CHARITABLE LEAD TRUSTS: NO TIME LIKE THE PRESENT

PG CALC WEBINAR

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I. Introduction

Non-grantor lead trusts offer wealthy individuals the opportunity to pass assets to their heirs at substantial tax savings while providing immediate benefits to one or more charities they care about. Grantor lead trusts offer a wider range of donors a tax-efficient way to fulfill multi-year pledges or offset an income windfall while fulfilling charitable wishes. It is even possible to create a "defective" lead trust that combines characteristics of both.

The extremely low monthly IRS discount rate, a stock market at or near record highs, and the possibility of increased estate taxation within the next few years combine to create ideal conditions for turning lead trust prospects into lead trust donors. Take advantage of the moment. Completing even a handful of lead trusts could make a big difference to the finances of your organization.

II. Definition of a Charitable Lead Trust

A. Introduction

A typical charitable lead trust ("CLT") is the reverse of a charitable remainder trust ("CRT"). Instead of making payments to one or more individuals and then distributing the remainder to one or more charities, it makes payments to one or more charities, and then distributes the remainder to one or more individuals. A CLT is a gift of an income interest. It derives its name from the fact that the charity's interest leads off, i.e., is paid first.

CLTs usually last for a term of years, but they can last for the lifetime(s) of one or more individuals having a certain relationship to the donor. They can be established during the lifetime of the donor or at the donor's death through a will.

A CLT – as its name suggests – is simply a trust with one or more charitable organizations as its lead beneficiaries. When a donor establishes a CLT, the trust will usually be a qualified CLT, meaning that it meets requirements that result in various federal tax benefits for both the donor and the trust itself. All references to CLTs in this paper are to qualified CLTs, unless noted otherwise.

B. Statistics

Unfortunately, the IRS stopped publishing statistics on split-interest gifts after 2012, so these are the most recent nationwide statistics we have on charitable lead trusts, charitable remainder trusts, and pooled income funds. Nevertheless, while increasingly stale, my guess is that they still give an accurate sense of where lead trusts fit in planned gift philanthropy.

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Split-interest trust statistics from the IRS based on Form 5227s filed in 2012

Item	Total	Size of end-of-year book value of total assets (in $1,000s)				
		Under $500,000	$500,000 under $1,000,000	$1,000,000 under $3,000,000	$3,000,000 under $10,000,000	$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)
CLT Number of	6,498	2,658	1,406	1,353	757	324
Change from 2011	-1.798%	-7.193%	-2.089%	3.599%	7.224%	6.230%
CLT Total net	23,705,416	413,545	995,305	2,266,958	4,048,280	15,981,328
CRAT Number of	14,616	11,944	1,429	912	279	52
Change from 2011	-7.855%	-7.080%	-13.499%	-10.500%	1.455%	-16.129%
CRAT Total net	6,447,093	1,272,029	1,039,877	1,475,705	1,338,531	1,320,951
CRUT Number of	91,250	65,444	13,587	9,012	2,532	675
Change from 2011	-2.748%	-2.629%	-2.231%	-3.780%	-4.164%	-5.330%
CRUT Total net	85,240,003	11,233,56	9,435,936	14,307,81	12,517,904	37,744,783
PIF Number of	1,324	1,011	104	122	64	23
Change from 2011	-5.563%	-5.514%	-10.345%	0.826%	-9.859%	-4.167%
PIF Total net assets	1,254,989	114,910	80,459	199,917	335,990	523,713

Source: http://www.irs.gov/uac/SOI-Tax-Stats-Split-Interest-Trust-Statistics

As you might expect, charitable remainder unitrusts (CRUTs) are by far the most common of the four vehicles listed, outnumbering charitable remainder annuity trusts (CRATs) almost six-fold, CLTs (lead annuity trusts and lead unitrusts combined) over 14-fold, and PIFs 66-fold. CRUTs also hold the greatest value in assets, but here CLTs come in second and CRATs a distant third. In other words, CLTs tend to be very large. The average book value of a CLT filing in 2011 was over $3.6 million, far larger than the average value of a charitable remainder trust or pooled income fund. Nevertheless, a substantial fraction of CLTs, over 40%, had a book value of less than $500,000.

The statistics above are interesting, but they only hint at the benefit each type of split-interest gift provides to charity. The table below shows how much each type of split interest trust distributed to charity in 2010 (5227s filed in 2011).

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Total Charitable Distributions, by Type of Trust and Charity Type, Filing Year 2011[1]

[All figures are estimates based on samples—money amounts are in thousands of dollars]

	All		CRTs[2]		CLTs		PIFs	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Total	**27,992**	**$3,065,001**	**10,084**	**$1,905,209**	**17,348**	**$1,119,219**	**561**	**$40,573**
Arts, culture, and	2,575	$158,759	632	$118,253	1,937	$39,759	6	$746
Education	6,275	$741,872	2,634	$586,612	3352	$135,481	289	$19,779
Environment, animals	1,789	$30,148	359	$18,010	1,397	$10,189	33	$1,950
Health	3,103	$264,817	971	$234,306	2,068	$29,296	64	$1,216
Human services	4104	$99,460	932	$72,069	3098	$26,292	73	$1,098
International, foreign	827	$21,028	248	$15,801	579	$5,227	0	$0
Public, societal benefit	4,580	$1,492,081	1,262	$683,743	3,268	$796,286	50	$12,052
Religion related	4372	$194,896	2,939	$154,884	1399	$36,297	36	$3,714
Mutual membership	12	$21	0	$0	1	$4	11	$17
Other	354	$61,917	106	$21,529	248	$40,388	0	$0

[1] Values in this table determined by adding values for distributions of principal and distributions of income.
[2] CRT values determined by adding values for distributions from CRATs and distributions from CRUTs.

One fact that jumps out is that in 2010 CLTs distributed nearly 60% as much to charity as CRTs - $1,119,219 vs. $1,905,209 – despite holding less than ¼ the assets. Which is to say, comparing book values overlooks an essential difference between CLTs and CRTs: CLTs distribute funds to charity every year of their existence while almost all CRTs distribute funds to charity just once at their very end.

Interestingly, the same IRS statistics for two years earlier (the 2009 filing year) showed CLTs distributing nearly the same amount to charities as CRTs. What happened to change the relationship so dramatically? Assets recovered a lot of their value after the financial crisis of 2008. The S&P 500 rose 40% over 2009 and 2010, for example. Consequently, the value of the assets distributed by terminating CRTs during 2009 and 2010 also increased substantially, nearly 50%. Meanwhile, distributions from CLTs changed little during the same time span, which makes sense since most CLTs are annuity trusts that make the same payment each year. One lesson to learn from those years is that the amount of CRT distributions to charity can change significantly due to economic conditions at the time of termination while distributions from CLTs are less susceptible to the vagaries of timing.

