CHARITABLE LEAD UNITRUST (CLUT)

(CHARITY IS INCOME BENEFICIARY)
(DONOR'S CHILDREN ARE REMAINDER BENEFICIARIES)

TECHNICAL PREFACE

OVERVIEW

A Charitable lead trust (CLT) is a split-interest Trust set up by a Donor that gives one or more charities designated by the Donor a stream of income during the term of the Trust. It also provides a remainder interest in the property which is returned to the Donor or the Donor's family at the end of the Trust term.

With this technique, the Donor's attorney drafts a CLT document in which a Trustee is named to invest and manage property transferred to the Trust. The Donor transfers cash or other property to the Trust and, depending upon whether the CLT is a Grantor or Non-Grantor Trust, may receive a charitable deduction equal to the present value of the income interest that goes to charity while the Trust is in existence. This present value is determined through the use of government tables and a specified formula. One or more Charities are named to receive a stream of income for a period of years, either for a fixed term of years, for one or more persons' lifetimes, or for a combination of the two. Although there is no minimum period for the term of the Trust, the Trust must not exceed a maximum period determined by the rule against perpetuities in the state under whose laws the Trust was organized.

The remainder interest in the Trust, that is, what is left over after the Charity's interest terminates goes either to the Donor or another person or person's designated by the Donor.

A Charitable lead trust may be created during the Donor's lifetime (Intervivos Trust) or at death in the Donor's will (Testamentary Trust). Any function that could be considered self dealing by the Trustee, which usually occurs when the Trustee is the Donor or member of the Donor's family, should be done by a Special Trustee other than the Donor. Such functions that would best be performed by a Special Trustee would include the sale of real estate or other appreciated property that was transferred to the CLT by the Donor.

TYPES OF CLTS

There are essentially two main types of Charitable Lead Trusts: Charitable Lead Annuity Trusts (CLATs) and Charitable Lead Unitrusts (CLUTs). A Charitable Lead Annuity Trust pays the Charity a fixed percentage of the initial amount of property transferred to the Trust. For example, a contribution of $100,000 to an 8% annuity Trust would provide a payout to Charity of $8,000 in the first year and each year thereafter.

A Charitable Lead Unitrust pays a fixed percentage of the value of the Trust property as valued each year. For example, a contribution of $100,000 to an 8% Unitrust would provide a payout to Charity of $8,000 in the first year. If the Unitrust property had an investment return of 10% the second year payout would be 8% of $110,000, or $8,800, and so forth.

TAX IMPLICATIONS

In general, the taxation of Charitable Lead Trusts is governed by Sections 170(f)(2)(B), 2055(e)(2)(B), and 2522(c)(2)(B) of the Internal Revenue Code.

Income Taxation

Unlike a Charitable Remainder Trust, a Charitable Lead Trust is not tax-exempt. Therefore, income in the Trust will be taxed to the Trust or, in the case of a Grantor CLT, to the Grantor. A Grantor CLT is created when the Grantor retains the remainder interest in the Trust or another power that causes the Trust to be a Grantor Trust, such as the power to substitute assets of equal value for Trust assets. The Trust will also be a Grantor Trust if the Trustee is given the power to use Trust income to pay premiums on a policy on the life of the Grantor or the Grantor's spouse. An income tax deduction is available to the Donor at the time of transfer for transfers of property to a Grantor CLT and is not available for transfers to a Non-Grantor CLT. In a Grantor CLT, in which the Grantor takes an income tax deduction for the transfer of property to the Trust, Trust income is taxable the Grantor in the year it accrues.

Because a Grantor CLT causes Trust income to be taxed to the Grantor, the CLT has limited use for income tax purposes. The primary benefit of a CLT is in the Donor's ability to transfer significant amounts of property to his/her family at a discounted value for estate and gift tax purposes.

Contributions to a Grantor CLT are subject to the same limits as other charitable contributions. Generally, a Donor may deduct up to 50% of adjusted gross income for amounts contributed to qualified charitable organizations. If the deductible contribution exceeds the deduction limit, the excess may be carried over for five more years.

Gift Taxation

When the Donor and/or the Donor's spouse retain the remainder interest in a CLT, no taxable gift occurs when the CLT is established. However, when someone other than the Donor or the Donor's spouse is the remainder beneficiary of a CLT, the remainder beneficiary's interest is considered for gift tax purposes to be a taxable transfer from the Donor to the beneficiary (IRC Sec 2511(a)). The gift is measured by the present value of the income interest at the time of the transfer (IRC Sec 2511(a)). Since the transfer is not a gift of a present interest, it does not qualify for the gift tax annual exclusion (IRC Sec 2503(b)). The present value of the income interest that is designated for charity qualifies for the unlimited gift tax charitable deduction (IRC Sec 2522(c)(2)(B)).

Estate Taxation

If the Donor is the remainder beneficiary, all CLT assets are included in the Donor's estate for estate tax purposes, however, the present value of the Charity's remaining stream of income qualifies for the unlimited estate tax charitable deduction. [IRC Sec. 2036(a)(1) and 2055(e)(2)(B)] If the CLT is a testamentary trust for the benefit of the Donor's family, the Donor's estate will receive an estate tax charitable deduction equal to the present value of the Charity's remaining stream of income.

Generation-Skipping

The unlimited charitable deduction for the full value of the Charity's interest is available for generation-skipping tax (GST) purposes only for Charitable Lead Unitrusts (CLUTs) and not for Charitable Lead Annuity Trusts (CLATs). Instead of a deduction, a CLAT uses an adjusted exemption that significantly reduces the value of the CLAT for GST purposes. [IRC Sec. 2642(e)] The generation-skipping tax exemption, if applicable, is allocated at the end of the Trust term, rather than when property is transferred to the CLT. Thus, the "freeze" potential of a CLT for multi-generational skips is diminished. When, however, a CLT is used in a generation-skipping arrangement, the Charitable Lead Unitrust is the preferred vehicle.

Important Note: This material is for educational purposes only. In all cases, the approval of a client's legal and tax advisers must be secured regarding the implementation or modification of any planning technique as well as the applicability and consequences of new cases, rulings, or legislation upon existing or impending plans.