Charitable Lead Annuity Trust

In General

A donor may transfer assets to an irrevocable Charitable Lead Annuity Trust (CLAT). The trust then pays a *fixed dollar amount* to a qualified charity for either a set number of years or the lifetimes of individuals. When the trust term has ended, the remaining assets are distributed to the donor, his or her spouse, heirs or others.

The trust must pay out the same dollar amount each year, without regard to its earnings. If the trust earns more than it pays out to the charitable beneficiary, those extra earnings (or asset appreciation) will pass to the non-charitable beneficiaries (children, grandchildren, others) without additional estate or gift taxes.

Valuation of assets is required only at the time the assets are transferred to the CLAT. A new trust will be required if additional contributions are made in later years. Ideally, assets in the CLAT should have both income potential (to make the required payments to the charitable beneficiary) and growth potential (to pass long-term appreciation to the ultimate beneficiaries with a minimum of estate or gift taxes).

After the lead (or income) period has expired, if the beneficiary of the trust is other than the donor or his or her spouse, there may be a taxable gift. The gift tax would be based on the present value of the beneficiaries' right to receive the trust remainder at some future time. This calculation is dependent upon the term of the trust, the amount payable each year to the charity and the applicable federal rate (AFR) at the time of the transfer.

Planning Considerations

A donor establishing a CLAT needs to consider several key issues:

- **Income tax deduction:** If certain requirements are met, an income tax deduction is allowed for the value of the income passing to charity. With a grantor trust the donor is considered the owner of the trust (taxable on the income under the grantor trust rules) and is allowed the tax deduction, subject to certain percentage of AGI limitations. If the trust is a non-grantor trust, the trust itself is permitted an unlimited tax deduction for distributions to qualified charities. If these requirements are not met, no charitable income tax deduction is allowed to either the donor or the trust.

- **Remainder interest:** At the end of the trust term, should the assets remaining in the trust revert to the donor or pass to other individuals such as the donor's heirs?
- **Generation-Skipping Transfer Tax (GSTT):** A taxable event for GSTT purposes will occur if the individuals who ultimately receive the assets when the trust terminates are considered to be "skip'" persons, such as the donor's grandchildren or a later generation.

Estate Tax Reduction

Frequently, CLATs are set up as non-grantor trusts, with the ultimate beneficiary of the trust assets being someone other than the donor or his or her spouse. Such CLATs typically provide no income tax deduction to the donor, but do provide a means of transferring assets to children or grandchildren, with substantial valuation discounts. For example, at a 4.8% AFR, a 10-year CLAT, paying 5% annually[1] to a charity, offers a 44.5% discount from market value. The same trust, over a 15-year term, offers a 53.8% discount from market value; over 20 years a 64.8% discount from market value is achieved.

The CLAT is an excellent way for affluent individuals to meet charitable obligations, as well as make discounted, deferred transfers to heirs.

[1] 5% of the value of the assets, as measured at the time of the transfer into the CLAT. For example, given assets worth $1,000,000 at the time of transfer, a 5% payment would yield a fixed payment to charity of $50,000 per year, for the term of the trust.

Disclosure Notice

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