Morgan Stanley

Charitable Lead Annuity Trusts

Charitable Giving

With a Charitable Lead Annuity Trust (CLAT), a donor transfers property to a trust and the trust pays one or more charities an annuity for a term of years or for the lifetimes of one or more individuals. When the term of the annuity ends, any property remaining in trust is paid to one or more designated non-charitable beneficiaries. The value of the charity's annuity interest is based on an IRS discount rate. The CLAT can produce federal estate and gift tax savings if the trust property produces an annual return in excess of the discount rate over the term of the annuity.

Alternatives

There are two types of CLATs: a grantor CLAT where the grantor (or donor) is treated as the owner of the trust for income tax purposes and (ii) a non-grantor CLAT where the trust is a separate entity for income tax purposes.

Grantor CLAT

A transfer to a grantor CLAT generates an upfront charitable income tax deduction for the donor equal to the present value of the charity's annuity interest calculated using a discount rate set by the IRS each month. The donor is allowed to use the IRS discount rate for the month of the transfer to the trust or the discount rate for either of the two prior months, whichever produces the greatest income tax deduction. In general, the income tax deduction for a transfer of cash to a grantor CLAT is limited to 30% of the donor's adjusted gross income (AGI) and

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a transfer of qualified appreciated stock that is long-term capital gain property to a grantor CLAT, though deductible at fair market value, is limited to 20% of AGI.[1] Any excess deduction may be carried over for use in the following five years, subject to the AGI limitations. The grantor of the CLAT is taxable on the income of the CLAT during the term of the charity's annuity because he or she is treated as the owner of the trust for income tax purposes. Retention of this tax liability may substantially offset or eliminate entirely the benefit of the up-front income tax deduction. If the donor ceases to be treated as the owner of the trust before the charity's annuity interest terminates (e.g., on death), the grantor must include as ordinary income that year the difference between the original income tax deduction and the discounted value of all amounts paid to charity up to that point.

Non-Grantor CLAT

With a non-grantor CLAT, the donor does not get an up-front charitable income tax deduction and is not taxed on trust income. The trust is a separate taxable entity and can take a charitable income tax deduction, without limit, for the amounts paid to charity each year.[2]

Which Is Better?

Depending on the circumstances, a grantor or non-grantor CLAT may be more advantageous to the donor and/or the remainder beneficiaries. The non-grantor CLAT is often used by donors who have exceeded the AGI limits for charitable income tax deductions.

Gift Tax

The actuarial value of the remainder of the CLAT (i.e., the discounted value of what is expected to be left in trust after the expiration of the charity's annuity) is a taxable gift to the remainder beneficiaries. There is no minimum or maximum term or annuity, so the trust can be structured so that the value of the charity's interest is equal to the market value of the property placed in trust, in which case no taxable gift results ("zeroing out" the CLAT).

Estate Tax

Assets in a non-grantor CLAT will generally not be included in the donor's estate for federal estate tax purposes unless the donor retains certain powers. All or a portion of the assets in a grantor CLAT are typically included in the grantor's estate for federal estate tax purposes.

Private Foundation Rules

A CLAT is ordinarily subject to the private foundation rules, which generally may impose excise taxes on acts of self-dealing between the CLAT and persons considered related to it ("disqualified persons"), owning too much of a business, investments that jeopardize the CLAT's charitable purpose and certain expenditures deemed inappropriate for tax purposes. The rules concerning owning too much of a business do not apply if the CLAT and disqualified persons collectively own less than 20% of the voting interests of the business (or 35%, if certain other conditions are met), or if the aggregate value of the federal charitable deduction(s) allowed with respect to the CLAT is less than 60% of the total value of the trust. The rules regarding jeopardy investments may not apply if the investment was contributed to the CLAT by the donor (rather than purchased by the trustee). A private foundation created by the donor of the CLAT may receive the annuity, though in that case careful structuring is required to avoid violation of the private foundation rules or inclusion of the assets in the donor's estate.

Notes:
[1] For long-term capital gain property that is not qualified appreciated stock, the deduction will be limited to the lesser of fair market value and cost basis.

[2] In some instances when the CLAT has "unrelated business taxable income," the portion of the charitable deduction allocable to such income will be disallowed.

Advantages

The CLAT can produce federal estate and gift tax savings if the trust property produces an annual return in excess of the IRS discount rate over the term of the annuity. The donor effectively shifts all of the return on the trust property in excess of the benchmark IRS discount rate to the remainder beneficiaries without making an additional taxable gift.

Disadvantages

There are no federal estate or gift tax savings if the trust property underperforms the IRS discount rate. A CLAT is generally ineffective for avoiding the generation-skipping transfer tax, an additional layer of tax imposed on transfers to grandchildren or anyone else treated as being two or more generations younger than the transferor. In addition, assets will only be available to the non-charitable beneficiaries following the end of charity's payment term.

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Important Disclosure

Morgan Stanley Smith Barney LLC does not accept appointments nor will it act as a trustee but it will provide access to trust services through an appropriate third-party corporate trustee.

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