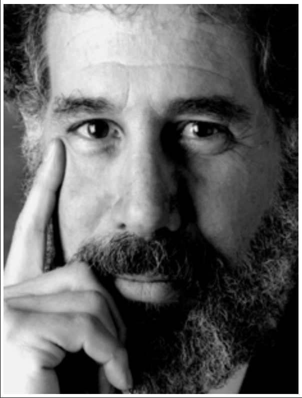

Leimberg's Think About It

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WHAT EVERY PLANNER NEEDS TO KNOW ABOUT CHARITABLE LEAD TRUSTS

Introduction

People are motivated to make gifts to charity by a variety of reasons, including:

- To further the charity's mission
- To support their sense of stewardship
- To share their good fortune
- To create a kind of immortality

In addition to these reasons, donors can also be motivated by tax considerations when deciding to make charitable gifts.

The majority of charitable giving is done by volunteer work or by simply writing a check to a charity of choice. However, for those who are seeking to achieve multiple objectives, more sophisticated giving techniques can be considered.

For example, an affluent person seeking to help a charity and also solve some tax problems might consider implementing a lifetime charitable remainder trust (CRT). Under a CRT, the *donor* usually receives an annuity for life or for a stated number of years, after which the remainder interest, the amount left in the trust at the donor's death, passes to the *charity*.

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If properly implemented, a CRT creates a number of tax benefits for the donor:

- No capital gains tax is generated on the sale of appreciated assets after they have been donated to the CRT.
- The donor receives an immediate charitable income tax deduction equal to the value of the donation minus the present value of the annuity stream.
- The donor's estate receives a future estate tax deduction for the value of the charitable remainder interest.

Where life insurance professionals are involved in the CRT process, they often encourage the donor to consider the purchase of a life policy to replace the value of the asset donated to the CRT. Where the donor faces an expected estate tax problem, the insurance is typically owned by an irrevocable life insurance trust (ILIT). Under these circumstances, the ILIT is sometimes called a *wealth replacement trust*.

Because of their tax characteristics, CRTs work best at times when capital gains tax rates, estate tax rates, and interest rates are high.

In today's environment, capital gains tax rates are still relatively low—15% versus a top income tax rate of 35%. Estate tax rates currently max out at 45%, which is lower than the 55% of ten years ago. Finally, interest rates are currently very low by historical standards.

Based on current factors, those who want to make sophisticated charitable gifts may be better served to consider a charitable lead trust (CLT) rather than a CRT.

CLT Basics

A CLT can be structured as a *grantor trust*, meaning the income earned by the trust is taxable to the grantor, or to a *non-grantor* or *family* trust, meaning the income earned by the trust is taxable to the trust.

The CLT, whether structured as a grantor trust or a family trust, must pay a fixed percentage of the trust's initial value (annuity trust) or a fixed percentage of the trust's annual value (unitrust) to the designated charity for the term of the trust.

The annuity or unitrust amount must be paid, not less often than annually, for a period that is measured by a specified term or for the life or lives of an individual or individuals.

CLT as a Grantor Trust

Here's how a Grantor CLT usually works:

1. The donor chooses the term of the charitable lead interest and other trust details.
2. The donor decides on the amount of the annuity or unitrust payment to be directed to the designated charity for the term of the trust.
3. The donor contributes assets to the Grantor CLT.
4. The trust makes the payments specified in the CLT document.
5. When the trust term ends, the right to the remaining assets, including any undistributed appreciation, returns to the donor.

In order to qualify for the income tax charitable deduction, the grantor must be treated as the owner of the trust for income tax purposes. Because in the Grantor CLT the grantor keeps a reversionary right to the remainder interest, this test is met.

CLT as a Family Trust

It is also possible to configure a charitable lead trust as a family trust (Family CLT). A Family CLT works the same way as a Grantor CLT except that under a Family CLT, family members *other than the grantor* are the remainder beneficiaries.

The grantor of a Family CLT is *not* entitled to an income tax deduction—nor is the grantor taxed on trust income. Instead, the Family CLT is taxed as a complex trust (meaning the trust is taxed on its own income), and the trust receives an income tax deduction for the lead interest paid to charity.

The grantor of a Family CLT is also making a taxable gift to family members at the trust's inception based on the present value of the remainder interest.

Hybrid CLTs

Through the use of sophisticated drafting techniques, it is possible to create CLTs that have mixed characteristics. For example, it is possible to draft a CLT that is treated as a Grantor CLT for income tax purposes but is treated as a Family CLT for gift tax purposes. The key to that type of hybrid is the use of intentionally defective grantor trust provisions in the CLT. Other types of hybrids are also possible.