C. Who is a typical lead trust prospect?

Someone wealthy! Because the lead trust is irrevocable, the donor needs to have considerable assets in addition to those funding the lead trust. Often, the lead trust is being used to transfer assets to heirs with reduced estate taxes. This type of estate planning is only of concern to individuals whose taxable estate exceeds their available unified gift and estate tax exemption.

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In 2021, this exemption is $11,700,000, $23,400,000 per married couple, which eliminates all but about 0.1% of estates from federal estate tax. It is that 0.1% for whom the non-grantor lead trust will have the most appeal. And they are worth pursuing. The IRS statistics from 2012 indicate that the 324 lead trusts with a book value over $10 million had a mean book value of over $49 million. Their book value was nearly $16 billion and represented two-thirds of the total book value of all lead trusts.

That being said, notice from the IRS statistics that 41% (2,658 out of 6,498) of all lead trusts in 2012 had total assets of under $500,000 and 63% (4,064 out of 6,498) of all lead trusts had total assets of under $1,000,000! The statistics do not distinguish between grantor and non-grantor lead trusts, but my guess is that many of the smaller lead trusts were grantor lead trusts. We'll explore later why that would be the case.

III. Charitable Lead Trust Characteristics

A. Diagram

In many ways, a charitable lead trust is the reverse of a charitable remainder trust, as described in the diagram below.

B. Drafting Considerations

Irrevocability
To be a qualified charitable lead trust, the CLT must be irrevocable.

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Timing of gift
A CLT may be funded during life – an *inter vivos* CLT – or at death – a testamentary CLT. There are certain financial advantages to funding a CLT during life that we will explore later on.

Payments
The payments made by a lead trust must be in the form of either (1) an annuity amount, i.e., a fixed dollar amount (a charitable lead annuity trust or CLAT), or (2) a unitrust amount, i.e., a fixed percentage of the net fair market value of trust assets re-valued annually (a charitable lead unitrust or CLUT). Unlike CRTs, CLTs have no minimum or maximum payment percentage. In addition, unlike with charitable remainder unitrusts, qualified CLUTs come in one form only; net income, makeup, and qualified CLUTs may not include flip provisions.

Beneficiaries
Instead of making payments to one or more individuals for the duration of its term and then distributing its remaining principal to one or more charities, a lead trust makes payments to one or more charities for the duration of its term, and then distributes its remaining principal to one or more individuals.

If the donor creates a non-grantor CLT, where the remaindermen of the trust are individuals other than the donor, the benefitting charity must be described in IRC Sections 2055(a) and 2522(a). A gift or estate tax deduction is allowed when the income is paid to a foreign charity.

If the donor creates a grantor CLT, which ordinarily means the remainderman of the trust is the donor, the charity must be described in Section 170(c) and must be a domestic charity. A private foundation can be the income beneficiary, but more restrictive limitations on the deduction will apply. To qualify for the higher limitations, the income interest should be paid to a charity described in IRC Section 170(b) (1) (A).

Term
CLTs usually last for a term of years. Unlike CRTs, CLT terms are not limited to a maximum of 20 years. If state law includes a rule against perpetuities, however, the trust term must abide by that rule.

CLTs also can last for the lifetime of the remainder beneficiaries or for the lifetimes of one or more individuals "who, with respect to all non-charitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. Thus, remainder beneficiaries can include step-children and step-grandchildren of the individual who is the measuring life and charitable organizations (described in Internal Revenue Code sections 170, 2055, or 2522)." (See IRS final regulations published in Treasury Decision 8923).

Trust Additions
Although Treasury Regulations are not explicit about the permissibility of making additions to CLATs or CLUTs during their terms, the IRS has issued private letter rulings that suggest that the rules match those for CRATs and CRUTs. That is to say, it is not permissible to make an addition to a CLAT and it is permissible to make an addition to a CLUT. The donor of an addition to a CLUT is eligible for a tax deduction equal to the increase in value of charity's income interest in the trust attributable to the addition.

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Private Foundation Rules
A CLT governing instrument must prohibit violation of the private foundation rules described in IRC Sections 4941(d), 4943(c), 4944, and 4945(d). These rules prohibit a trust from engaging in an act of self-dealing or making taxable expenditures. If the deductible value of the CLT's lead interest is 60% or more, it is also subject to the prohibitions against excess business holdings (the trust plus the donor and all other "disqualified" persons must hold less than 20% of a business enterprise) and jeopardy investments.

Sample agreements from IRS
In 2007, the IRS published Revenue Procedures 2007-45 and 2007-46 to provide guidance on how to draft a trust instrument for a qualified CLAT. The revenue procedures address grantor and non-grantor *inter vivos* and testamentary trusts established for a term of years or one measuring life. The guidance provided by the IRS in the revenue procedures takes the form of sample basic wording for a trust instrument, sample optional wording, and certain annotations. In 2008, the IRS published Revenue Procedures 2008-45 and 2008-46 that cover how to draft trust instruments for qualified *inter vivos* and testamentary, grantor and non-grantor CLUTs.

The IRS will recognize a trust as a qualified CLAT or CLUT if the trust operates in a manner consistent with the terms of the trust instrument, if the trust is a valid trust under applicable local law, and if the wording of the trust instrument is substantially similar to the sample basic wording set forth in the appropriate revenue procedure (with the wording for any alternative provisions likewise reflecting the sample optional wording set forth in the appropriate revenue procedure). A trust instrument that contains substantive provisions in addition to those found in the appropriate revenue procedure (other than those necessary to establish a valid trust under applicable local law that are not inconsistent with pertinent federal tax requirements), or that omits any provision found in the appropriate revenue procedure, will not necessarily be disqualified, but neither will it be assured of qualification under the provisions of the appropriate revenue procedure.

C. Gift and Estate Taxation

One must have a basic understanding of the federal system of gift and estate taxation in order to understand the potential benefits of funding a CLT. The system is based on exemptions and rates, along with some complicated rules about the interplay between gifts made during lifetime and those transfers made at death.

The assets in a person's estate are assessed an estate tax after the person dies. The federal estate tax is assessed against a person's taxable estate, as determined on the federal estate tax return (Form 706). As with gift taxes, if a net estate tax is due, it is usually payable by the estate of the deceased taxpayer.

