

Charitable Lead Trust (CLT)

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WHAT IS A CHARITABLE LEAD TRUST?

A Charitable Lead Trust (CLT) is an irrevocable trust that can be established and funded during the grantor's lifetime or upon the grantor's death. Once established, a designated eligible charity receives either an annuity (Charitable Lead Annuity Trust/CLAT) or unitrust payment (Charitable Lead Unitrust/CLUT) over the term of the CLT. The payment from a CLAT is a fixed amount based on a percentage of the initial contribution; the payment from a CLUT is based on a fixed percentage of the value of trust assets each year. At the end of the CLT term, the remaining assets are paid to the designated noncharitable beneficiaries, e.g., the grantor or the grantor's family.

WHY USE A CLT?

A CLT affords grantors who are charitably inclined the opportunity to benefit their charity of choice while transferring wealth to their family with little to no gift and estate tax.

WHAT ARE THE ADVANTAGES OF A CLT?

There are several advantages to establishing a CLT. First is the ability to benefit charity. The technique rarely leads to a net positive result for the family alone so, without charitable intent, it may make sense to consider other ways to reduce estate tax.

Second, the value of the payments to charity reduces the value of the grantor's taxable estate. In other words, the grantor can leave assets to family at a lower transfer tax cost. The technique works even better (i.e., more can be transferred to noncharitable beneficiaries) in a low interest rate environment since the tax value of payments to charity is equal to the present value of the payments calculated by using a discount rate set by the IRS. The more the total return on trust assets exceeds the discount rate, the more that can pass to family without transfer tax. In fact, depending on the amount and term of payments, it is possible to "zero out" the gift so assets can be transferred with no gift or estate tax.

Finally, if the trust is structured as a grantor trust, the grantor receives an income tax deduction equal to the amount of the charitable interest and can retain a power to change charities. In this case, the grantor will pay tax on trust income, which can be an advantage (a) if the grantor's effective tax rate is lower than the trust's—which is often the case because of the low income threshold at which trusts reach the highest income tax bracket—and (b) because tax payments are, in essence, tax-free gifts to family. Note that, in many cases, the grantor may choose to structure the

trust as a non-grantor trust, foregoing the income tax deduction but avoiding tax liability on trust income because the taxes will be paid by the CLT. The CLT will receive charitable deductions for the annuities paid to the charities.

WHAT ARE THE DISADVANTAGES OF A CLT?

With any strategy, there are also disadvantages. For example, if the trust assets do not perform as expected, the amount passing to beneficiaries at the end of the CLT may not be as large as anticipated. In addition, a CLAT (specifically) may not be an ideal strategy if a grantor is transferring assets to grandchildren or more remote descendants because of how the generation skipping transfer (GST) tax exemption is applied to CLTs. It is possible to avoid negative GST consequences by leaving the remainder interest to a carefully-designed trust that provides for the health and education of grandchildren and for additional payments to charity. Another way around the GST problem is using a CLUT instead of a CLAT, although, because a CLAT provides for more certain payments to charity and has greater potential to maximize the transfer to family, the CLUT is not as popular.

WHO ARE THE CANDIDATES FOR THIS STRATEGY?

In order for the CLT to be appropriate, the client should be charitably inclined. They—and their family—should also be willing to make an irrevocable gift, and forego ownership of and income from the assets to be transferred for a term of years.

WHAT ARE THE NEXT STEPS?

Please contact your Baird Advisor and your estate planning attorney if you think a CLT might be the right solution for you and your family.