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CHARITABLE LEAD TRUSTS

In our current climate of low (yet unstable) interest rates, the charitably inclined client should consider the tax advantages to be gained through an often overlooked charitable giving device, the charitable lead trust. The charitable lead trust is the converse of the more common deferred giving tools. In a charitable lead trust, the donor transfers property to a trust that provides for payment of the income interest to a charitable organization for a period of years or the life or lives of an individual or individuals, and, upon expiration of the period, provides that the remainder interest in the trust either reverts to the grantor or passes to a non-charitable beneficiary. Stated differently, the charitable lead trust is a charitable gift of the income interest in property.

In order to gain the charitable deduction for income or transfer tax purposes inherent in the donor's charitable gift of an income interest, the charitable lead trust must meet specific criteria. In particular, the income interest must be paid to the charity as a guaranteed annuity (a charitable lead annuity trust) or it must be paid as a fixed percentage of the fair market value of the trust property determined on an annual basis (a charitable lead unitrust).

As a general rule, the charitable lead trust is best utilized to minimize the gift, estate and generation-skipping transfer taxes imposed upon a taxpayer's transfer of property to another, as opposed to securing an income tax deduction. In order for a donor to obtain a current income tax deduction for the present value of future payments to a charitable beneficiary, the donor must be treated as the owner of the income interest under the grantor trust rules. Consequently, the donor must include the income of the trust in his or her income in all years that it is being paid to a charitable beneficiary. This is generally too high a price for most donors to pay in order to obtain a one-time income tax deduction in the year of the gift. Moreover, the deduction cannot exceed thirty percent (30%) of the donor's contribution base, and, if the donor ceases to be treated as the owner of the income interest for whatever reason during the trust term, the deduction must be recaptured by the donor to the extent that the deduction previously allowed exceeds the discounted value of amounts actually paid by the trust to the charitable donee. Nonetheless, in certain situations, it may be desirable to use a charitable lead trust to obtain an income tax deduction for the lifetime charitable gift of an income interest.

One such instance might involve a taxpayer who, in one year, has an unusually high level of income, a portion of which will be taxed at the rate of 35% (or higher). If the taxpayer expects that income in future years will be substantially less and that he or she will consequently be taxed in lower tax brackets, the taxpayer should consider establishing and funding a charitable lead trust in the high-income year. The resulting charitable income tax deduction will offset income otherwise taxable at the taxpayer's maximum marginal rate. Although the donor must recognize taxable

income distributed to the charitable beneficiary from the charitable lead trust in the following years, that income will generate less tax. Moreover, if the trust is funded with tax exempt bonds, the additional tax in subsequent years may be virtually eliminated.

A donor can obtain an income tax deduction in substance, if not in fact, by establishing a charitable lead trust over which he or she will not be treated as the owner of the income interest under the grantor trust rules. Because the income of the trust is no longer attributed to the donor for income tax purposes, such an exclusion from the donor's income each year heeds virtually the same result as if the donor received the income and paid it to the charitable beneficiary obtaining an income tax deduction each year for the amount of payment.

As stated previously, the most common use of the charitable lead trust is to reduce transfer tax (gift, estate and generation-skipping) liability. The present value of the charitable income interest in a lead trust is deductible for federal gift or estate tax purposes. It is also deductible for generation-skipping transfer tax purposes with regard to transfers made to a charitable lead unitrust. Therefore, when a charitable lead trust is funded (during lifetime or at death), the taxable transfer to the non-charitable remaindermen is reduced by the present value of the intervening charitable income interest. The greater the deductible charitable income interest, the lesser the estate or gift tax consequence on transfer of the remainder interest.

Because of this result, it is possible to leverage the unified credit against the estate and gift tax to shelter a transfer of property to heirs that would, but for the intervening charitable income interest, be valued and taxed at a much greater amount. For example, if a donor makes a lifetime gift of \$1,000,000.00 to a charitable lead annuity trust providing for a 5% guaranteed annuity to a charity for 20 years, remainder to donor's children, and the applicable federal mid-term rate used for valuing the income interest is 4.2%, the taxable gift to the donor's children would be valued at \$332,360.00, instead of the \$1,000,000.00 initially transferred to the charitable lead annuity trust. Moreover, assuming that the donor had full use of his or her unified credit, the taxable gift would be fully sheltered from gift tax. Estate tax costs are also minimized because any subsequent appreciation in the value of the property is not includable in the donor's estate and thus is not subject to the estate tax. Even if the property's value appreciates substantially during the donor's lifetime, the value included in determining the donor's estate tax under the unified transfer tax system is "frozen" at \$332,360.00, the value of the lifetime gift to the children.

Similar planning is possible in the generation-skipping transfer tax area with regard to using a charitable lead unitrust to leverage the generation-skipping transfer tax \$1,000,000.00 exemption amount for transfers to grandchildren. It is also possible to "freeze" the value of a future generation-skipping transfer as of the date that the charitable lead unitrust is funded. Current revenue provisions make it impossible to determine with any accuracy the generation-skipping transfer tax consequences of a transfer to a charitable lead annuity trust. Therefore, if a generation-skipping transfer tax may apply, it is advisable to instead use a charitable lead unitrust.

Charitable lead trusts tend to be most popular during periods of low interest rates because a low applicable federal mid-term rate (AFMR) results in a greater gift or estate tax deduction (and less transfer tax liability) for amounts passing to charitable beneficiaries. However, the charitable lead annuity trust is more sensitive than the charitable lead unitrust to fluctuations in the AFMR.

As interest rates start to rise again, the charitably inclined individual should consider including a charitable lead trust in his or her estate plan. By locking in the benefits of using a lower AFMR for valuation purposes, a charitable lead trust can significantly reduce the potential transfer tax on amounts passing to non-charitable beneficiaries, and, at the same time, can provide a significant cumulative charitable gift to a worthy charitable organization.

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