Gross Estate The total value of a person's estate before any deductions are made for taxes, funeral expenses, attorney's fees or administration costs. The proceeds of life insurance are included in the gross estate if the policies were owned or controlled by the decedent. One-half of property owned jointly with the spouse is also included.

Basis step-up Appreciated assets passing to heirs receive a step-up in cost basis upon the death of

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the decedent. This step-up in basis erases the potential capital gain associated with an appreciated asset up to the decedent's date of death. If the heirs subsequently sell the property, the taxable gain is calculated based on the fair market value at the time of death, not the fair market value at the time the asset was originally acquired by the decedent.

Estate tax marital deduction –The first spouse to die can leave an unlimited amount to the surviving spouse, who is a U.S. citizen, completely free of federal estate tax. The amount passing to the surviving spouse can qualify for this marital deduction if it is given outright or under certain approved trust arrangements. Property passing to a surviving spouse, who is not a U.S. citizen, is not eligible for the marital deduction, unless the property passes to the alien spouse through a qualified domestic trust (QDT).

Deductibility of lifetime gifts to charity - A donor is allowed an unlimited gift tax charitable deduction for lifetime gifts to qualified charities. A non-grantor lead trust is a gift of a future interest to the remainder beneficiaries of the trust, so the $15,000 annual gift tax exclusion does not apply. Consequently, the entire present value of that interest is a taxable gift.

Deductibility of bequests to charity - A donor is allowed an unlimited estate tax charitable deduction. As with a non-grantor lead trust created during life, a testamentary non-grantor lead trust is a gift of a future interest to the remainder beneficiaries of the trust, so the present value of that interest is taxable in the donor's estate.

Gift and estate tax exemption – As of 2021, each person is eligible for a lifetime federal gift and estate tax exemption of $11,700,000. This means that a person can make taxable transfers during life and at death with a combined value of $11,700,000 without paying any federal estate tax. If a decedent's taxable estate is not large enough to use all the exemption available (99.9% are not), the decedent can elect to port any unused exemption to his or her surviving spouse. So, married couples have a combined gift and estate tax exemption of $23,400,000 in 2021. The exemption amount is indexed for inflation. It increases each year, as a result.

The 2017 Tax Act roughly doubled the federal gift and estate tax exemption amount. Absent action by Congress, that doubling will expire at the end of 2025, in which case the exemption would drop from $11.7 million to about $6 million. The Biden Administration has proposed lowering this exemption even further to $3.5 million, its level in 2009. The possibility that the gift and estate exemption may decrease substantially in 2026, or even sooner, has created a strong incentive for wealthy donors to consider funding a charitable lead trust before such a decrease goes into effect. We will illustrate this incentive in a case later in this paper.

Calculation of a Taxable Transfer

- $800,000 gift in 2000. No prior taxable gifts at the time and no others made prior to subsequent death.
- Death in 2021
- $15,000,000 estate upon death.

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(a) $800,000 Gift Made During Lifetime in 2000

Taxable gift made in 2000	$800,000
Prior taxable gifts	0
Gift Tax (from 2000 table)	$267,800
Less unified credit (in 2000)	- $220,550
Gift tax paid	**$47,250**

(b) Settlement of $15,000,000 Estate in 2021

Estate in 2021	$15,000,000
Prior taxable gifts	+ $800,000
Taxable estate	$15,800,000
Tentative tax (from 2021 table below)	$6,265,800
Less 2021 estate tax credit	- $4,625,800
and prior gift tax paid	- $47,250
Estate tax paid 2021	**$1,592,750**

Gift and Estate Tax Rate Schedule in 2013 - 2021

Taxable Transfer	Tax	% on Excess
0	0	18
10,000	1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	40

Top estate tax bracket = 40%

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D. Funding Considerations

Most any kind of property, theoretically, can be transferred to a CLT. Property with a potential for significant future appreciation is especially appropriate to transfer to a non-grantor CLAT, as the any growth within the trust can be accumulated for heirs free from gift and estate taxes. Cash is often included as part of the funding assets to make payment of the charitable distributions during the early years possible without forcing the sale of other funding assets.

The non-grantor CLT could be used to preserve a closely held business for the next generation. The children would receive the stock at the end of the trust term, possibly with only a fraction of the value having been subject to transfer taxes. One concern is making the required payments to charity if the stock pays little or no dividends. These payments must be made, since a "net income" CLUT is not permitted. The corporation might be willing to purchase some stock from the trust. Alternatively, the trust could distribute stock to the charity in satisfaction of the required payments. At some future time, the charity would sell the stock to the corporation, to other stockholders, or perhaps to an external buyer to whom all stockholders are willing to sell. When in-kind distributions are made in satisfaction of the payment, the trust will be taxed as if it had sold the property and paid the proceeds to charity. The deduction for charitable payments should, however, offset the taxable gain.

A non-grantor CLT could be used to replace an appreciated stock with a diversified portfolio over the duration of the trust. The trustee would sell shares of the stock each year such that the realized gain would be offset by the charitable distribution deduction, resulting in no income tax. The sale proceeds in excess of the charitable distribution would be reinvested in a diversified portfolio. Over the course of the trust term, the appreciated stock could be largely or completely replaced by diversified investments no tax cost.

As noted earlier, a CLT is prohibited from acts of self-dealing and, if the deductible value of the CLT's lead interest is 60% or more, it is also subject to the prohibitions against excess business holdings (the trust plus the donor and all other "disqualified" persons must hold less than 20% of a business enterprise) and jeopardy investments. In the case of a CLT funded with closely held stock or a family business, the restriction against excess business holdings may influence the donor to limit her deduction to less than 60% of the funding amount, or seek other assets with which to fund the lead trust.

IV. NON-GRANTOR CHARITABLE LEAD TRUST

A. Description

In a non-grantor charitable lead trust, the grantor (or donor) is not treated as owner of the trust assets. At the termination of the trust, the remaining principal is distributed to individuals other than the donor, typically family members. The purpose of the non-grantor lead trust is to support one or more charities and then pass property to heirs at reduced gift and estate tax cost.

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B. Gift and Estate Tax Consequences

Since the donor retains no personal financial interest in the trust, he/she does not receive an income tax deduction. Rather, the donor makes a *taxable gift* to the remainder beneficiaries of the trust. The size of this taxable gift equals the present value of the beneficiaries' remainder interest, which in turn equals the value of the assets transferred to the trust *minus* the present value of the payments to be made to charity.