These hybrids may work for selected circumstances. Depending on the particular configuration, some or all of the tax considerations below will apply.

Taxes

The tax characteristics of a CLT depend on whether it is configured as a grantor trust or a family trust.

Income Tax Deduction for Grantor CLT

The donor of a Grantor CLT can take an immediate charitable contribution deduction for the present value of the income interest that is being allocated to the charity.

The value of the charitable deduction is calculated based on the following formula:

> The present value of the charitable annuity or unitrust stream discounted based on the current applicable federal rate (e.g., 2.4% in March 2009) or the rate for one of the two months prior to the transaction. See IRC Section 7520 (a).

The charitable gift is deemed "for the use of the charity" and qualifies for a 30% of adjusted gross income (AGI) deduction. See IRC Section 170 (b) (1) (B). The AGI limit may be reduced to 20% if the lead beneficiary is a private foundation rather than a public charity.

If the charitable income tax deduction cannot be fully used in the year of the gift, as long as the annuity beneficiary is a public charity, the deduction may be carried forward for up to five years.

Here's an example. Say that George sets up a Grantor CLT with $10 million of assets. Say also that George sets up a 10-year CLT naming a public charity as annuity beneficiary with a 7% annual annuity payout at the end of each year. Based on current interest rates, that would generate a current income tax deduction of about $6.15 million—equal to the present value of the annuity interest. If the entire deduction cannot be used in the year of the gift, it can be carried forward for up to five tax years.

For those who need to calculate the charitable deduction for Grantor CLTs, it helps to have a software program designed for that purpose.

In general, the longer a Grantor CLT lasts, the larger the total annuity that will be paid to charity, and so the larger the tax deduction it generates.

However, the tax benefit of the initial charitable deduction is mitigated by the fact that the income earned each year by the CLT is taxable to the grantor during the term with no offsetting current charitable deductions at the time the annuity or unitrust amounts are paid to the charity.

If the grantor dies prior to the end of the charitable lead term, some of the charitable income tax deduction will be recaptured. The reason for the recapture is that the grantor's death transforms the CLT into a non-grantor trust. The amount recaptured is based on the present value of the scheduled post-death payments to charity.

Gift Tax Deduction for a Family CLT

The Family CLT is designed to transfer wealth from the grantor to the non-charitable beneficiaries at a discount while also providing a lead benefit to the charity. The transfer from the grantor to the family members is a taxable gift. The gift is discounted by the value of the charitable lead interest. The lead interest is calculated the same way as the income tax deduction is calculated for a Grantor CLT.

Say that George from our prior example sets up a Family CLT with $10 million of assets. Say also that George sets up a 10-year CLT naming a public charity as annuity beneficiary with a 7% annual annuity payout at the end of each year. He also names his children the remainder beneficiaries.

Based on current interest rates, that would generate a current *gift* tax deduction of about $6.15 million—equal to the present value of the annuity interest. The taxable value of the gift from George to his children would be $3.85 million, and George would owe gift taxes based on that gift amount.

If the Family CLT assets grow more rapidly than the applicable federal rate (AFR), the children will receive a substantial remainder interest—free from additional gift taxes. For example, if the assets grow at a 7% interest rate, the value of the remainder interest would be $10 million at the end of the CLT term.

On the other hand, if the CLT assets decrease in value during the first ten years, the children may receive nothing at the end of the charity's annuity payment stream.

Death-time Tax Issues

For a Grantor CLT, if the trust ceases to be a Grantor Trust—for example, at the death of the grantor—a portion of the income tax deduction is recaptured. The recaptured amount is based on the value of the yet-unpaid lead payments to charity.

For a Family CLT, the gift is complete at the time the CLT is created. There is no recapture of any gift in the event the grantor dies before the end of the lead interest to charity. Further, the value of the trust is excluded from the grantor's estate at the grantor's death.

Under normal circumstances, one might expect that the grantor of a Family CLT could allocate part of his GST exemption at the trust's inception to make the CLT exempt from generation-skipping taxes. However, under a special provision of Code Section 2642(e), the final calculation of the amount of a Family CLT exempt from the GST cannot be made until the *end* of the lead interest. That fact makes GST planning with CLTs problematic.

Testamentary CLTs

Even in a favorable interest rate environment, lifetime Family CLTs can still generate a substantial gift tax problem. For those who intend to transfer significant wealth to family members, the relatively small size of the $1 million lifetime gift tax exemption can create a barrier to Family CLT planning.

