

The Appeal of Charitable Lead Trusts

Charitable lead trusts offer your clients a dependable vehicle for supporting their favorite charities, a way to preserve their wealth for the next generation, and significant tax advantages, especially when interest rates are relatively low.

With interest rates rising from their historic lows of the past few years, advisors may wish to explore the merits of **charitable lead trusts** (CLTs) with their philanthropically minded clients—before rates rise any further and diminish the tax benefits of these important wealth planning tools.

The opposite of the more-popular **charitable remainder trust**—in which a client receives income for a specified term or for life and any remaining assets go to a named charity—a charitable lead trust pays income to a charity for a specified period of time, after which trust assets revert to the owner or his or her family. Some charitable lead trusts are created solely for income tax purposes. Most often, though, these trusts are designed to exclude assets—and subsequent appreciation on those assets—from a donor's taxable estate.

"The charitable lead trust combines estate planning with a charitable device," says Lawrence P. Katzenstein, an estate planning attorney with Thompson Coburn LLP in St. Louis, Mo. "It benefits the charity and also moves property to the next generation at a lower estate tax cost." Charitable lead trusts can take several forms, including the **charitable lead unitrust** and the more common **charitable lead annuity trust**, which is most attractive when interest rates are low.

Supporting Cherished Causes Through a Community Foundation

Community foundations are ideal venues for charitable lead trusts, which allow clients to make and direct a significant charitable gift while preserving family wealth for the next generation. Consider the case of Mary Lemmon, age 65, who grew up in a family where charitable giving was a way of life. She has passed these philanthropic values on to her two daughters, ages 43 and 39, but in case something happens to her, she wants to ensure that her favorite charities continue to receive an annual income for a set number of years. After that, Mary wants the remainder of her estate to pass to her daughters at a low estate tax cost.

To accomplish her objectives, Mary set up a charitable lead trust to support a donor advised fund at the Peninsula Community Foundation in San Mateo, Calif., funding it with \$1 million worth of appreciated securities. The fund supports causes important to Mary, such as Kara, a grief-counseling group in Palo Alto, and educational, arts, and health programs benefiting children and adults in East Palo Alto.

Lower Interest Rates Mean Higher Deductions

At the time assets are placed in a charitable lead trust such as Mary Lemmon's, the client receives a current gift tax deduction equal to the present value of the income

stream that will be going to charity. If the CLT is a guaranteed annuity, the lower the interest rate that is used for this calculation, the higher the deduction will be, which is why experts recommend establishing charitable lead annuity trusts before interest rates rise further. The relevant interest rate is 120 percent of the federal midterm rate, also known as the 7520 rate, which is announced each month by the Internal Revenue Service.

Typically, assets transferred to a CLT will not be included in a client's estate. This makes CLTs good vehicles for transferring assets that are expected to increase substantially in value after the trust is created—provided the trust will not need to liquidate the assets to meet its obligations to the charity. CLTs can also be advantageous when there is a significant difference between the 7520 rate and the fund's expected return—another good reason to establish a CLT when interest rates are low.

The Ideal Client Profile for Charitable Lead Trusts

According to Katzenstein, charitable lead trusts are suitable for clients who:

- Do not need current income
- Can afford to set aside a portion of their assets for a certain number of years
- Want to make annual gifts to charity
- Want to ensure their heirs receive an inheritance—but not immediately
- Want to reduce estate taxes
- Own securities, real estate, or other assets that they expect to increase in value over the term of the trust

With the federal estate tax capturing as much as 46 percent of transfers over \$2 million—and many states now claiming their share as well—forward-thinking advisors and their clients are acting now to lower the tax on their eventual estates. Still, there are some important issues to consider when recommending charitable lead trusts:

- They are irrevocable—that is, the trust cannot be changed or revoked if the estate tax law changes or the grantor needs funds
- The recommended minimum is \$1 million
- Charitable lead trusts work best with low-basis assets because increases in value after the trust is created will not be included in the client's estate
- Ideally, investments should outperform the 7520 rate; this requires diversification and sound investment management

Why Community Foundations Are Ideal Recipients

From a legal standpoint, Katzenstein agrees that community foundations make ideal recipients of charitable lead trust income. Because the foundation is in charge of directing the funds to specific causes, the client is in no danger of having the trust taxed in his estate for reasons of retaining excessive control over the disposition of trust assets.

Mary Lemmon has also found community foundations to be ideal recipients of trust income—albeit for more personal reasons. The Peninsula Community Foundation sponsors programs that align with her charitable priorities. She also relies on the Foundation to learn more about other local causes so she can recommend grants to

those organizations. "Mary is very open to learning about other programs in the community and really wants to help where help is needed most," says Victoria Mendiola, Director of Donor Resources at the Peninsula Community Foundation. With her charitable lead trust, Mary is supporting the Foundation while preserving family wealth for future generations.

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