

What You Always Wanted to Know About Charitable Lead Trusts But Were Afraid to Ask

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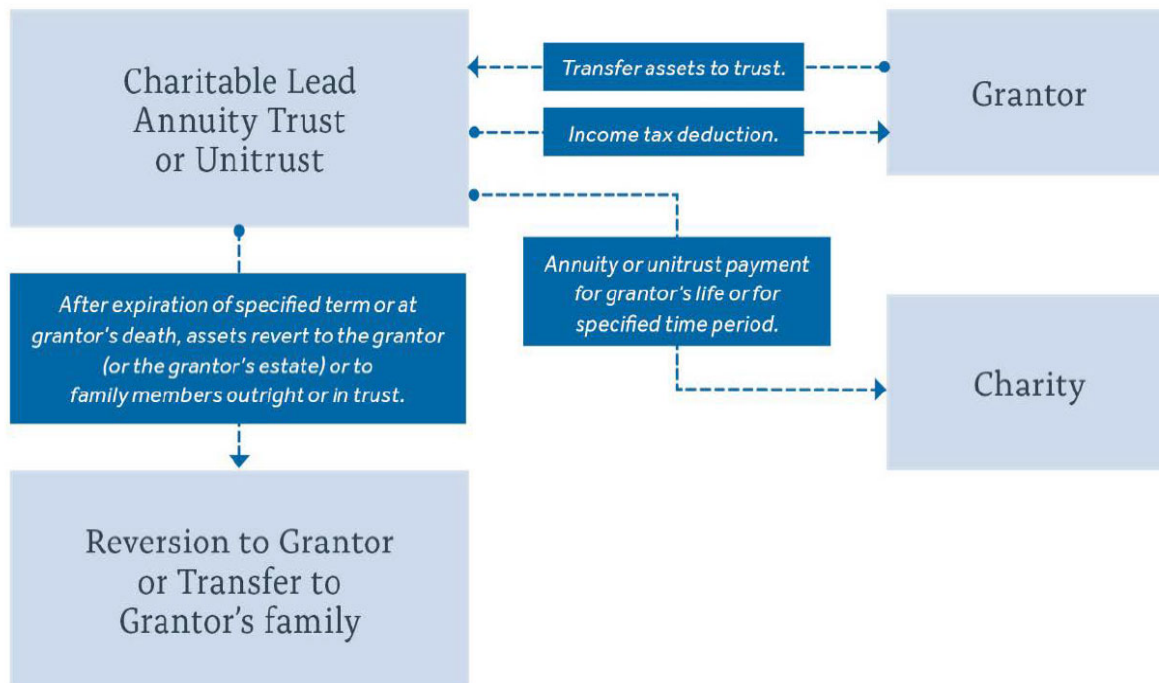


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The Basics: What is a CLT?



- Reverse of the Charitable Remainder Trust (CRT).
- Gifts to a charitable remainder trust (CLT) provide income to the **charity** for life or for a specified term of years.
- At the end of the trust term, the non-charitable beneficiary (heirs, etc.) receives the remainder of trust assets.
- Contribution may or may not be tax deductible depending on tax characteristics of trust.
- **Can be set up during lifetime or at death.**

Design Basics: CLAT versus CLUT



A CLAT is an arrangement in which the trust provides fixed annuity payments based on the FMV of the donated property at the time of the gift.



A CLUT is an arrangement in which the trust provides annual payments based upon a fixed percentage of the trust assets as revalued each year.



Charitable interest is based on present value of stream of payments provided under trust terms.



Remainder interest (taxable gift) is difference between charity's value and the fair market value of property contributed.

Design Basics: CLAT versus CLUT

- Example Calculations:
 - Initial Contribution: \$1 Million
 - 7520 Rate: 1.4% (this month or prior two are allowed – the lower the better)
 - Term: 20 years
 - Payout Rate: Varies per examples
 - Growth Rate: 5%

Design Basics: CLAT versus CLUT

- CLAT Calcs:

Term	Payout	Charitable Value	Gift Tax Value	Remainder Value
10	4%	\$ 370,848	\$ 629,152	\$ 1,125,779
10	10.79%	\$ 1,000,000	\$ -	\$ 272,232
20	4%	\$ 693,564	\$ 306,436	\$ 1,330,660
20	5.77%	\$ 1,000,000	\$ -	\$ 746,281

Design Basics: CLAT versus CLUT

- CLUT Calcs:

Term	Payout	Charitable Value	Gift Tax Value	Remainder Value
10	4%	\$ 331,322	\$ 668,678	\$ 1,104,622
10	10.79%	\$ 675,363	\$ 324,637	\$ 550,770
20	4%	\$ 552,832	\$ 447,168	\$ 1,220,190
20	5.77%	\$ 690,082	\$ 309,918	\$ 856,761

Design Basics: CLAT versus CLUT

CLUT:

- Charity shares in upside growth (less benefit for heirs from arbitrage), but...
- Can make additional gifts during term,
- Can allocate GST exemption.