Many who are interested in managing estate tax issues may opt for a death-time bequest through a CLT. One of the most famous real-life examples of *testamentary CLT planning* occurred with the estate of Jackie Onassis.

The Onassis CLT could have saved Jackie's heirs substantial estate taxes and generated significant income for several charities. However, as things turned out, her will's charitable provisions were largely by-passed by the family after her death.

How might a properly implemented testamentary Family CLT work?

Say that Rita has a taxable estate worth $100 million. She creates a plan under which all her assets are transferred to a CLT at her death. The CLT provides that the trust will pay out a charitable annuity payment of $8,000,000 a year for 15 years. At the end of the 15 years, the remainder interest will be transferred to Rita's children.

Based on the current applicable federal rate (2.4% in March, 2009), the value of the remainder interest would be just $216,800. The estate would be entitled to charitable estate tax deduction for the rest. With the current exemption amount, the estate would avoid federal estate taxes on the transfer of wealth. In fact, it is possible to put together a Family CLT or Testamentary CLT for which the value of the gift or estate taxable amount is zero. If property increases in value as expected, the family really benefits.

As with the lifetime Family CLT, if the CLT assets grow more rapidly than the applicable federal rate (AFR), the children will receive a substantial remainder interest—either estate tax free or at a substantial estate tax discount.

On the other hand, if the CLT assets do not grow at least as rapidly as the 2.4% federal rate, the children may receive little or nothing at the end of the charity's annuity payment stream.

If the affluent client is convinced that the assets earmarked for the CLT will outperform the current AFR at the time of death, a testamentary Family CLT can create a positive tax result for the family.

Income Management of Grantor CLTs

A charitable remainder trust is a tax-exempt entity. A charitable lead trust is not.

The grantor must recognize the taxable income earned by a Grantor CLT during the charitable payout phase. For a Family CLT, the income is typically recognized by the trust itself. To maximize the income tax effects, the typical CLT is administered to minimize the taxable income.

Remember George from our prior example? Let's say that the $10 million he has earmarked to the CLT, which is designed to pay him an annuity payment of 7% for ten years, is made up of the following assets:

- $2 million in cash
- $3 million in growth-oriented marketable securities with little current appreciation
- $4 million worth of income-producing commercial real estate with some appreciation, which is expected to grow substantially in value
- A policy insuring George's life for $10 million with $1 million of cash value

The trustee of the CLT could choose to meet its income obligation to the charity of $700,000 per year by using the cash first. While the grantor of the trust would have to pay income taxes on the interest earned by the cash, the tax result would be relatively small.

After the cash is exhausted, the trustee might liquidate securities with little or no appreciation to meet its annuity payout obligation to the charity. The grantor would recognize capital gains on the liquidations, if any.

The trustee might instead decide to borrow money against the other trust assets to raise the needed annuity payments. Loans against securities, commercial real estate or life insurance are not considered to be income taxable transactions until the underlying assets are disposed of.

With the trustee of the Grantor CLT making smart tax management choices with regard to the resources used to fund the annuity distributions, the grantor's income tax liability can be minimized.

Life Insurance Opportunities

When life insurance is used in conjunction with charitable *remainder* trust planning, it is usually owned by an ILIT to replace the remainder interest designated for charity. The Family CLT creates a kind of reciprocal opportunity. Life insurance owned by an irrevocable trust can replace the value of the *lead* interest.

Those who choose to create testamentary CLTs usually do so to minimize their estate tax exposures. For many, CLT planning will not solve the whole estate tax problem. Life insurance can be used as a tool to cover any remaining estate taxes.

Finally, life insurance can fit into hybrid trusts—those that use the grantor trust technique to straddle between Grantor and Family CLT objectives. Life insurance cash values are accessible on a tax-favored basis to minimize the adverse income tax result for the grantor. Such distributions can support the charitable lead income stream. Finally, if the grantor survives the lead term of the trust, the life insurance policy, its remaining cash value, and its death proceeds are available for family members.

Conclusion

CLTs can work very well in a low interest rate environment. For a Grantor CLT, the low interest rates mean that the value of the charitable deduction is higher. For those who create Family CLTs, the low interest rates mean that greater gift tax discounts are possible. Finally, for testamentary CLTs, the current interest rates mean that estate tax discounts are maximized.

When assets contributed to a CLT are likely to appreciate more aggressively than the Section 7520 interest rate, tax leverage is created for the grantor or the family.

In a low interest rate environment such as we are experiencing currently, CLT planning offers affluent clients opportunities to satisfy charitable objectives while also meeting income tax planning, gift tax planning, and estate planning objectives. And there's still an important role for life insurance to play in most plans.

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