The method of computing these values is the same as for comparable CRTs, except that the deductible portions are reversed. With a CRT, the remainder interest is deductible. With a CLT, the income interest is deductible, since that is the portion that goes to charity.

The charitable deduction available for a CLT is a function of the following factors:

- Funding amount
- Term length
- Lead trust type
- Payment %
- Payment frequency
- Payment timing
- IRS discount rate

Importance of IRS discount rate
Unlike life income gifts, such as gift annuities and charitable remainder trusts, the *lower* the IRS discount rate, the *higher* the charitable deduction earned by a lead trust. The size of the effect is minor for CLUTs, but substantial for CLATs.

IRS discount rates are extremely low right now, as shown below. This means that it is a particularly opportune time for donors with the potential to fund a lead trust to be considering a CLAT.

IRS discount rate range since inception in May 1989: 0.4% (11/2020) - 11.6% (5/1989)
IRS discount rate in January 2021: 0.6%

The following tables show that a CLAT benefits considerably from a low IRS discount rate environment, whereas a CLUT is affected little by fluctuations in the IRS discount rate.

For example, in July 2007, when the discount rate was 6.0%, a 20-year 5% CLAT earned a 57.3% deduction and needed to pay 8.72% of its initial value to earn a 100% deduction. Today, in January 2021, the same 20-year 5% CLAT earns an 94.0% deduction and requires a payment rate of just 5.32% to earn a 100% deduction.

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5% CLAT, 20-Year Term, Payments Annual at End

IRS Discount Rate	Deduction %	100% Deduction Payout Rate
0.6%	94.0%	5.32%
1.0%	88.4%	5.54%
2.0%	81.8%	6.12%
3.0%	74.4%	6.72%
4.0%	68.0%	7.36%
5.0%	62.3%	8.00%
6.0%	57.3%	8.72%

By increasing the payout to charity and lengthening the trust term, the amount of the taxable gift can be reduced. In the case of a CLAT, it is even possible to earn a 100% deduction, thereby reducing the taxable gift can to zero, an attractive outcome for many lead trust donors. As shown in the table below, a CLUT cannot earn a 100% deduction.

5% CLUT, 20-Year Term, Payments Annual w/12 months delay

IRS Discount Rate	Deduction %	100% Deduction Payout Rate
0.6%	63.9%	n/a
1.0%	63.8%	n/a
2.0%	63.4%	n/a
3.0%	63.0%	n/a
4.0%	62.7%	n/a
5.0%	62.3%	n/a
6.0%	62.0%	n/a

The following charts show the percent of a contribution to a charitable lead trust qualifying for a gift or estate deduction, based on various payout rate and trust term combinations, using the January 2021 IRS discount rate of 0.6 percent, and assuming annual payments at the end of the year.

CLAT: Percent of Contribution Deductible

Payout Rate	Trust Term in Years			
	10	15	20	25
5%	48%	72%	94%	100%
6%	58%	86%	100%	100%
7%	68%	100%	100%	100%
8%	77%	100%	100%	100%
9%	87%	100%	100%	100%
10%	97%	100%	100%	100%
11%	100%	100%	100%	100%
12%	100%	100%	100%	100%

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CLUT: Percent of Contribution Deductible

Payout Rate	Trust Term in Years			
	10	15	20	25
5%	40%	54%	64%	72%
6%	46%	60%	71%	79%
7%	51%	66%	76%	84%
8%	56%	71%	81%	87%
9%	61%	76%	85%	90%
10%	65%	79%	88%	93%
11%	68%	82%	90%	95%
12%	72%	85%	92%	96%

Note: These percentage amounts would be exactly the same for a grantor charitable lead trust, but would qualify for an income tax charitable deduction rather than a gift tax deduction.

CLT growth escapes gift and estate tax
The federal gift and estate tax structure we reviewed earlier is important to understanding the tax benefits of CLTs.

1. The gift tax charitable deduction available for funding a CLT makes it possible for a donor to transfer funds to heirs at little or no tax cost. This is particularly true in the current environment of extremely low IRS discount rates. As already noted, for example, it is relatively easy to construct a CLAT of sufficient payment rate and duration to "zero-out" the taxable gift altogether.

2. Furthermore, once a donor transfers assets into a non-grantor CLT, these assets are out of the donor's estate. This means that they will not be subject to further gift or estate taxation (generation skipping tax, when it applies, is a different story that we will get to later). Consequently, one of the great tax planning benefits of the CLT is that asset appreciation that occurs within the trust escapes gift and estate taxes.

   For example, if a CLT is funded with $1,000,000 and the CLT principal is worth $1,500,000 when the CLT terminates, the $500,000 increase in value will have escaped both gift tax when the trust was funded (the value didn't exist yet so it couldn't be taxed) and estate tax when the trust terminated (the trust is out of the donor's estate so the final distribution is not subject to estate tax).

CLATs are generally preferred over CLUTs for transferring wealth because all investment return in excess of the required charitable payments accumulates for heirs. In contrast, a CLUT shares its growth with its charitable lead beneficiaries in the form of larger recalculated annual payments. Under the current extremely low IRS discount rate, a CLAT can accumulate more for heirs than when the IRS discount rate is higher because the desired gift tax deduction is obtainable with smaller charitable payments.

Generation Skipping Tax
The generation skipping tax (GST) applies to transfers between a donor and "skip" persons. It is intended to prevent taxable transfers from skipping a generation of taxation.

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A "skip" person includes a donor's lineal descendants who are two or more generations below the donor – grandchildren, great grandchildren, etc. – or non-lineal descendants who are 37 ½ years or more younger than the donor. There is an exception available to "skip" persons where the intervening generation has died prior to the creation of the CLT. For example, a CLT that terminates in favor of a donor's grandchild is not subject to GST if it was funded after the donor's child who parented the grandchild has died.

GST applies at the termination of a lead trust and at the top estate tax rate then applicable.

GST Exemption
There is a GST lifetime exemption available for transfers subject to GST. The GST exemption in 2021 is equal to the estate exemption, $11,700,000. Unlike the gift and estate tax exemption, unused GST exemption cannot be ported to a surviving spouse.

Computing the GST
The proportion of a CLT's final distribution subject to GST depends on a number of factors that feed into the computation of an "inclusion ratio." Among these factors is the allocated GST exemption amount. An inclusion ratio ranges from zero to one. Zero means 0% of the final distribution is subject to GST. One means 100% of the final distribution is subject to GST.

