

The Wealth Counselor

A monthly newsletter for wealth planning professionals

Charitable Lead Trusts

Volume 4, Issue 11

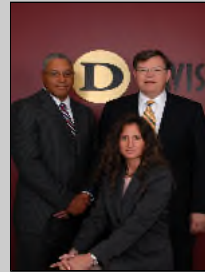
For the right client, the right charitable lead trust (CLT) can provide significant planning opportunities for reducing generation skipping transfer (GST), estate, gift, and/or income taxes. However, the CLT is a woefully underutilized strategy today. This issue of *The Wealth Counselor* examines CLTs and the planning opportunities they afford, especially in today's low interest rate, depressed asset value environment.

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Charitable Lead Trusts Generally

A CLT is a split-interest irrevocable trust. Under a CLT, a charitable beneficiary or beneficiaries receive their entire benefit first (the "lead" interests), and then the non-charity beneficiary or beneficiaries receive whatever is left (the "remainder" interests). A CLT can be established as an inter vivos trust (i.e., during lifetime) or at death. The latter is a testamentary CLT or TCLT. CLTs come in two flavors - CLAT and CLUT.

The CLAT

Under a CLAT, the charitable beneficiary or beneficiaries receive an annuity (an amount determined without regard to the value of the trust assets). Assets cannot be added to a CLAT other than at its initial funding.

Planning Tip: With a CLAT, until the annuity term ends or the CLAT's assets are exhausted, the charity's payment stream is independent of how well or poorly the CLAT's investments perform. The remainder interest, on the other hand, is highly leveraged. It will be greatly impacted by the CLAT's investment performance. Thus, it is critical that the planning team include a financial advisor who will monitor the CLAT's investment performance and offer sound investment guidance to the trustee.

The CLUT

Under a CLUT, the charitable beneficiary or beneficiaries receive unitrust payments (a fixed percentage of the trust balance as of the end of the prior year). Assets can be added to a CLUT at any time.

Planning Tip: With some CLTs, the tax affected is the estate or gift tax, and with others it is the income tax. The timing of the charitable deduction associated with the CLT is affected by whether it is a grantor trust for income tax purposes.

Why Use a CLT?

The planning intent of a CLT is to use what the client hopes will be a positive difference between the actual rate of return on the trust assets and the "7520 Rate" to achieve a tax-favored transfer of assets to non-charity beneficiaries.

Each month the IRS determines minimum interest rates that must be charged on short-term (less than 3 years), mid-term (3-to-9 year), and long-term (more than 9 year) loans between related persons to avoid the imputation of a gift to the transaction. The 7520 Rate in any month is 120% of that month's mid-term rate. When reporting a CLT to the IRS, the taxpayer may use the lowest among the 7520 Rates for the month of the CLT's creation and the two prior months.

Planning Tip: CLTs are particularly suited for hard-to-value assets (such as real estate or family limited partnership or limited liability company interests).

Planning Tip: Fund a CLT with discounted interests in a family limited partnership or limited liability company. Doing so will increase the CLT's success probability and leverage the inter-generational transfer of wealth.

The Impact of Interest Rates on CLTs

Low 7520 Rates are beneficial for taxpayers who fund CLTs because the IRS assumes that the CLT's assets will grow at exactly the applicable 7520 Rate. If the CLT assets grow at more than the applicable 7520 Rate, the client will pass additional assets to beneficiaries free of gift and estate taxes and without using any of his or her gift and estate tax exemption. The lower the 7520 Rate, the more likely the CLT will outperform that assumed growth rate.

Temporarily depressed asset values have the same effect on CLT success probability that a low 7520 Rate does.

Planning Tip: Combining a historically low 7520 Rate with temporarily depressed asset values creates a CLT-favored environment that is unlikely to be seen again. Now is the time to talk to your charitably-inclined clients who are worried about estate taxes.

Planning Tip: The November 2009 7520 Rate is 3.2%, unchanged from October. To put that in context, in its 10 1/2 year history, there were only 6 months in which the 7520 Rate was lower - the first 5 months of 2009 and July 2003 - and there were 15 months in which it exceeded 10%.

