



This Could be the Year of the Charitable Lead Trust

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The combination of extremely low monthly IRS discount rates, a stock market at or near record highs, and the possibility of increased estate taxation before the year is over creates ideal conditions for turning lead trust prospects into lead trust donors. Take advantage of the moment! Completing even a handful of lead trusts could make a big difference to the finances of your organization.

Non-grantor lead trusts offer wealthy individuals the opportunity to pass assets to their heirs at substantial tax savings while providing immediate benefits to one or more charities they care about. Grantor lead trusts offer a wider range of donors a tax-efficient way to fulfill multi-year pledges or to offset an income windfall while fulfilling their charitable wishes.

Definition

A charitable lead trust (CLT) is, in many ways, simply the reverse of a charitable remainder trust (CRT). Instead of making payments to one or more individuals, and then distributing its remainder to one or more charities, a CLT makes payments to one or more charities, and then distributes its remainder to one or more individuals. A CLT is a gift of an income interest to a charitable organization; it derives its name from the fact that the charity's interest leads off.

Non-Grantor Lead Trusts – An Opportunity to Appeal to the Wealthy

The most common form of lead trust is a non-grantor lead trust. A non-grantor lead trust distributes its remainder to one or more individuals named by the donor, often children or grandchildren. Because the donor of a non-grantor lead trust gives up all access to the

property that funds the trust, a CLT donor needs to have substantial assets in addition to those used to fund the lead trust. The donor receives a gift tax deduction, not an income tax deduction, for the present value of the payments promised to charity.

The non-grantor CLT is a *taxable* trust: it pays income tax on net income in excess of its total payments to charity for the year. It is also not includable in the donor's estate, so any assets remaining in the non-grantor CLT when it terminates are passed on to the beneficiaries free of estate tax. Note, there is also no step-up in cost basis when the CLT is funded or when the donor's heirs receive the remaining assets, so funding a CLT is not a means to avoid capital gains tax.

A non-grantor lead trust is most appealing when it will reduce the taxes owed by the donor's estate. This type of estate planning is of most concern to individuals whose taxable estate exceeds their available unified federal gift and estate tax exemption. In 2021, this exemption is \$11,700,000, or \$23,400,000 per married couple, which means only one of every one thousand estates owes federal estate tax. It is this 0.1% for whom the non-grantor lead trust has the most appeal – and they are worth pursuing. IRS statistics from 2012 – the latest available – indicate that lead trusts funded with over \$10 million represented two-thirds of the total funding amount of lead trusts that year, and their average funding amount was over \$49 million.

A Low IRS Discount Rate Means High Lead Trust Deductions

Unlike life income plans, such as gift annuities and charitable remainder trusts, the lower the monthly IRS discount rate, the *higher* the charitable deduction enjoyed by the donor of a charitable lead trust. This means that the charitable deduction for funding a lead trust, in particular a charitable lead annuity trust (CLAT), has been at record highs since interest rates plummeted at the start of the pandemic. The IRS discount rate has been creeping up over the last six months, but it is still extremely low, meaning that lead annuity trust deductions are still very high.

For example, a donor of a CLAT with a 20-year term can achieve a 100% charitable deduction by setting the payout rate at 5.6538% using the May 2021 IRS discount rate of 1.2%. A donor could fund this CLAT with \$100 million and not owe one penny of gift tax. Should the CLAT earn net investment returns of 6% annually during its term, a reasonable assumption, 20 years later it would pass more than \$100 million to the donor's heirs free of gift and estate taxes. If the beneficiaries were the donor's grandchildren, however, there would be generation-skipping transfer tax (GSTT) to consider. Without going into the intricate details, funding a lead unitrust may be the best way to minimize GSTT concerns when a donor wants to name grandchildren or other young individuals as beneficiaries of a CLT.

Possible Tax Changes Create Urgency for Some Donors

Donors don't like uncertainty. Right now, we are clearly in uncertain times regarding federal taxes. The 2021 American Families Plan, announced recently by President Biden, includes a proposal to eliminate the step-up in cost basis for estate transfers of capital gains above \$1 million (\$2.5 million for a married couple when combined with existing real estate exemptions). These gains would be taxed in the estate at 39.6%, the new proposed top federal income tax rate. They would also be subject to existing estate taxes and the 3.8% Medicare surtax. In addition, the heirs would inherit the cost bases of the deceased, so the donor's capital gains would be taxed a second time if the heirs sell the assets. Some donors may be motivated to fund a CLT now, before these changes have a chance to become law, to avoid the application of capital gains tax at death.

