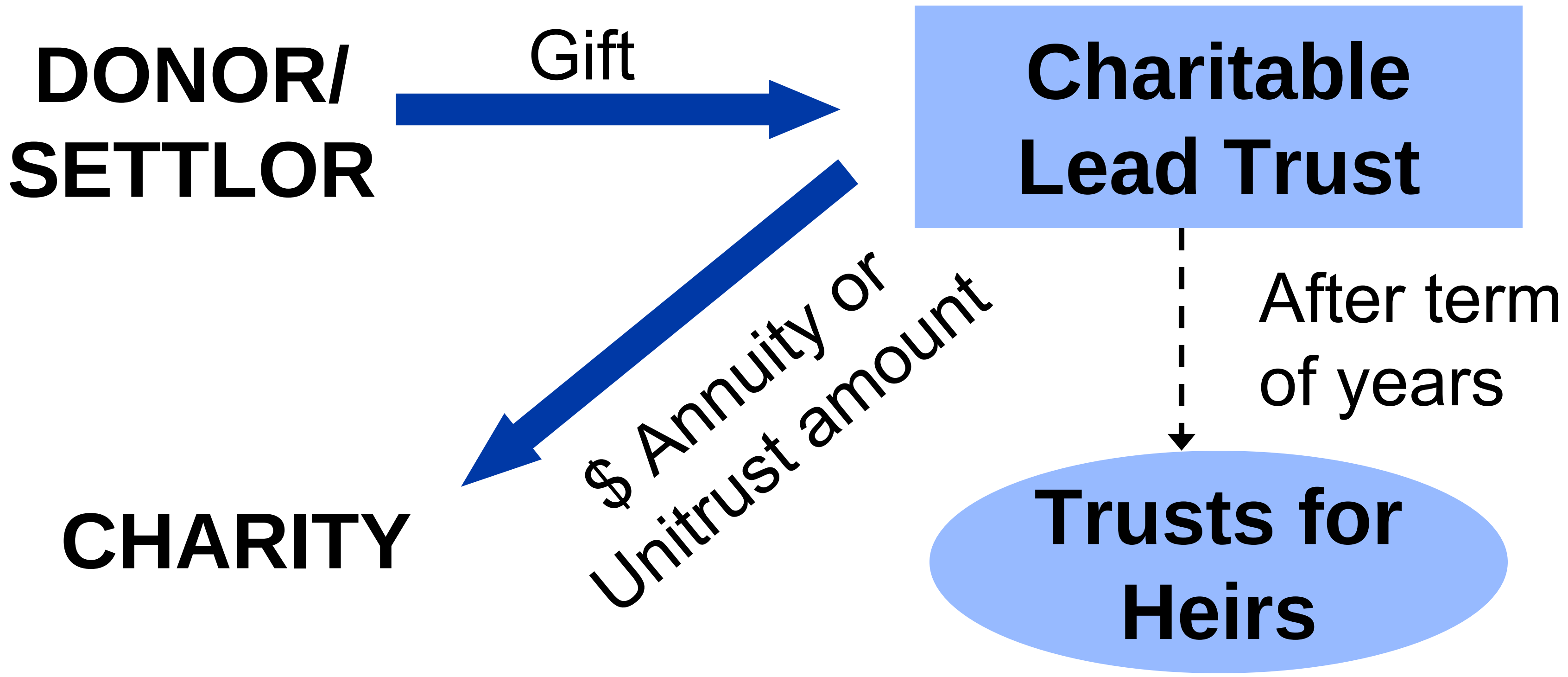
DONOR/
SETTLOR
Gift
Charitable
Lead Trust
$ Annuity or
Unitrust amount
CHARITY
After term
of years
Trusts for
Heirs

Why Establish a Charitable Lead Trust?

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- Assets to heirs at discounted rates
- "Endow" your gift to charity for a term of years
- Deplete your taxable estate at low or no gift or estate tax cost

Who Should Establish a Charitable Lead Trust?

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- Philanthropic intent
- Do not need all your assets to live on
- Heirs can wait a period of time before receiving assets from Trust

Basic Types

Three Basic Decisions:

- Annuity Trust v. Unitrust
- Testamentary v. Intervivos
- Grantor v. Non-grantor

Annuity v. Unitrust

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- Unitrust: fixed percentage
  - GST planning possible
- Annuity: fixed payments
  - Generally more for heirs
  - GST planning difficult

Testamentary v. Intervivos

- Testamentary
  - Estate tax charitable deduction for present value of annuity stream
  - Can allocate GST but same issue of CLAT v. CLUT

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- Intervivos
  - Gift tax: completed present gift to heirs of a future interest
    completed present gift to charity
  - Estate tax: out of estate so long as settlor does not retain control of beneficial enjoyment
    - Who can be the charitable annuitant?
    - Who can be the trustee?
  - Income tax: grantor v. non-grantor

Grantor v. Non-Grantor CLT

- Non-Grantor CLT
  - Donor does not get income tax deduction upon contribution
  - CLT is separate taxpayer
    - Compressed rate table
    - Higher marginal rates for ordinary and passive income
  - CLT has unlimited deduction from income tax for payments to charity
    - No carryforward
    - Gifts to foreign charities qualify
    - Watch unrelated business income trap
  - All testamentary CLTs

Grantor v. Non-Grantor CLT

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- Grantor CLT
  - Grantor retains certain powers
    - Toggle powers off
  - Grantor gets charitable income tax deduction for present value of annuity payments
    - Gift "for use of" charity
    - Recapture
  - Grantor pays income tax as additional tax-free gift to heirs
  - Caution: Capital gains to donor on distribution of appreciated assets in payment of annuity

Gift Tax - How Does It Work?

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- Completed present gift of a future interest

- Three factors determine size of gift
  - Length of term
  - Annuity or unitrust percentage
  - 7520 rate

- What is a successful CLT?

3 Ways to "Supercharge" the Gift

- Fund with discountable asset
- Increasing annuity payments
- Grantor trust

Discountable Assets

- Example: gift of limited partnership interest holding passive investment assets
  - Assume: 7520 rate = 1.4%
    $1 million NAV
    discount off NAV = 25%
  - Without discount: Hurdle rate = 1.4%
  - With discount: Gift valued at $750,000
    Hurdle amount =
    ($750,000)(.014) = $10,500
    Hurdle rate = $10,500/1mm = 1.05%

Increase Annuity Payments

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- Like GRAT: increase by 20% each year
- Shark Fin CLAT
- Issue: what is charitable intent of donor?

Grantor Trust

- CLT is not depleted by having to pay income taxes
- Grantor’s taxable estate likewise depleted without paying gift tax
- Toggle off grantor trust status

Traps for the Unwary

- Private foundation rules apply
  - Self-dealing
  - Jeopardizing investments
  - Excess business holdings
- Unrelated business income reduces charitable deduction in non-grantor trust
- Asset must generate cash flow required to pay annuity
  - Unwanted discount if interests in closely held business used to pay annuity
    - Could be deemed self-dealing if appraised value per unit is too high
  - Deemed sale of appreciated assets distributed from grantor trust

Traps for the Unwary (Cont'd)

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Best assets to use

- Discountable
- Reliable cash flow
- Pop in value a plus
- Avoid risks of self-dealing

- Application to closely held family business

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