The inclusion ratio for a CLAT is determined when the CLAT terminates. The value of the assets in the CLAT at termination are a factor in determining the inclusion ratio for assessing GST. Since the value of CLAT assets upon termination is difficult to predict, it is also difficult to determine how much GST exemption to allocate to minimize a CLAT's GST exposure. In contrast, the inclusion ratio for a CLUT is determined when the CLUT is funded. With a CLUT, then, a donor can be precise in allocating the GST exemption, whereas with a CLAT a donor will almost certainly either allocate more GST exemption than necessary or not enough. Consequently, many planners prefer the CLUT when GST is a concern.

GST Adjusted Exemption
The GST exemption amount is adjusted for lead annuity trusts. No adjustment is made for lead unitrusts. The adjusted exemption equals the exemption amount entered compounded annually over the term of the trust by the IRS discount rate used to compute the deduction. For example, the adjusted exemption for a 20-year lead annuity trust calculated using a 0.6% IRS discount rate to which a $11,700,000 exemption is allocated would be:

$\$11{,}700{,}000 \times (1{+}.006)^{20} = \$11{,}841{,}203$
[Note: you can do this calculation in Excel using the formula = *11,700,000*(1.006^20)*]

GST Inclusion Ratio
The factor by which transferred property is multiplied to determine the amount subject to generation skipping tax (GST) is called the inclusion ratio. The inclusion ratio (IR) is calculated as follows:

CLUT: IR = 1 – (GST exemption used / (net principal placed in trust – gift tax deduction))
CLAT: IR = (principal value at termination – GST adjusted exemption) / principal value at termination

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Note that the inclusion ratio for a CLUT will be zero whenever the GST exemption allocated at the time of transfer to the CLUT equals the taxable gift. If the inclusion ratio is zero then you know the GST assessed at trust termination will be $0, no matter how much the CLUT distributes to its remainder beneficiaries.

For a CLAT, the inclusion ratio will be zero only if the GST adjusted exemption is equal to or greater than the trust principal at termination. There is no way to know what that principal value will be, however, so there is no way to allocate the precise amount of GST exemption needed to make the inclusion ratio (and GST) zero.

Generation Skipping Tax

The generation skipping tax (GST) is assessed at the time assets are transferred to the heirs.

The GST is calculated as follows:

GST = IR x principal after num years x top estate tax bracket. *

* In 2021, the top federal estate tax bracket is 40%.

Who pays generation skipping tax?

Direct skip: executor if by will, transferor if during life

Taxable distribution: transferee (e.g., income beneficiary pays GST on CRT distribution)

Taxable termination: trustee (e.g., trustee pays GST on CLT corpus distribution to heirs)

Example: Ms. Falcone transfers $5.45 million to a charitable lead unitrust having a duration of 20 years and a payout rate of 5%. The applicable IRS discount rate is 0.6% and the trust pays charity annually, twelve months after its annual valuation date. Her granddaughter is remainderman of the trust. Ms. Falcone allocates $3,607,400 of her lifetime exemption to the transfer, leaving $8,092,600 of GST exemption for to allocate to other generation skipping transfers. Generation-skipping transfer tax due upon termination of the trust will be:

Inclusion ratio equals

$$1 - \frac{3,607,400}{10,000,000 - 6,392,600} = 0$$

0 x 40% = $0 GST

Example Two: Instead of transferring the $10 million to a charitable lead unitrust, Ms. Falcone transfers it to a charitable lead annuity trust. This time she allocates her entire $11.7 million lifetime GST exemption to the transfer. The applicable discount rate when the trust is established is 0.6 percent. The trust earns a total investment return of 8%/year. When it terminates, the trust property has appreciated to $23,495,622. Generation-skipping transfer tax due upon termination of the trust will be:

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Adjusted exemption = 10,000,000 x 1.006^20 = $13,186,984

Inclusion ratio equals= (23,495,622-13,186,984) / 23,495,622 = 0.438747

0.438747 x 40% = .175499 (GST tax rate)

23,495,622 x .175499 = $4,123,455 GST

C. Income Tax

A non-grantor CLT, unlike a CRT, is not tax-exempt. Trust tax rates on earned income, such as bond interest, match the rates for individuals, but apply at much lower taxable income levels. In 2021, a CLT will be in the 37.0% income tax bracket once it has taxable income greater than $13,050, for example. Compare that to a married couple who file jointly; they do not reach the 37.0% bracket until they have more than $628,300 of taxable income. See below the income tax tables for trusts and married couples filing jointly for more detail.

Federal estate and trust income tax schedules 2021

Taxable Income*	Tax	% on Excess
0	$0	10
2,650	265	24
9,550	1,921	35
13,050	3,146	37

Source: Revenue Procedure 2020-45

Married Filing Jointly Income Tax Schedule: 2021

Taxable Income*	Tax	% on Excess
$0	$0	10
19,900	1,990	12
81,050	9,328	22
172,750	29,502	24
329,850	67,206	32
418,850	95,686	35
628,300	168,993.50	37

Source: Revenue Procedure 2020-45

As with individuals, a CLT pays a 15% or 20% tax on qualified dividends, such as dividends from publicly traded securities, depending on how much taxable income it has.

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Unlimited income tax deduction for distributions to charity
Unlike individuals, whose charitable deductions typically are limited to 60% (cash gifts) or 30% (appreciated property gifts) of adjusted gross income, a CLT can take an unlimited charitable deduction for amounts paid to a qualified domestic charity. A CLT will not need to pay any income tax in a year during which it distributes all of its income in satisfaction of its charitable payments.

Order in which CLT income is distributed
The order in which a CLT distributes different categories of income becomes important in years when the CLT has more income than it distributes to charity. In these years, what the CLT distributes also determines what kind of income it has retained and therefore the tax it will pay on that retained income.

The IRS position is that regardless of any ordering provisions set forth in the trust instrument, the character of income distributed by a CLT reflects proportionally the character of all income earned by the CLT. For example, if a CLT has $100,000 of taxable income in a year -- $80,000 in capital gain from the sale of stock, $15,000 of interest income, and $5,000 of qualified dividends -- and distributes $60,000 to charity that year, it will be deemed to have distributed $48,000 of capital gain, $9,000 of interest income, and $3,000 of qualified dividends. The CLT will owe tax on the retained income as follows:

$6,000 of interest income	=	$1,069
$2,000 of qualified dividends x 15%	=	$300
$5,050 of capital gain income x 15%	=	$758
$26,950 of capital gain income x 20%	=	$5,390
		$7,517

Some commentators believe that the IRS is on shaky ground here and that ordering provisions in the trust should be valid. In this case, the following order of distribution would be desirable, as it would minimize the income tax owed be the CLT:

1. ordinary income, including short-term capital gain and non-qualified dividends, but excluding UBTI
2. 50% of UBTI
3. capital gain other than short-term capital gain
4. qualified dividends
5. balance of UBTI
6. tax-exempt income
7. principal

D. Capital Gains Tax

A CLT inherits the donor's cost basis in the assets contributed to fund the trust, increased by any gift taxes paid that were attributable to the property's appreciation. What if the CLT sells appreciated property?

