CHARITABLE LEAD TRUSTS: PLANNING BENEFITS AND PITFALLS

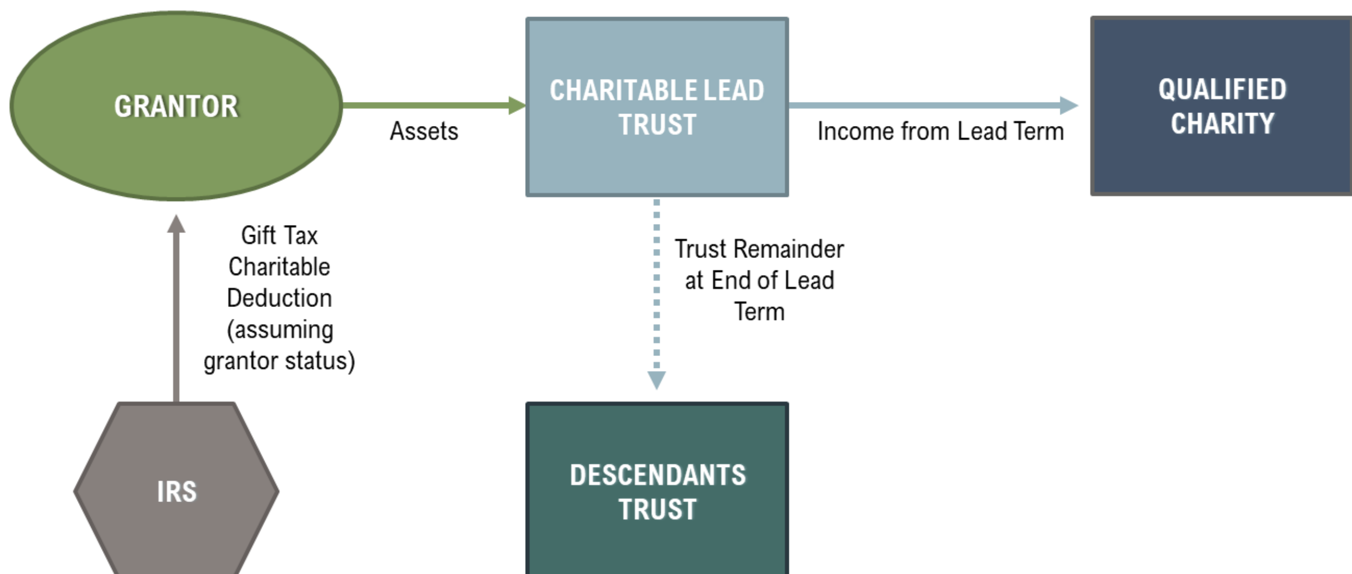
Ultra-affluent families with excess capital often have dual goals of charitable giving and preserving wealth for future generations. The Charitable Lead Trust ("CLT") is an ideal vehicle for accomplishing these competing objectives.

A CLT is essentially the opposite of a Charitable Remainder Trust ("CRT") because the "lead" interest is paid annually to the family's designated charity rather than to non-charitable beneficiaries or trusts for their benefit. At the termination of the CLT, the remainder is distributed or allocated to the non-charitable beneficiaries or trust(s) for their benefit rather than charity.