Testamentary Charitable Lead Trusts

Historically, the most commonly employed CLT has been the testamentary CLAT, which is referred to by its acronym, TCLAT. And of the TCLATs, the most commonly employed was the particular type known as the "zeroed out" TCLAT.

Some clients are extremely averse to the idea of paying estate taxes. The zeroed out TCLAT is popular because it assures that, no matter what, no one will have to write a check to the IRS to pay federal estate taxes when the client dies.

The downside of the TCLAT for the beneficiaries who would otherwise get the

net (under current law, 55% minus the state tax rate) of whatever assets are used to fund the TCLAT is two-fold. First there is the timing. With a TCLAT, the charity gets 100% of whatever it is going to get and the remainder beneficiaries get just that - the remainder, if there is any. Then there is the risk. Unless the TCLAT performs well, there may not be a remainder at all!

Planning Tip: To reduce the probability of your client's beneficiaries' lobbying against the TCLAT strategy, suggest putting life insurance in an ILIT to give the beneficiaries assets to tide them over until their remainder interest in the TCLAT matures.

Inter Vivos Charitable Lead Trusts

For charitably inclined clients with taxable estates, establishing a CLT during lifetime may be preferable to waiting until death. Establishing a lifetime CLT allows the client to enjoy the personal satisfaction of having the charitable distributions made during his or her lifetime. Often the charitable beneficiary is one with which the client is heavily involved and so there may be a real opportunity to influence how the payments are put to use by the charity.

Planning Tip: A lifetime CLT often allows our clients to expand their charitable giving in a meaningful way, either by payments directly to their favorite charities or through their own private foundation. Lifetime CLTs are also beneficial in expediting the transfer of wealth to our clients' beneficiaries.

Inter Vivos CLATs

The typical remainder beneficiaries of a CLT are the client's children or grandchildren. Those remainder assets can pass outright to the beneficiaries, or can continue to be held in trust. Those trusts can be either new trusts or the remainder can pour over into trusts previously established for their benefit and protection.

Under the Internal Revenue Code ("Code"), with an inter vivos CLAT, the client must allocate enough GST exemption for the contributed assets to grow by the 7520 rate. Thus, inter vivos CLATs are not well-suited for GST purposes.

Planning Tip: If the remainder interest of a CLAT will be held in trust, that trust should either (a) have as beneficiaries only individuals who are not in or assigned to a generation below the donor's children; or (b) be included in the taxable estates of beneficiaries who are in or assigned to a generation of or above the donor's children (e.g., by granting the beneficiaries a general power of appointment). Doing either means that there will be no GST taxable distributions from or terminations of the CLAT.

Inter Vivos CLUTs

For some clients, making sure that there will be no GST liability is more important than the magnitude of the estate or gift tax liability. For that situation, the inter vivos CLUT is the CLT of choice.

The CLUT may also be the CLT of choice for the client who cannot contribute all of the CLT assets at one time because the alternative is multiple CLATs.

Planning Tip: If any of the CLT beneficiaries are grandchildren or younger beneficiaries (e.g., a beneficiary that is a dynasty trust), consider the advisability of using a CLUT. With a CLUT, the client can allocate GST tax exemption at inception.

"Zeroed-Out" CLATs

Both TCLATs and inter vivos CLATs can be "zeroed out." However, what is "zeroed out" in a TCLAT, however, is not the same as what is "zeroed out" in a lifetime CLAT.

The most often-used "zeroed out" CLAT is the TCLAT. Its design "zeroes out" the liability of a decedent's estate to pay estate taxes. With a lifetime "zeroed out" CLAT, on the other hand, what is "zeroed out" is the gift attributed, for gift tax purposes, to the CLAT's remainder interest.

How a "Zeroed Out" TCLAT Works

The TCLAT is created under a taxpayer's revocable living trust (RLT) or will. Upon the taxpayer's death the TCLAT is funded with that amount of assets necessary to completely eliminate ("zero out") the decedent's estate tax liability. The annuitant will be one or more qualified charitable organizations designated in the RLT or will. The annuity payments must be made not less frequently than annually. They can be either level or increasing over time (and not limited to a maximum of 120% of the prior payment like GRATs) - see "Back Loaded CLATs" section below.