It is very unusual for capital gains tax and estate tax to be assessed on the same assets at death, so it seems likely that one or both these proposed taxes will be modified before a final bill is passed. For example, the proposal made by the Biden campaign last year to decrease the federal gift and estate tax exemption to \$3.5 million may gain traction during negotiations. This sort of change would expose many more estates to estate tax. The Biden campaign also proposed decoupling the currently unified gift and estate tax deduction, limiting the gift tax exemption on lifetime gifts to \$1 million, a dramatic decrease from the current \$11.7 million exemption. Some donors may be motivated to fund a CLT now to avoid increased gift and estate taxes that may confront them before the year is over.

Grantor Lead Trusts – Produce a Big Income Tax Deduction When You Need It

A CLT is a "grantor" trust if the grantor (or donor) is treated as owner of the trust under the grantor trust rules of IRC Sections 671 through 677. In most cases, this is because the trust principal will be returned to the grantor at the end of the trust.

The donor of a grantor CLT receives an income tax deduction for the present value of the payments promised to charity. The deduction calculation for a grantor CLT is exactly the same as the one for a non-grantor CLT. Hence, a 20-year grantor CLAT paying 5.6538% would earn a 100% charitable deduction, just like the non-grantor CLAT we looked at earlier. The difference is that it would be an income tax deduction rather than a gift tax deduction. The contribution to a grantor CLT is subject to a 30-percent deduction limitation with the usual five-year carryforward. The 30-percent limitation applies whether the trust is funded with cash, long-term appreciated property, or ordinary income property, so long as all charitable beneficiaries are public charities.

The donor is taxed on all of a grantor trust's income, including the income paid to the charity. A portion of the donor's income tax deduction will be recaptured if he or she

ceases to be owner of the trust before the trust term expires. For example, if a donor establishes a 15-year grantor CLT, receives an income tax charitable deduction, and dies after 10 years, part of the deduction will be recaptured upon the donor's death.

The combination of the exceedingly low discount rates and the low maximum tax rates on qualified dividends and capital gains has breathed new life into the grantor CLAT. In the past, such trusts generally did not make economic sense unless the grantor expected to be subject to a much higher income tax rate in the year the trust was funded than in ensuing years.

These days, a grantor CLAT is often suggested as a tax-efficient way for a donor to pay off a multi-year pledge. The donor can earn a very large income tax deduction, perhaps even equal to 100 percent of the funding amount, fulfill the pledge using payments from the grantor CLAT, and likely receive a sizeable balance from the trust when it terminates. The grantor CLAT is also appealing from the charity's perspective because it locks in the payments, effectively eliminating the possibility that the donor will not fulfill her pledge. The proposed increase in the top income tax bracket to 39.6% might cause some would-be grantor CLT donors to delay their gift in the hope of saving more income tax after the higher rate goes into effect. On the other hand, the Biden administration has proposed limiting income tax charitable deductions to 28%, which would reduce the value of the deduction for donors in higher tax brackets. Donors worried about this possibility may want to make their gift now when their deductions can save up to 37%.

Conclusion

Current conditions make the charitable lead trust an attractive gift plan for certain donors interested in supporting your charity. For donors who are wealthy enough to be concerned about estate taxes, the possibility that tax law changes may increase their estate tax exposure before the year is out may motivate them to fund a non-grantor lead trust before these changes take effect. For donors seeking a tax-efficient way to fulfill a multi-year pledge or to offset unusually high taxable income in 2021, a grantor lead trust may offer a good solution. The still-extremely-low IRS discount rate makes lead annuity trust deductions very attractive at the moment – but that may not last. The IRS discount rate has been gradually rising over the past six months, and that trend appears likely to continue. The slowly shrinking deduction available for funding a CLAT provides yet another motivation for funding a lead trust sooner rather than later.