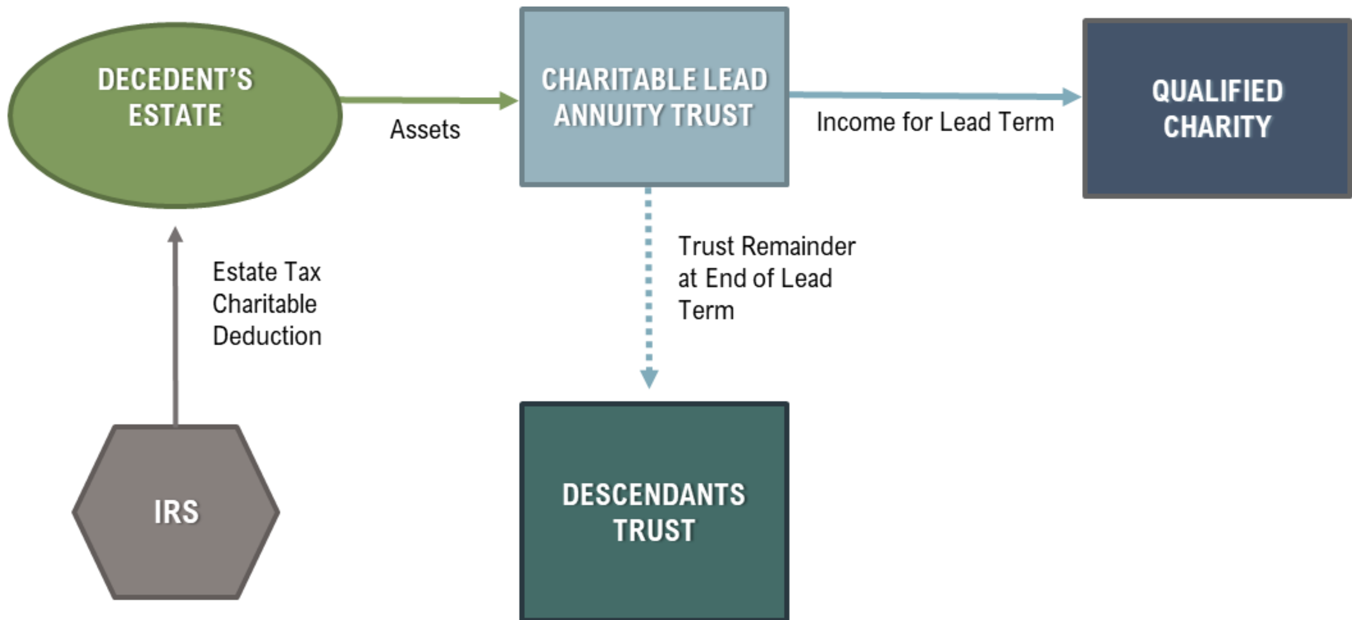
Overview

A CLT pays income to a charity for a specified period. The "income interest" can be measured by one or more lives, a term of years, or a combination of both. The remainder interest is transferred to one or more non-charitable beneficiaries, most typically a trust for the benefit of the grantor's descendants. For example, a donor may create such a trust during their lifetime and/or upon their death, instructing the trustee to pay income to a designated charity for 20 years and to distribute the principal at the end of the term to the donor's descendants (outright or in trust).

A lifetime CLT is illustrated below.



A testamentary CLT is illustrated below:



A zeroed-out CLT can be used to reduce the donor's taxable estate or gift tax to zero. A zeroed-out CLT is achieved by setting the payout rate to the charity high enough over the designated term so that the present value of the charitable income stream equals the entire value of the property initially transferred to the trust. If the present value of the charitable lead interest is less than the value of the property utilized to fund the trust, the difference is treated as either part of the taxable estate with no offsetting estate tax charitable deduction (in the case of a testamentary CLT) or a reportable gift (in the case of a lifetime CLT).

The valuation of the present value of the charitable lead interest is governed by IRC Section 7520 and is based on tables that assume a rate of return equal to 120% of the Applicable Federal Midterm Rate (the "7520 Rate"). The Service has issued Publication 1457 (Actuarial Values, Alpha Volume), which contains tables to be used in determining the present value of an annuity interest for life or for a term of years. The 7520 Rate for any given month is published in a Revenue Ruling issued toward the end of the preceding month. For charitable transfers, taxpayers may choose between the 7520 Rate for the current month and those in effect for the two preceding months.

Using the IRS tables, taxpayers are able to structure a charitable lead trust to obtain an income, gift, or estate tax deduction based on a percentage of the amount transferred in trust. Special care must be exercised, however, to avoid negative Generation-Skipping Transfer ("GST") Tax implications.

