

Reduce Your Gift and Estate Taxes Through a Charitable Lead Trust

What's one way you can give assets to your favorite charitable organization, create a gift or estate tax deduction for yourself and leave assets to a noncharity beneficiary? Establish a charitable lead trust (CLT).

With a CLT, one or more charitable beneficiaries receive annuity or unitrust interest payments during the trust term. At the end of the trust term, the remaining trust assets either go back to the donor or are paid to another noncharity beneficiary. You can establish a CLT either during life or upon death and receive a gift or estate tax deduction for the interest passing to charity. Also, under limited circumstances, you may also receive an income tax deduction.

Although the CLT offers many advantages, there is no guarantee that assets will be available for the noncharity, remainder beneficiary. If established at the right time with respect to the market, the trust can substantially benefit the charity and still leave funds for the remainder beneficiary. But if the trust underperforms, little or nothing may remain at the end of the trust term.

CLT Tax Treatment

Creating a CLT results in a gift or estate tax charitable deduction depending on whether you create the CLT during life or upon death. How you calculate the deduction depends on whether the charitable lead interest is a guaranteed annuity or a unitrust. Annuity payments are calculated as a percent of the original trust principal, while unitrust payments are calculated annually based on an annual revaluation of the trust. The charitable gift or estate tax deduction equals the present value of the annuity or unitrust interest that passes to charity.

Creating a CLT can result in a taxable transfer equal to the value of the remainder, noncharitable interest. If the trust is properly structured, however, the gift or estate tax can be reduced or sometimes eliminated. For example, when establishing a testamentary lead trust, (i.e., a trust that begins on your death) you may set the payout based on a formula that maximizes the charitable deduction and minimizes or eliminates the estate tax. Regardless of whether the initial transfer is taxable to the noncharity beneficiary, future appreciation of the assets funding the trust escape both gift and estate taxes. Therefore, establishing a CLT with appreciating assets is generally a good idea.

The Income Tax Deduction Question

Taxpayers rarely establish CLTs to gain an income tax deduction. Generally, tax law allows an income tax charitable deduction only if all trust income is taxable to the grantor, as is the case with grantor trusts.

CLTs Take Careful Planning

Successful CLT planning must consider all tax implications, including the effects of the generation-skipping transfer tax, which we did not discuss here. The CLT, while not widely used, can provide a great gift or estate tax deduction to the donor, allow the donor to achieve charitable objectives and potentially provide substantial benefits for noncharity remainder beneficiaries all at little or no transfer tax cost.

We would be pleased to help you examine the tax benefits and pitfalls of establishing a CLT for you. Call us anytime.

Who Gets What: A Sample CLT

To see how the charitable lead trust operates, consider the following example. On Jan. 10, 1998, Bob establishes a charitable lead annuity trust (CLAT) with \$1 million. The charity will receive an 8% annuity (\$80,000 per year) for 20 years. Based on the interest rates, the annuity rate and the term, Bob will receive a charitable gift tax deduction of \$834,504, resulting in a taxable transfer to the noncharity remainder beneficiary of \$165,496.

CLTs in the Mirror: The Charitable Remainder Trust (CRT)

CRTs are the inverse of CLTs. With a CRT, the grantor or other noncharity beneficiaries receive annuity or unitrust payments for the trust term, and when the trust term ends, the remainder interest goes to a charity. The CRT offers income tax advantages as well.