USING A CHARITABLE LEAD TRUST for Estate Tax Planning

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A charitable lead trust (CLT) is an irrevocable trust that allows donors (called grantors) to give money or property to fund an income stream to charity for a term of years while also retaining the rights to the remainder property. Any assets remaining in the trust are distributed to the grantor or other individuals.

A CLT can then be established as a charitable lead annuity trust (CLAT), which pays a fixed dollar amount based on a percentage of the initial funding amount to a charity for a specified length of time, or a charitable lead unitrust (CLUT), which pays a percentage of the trust's value, as calculated each year, to the charitable income beneficiary.

A CLAT is more suitable if the grantor wants to maximize the benefit to the non-charitable beneficiary and expects the assets in the trust to appreciate over time. A CLUT is more suitable if the grantor expects the trust assets to decline over the term of the trust, such that revaluing the income payment year to year may result in more assets left for the remainder beneficiary.

Below, we'll review how a CLT can help with planning for estate taxes.

Estate Tax Freeze Techniques

In 2022, the federal lifetime gift and estate tax exemption is $12.06 million per person. This means the IRS will add the total value of reportable gifts made during an individual's lifetime to the value of assets in that individual's estate. Gifts made during the individual's lifetime won't be taxable unless they exceed the exemption amount. It's important to note that some states also tax gifts and estates if they exceed the state's exemption amount.

If the total exceeds the exemption amount, that individual may be subject to estate tax. An estate tax freeze may be one option to avoid this. The idea behind an estate tax freeze is to make a reportable gift, generally of an asset or assets expected to appreciate over time and often through a vehicle such as a trust. Although the grantor will be making a gift that counts against the lifetime exemption amount, any future appreciation on the asset(s) will be outside of the grantor's estate. Using a CLT is one such strategy.

How CLTs Can Help

There are two common structures for a CLT intended as an estate tax freeze vehicle.

Non-grantor lead trust. This is treated as a separate tax-paying entity subject to trust income taxation. The trust can deduct the payments made to the charitable beneficiary each year to reduce the tax implications. Someone other than the grantor is the remainder beneficiary. The grantor does not receive an income tax deduction when funding the trust but makes a completed gift to the remainder beneficiary and is able to deduct the present value of the income stream going to the charity from the value of the gift. Any appreciation of the assets passing to the remainder beneficiary occurs outside of the grantor's estate.

Intentionally defective grantor lead trust. The donor is considered the owner of the CLT assets for income tax purposes, but someone other than the grantor is the remainder beneficiary. Similar to a non-grantor lead trust, funding the trust makes a completed gift to the remainder beneficiary at a discounted value. The grantor can deduct the present value of the income stream to the charity from the value of the gift. Unlike a non-grantor lead trust, all income tax liabilities of the trust flow through to the grantor's personal income tax return, and the grantor can take a charitable income tax deduction equal to the present value of the income interest passing to charity. Having the grantor pay the taxes on behalf of the trust accomplishes two things:
1) the grantor is ensuring that more of the trust's assets pass to the remainder beneficiary
2) the grantor is further reducing their estate by using liquid assets to pay the tax liability

How Do I Get Started?

Work with your attorney to draft a CLT document and determine the appropriate structure, income timeline, and payout rate for the trust. Once your CLT has been established, you can begin the process of retitling assets in the name of the trust.

A Pivotal Role

Using a CLT for estate tax planning may help reduce your estate tax liability, but it can also be a pivotal part of your financial plan, ensuring that you meet your charitable goals while also providing a benefit to your family. The rules for CLTs and their drafting are complex, so it is essential to work closely with your attorney and tax advisor.

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