CLAT:

- Can zero-out gift for gift tax purposes,
- Generally better gift tax leverage with growth assets, but...
- Payments fixed during term,
- No additional gifts during term,
- No GST allocation possible during term.

Design Basics: CLAT versus CLUT

GST Planning Option with CLAT: Remainder beneficiary as Health, Education Exclusion Trust (HEET)

- HEET receives remainder from CLAT at termination.
- Charity is current discretionary beneficiary of trust (to avoid GST taxable event), and trustee retains ability to make payments for health and education costs of skip beneficiaries (grandchildren, great-grandchildren, etc.).
- Payments for health care and education are exempt from GST tax.

Other GST Planning Option: Sale of Remainder Interest to GST Trust

- IRS has not ruled on this.
- Basis in property received equal to purchase price (and gain for cash received?)

CLT Client Profile

- Clients who are:
 - Interested in providing funds over time to charity.
 - Potentially seeking income tax deduction.
 - Interested in shifting assets to heirs at reduced gift tax cost.
 - Interested in leaving assets to heirs at reduced estate tax cost.
- Important to contrast with other planning options depending on specific client objectives:
 - Donor advised fund and ILIT?

Income Tax Deduction Issues and Considerations

- “Grantor” CLT:
 - Client gets income tax deduction based on value of charity’s interest in trust (per examples above).
- Unique Deduction Rules and Limits:
 - Charitable income tax deduction limited to 30% of donor’s AGI for year of donation (vs. the higher 60% limit for cash gifts to public charities).
 - 20% AGI limit for gifts of appreciated capital gain property and where charitable recipient is a private foundation (see more discussion below).
 - Unused deduction: five-year carry forward available.
- Deduction is valued based on present value of payments by CLT:
 - Certain assets, such as ordinary income property and short-term capital gains property are normally limited to deduction at cost basis – CLT may offer alternative.

Income Tax Deduction Issues and Considerations

- “Grantor” CLT:
 - As a grantor trust, donor is taxed on trust income annually – no deduction for charitable payment by trust or donor at that point.
 - Thus, while the donor receives an upfront income tax deduction equal to the actuarial value of the charitable income interest, this deduction is “recaptured” over time as the donor is taxed annually on the trust income.
 - Tax-planning on investments to minimize taxable trust income may be considered.
 - Recapture upon termination of grantor trust status:
 - If grantor trust status terminates prior to end of lead term, including upon death of grantor, initial charitable deduction is recaptured by donor up to extent not previously taxed through trust.
 - E.g.: Initial charitable deduction is \$1 million. Since inception, \$500,000 has been taxed back to grantor – \$1M less PV of \$500,000 of income (discounted to inception date) recaptured in the event grantor dies prior to term.

Income Tax Deduction Issues and Considerations

- More on “Grantor” CLT Recapture Issue:
 - Arbitrage in potential tax rate based on type of income, marginal bracket, etc.
 - Tax asset management can mitigate as recapture ends once lead term expires.
 - Potential life insurance need to address risk of premature death.

Income Tax Deduction Issues and Considerations

- Non-Grantor CLT:
 - No income tax deduction by donor for value of charity's interest in trust, but all charitable payments are deductible by trust against trust income.
 - No AGI limit applies to trust under 642(c).
 - No carryforward of excess deduction available, though, so income management important.
 - Non-Grantor trust not subject to deductibility limits for foreign charitable gifts that individuals may be limited by.

Other CLT Considerations

Certain Private Foundation excise tax rules apply to CLTs:

- Governing trust instrument must contain specific prohibitions against (i) self-dealing; (ii) excess business holdings; (iii) jeopardy investments; and (iv) taxable expenditures.
- CLT will not be subject to private foundation restrictions on excess business holdings or jeopardy investments, however, if the present value of the charitable lead interest or interests does not exceed 60% percent of the net value of the trust assets on the valuation date.