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When a CLT sells appreciated property, it is taxed on the realized gain. As with earned income, the taxable gain is offset by the income tax charitable deduction to the extent that this realized gain is distributed to the charity in the year it was realized.

Beneficiaries inherit cost basis of CLT
When an *inter vivos* CLT terminates, the remaindermen inherit the donor's cost basis in the CLT assets, with adjustments. There is no step-up in cost basis as there is for assets that pass through a benefactor's estate. In contrast, when a *testamentary* CLT terminates, the cost basis inherited by the remaindermen equals the value of the assets at the time of the donor’s death (that is, there is a step-up in cost basis at the time of funding, but not at termination).

Since the top gift and estate tax rates are considerably higher than the top capital gains tax rate, it is usually advantageous to shelter appreciation from gift or estate tax and have it taxed as capital gain instead. Still, in discussing the tax consequences of a CLT with a prospect, it is important to point out that beneficiaries could receive CLT assets that will trigger significant capital gains tax if sold.

V. Grantor CLT

A. Description

A CLT is a “grantor” trust if the grantor (or “donor”) is treated as owner of the trust under the grantor trust rules of IRC Sections 671 through 677.

In particular, the grantor will be treated as owner if he or she retains a reversionary interest in the trust having an actuarial value exceeding five percent of the value of the trust corpus at the time the trust was established.

In almost all cases where the trust principal will be returned to the grantor, the grantor will be treated as owner. Only in cases where the payout to charity is high enough and the trust term long enough to make the actuarial value of the reversionary interest five percent or less, would additional language in the trust instrument be needed for the trust to retain grantor status. One way to accomplish this is to include the clause below, which is provided by the IRS in the sample trust language included in Rev. Proc. 2007-45:

Retained Powers and Interests. During the Donor's life, [individual other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1)] shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value.

B. Income, Gift and Estate Tax Consequences

The grantor of a grantor lead trust is entitled to an income tax charitable deduction in the year of the gift for the present value of the payments that will go to charity. In contrast to the non-grantor charitable lead trust, no deduction is allowed each year for payments to charity.

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A gift in the form of a grantor lead trust is considered to be "for the use of" a charity. Consequently, the contribution is subject to a 30-percent deduction limitation, so long as each charitable beneficiary of the trust is required to be a public charity. Interestingly, the 30-percent limitation applies to the deduction associated with a contribution of long-term appreciated property, as well as the deduction associated with a contribution of cash or ordinary income property. If, however, a charitable beneficiary is or may be an entity other than a public charity, such as a private non-operating foundation, a 20-percent limitation will apply in the case of long-term capital gain property contributed to the trust. In any event, a five-year carryforward is allowed.

The donor is taxed on all a grantor trust's income, even on the income paid to the charity. Likewise, the donor is taxed on realized capital gains, even if they are accumulated within the trust. A mentioned earlier, if appreciated property is distributed in-kind to the charity in satisfaction of the annuity trust or unitrust amount, the property will be considered to have been sold and the cash distributed, thereby causing the grantor to recognize the gain.

A portion of the donor's income tax deduction will be recaptured if he or she ceases to be owner of the trust before the expiration of the trust term. For example, if a donor establishes a 15-year grantor CLT, receives an income tax charitable deduction, and dies after 10 years, part of the deduction will be recaptured. The amount recaptured is the amount of the deduction less the discounted value of the amounts already paid to charity.

C. Applications

The combination of the exceedingly low discount rate and the continuation of low maximum tax rates on qualified dividends and on most capital gains has breathed new life into the grantor CLAT. In the past, such trusts generally did not make economic sense unless the grantor was subject to a much higher income tax rate in the year the trust was funded than he or she would be in ensuing years.

These days, a grantor CLAT is often suggested as a tax efficient way for a donor to pay off a multi-year pledge. The donor can earn a very high income tax deduction, perhaps even equal to 100 percent of the funding amount, fulfill the pledge using payments from the grantor CLAT, and likely receive a sizeable balance from the trust when it terminates. The grantor CLAT is also appealing from the charity's perspective because it locks in the payments, effectively eliminating the possibility that the donor will not fulfill her pledge.

VI. Intentionally Defective ("Super") Grantor Trust

It is possible to create a charitable lead trust that has both grantor trust and non-grantor trust characteristics. The trust will distribute its remaining principal to the donor's heirs when it terminates. However, the donor retains just enough rights in the trust for the trust to be considered a grantor trust for income tax purposes and a non-grantor trust for gift and estate tax purposes. As a result, the donor pays tax on the trust's taxable income, but the trust's assets are

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out of the donor's estate. The donor receives both an income tax deduction and a gift tax deduction in the year the trust is created.

Drafting Considerations
In most cases, donors want to establish a lead trust as a non-grantor trust so as to avoid the recognition of income earned by the lead trust term. There are situations, however, where a lead trust donor may want an income tax charitable deduction upon funding a lead trust even though the donor will have to recognize income and realized capital gain during the term of the trust. To be treated as a grantor trust for income tax purposes, the trust has to include provisions so that the donor is treated as the owner of the trust, which triggers the grantor trust rules for income tax purposes. The trust has to be carefully drafted to trigger this grantor status without causing the trust to be included in the donor's estate. Drafting the language to cause the lead trust to be treated as a grantor trust for income tax purposes and a non-grantor trust for estate and gift tax purposes is referred to as creating an "intentionally defective grantor trust." To prevent confusion on the part of donors the term "intentionally defective" is generally avoided. Charities sometimes market these trusts as "Super CLTs" or "Double Deduction CLTs".

Funding Considerations
Since the donor receives an income tax and gift tax deduction upon establishing an intentionally defective grantor lead trust, there are additional funding opportunities that would not be as attractive with a non-grantor or grantor lead trust. A donor may have highly appreciated securities they would like to use to fund a lead trust. Unless these securities generate sufficient income to satisfy the lead interest, the trustee will generate significant capital gain tax by selling appreciated securities inside either a non-grantor or a grantor lead trust.