If the underlying transferred assets grow at a rate greater than the IRS mandated discount rate required to calculate the present value of the charity's lead interest, then the donor's heirs will ultimately benefit from any excess growth during the charitable lead term.

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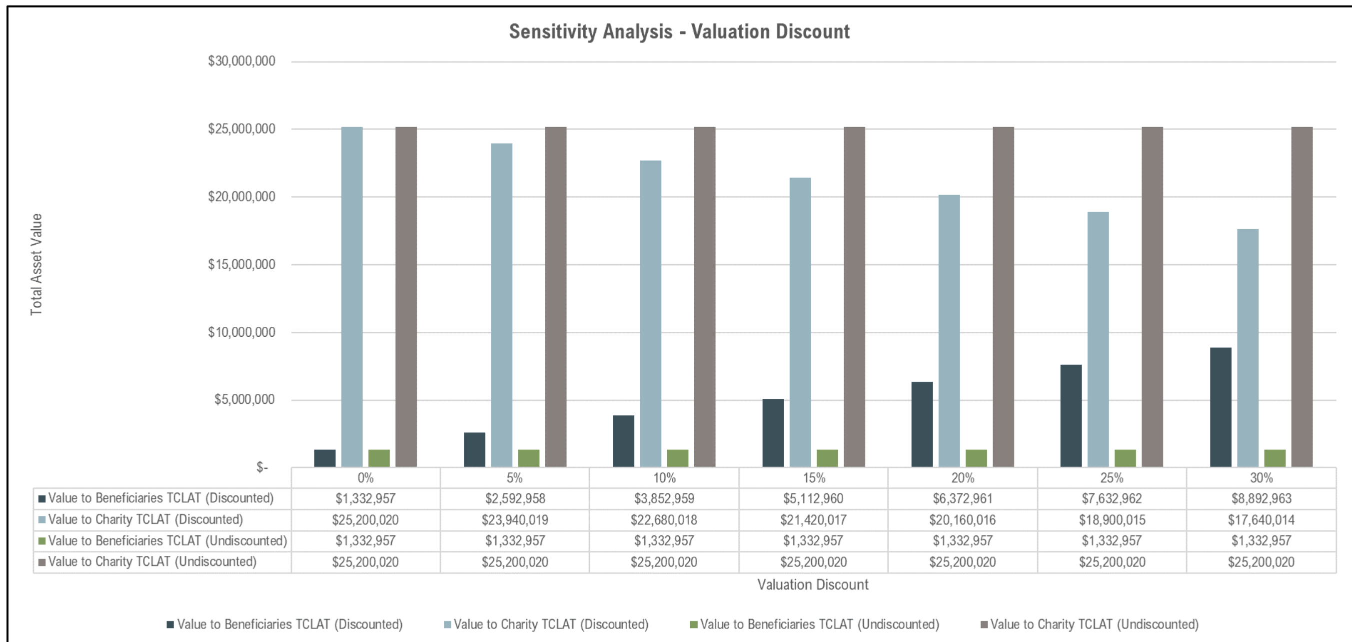
The results of the CLT strategy are most dependent on the following material variables and their relationship with one another:

- Cost basis of assets that fund the CLT
- The IRS 7520 interest rate required to calculate the charitable lead payments
- Transfer tax valuation discount (or lack thereof) applied to the transferred property
- Actual income and growth assumptions of the CLT assets during the lead period

In particular, the charts that follow illustrate how the allocation of a family's capital can change between the family non-charitable beneficiaries and the designated charity under a typical Charitable Lead Annuity Trust ("CLAT") structure (described further below) depending on the extent of potential valuation discounts applicable to the transferred property and the assumed investment asset performance of the transferred assets relative to the IRS required discount rate utilized to calculate the charitable lead payments.

