Buchheit Law, PLC
Lindsey Buchheit, Attorney
204 1st Street, Suite B3
Sergeant Bluff, Iowa 51054
712.823.1024 (Office Phone)
712.823.1025 (Fax)
Lindsey@Buchheitlaw.net
www.Buchheitlaw.net

CHARITABLE LEAD TRUSTS ("CLT")

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I. CLT Basics

A. Opposite of deferred giving: Donor ('D") transfers property to a trust providing an income stream to charity for a term of years or the life or lives of an individual(s), and the remainder reverts to D or passes to other noncharitable beneficiaries.

B. Differences from Charitable Remainder Trusts: (1) Charity receives *income* interest rather than remainder interest; (2) CLTs are not subject to the 5% minimum and 50% maximum payout requirements; (3) Term of years for a CLT is not restricted to 20 years.

C. Deduction: Receive a deduction only if the trust income is – (1) a guaranteed annuity (CLAT); or (2) a fixed percentage (distributed at least once / year) of the fair market value of the trust corpus (valued annually).

> Example: D transfers $100,000 to a CLAT which pays a $9,000 guaranteed annuity to Charity ("C") at the end of each year for a 5-year period. The remainder interest reverts to D. IRS tables determine the value of the deduction. Since D retained the reversion right, D will be treated as the owner of the trust and receives a charitable deduction for income and gift taxes equal to the present value of the lead interest (i.e., 4.5023 x $9,000 = $40,521).

D. Income Interest: (1) must be irrevocable & payable 1 X / year; (2) may be for a term of years and/or for the life of the individual; and (3) the income beneficiaries may be named in the trust or, for a fixed unitrust payment, trustees may be given discretion to choose the charity(ies).

E. Income Tax Benefits:

> Example: Assume D in the preceding example is in a 35% income tax bracket. D will receive a current income tax deduction of $40,521, but will report the trust income as his own during the lead period. Thus, D will benefit from a deduction of $40,521 in the first year (or carried over for up to five years if necessary), but he will be taxed on the income going to charity in the amount of $45,000 spread over five years.

II. Practical Applications

A. Income Tax Planning. Because D must claim the trust income to obtain an income tax deduction, the tax planning utility of CLTs is limited to certain situations.

1. *Unusually High Income Year.* D may have a year of unusually high income and face a higher tax bracket in that year. If D plans to use a significant portion of that income for charitable gifts, he can use a CLT to lower income to lower tax levels in the first year, and then spread out the income tax consequences to later years, when D presumably will be in lower tax brackets.
2. *Anticipating Lower Tax Rates.* If tax rates are expected to be much lower in year 2 (and perhaps following), D can use a CLT to claim a deduction in year 1 while effectively making the gift in later year(s). The cash saved in the initial year may be used for investment opportunities or other alternatives that promise significant future gains.
3. *Using Tax-Exempt Bonds.* A donor who funds a CLT with tax-exempt municipal bonds will receive a current income-tax deduction, but will not have to recognize income in future years because of the income from the bonds is exempt from federal income tax.

B. Intrafamily Giving. A common use of CLT is to transfer D's asset(s) to one or more people with a reduced gift and estate tax cost.

1. The value of asset given to the heir for gift and estate tax purposes is reduced by the value of the lead interest.
2. Future capital appreciation of the underlying asset is trapped in the estate of the remainder beneficiaries, passing from D to his heirs free of federal estate tax.
3. Example: D has a taxable estate and owns farmland with a FMV of $500,000, which D expects to rise greatly in value, exacerbating D's estate tax problem. D creates a CLAT using the farmland under which his favorite charity will receive an annuity of 8% of the initial asset value (i.e., $40,000 per year) for a period of 15 years. At the end of the lead period, the farmland will pass to D's heirs. The IRS uses 11.4359 as the valuation factor to price the charity's lead interest. The present value ("PV") of the charitable lead interest is $457,436 (i.e., [$500,000 FMV] x [11.4359 valuation factor]). D may use this as a charitable deduction in the current year and carry forward until the earlier of its being exhausted or five years, although D will also be taxed on the trust income throughout the 15-year term. The gift of the remainder interest to the heirs is a taxable lifetime gift, but the value of the gift for transfer tax purposes is only $42,564 (i.e., [$500,000 FMV at transfer] — [$457,436 present value of charitable interest]). Any appreciation in the value of the underlying assets in the trust will pass to D's heirs with the remainder interest free of federal estate or gift tax.

C. Testamentary Use of CLATs and CLUTs. D may provide for the creation of a CLAT or CLUT in his will or trust. Advantages and results may include:

1. The estate receives a charitable deduction against estate taxes for the present value of the annuity or unitrust interest.
2. Unlike D establishing a lifetime CLT, the estate will not be required to pay tax on the income earned during the lead period.
3. Remainder beneficiaries receive the property after the lead period, plus all appreciation on the property accrued during the lead period without extra estate or gift taxes.

D. Impact of Interest Rates on CLT Utility.

1. *Lower interest rate = high deduction.* Periods of lower interest rates favor the use of CLTs. The lower the interest rate, the larger the present value of the lead interest and, if structured as a grantor-type CLT, the larger the charitable deduction for D.
2. *Lower interest rate = lower transfer tax.* The lower interest rates will also lower the value of remainder interest for transfer tax purposes.