17. THE CHARITABLE LEAD TRUST

Introduction

The charitable lead trust is an irrevocable, split interest trust. Simplistically, it is the "reverse" of the more familiar charitable remainder trust in that payments are first made to one or more qualified charities for a term certain or for a term measured by one or more lives. Upon expiration of the term, the remaining trust estate either reverts to the Grantor or is distributed to other non-charitable recipients, often the Grantor's family members.

Under the right circumstances, charitable lead trusts can be used quite effectively by clients (typically those with a high net worth) who have both philanthropic and tax objectives. Properly structured, a charitable lead trust allows the client to make a gift of income to charity for a period of time and then pass property to individual beneficiaries with reduced or no gift and/or estate tax. However, the tax issues can be tricky. Working closely with qualified tax and legal counsel is essential when developing this type of trust.

1. Types of Charitable Lead Trusts: Depending on the Donor's circumstances, wishes and goals, the trust can be structured as either a charitable lead unitrust or a charitable lead annuity trust, as either a grantor charitable lead (unitrust or annuity trust)or a non-grantor charitable lead (unitrust or annuity trust). Lead trusts can be created during the Donor's lifetime [*inter vivos* charitable lead (unitrust or annuity trust)] or upon the Donor's death [testamentary charitable lead (unitrust or annuity trust)].

A. Charitable Lead Unitrust: A charitable lead unitrust annually pays to charity a unitrust amount equal to a stated percentage of the net fair market value of the trust assets, valued annually.

B. Charitable Lead Annuity Trust: A charitable lead annuity trust annually pays to charity a specified amount, either a fixed dollar amount or a percentage of the initial value of the trust.

C. Grantor charitable lead (unitrust or annuity trust): If the Donor retains a reversionary interest of more than 5% in the charitable lead trust assets and/or retains certain administrative control(s) over the trust (is treated as the "owner" of the trust), the trust is characterized as a grantor charitable lead trust. The advantage to such characterization is that the Donor may be entitled to an income tax deduction upon creation of the trust; the disadvantage is that the Donor will be taxable on the income paid by the trust to the charity.

D. Non-grantor charitable lead (unitrust or annuity trust): If the remainder of the lead trust is to be distributed to the Donor's family or other non-charitable beneficiaries (not Donor or Donor's spouse) upon termination of the trust and the Donor does not retain controls over the administration of the trust, the lead trust is characterized as a non-grantor charitable lead trust. The Donor will not be able to take an income tax deduction upon creation of the trust and will not be taxed on the trust income.

2. General Requirements for all Qualified Charitable Lead Trusts

A. Trust term: Under a charitable lead trust, payments are made to charity for a specified period, either a specific term of years ("term certain"), for the life or lives of identified person or persons ("measuring life/lives"), or for a life or lives of identified person(s) and then a term of years. The length of the trust term can have income, gift and/or estate tax ramifications. Accordingly, care should be taken in choosing a trust term.

i. Term certain: Unlike charitable remainder trusts, there is no 20-year limitation on the length of the term certain; with some restrictions, it can be as long or as short as the Donor wishes and as will best meet Donor's goals.

ii. Measuring life: The measuring life or lives a) must be a life or lives "in being" (ie, alive) at the inception of the lead trust, and b) must be the Donor, the Donor's spouse or another person who is either a lineal ancestor or the spouse of a lineal ancestor to all of the non-charitable beneficiaries of the lead trust.

iii. Commutation: Generally, a charitable lead trust that gives the trustee the authority to "commute" the trust (prepay the charitable amounts and terminate the trust early) is not qualified.

iv. Rule Against Perpetuities: In some states, the application of this ancient rule may limit the duration of the lead trust. The rule generally requires a trust interest to vest, if at all, within "a life in being plus 21 years." In such jurisdictions, a) the trust term should be carefully determined in light of the Rule, and b) the trust instrument should include a Rule Against Perpetuities Savings Clause, which clause operates to ensure compliance with the Rule notwithstanding whatever else the trust instrument may say.

B. Payments to Charity:

i. Guaranteed payment: The charity must have an irrevocable right to receive a guaranteed annuity or unitrust amount at least annually. Trusts providing for the payment of "net income" or "income only" are not sufficient and do not qualify as charitable lead trusts.

ii. Amount: Unlike charitable remainder trusts, there are no minimum or maximum payment amount requirements.

iii. Nature of payments: Payments may be made in cash or in kind, from income and, to the extent income is insufficient, from principal.

iv. Choice of Charities: A charitable lead trust must have at least one qualified charitable lead beneficiary and may have more than one. Donor may give the trustee of the lead trust the authority to select the charitable beneficiary(ies), provided, however, doing so has potential tax implications if the Donor him/herself is serving as the trustee. Also, Donor may retain the right in the trust instrument to change charitable beneficiaries after inception of the lead trust. However, retaining such right may cause some or all of the trust assets to be included in the Donor's gross estate for estate tax purposes.

C. Funding: Most any type of property can be used to fund a charitable lead trust, although there are some restrictions as to the use of mortgaged property and closely held stock. Also, while appreciated property is a perfectly acceptable asset to fund a lead trust (and is a preferred asset to fund a charitable remainder trust), any gain realized by the trust upon the subsequent sale of the property will be taxable to the Donor (grantor trust) or the trust (non-grantor trust), or, if the property is not sold by the trust but held and then eventually transferred to the non-charitable beneficiaries, those beneficiaries will take on the Donor's basis in the property, not receiving the stepped-up basis they would have received had the Donor left them the property at Donor's death. Accordingly, using appreciated property to fund a charitable lead trust may be disadvantageous to Donor and/or Donor's non-charitable beneficiaries.