Exhibit 1: Valuation Discount Impact

As reflected below, the non-charitable beneficiaries receive more over time as the valuation discount applied to the assets that fund the CLAT increases. For ease of comparision, the calculations in the chart below disregard income taxes during the CLAT annuity period.



	0%	5%	10%	15%	20%	25%	30%
Value to Beneficiaries TCLAT (Discounted)	$1,332,957	$2,592,958	$3,852,959	$5,112,960	$6,372,961	$7,632,962	$8,892,963
Value to Charity TCLAT (Discounted)	$25,200,020	$23,940,019	$22,680,018	$21,420,017	$20,160,016	$18,900,015	$17,640,014
Value to Beneficiaries TCLAT (Undiscounted)	$1,332,957	$1,332,957	$1,332,957	$1,332,957	$1,332,957	$1,332,957	$1,332,957
Value to Charity TCLAT (Undiscounted)	$25,200,020	$25,200,020	$25,200,020	$25,200,020	$25,200,020	$25,200,020	$25,200,020

[1] See footnote for assumptions utilized in analysis. Past performance is no guarantee of future results. Please see our disclosure at the end of this document.

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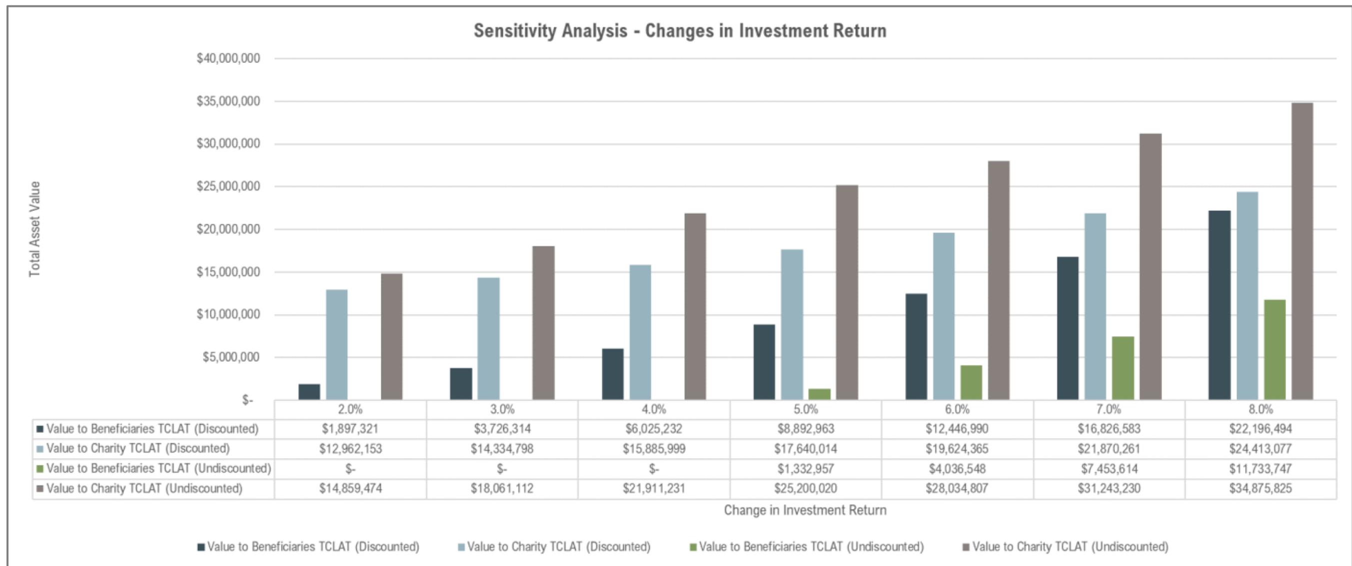
Exhibit 2: Growth Rate Impact

As reflected below, the non-charitable beneficiaries receive more over time to the extent the underlying investment performance of the CLAT assets exceeds the required IRC Section 7520 rate utilized to calculate the charitable lead payments. For ease of comparison, the calculations in the chart below disregard income taxes during the CLAT annuity period.