The annuity payments end when the TCLAT is exhausted or all annuity payments have been paid. At that point, any remaining trust assets go to the remainder beneficiaries, who are not charities.

How a "Zeroed Out" Inter Vivos CLAT Works

The taxpayer creates and funds a CLAT. The CLAT is so designed that the present value of the stream of annuity payments to the charity or charities, computed using as a discount rate the lowest 7520 Rate that can be chosen for that CLAT, is exactly equal to the value of the assets contributed to the CLAT. In other words, they "zero out."

As with the TCLAT, the annuity payments will be to one or more qualified charitable organizations designated in the CLAT. They must be made not less frequently than annually and they can be either level or increasing over time (and not limited to a maximum of 120% of the prior payment like GRATs). The annuity payments end when the CLAT has no remaining assets or the specified date for them to end is reached.

At that end point, any remaining trust assets go to the remainder beneficiaries, who are not charities. Because the anticipated value, determined using the applicable 7520 Rate, of the remainder was set at zero when the CLAT was established, there is no gift tax exemption used or gift tax paid, regardless of how large the remainder actually turns out to be.

Planning Tip: Both of the "zero out" techniques are "heads you win, tails you tie"

strategies. If the CLAT is exhausted before the annuity term ends, that is a tie for the remainder beneficiaries compared with the donor making a direct gift to charity. However, if there turns out to be a remainder, that is a win for the remainder beneficiaries and the taxpayer who desires to transfer wealth to another generation did so without incurring gift tax liability.

Planning Tip: A private foundation can be a charitable beneficiary of a CLAT or a TCLAT. However, the taxpayer who funds a CLAT must have very limited authority over which charity is to receive money from the foundation that is its beneficiary because having too much control has adverse tax consequences.

Planning Tip: One of the items on the Treasury Department's "wish list" of changes it would like Congress to make to the Code is elimination of the zeroed out CLAT. Treasury would like for the Code to require that the remainder interest of a CLAT be at least 10% of the CLAT funding.

Some CLT Examples

Suppose Fred (age 65) and Wilma (age 60) transfer \$5,000,000 to a 9-year zeroed-out CLAT in November 2009 when the 7520 Rate is 3.2%.

If the CLAT assets grow at exactly 3.2%, it will transfer \$6,636,997 to charity and \$0 to the non-charity beneficiaries (e.g., Pebbles and Bam-Bam). However, if the CLAT assets grow at 10%, it will transfer \$2,990,237 to the non-charity beneficiaries in addition to the \$6,636,997 to charity. Note that if the assets transferred to charity continue to grow at 10% the total amount transferred to charity will equal \$8,799,501.

Suppose instead that Fred and Wilma transfer \$5,000,000 of an entity interest that is discounted 30% from the value of the underlying assets (e.g., an interest in a Family Limited Partnership). If the CLAT has sufficient cash flow to make all annuity payments in cash, the CLAT will transfer \$5,374,802 in underlying asset value to the beneficiaries in addition to the \$6,636,997 in cash to the charity. Of the asset value of the remainder received by the beneficiaries, the entity discount accounts for \$2,384,565 and the remaining \$2,990,237 is due to the earnings spread between the 3.2% 7520 Rate and 10% return, as in the last example.

Planning Tip: As the above example demonstrates, funding a CLT with discounted assets significantly increases the tax-free transfer of wealth to beneficiaries. A similar asset-transfer result would obtain in both examples had the client chosen to use a CLUT because the non-charity beneficiaries were their grandchildren. However, the tax avoided would have been GST tax and gift tax.

"Back Loaded" CLATs

Recently issued IRS sample CLAT forms confirm that with CLATs we can increase the annual payout to charity during the term of the annuity. "Back loaded" Grantor Retained Annuity Trusts (GRATs) have been in use for some time based on earlier-published IRS sample documents. The advantage of a back loaded CLAT is it allows the trust assets to accumulate more rapidly during the term as a consequence of the lower initial charity distribution requirements.