No early termination allowed: cannot permit pre-payment of charity's interest to accelerate benefit to remainder beneficiary.

- Such a provision disqualifies charitable deduction for income, gift and estate tax.
- The Internal Revenue Service has permitted commutation of a CLAT when the annuity payments are prepaid in full with no discount. Ltr. Rul.200225045; Ltr. Rul. 199952093.

Other CLT Considerations

- Asset Funding Considerations:
 - Cash
 - Need arbitrage opportunity.
 - Securities
 - Good vehicle, but volatility risk.
 - LLC/Partnership Interests
 - Discounting and growth opportunities.
 - Private foundation rules (Self-dealing, excess business holdings, jeopardy investments).
 - UBIT charitable deduction limits (50%).
 - S Corp Stock
 - Grantor CLT or Non-Grantor ESBT (but no deduction against S Corp income).
 - Notes Receivable – avoid self-dealing if note created via revocable trust.
 - **Be aware of substantiation requirements for gifts in excess of \$5,000.**

CLT Common Questions

Does charity need to be named up front?

- No, but lead distributions must be limited to a class of beneficiary.
- Trustee or committee may select charity or among group of charities.

Can donor change designated charity?

- Yes, but trust will be included in donor's estate if death occurs during term.
- Committee or designated individual may possess such power.

Can donor's private foundation be named as lead beneficiary?

- Yes, but income tax deduction may be limited, and donor's control over foundation may trigger CLT inclusion.
- Foundation can draft around this possibly.

Can donor's donor advised fund be named as lead beneficiary?

- Yes – generally preferred option.

CLT Common Questions

Who can serve as Trustee?

- Donor/grantor as Trustee likewise creates estate tax inclusion risk unless role is solely administrative (as with a CLUT).
- Spouse/Remainder beneficiary may be good option.
- Corporate trustee possible but adds cost.

Who can be a measuring life for purposes of lead term?

- Donor, donor's spouse, or lineal ancestor or spouse of lineal ancestor of remainder beneficiary(ies).
- Shortened life expectancy (though not terminally ill) may be CLT valuation opportunity.
- Will not "zero-out" for gift tax purposes generally.

CLT Common Questions

- Can lead payment change over the term?
 - Increasing payment rate can increase long-term performance, reduce near term volatility risk:

Term	Payout	Charitable Value	Gift Tax Value	Remainder Value
10	4.24% (20% Increase)	\$ 1,000,000	\$ -	\$ 339,510
10	10.79%	\$ 1,000,000	\$ -	\$ 272,232
20	0.66% (20% Increase)	\$ 1,000,000	\$ -	\$ 1,075,769
20	5.77%	\$ 1,000,000	\$ -	\$ 746,281

- But.... very little guidance on permissible rate of increase
 - Regs seem to permit, but no concrete examples.
 - 20% is max rate allowed for GRATs.

CLT Common Questions

- “Shark fin” CLATs
 - Regulations do not specify what is considered a “guaranteed annuity,” theoretically permitting nominal payment for period of years with balloon at the end.
 - IRS has not ruled on this area, but numerous risks are present.
 - Some promoters position single premium life insurance policy and annuity or muni-bond for shark fin CLATs.

CLT Common Questions

Can CLT make distributions to charity “in kind”?

- “Grantor” CLT: yes – no income recognized upon doing so.
- Non-Grantor CLT: yes, but gain may be realized by trust.

Can Trustee borrow to make lead payment to avoid in kind distribution?

- Yes, but cannot borrow from donor or individual/entity related to donor under private foundation rules.

Can tax status of CLT change (i.e., non-grantor to grantor and vice versa)?

- Yes, but beware of recapture issue.

CLT Common Questions

Can CLT own life insurance?

- Implicates charitable split dollar prohibitions of IRC 170(f)(10) – consider gift of paid-up policy.

Can CLT own LLC/entity that owns life insurance?

- Risky, but arguably ok if CLT has little if any control over LLC decision to purchase life insurance.
- Can LLC be partially owned/controlled by donor? Does that violate private foundation rules? Possible risks in both situations.

Can lead payments be used by charity to buy life insurance?

- Generally, yes, so long as charity makes that decision independently.
- Life insurance for a portion can act as wealth replacement upon trust termination.

Where else does life insurance fit in as a planning option with CLTs?

- Replace delay in receipt of CLT proceeds under testamentary arrangement.
- Testamentary CLT provides step up in basis on property to CLT as well.



Thank You