	2.0%	3.0%	4.0%	5.0%	6.0%	7.0%	8.0%
Value to Beneficiaries TCLAT (Discounted)	$1,897,321	$3,726,314	$6,025,232	$8,892,963	$12,446,990	$16,826,583	$22,196,494
Value to Charity TCLAT (Discounted)	$12,962,153	$14,334,798	$15,885,999	$17,640,014	$19,624,365	$21,870,261	$24,413,077
Value to Beneficiaries TCLAT (Undiscounted)	$-	$-	$-	$1,332,957	$4,036,548	$7,453,614	$11,733,747
Value to Charity TCLAT (Undiscounted)	$14,859,474	$18,061,112	$21,911,231	$25,200,020	$28,034,807	$31,243,230	$34,875,825

[2] See footnote for assumptions utilized in analysis. Past performance is no guarantee of future results. Please see our disclosure at the end of this document.

The ability to establish a trust either during lifetime or at death and fund it with appreciating property and structure the transfer for estate and gift tax purposes so that the remainder interest has an actuarial value of zero, is a potentially powerful planning technique that can transfer wealth to lower generations in a tax efficient manner. The zeroed-out CLT strategy is especially attractive for wealthy families that have exhausted other advanced planning strategies or have otherwise exhausted their remaining applicable exclusion amount(s). However, a CLT is not for everyone. A CLT is not appropriate, for example, if the family cannot afford, or does not desire, to divert significant multi-generational family resources to charity as opposed to family members.

Transfer tax goals with respect to charitable lead trusts created during lifetime or at death include minimizing or eliminating the amount of the taxable gift to be reported and preventing the inclusion of the trust in the grantor's estate. To ensure the trust is excluded from the estate, the grantor must be careful to avoid the application of IRC Sections 2036 and 2038. For example, the grantor must not retain the right to designate the persons who will possess or enjoy the income from the property.

As a practical matter, this means the grantor should not be the trustee of the trust or continue to be involved in those activities of the charity receiving the income (if the grantor specifically helps determine

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future grant recipients). This requirement may present a problem if the charity is a family foundation and the grantor has too much control in selecting grant recipients with respect to funds received from the CLT.

Grantor Trust or Non-Grantor Trust

Unlike a CRT, a CLT can be structured as either a grantor trust to the donor or as its own taxable trust for income tax purposes. A CLT funded after death of the donor will, by definition, be its own taxable trust and will therefore file its own return and track its own income and deductions. In the case of a CLT created during the life of the donor, the Internal Revenue Code sets forth two primary requirements in order for the grantor to generate an upfront charitable income tax deduction equal to the value of the charitable interest:

- The interest must be in the form of a "guaranteed annuity" or "unitrust" interest, and

- The grantor must be treated as the owner of the interest as determined by applying IRC Section 671, et. al. (i.e., the grantor trust rules).

No upfront charitable income tax deduction is available to the grantor of a lifetime CLT that is structured as a non-grantor trust. Instead, the CLT's taxable income each year is reduced by the charitable lead payment the trust makes that year which qualifies as a charitable income tax deduction at the trust level (subject to the UBTI restrictions discussed in greater detail below).

CLAT vs. CLUT

CLTs may be formed as either Charitable Lead Annuity Trusts (CLATs) or Charitable Lead Unitrusts (CLUTs). A CLAT pays an annual annuity amount, expressed as a percentage of the initial value of the trust assets. This amount does not change during the lead term. A CLUT pays a fixed percentage of the trust assets re-valued on an annual basis. A CLAT will generally allow heirs to participate in more of the trust's appreciation over time since the charitable lead interest is based on the trust's initial value and does not increase over time as the trust assets grow. Given this distinction, CLATs are more common than CLUTs.

