Charitable Lead Annuity Trusts

Background: One sophisticated estate planning strategy, clearly of limited interest to only a small group of individuals, is the charitable lead annuity trust, or CLAT. Such a trust is a split-interest trust that is created by a donor during the donor's lifetime that pays an annuity to a charity for a term of years, or for the life of the donor and another individual. At the end of the CLAT's term, any assets remaining in the trust pass to non-charitable remainder beneficiaries, generally the donor's children. The goal of a CLAT is to reduce a beneficiary's potential tax liability upon inheritance. Or the donor can hold a reversionary interest in the CLAT after the annuity period ends. A CLAT is either established for the lifetime of one or more persons, or if for a term of years, the duration is limited to 20 years.

CLAT is Not Tax Exempt: Unlike a charitable remainder trust (CRT) a CLAT is not tax exempt. As explained below, the donor may receive a one-time tax deduction for the fair market value of his/her full donation to the CLAT at the time that it is established.

Income Tax Benefits: A CLAT can be structured as a *grantor* trust, which enables the donor to realize income tax benefits. There can be two types of CLAT, either a *grantor* CLAT, or a *non-grantor* CLAT.

> ***Grantor* CLAT:** With the *grantor* CLAT, the donor receives an income tax charitable deduction for the full present value of the charity's lead interest at the time the CLAT is created. The donor then pays the CLAT's income tax liability each year under the customary *grantor* trust rules. A *grantor* CLAT increases the basic gift tax benefit of an inter vivos CLAT in two ways: (i) payment of the CLAT's income tax produces an additional tax-free transfer to heirs, like any other *grantor* trust; and (ii) the upfront charitable income tax deduction may be worth more than the later tax cost to the donor; the donor receives the charitable deduction when the CLAT is created, but the tax on the CLAT's income is deferred. Thus, the upfront charitable deduction may offset ordinary income now, while the donor's income is taxed on later may be capital gains taxed at a lower rate. However, a *grantor* CLAT will help to reduce the 3.8% net investment income tax (NIIT) because all trust income is added to the

donor's other income on his/her Form 1040. There can however be deduction limitations based on whether the trust benefits a public charity or a private foundation. But, as noted, the trust's investment earnings are taxable to the donor for the life of the CLAT.

***Non-Grantor* CLAT:** With a *non-grantor* CLAT, the donor receives no upfront income tax deduction when the trust is created. Yet, since the CLAT is a taxable entity (in contrast to a charitable remainder trust, which is a non-taxable entity) the donor can receive an income tax charitable deduction under IRC 642(c) as annuity payments are made to the charitable lead beneficiary. Accordingly, the CLAT is subject to income tax only on its income that is more than the annuity payment amount distributed by the CLAT to the charity beneficiary. Unlike the donor, the CLAT may take a tax deduction for the distribution to the charity with no limits on the deduction. A *non-grantor* CLAT can be used to reduce the 3.8% NIIT. Outright gifts to charity and transfers to CRTs do not reduce the NIIT because they produce a below-the-line deduction under IRC 170 that to not reduce the donor's modified adjusted gross income (MAGI) or net investment income (NII.) A *non-grantor* CLAT can produce a charitable deduction that indirectly benefits the donor. When the CLAT makes its annual annuity payment to the charitable lead beneficiary, the NII of the CLAT is reduced by the share of the IRC 642(c) deduction that is allocable to the NII that is distributed to the charity, thus reducing the amount of NIIT on the CLAT. Because the deduction leaves more in the CLAT to pass to the non-charitable remainder beneficiaries, it indirectly provides the donor with a charitable deduction against the NIIT. This income tax structure is more suited to minimizing transfer taxes.

Pros and Cons: To decide if a CLAT makes sense for a philanthropically inclined individual, especially with a testamentary CLAT that, if formed on the donor's death, will have a step-up in income tax basis, consider the following:

Pros: The benefits to the donor who adopts a CLAT are:

(i) the CLAT makes regular charitable giving easy, since the annuity is paid from the CLAT to the designated charitable beneficiary, eliminating the donor's annual gifts to the charity;
(ii) the CLAT can be used to reduce gift and estate taxes, by removing the assets from the donor's gross estate;
(iii) the CLAT can possibly shift wealth to the donor's children who are the CLAT's remainder beneficiaries at little or no transfer tax-cost, if the CLAT is 'zeroed out' upon its funding and how the annuity amount paid to the charity is set; when interest rates are low, the likelihood of the CLAT assets will outperform the AFR rate is greater and thus the remainder beneficiaries of the CLAT will receive excess CLAT property tax-free at the end of the charity's annuity term (which will be more difficult in a period of high interest rates);
(iv) the CLAT can provide to the donor an upfront charitable income tax deduction if structed as a *grantor* CLAT; and
(v) if the donor transfers appreciated property to the CLAT that will not trigger a capital gains tax because the transfer is not considered a sale or exchange of the property.

Con: The drawbacks to a CLAT are:

(i) a CLAT is not tax-exempt, unlike a CRT- either the CLAT or the donor pays the income tax on the CLAT's income;
(ii) if the donor dies during the annuity payment period, the full value of the CLAT will be included in the donor's gross estate, but a charitable deduction will be allowed for the present value of the remaining charitable income interest;
(iii) the trust earnings may be taxed to the donor depending on the type of CLAT created;
(iv) because the CLAT is an irrevocable trust, the donor cannot access the assets transferred to the CLAT;
(v) unlike a CRT, the charitable beneficiary of the CLAT is unchangeable;
(vi) the donor cannot allocate his/her GST exemption to the remainder beneficiaries until the annuity period comes to an end,

which is why often grandchildren of the donor are not named as remainder beneficiaries of the CLAT;

(vii) the CLAT will take the donor's basis in the property and thus it will realize a taxable capital gain if the donated property is sold by the CLAT trustee for more that the adjusted cost basis; and

(viii) as a split-interest trust, the CLAT must file Form 5227 annually to report financial activity and to enable the IRS to determine if the CLAT should be treated as a private foundation, and if a *non-grantor* CLAT it must file a Form 1041 each year.

IRS Forms: The IRS has issued model Charitable Lead Annuity Trust forms (both inter-vivos and testamentary) with pre-approved language [Revenue Procs. 2007-45, 2007-46].

Conclusion: A CLAT is infrequently used in estate planning because of the cost and complexity associated with administering an irrevocable trust. In addition, CLATs are normally only used by wealthy individuals who are very charitably inclined through annual gifts and donations. If the currently high applicable exemption amounts persist going forward, few individuals will be CLAT candidates, unless they have already fully used their available applicable amounts and they still wish to transfer more wealth to their heirs gift or estate tax-free, probably through testamentary CLATs.

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