D. Trustee: There are no limitations upon who may serve as trustee of a charitable lead trust. However, a Donor should be cautious about serving as trustee him/herself, as some trustee powers (such as the power to designate charitable beneficiaries or apportion the annuity/unitrust payment between charities), if held by the Donor/Trustee, may cause some or all of the trust assets to be included in the Donor's gross estate. The trustee of a lead trust is subject to the same requirements as trustees of other types of trust, such as the fiduciary duty of loyalty to all trust beneficiaries (income and remainder), compliance with the Prudent Investor Act, and other regulations applicable to trustees in your jurisdiction.

E. Application of Private Foundation Rules: To qualify for income, estate and/or gift tax deductions, the lead trust must specifically prohibit 1) self-dealing [IRC §4941(d)], 2) making taxable expenditures [IRC §4945(d)], 3) retaining excess business holdings [IRC §4943(c)], and 4) making investments that jeopardize its purpose [IRC §4944].

3. Tax Issues

A. Trust Income Issues: Charitable lead trusts are not tax-exempt; the income earned and capital gains generated by the trust are taxable. The responsible party for such taxes depends upon the type of lead trust.

i. Grantor Lead Trust: All of the lead trust's income is taxable to the Donor, as is long term capital gain. If the Donor is able to take an income tax deduction upon the creation of the lead trust, no charitable deductions will be allowed for the annuity or unitrust amounts paid by the trust to charity during the trust term. (However, if more than the required annuity or unitrust amount is paid to a public charity, the Donor may deduct such excess amount.)

ii. Non-Grantor Lead Trust: The trust's income and capital gain are taxable to the trust. However, the trust may claim a deduction for all income (and capital gains) paid to charity.

B. Unrelated Business Taxable Income Issues: UBTI is allowable within a charitable lead trust. However, a non-grantor lead trust may not deduct any income paid to charity attributable to UBTI.

C. Generation Skipping Tax Issues: Often, a Donor will use a charitable lead trust to pass substantial assets to family members after the charitable lead period. While this technique may save Donor gift and /or estate taxes, if the trust is to "skip" a generation or two and pass assets to Donor's grandchildren or great grandchildren, the Donor may incur generation skipping taxes. While there are various exemptions available to alleviate the GST, if the assets to be transferred are substantial and/or if the Donor has made or provided for other gifts to his/her grandchildren, the exemptions may not be allocated to the lead trust or may otherwise be insufficient to eliminate the GST. Accordingly, when planning such a trust, the GST ramifications must be taken into account.

D. Income Tax Deduction Issues: Donor is entitled to an income tax deduction upon creation of the charitable lead trust only if the trust is a Grantor Trust, that is, if Donor retains a reversionary interest in the trust assets and/or retains certain administrative controls over the trust and is thus treated as the "owner" of the trust. As set forth above, Donor may be entitled to an income tax deduction in the year he/she sets up the trust, but, Donor will then be taxable on all the income the trust earns. Except in rare instances, such as when the trust is invested in tax exempt securities or when the Donor changes tax brackets after creating the trust, the initial deduction is not worth the subsequent taxes.

i. Deduction: If a Grantor trust, Donor is entitled to an income tax deduction equal to the value of a public charity's lead interest, subject to a ceiling of (usually) 30% of AGI with a 5 year carryover.

ii. Recapture of Deduction: If Donor ceases to be treated as the owner of the trust at any time during the term of the trust (such as in the event of Donor's death prior to termination of the trust), a portion of Donor's income tax charitable deduction will be recaptured.

E. Gift Tax Issues: The value of the charity's lead interest is subject to gift tax. Donor must file a gift tax return if the value exceeds the then current gift tax exclusion, but, Donor may claim a gift tax charitable deduction, zeroing out the tax. If the trust property is to be distributed to non-charitable beneficiaries (rather than revert to Donor) upon termination of the trust, the value of the non-charitable beneficiaries' remainder interest (present fair market value of the trust assets less the value of the charitable lead interest) is also subject to gift tax. Because the remainder interest is a future interest it does not qualify for the annual gift tax exclusion. Donor may be subject to a gift tax unless offset by Donor's unified transfer tax credit. Or, careful planning can reduce or even eliminate the gift tax. It is possible to structure the trust term and amount of payments to charity so as to make the value of the charitable interest (and therefore the gift tax charitable deduction) equal to (or close to) 100% of the trust assets—eliminating (or reducing) any gift tax on the remainder interest.

F. Estate Tax Issues: Donor's estate may be entitled to a charitable deduction for the value of the charity's lead interest at Donor's death. However, if the trust property is to revert to Donor upon termination of the trust and the Donor dies during the trust term, the value of Donor's reversionary interest will be includable in his/her estate. And, if Donor reserves certain administrative controls over the trust, the entire value of the trust may be includable in Donor's gross estate.

Conclusion

The charitable lead annuity trust or unitrust is an estate planning tool of somewhat limited utility. Its principal use is for distributing portions of very large estates to individual beneficiaries with the elimination or substantial reduction of gift or estate taxes, while at the same time making provision for substantial distributions for several years to the charity or charities chosen by the donor(s).