A donor could sell appreciated securities and use the cash proceeds to fund an intentionally defective grantor lead trust. The income tax charitable deduction generated by the funding of the intentionally defective grantor lead trust could offset the capital gain tax on the sale of the securities.

VII. Step Lead Trusts and "Shark Fin" Lead Trusts

The Step Lead Trust
The step lead trust differs from a standard charitable lead annuity trust only in the pattern of its payments to charity. While a standard lead annuity trust makes payments to charity that are the same amount every year, a step lead trust makes payments to charity that increase in steps during the trust term, for example 10%/year. The IRS made clear in Revenue Procedure 2007-45 that this sort of payment schedule meets the requirements of a CLAT. The IRS reaffirmed its position with a favorable private letter ruling regarding a 10-year testamentary CLAT with payments that will increase 20% each year (see PLR 201216045).

The Step CLAT can enable a donor to pass more assets to heirs than a standard CLAT that distributes the same amount to charity each year. This is possible because the Step CLAT allows more asset growth to occur early in the trust term, which can then compound over the remaining years of the trust. This compounding can more than offset the relatively large charitable distributions that occur in the last years of the trust. In the event that the Step CLAT experiences

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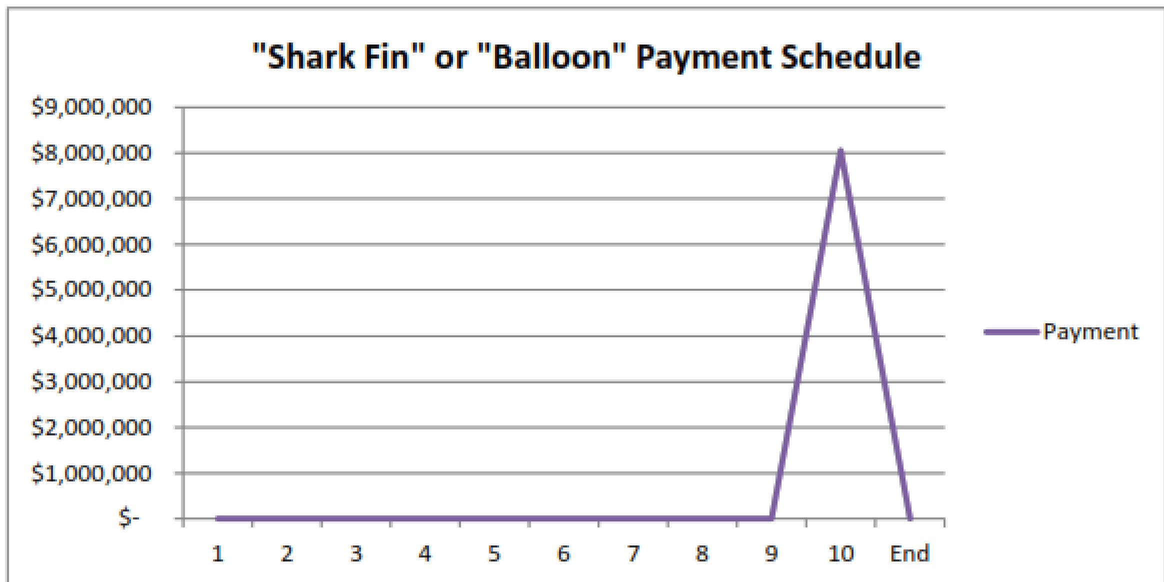
poor investment performance early in its term, it will be able to recover its value better than a comparable standard CLAT.

The Shark Fin Lead Trust
A shark fin (or "balloon") lead trust is just an extreme form of step lead trust: rather than increase its payments at a steady clip over the course of its term, a shark fin lead trust makes small payments every year of its term except the last, and then makes a very large payment in its final year. As you might expect, the shark fin lead trust has the potential to pass even more to heirs than the Step CLAT, since effectively all of its assets can grow inside the trust until its last year. If you graph this payment pattern – and use your imagination – the final payment looks something like a shark's dorsal fin slicing through the water.



It is also possible to structure a shark fin lead trust so that it makes large payments over several final years, not just one. In that case, the fin would look more like an airplane tail fin than a shark fin, with a flat top rather than coming to a point. It most likely would be shorter, too.

Note: The notion of having payments increase by no more than 20% each year is considered a "safe harbor" by some practitioners. It derives not from the revenue ruling mentioned earlier, but rather from a ruling regarding a grantor retained annuity trust (GRAT), a popular non-charitable estate planning vehicle.

VIII. Cases

A. Leave assets to children in a tax-efficient manner

Mr. Timothy has a $10 million estate and is looking for ways to reduce estate taxes, leave a portion of the estate to his two children, who are in their 20s, and make charitable gifts to his favorite causes.

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Mr. Timothy's attorney proposes contributing $2 million in assets to a 20-year CLAT with a charitable payout large enough to zero out the taxable gift. Using an IRS discount rate of 0.6%, that payout is only 5.321%. If the 2017 federal exemption amount ($5,490,000) applies after 2025 and the assets earn an 8% total return each year, funding the CLAT will pass about as much to the children as investing the $2 million for the same 8% total return and then passing the accumulated assets through Mr. Timothy's estate 20 years later ("No Trust" column below). Compare the "Benefit to Family" amounts for the two options. If the current federal exemption amount applies after 2025 on the other hand, the CLAT will not be as advantageous for the children as Mr. Timothy investing the assets himself and then passing them to his children through his estate.

The current speculation that the federal estate tax may, indeed, soon decline to 2017 levels, or even lower, creates a strong incentive for donors like Mr. Timothy to create a CLAT while the current high federal gift and estate tax exemption is still available.

	5.321% Non-Grantor Lead Annuity Trust	**No Trust**
Principal Placed in Plan	$2,000,000	$2,000,000
Annuity to CHARITY	$106,420	$0
Gift Tax Deduction	$2,000,000	$0
Taxable Gift	$0	$0
Gift Tax (paid 2021 by donor)	$0	$0
Total Income Tax Paid Over Term by Trust	$11,159	
Total Income Tax Paid Over Term by Donor		$979,361
Principal after 20 Years	$4,440,183	$7,421,692
If 2017 exemption amount applies:		
Estate Tax on No Trust (paid 2041)		$2,968,677
Benefit to Family	**$4,440,183**	**$4,453,015**
(ending principal less taxes)		
Total Distributed to CHARITY	**$2,128,400**	**$0**
Total Benefit	**$6,568,583**	**$4,453,015**
If current exemption amount applies:		
Estate Tax on No Trust (paid 2041)		$1,488,677
Benefit to Family	**$4,440,183**	**$5,933,015**
(ending principal less taxes)		
Total Distributed to CHARITY	**$2,128,400**	**$0**
Total Benefit	**$6,568,583**	**$5,933,015**

If a donor's estate is large enough to be subject to federal estate tax even with today's high exemption, then a CLAT's benefit to heirs compares favorably with "No Trust," regardless of

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which exemption will be in force when the donor's estate is settled. For example, if Mr. Timothy's estate is valued at $50 million rather than $10 million, the Benefit to Family of the CLAT and "No Trust" options would be the same as shown in the "2017 exemption amount applies" section above. That is, they would be about the same, but only the CLAT would also distribute more than $2 million to charity over 20 years. It works out this way because with an estate this large, every dollar above the exemption amount that Mr. Timothy passes to his children through his estate will be taxed at 40%.