A CLAT is designed to pay a "guaranteed annuity" to a charity. It can be expressed as a stated dollar amount or a percentage of the initial amount transferred in trust. For example, it can be $500,000 per year or 5% of an initial $10 million trust transfer. In either event, the charity will receive $500,000 per year for the stated charitable term, and the remainder will revert to the grantor or pass to another non-charitable beneficiary or one or more trusts for non-charitable beneficiaries at the end of the charitable lead term. Since the guaranteed annuity amount only needs to be determined once at the inception of the trust, the annuity trust is particularly attractive for transfers of assets that are difficult to value. It also will likely transfer a greater amount to the named remainder beneficiaries if the trust income (including unrealized asset appreciation) exceeds the guaranteed annuity required to be paid to charity.

A CLUT is designed to pay a qualified "unitrust interest" to charity. This interest must be expressed as a percentage of the fair market value of trust property and requires that the value be redetermined annually.

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For example, if the designated payout rate is 5% and the trust property increases in value from $10 million to $12 million, the annual payout to charity will increase from an initial $500,000 to $600,000. The annual valuation requirement may prove troublesome if a closely held business is held in a CLUT. Congress contemplated, however, that such an asset could be held in a CLUT if an independent trustee is named in the trust instrument.

Summary of Potential Benefits

- A zeroed-out CLAT is an estate and/or gift tax mitigation strategy that can produce a "zero-tax" result (i.e., estate and gift taxes can be mitigated or potentially eliminated).

- Estate assets other than Income in Respect of Decedent ("IRD") assets qualify for a "stepped-up" cost basis at death for income tax purposes. This allows the CLAT the ability to sell its initial underlying assets for cash with little or no income tax consequences.

- A lifetime CLAT likely has an advantage over a testamentary CLAT for two primary reasons:

  - The grantor may enjoy a charitable income tax deduction during his/her lifetime to the extent that the CLAT is structured as a grantor trust. To the extent that the CLAT is structured as a non-grantor trust, the CLAT can potentially time the recognition of capital gains to be offset by charitable annuity payments.

  - The IRC Section 7520 discount rate can be determined with certainty at the time the structure is implemented. The IRC Section 7520 rate is more uncertain for a testamentary CLAT because interest rates can fluctuate dramatically between the donor's current age and their death.

- The CLAT strategy can be structured to balance the client's philanthropy and family inheritance goals since the client's gift assignment or Will and/or Revocable Trust controls the charitable lead payout percentage, which ultimately controls the allocation of assets among charity versus family.

- The client can purchase life insurance during their lifetime to provide supplemental family benefits until the expiration of the charitable "lead period" following the client's death.

- If assets subject to a valuation discount (e.g., LLC units) are utilized to fund a CLAT, the charitable annuity payments are based upon the initial lower valuation. To the extent that ongoing annuities are not satisfied in-kind with LLC units and the underlying assets perform equal or greater than the 7520 discount rate, the remainder beneficiaries are likely to benefit from any initial valuation discounts claimed.

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Summary of Potential Pitfalls

- In the case of a testamentary CLAT, the charitable payout percentage reflected in the client's Will and/or Revocable Trust cannot be amended once death occurs. This could cause more to go to charity than the decedent intended based on the interest rate environment at the client's death.

- Unless life insurance is purchased to supplement the CLAT, family members may have to wait to monetize their beneficial enjoyment of the transferred assets, if at all, until the charitable lead period expires. Moreover, the family may not receive a benefit at all if the underlying CLAT assets do not outperform the IRC Section 7520 rate applied to calculate the charitable annual payout amount.

- If a CLUT is utilized, the charitable payout percentage will equal a fixed percentage of the CLUT assets re-valued annually. This means that the charity (as opposed to family remainder beneficiaries) will participate more in the appreciation. In contrast, a CLAT shifts more potential "upside" to family remainder beneficiaries since the charitable payout percentage is expressed as a fixed percentage of the CLAT's initial asset value.