Planning Tip: Back-loading can provide tremendous wealth transfer, particularly

for longer-term CLATs (e.g., longer than 10 years).

Planning Tip: CLTs are not for klutzes. CLTs are all about numbers. Mathematical errors in evaluating them can lead to disastrous results and extremely unhappy clients. The mathematically gifted team member (typically the CPA) should be the one who "runs the numbers" to provide the team and the client apples-to-apples comparisons of planning options; e.g., with and without the CLT, CLAT versus CLUT, and back loaded versus level annuity payment using various assumptions about real asset value growth and cash flow availability. There are commercially available packages to do these calculations, also.

Income Tax Planning with CLTs

Unlike Charitable Remainder Trusts, CLTs are not tax-exempt trusts. Therefore, some taxpayer has the income tax liability resulting from the CLT's taxable income.

The timing of the deduction for the charitable contributions depends on whether the CLT is a grantor trust for income tax purposes. If a CLAT is a non-grantor trust, the client gets no up-front charitable income tax deduction. Instead, the taxpayer (the trust) gets to take a deduction each year equal to the payment actually made to the charity by the CLT in that year.

Alternatively, by establishing the CLT as a grantor trust for income tax purposes, the client can take an upfront charitable income tax deduction for the present value (determined using the applicable 7520 Rate) of the annuity stream planned to be paid to the charity beneficiary or beneficiaries. However, the downside of making the CLT a grantor trust is that the client must report the CLT's annual trust income on his or her personal income tax return without a deduction for the annual annuity payment to charity. The client, having taken the charitable income tax deduction up front, is not permitted a "second bite at the apple." Thus back-loading a grantor CLAT has no income tax impact on the donor.

Planning Tip: For those clients with a large spike in income, establishing a grantor CLAT in the same year will generate an immediate charitable income tax deduction that can offset the spike in income. Taking the deduction in the first year and reporting as the taxpayer's own the CLT's income each year during the CLT's term thus has the effect of spreading the taxpayer's spike in income earned in the first year over the term of the CLT.

Planning Tip: If the grantor CLT invests in assets that produce capital gains or pay dividends, an ordinary income spike can not only be spread out over a period of years to take advantage of tax brackets, it can also be converted from ordinary income to income taxed at lower fixed rates.

Planning Tip: With a grantor CLT, it is incumbent upon the financial planning team member to manage the trust assets so as to minimize taxable trust income, thereby reducing the client's total income tax liability.

Some Planning Strategies to Consider

CLTs offer a number of strategic options for the charitably inclined client. Here

are just a few strategies to consider:

- Have the grantor of the CLT buy insurance on his life (including in an ILIT) to reduce or eliminate the estate tax liability for the trust's assets.
- Have the CLT hold improved real estate because real estate offsets taxable income with non-cash depreciation.
- Have the CLT hold indebted real estate because of the leverage and interest deductions.
- Have the CLT hold assets that produce capital gain or dividend income, especially if the CLT is not a grantor trust and thus income is taxed in compressed brackets.

Conclusion

CLTs are sometimes marketed as a planning panacea. They are not. Their being touted as such merely exposes the ignorance of the presenter. As the saying goes, "To a hammer, everything looks like a nail." There are no panaceas, just options.

While not right for all clients, CLTs can provide significant estate, gift, GST, and even income tax benefits for clients who are charitably inclined. However, CLTs are complex advanced planning tools. Their success depends on the entire planning team working together. It takes a cooperative effort to make sure that when selecting a CLT, it is the right strategy for that client. It takes a continued team effort to keep the client focused to maximize the probability that the CLT assets will outperform the assumed growth at the 7520 Rate, thereby maximizing the tax-free wealth transfer to the client's non-charity beneficiaries. With a CLT, you definitely can't "set it and forget it."

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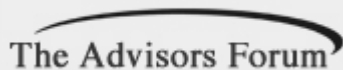
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