B. Step CLAT to provide more for heirs than a standard CLAT

What if instead of creating a $2 million CLAT with a 5.321% charitable payout, Mr. Timothy were to fund a $2 million Step CLAT where the payment to charity increases 20% each year? The payment amounts could be set to zero out the taxable gift, as follows:

2022	$11,752
2023	14,103
2024	16,923
2025	20,308
2026	24,370
2027	29,244
2028	35,092
2029	42,111
2030	50,533
2031	60,640
2032	72,768
2033	87,321
2034	104,785
2035	125,742
2036	150,891
2037	181,069
2038	217,283
2039	260,740
2040	312,887
2041	375,465

As you can see from the table below, even if the current $11.7 million federal exemption remains available, the Step CLAT rivals "No Trust" in its benefit to Mr. Timothy's children by distributing nearly $1 million more to them than the 5.321% standard CLAT is projected to do. Compare the "Benefit to Family" numbers below. Both distribute over $2 million to charity, although it is worth pointing out that the charity must wait longer to receive most of the dollars from the Step CLAT as compared to the standard CLAT.

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	Step Lead Annuity Trust	No Trust
Benefit to Family	**$5,399,539**	**$5,933,015**
	(ending principal less taxes)	
Total Distributed to CHARITY	**$2,194,028**	**$0**
Total Benefit	**$7,593,567**	**$5,933,015**

C. Shark fin CLAT to provide more for heirs than a standard CLAT

What if Mr. Timothy created a shark fin CLAT that distributed a nominal $1,000 each year for its first 19 years and then a balloon payment at the end of its 20th year big enough to zero out his taxable gift? The final payment would need to be $2,234,003 to achieve a 100% deduction. Assuming the same 8% annual total return as in the previous examples, the shark fin CLAT would pass on slightly less to the children than the step CLAT and slightly more to charity. It is worth noting that the charity would receive nearly all its dollars in year 20, so in present value terms, the shark fin CLAT is the least beneficial to the charity of the three CLAT variations Mr. Timothy has considered.

	Shark Fin Lead Annuity Trust	No Trust
Benefit to Family	**$5,335,355**	**$5,933,015**
	(ending principal less taxes)	
Total Distributed to CHARITY	**$2,253,033**	**$0**
Total Benefit	**$7,588,358**	**$5,933,015**

D. Short-term CLAT to pay off campaign pledge

You have solicited Mr. Watson, Chairman of your Board, for a $500,000 capital campaign gift to support a building campaign at your charity. Mr. Watson is prepared to make a gift at this level if he can pay it off in installments over the 5-year period of the campaign.

Solution #1

One possible solution would be for Mr. Watson to create a non-grantor CLAT with a 5-year term and an annual payment amount of $100,000. Given the brief duration of the trust, a 10% CLAT funded with $1 million should allow more than half of the funding amount to go to his kids.

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	10% Non-Grantor Lead Annuity Trust
Gross Principal	$1,000,000
Annuity to Charity	$100,000
Gift Tax Deduction	$491,120
Taxable Gift	$508,880
Gift Tax (paid in gift year by donor)	$0
Principal after 5 Years	$882,668
Benefit to Family	**$882,668**
Total Distributed to Charity	**$500,000**

You learn after further discussion that Mr. Watson's company has had a banner year and he is expecting to receive a very large bonus approaching seven figures this year. Hence, a large income tax deduction may be of particular interest to him this year.

Solution #2

A possible solution would be for Mr. Watson to create a 10% grantor CLAT with a 5-year term and an annual payment amount of $100,000. He would receive an income tax deduction of over $490,000 that he can use in the year of his gift to offset the taxable income from his bonus and he's projected to get back nearly $900,000 when the trust terminates. Remember, in the case of a grantor lead trust, the grantor must pay income and capital gain tax generated by the lead trust. The illustration below assumes the lead trust principal earns 3% annually in interest income, Since this income is insufficient to meet the $100,000 annual payment to charity, the trust would have to sell some principal over the years to fill the gap between income and payment to charity. The total tax payable by the grantor on this interest income and realized capital gain is projected to be $69,994.

	10% Grantor Lead Annuity Trust
Gross Principal	$1,000,000
Annuity to Charity	$100,000
Income Tax Deduction	**$491,120**
Income Tax Savings	**$181,714**
Total Income Tax Paid by Donor	$69,994
Principal Returned to Donor	**$882,668**
Total Distributed to Charity	**$500,000**

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Solution #3
Mr. Watson can realize his income tax savings goal and pass wealth to his children using the double deduction or super grantor lead trust. Once again, this is a grantor trust, therefore he will owe tax on the ordinary income earned by the trust and the capital gain realized as in the solution above.

	10% Super Grantor Lead Annuity Trust
Principal Placed in Plan	$1,000,000
Annuity to Charity	$100,000
Gift Tax and Income Tax Deduction	**$491,120**
Taxable Gift	$508,880
Gift Tax (paid in gift year by donor)	$0
Income Tax Savings	**$181,714**
Total Income Tax Paid by Donor	$69,994
Benefit to Family	**$882,668**
Total Distributed to Charity	**$500,000**

IX. Conclusion

The charitable lead trust is a powerful charitable planning tool that can be effectively adapted to fulfill a variety of donor objectives. It must be carefully and prudently drafted, administered, and invested to ensure the desired outcome. Under the right circumstances, a charitable lead trust can provide dramatic tax benefits to the donor and impressive financial support to charity at the same time. It can take just one charitable lead trust to make a year or more of effort worthwhile. Moreover, with the IRS discount rate below 1% and a possible decrease in the federal estate tax exemption looming, this is an especially advantageous time to encourage lead annuity trust gifts.

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