- The executor of the decedent's estate must wait until the expiration of the charitable lead period to allocate the decedent's GST exemption in the case of a CLAT as distinguished from a CLUT under the so-called Estate Tax Inclusion Period ("ETIP") rules. Accordingly, less GST exemption leverage is achievable if the underlying assets have significantly appreciated since the CLAT's initial valuation. In contrast, the decedent's executor does not have to wait to allocate the decedent's GST exemption immediately at the time the initial assets fund a CLUT.

  - A potential sale of a CLAT remainder beneficiary's expectancy interest to a GST Trust at the inception of the CLAT funding may be used as a strategy to mitigate the negative GST allocation issues associated with the requirement to wait to allocate GST exemption until after the expiration of the charitable lead period. This strategy is not without risk and could be challenged by the IRS.

  - Alternatively, the Grantor's Estate could sell assets to a GST Trust in exchange for a promissory note. If structured properly, this transaction would not be considered a prohibited transaction and the promissory note could then be utilized to fund the CLAT. This transaction could mitigate negative income tax consequences when dealing with assets that produce Unrelated Business Taxable Income ("UBTI"). In addition, the terms of the note could be structured to minimize income tax consequences to the CLAT, and the beneficiaries of the GST Trust would not have to wait until the end of the lead period to have access to the underlying assets.

- The type of assets that fund a non-grantor CLAT can create unintended income tax results. A few examples involve a lifetime CLAT funded with low-basis assets or a testamentary CLAT funded with a note receivable or other IRD asset that does not qualify for a step-up in basis at death. Ultimately if assets that fund a CLAT must be sold, the gain could create taxable income in excess of the CLAT's charitable income tax deduction for the tax year.

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- If a non-grantor CLAT is funded with debt-financed real estate assets or partnership interests that generate UBTI, negative income tax consequences may diminish the intended transfer tax benefits of a CLAT. A non-grantor CLAT's annual charitable deduction must be reduced (dollar-for-dollar) by the CLAT's share of UBTI. Real estate investments owned by CLATs that utilize leverage often produce debt-financed income. Debt-financed income is a form of UBTI.

- A so-called shark-fin CLAT has become a popular term among estate planning experts over the last 20 years. Under this strategy, charitable payments are backloaded rather than amortized with level annual installments during the lead period. This backloading presumably allows the underlying assets to accumulate given the longer compounding period before the trust has to satisfy the final charitable annuity payment. If the underlying assets have generated an excess return over the Section 7520 rate, the shark-fin CLAT (ignoring income tax consequences) is more likely to accumulate a higher ending value for the family's benefit after it satisfies all amounts required to be allocated to charity than a level CLAT.

    - An often-overlooked pitfall of a shark-fin CLAT is that the trust could incur more income taxes on an annual basis given the nature of the backloaded charitable income tax deduction. The loss of the charitable income tax deduction each year creates additional income taxes that can significantly erode the anticipated transfer tax benefits associated with a backloaded shark-fin CLAT.

    - As such, careful tax planning and advanced quantitative financial modeling should be initiated upfront before deciding whether a CLAT should be structured as a shark-fin CLAT or a CLAT that contemplates level charitable payments during the lead period.

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Footnotes

1. The calculations related to the above analysis utilize the following assumptions:
    - May 2023 §7520 rate of 4.4%
    - Annual total investment returns of 5.0%
    - Valuation discounts ranging from 0% to 30%
    - Initial funding of $10 million
    - Annual charitable payments ranging from $533,480 (30% discount) to $762,114 (0% discount)

2. The calculations related to the above analysis utilize the following assumptions:
    - May 2023 §7520 rate of 4.4%
    - Annual total investment returns ranging from 2.0% to 8.0%
    - Valuation discounts of 0% and 30%
    - Initial funding of $10 million
    - Annual charitable payments of $533,480 (30% discount) or $762,114 (0% discount)

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