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Testamentary Charitable Lead Trusts: A Strategy For the Other 99.8 Percent

BY L. PAUL HOOD, JR.

If I am given a formula, and I am ignorant of its meaning, it cannot teach me anything, but if I already know it, what does the formula teach me?[1]

Ever since the Tax Cuts and Jobs Act (TCJA) doubled the estate and gift tax applicable exclusion amount (AEA) from $5 million to $10 million (thereafter indexed), but now $15 million per person beginning in 2026, the number of taxable estates further dwindled. However, as the number of potential estate taxable estates post-OBBBA (One Big Beautiful Bill Act) dwindled even more, techniques such as formula testamentary charitable lead annuity trusts (T-CLATs) are not needed as they have been traditionally used. But was that the end of the line for formula T-CLATs? No, indeed!

My epiphany?

Very few people will have estate tax concerns post-OBBBA. It is estimated that approximately 132,000 U.S. households have to worry about the federal estate tax due to the high AEA. Unless there's a sea change in a trend that we have observed since the 1940s, the traditional way we thought of using formula T-CLATs has become unnecessary except for those who have federal estate tax issues.

However, lots of families who are below the AEA are charitably inclined. Many are altruistic forward-thinking and grateful pay-it-forward souls who are not interested significantly in the "tax benefits" or the public recognition for having made such a charitable split-interest gift.

L. Paul Hood, Jr.

Misguided focus on taxes.

One of the biggest and saddest developments in philanthropy since the advent of the modern income tax (1913), estate tax (1916), and gift tax (first enacted in 1924), one principally brought on by the professional wealth and estate planning community, has been the primary emphasis on the tax benefits over the other benefits (e.g., the client/donor's charitable passion/intent, etc.). Today, it's the only real benefit that the professional advisory community still principally discusses, and remains focused on. While in most instances, it pays press-release lip service to the nontax benefits.

Consider the following evidence of that unique American altruistic/charitable spirit:

- "Circling the wagons," which provided a defense against being bushwhacked out on the trail West.
- Volunteer fire efforts.

Mary Ann Liebert

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- Folks "pitching in" to help neighbors raise homes and barns and build/mend fences.
- The importance of being a "good neighbor," which turned into one of the most valuable and stable brands for a household-name company for decades.

My idea?

The professional estate planning community needs to push a "circle-the-wagons for your community©" publicity/public service information campaign on the importance of charitable giving for giving's sake, untethered to tax deductions (which few individual taxpayers who don't itemize can use, outside of the paltry annual limit on income tax charitable contribution deductions for nonitemizers).

Not until the professional estate planning and wealth management communities become truly authentically altruistic, can they lead the citizenry back to our country's altruistic identity. If the professional estate and wealth management communities do not right themselves and soon, each risks losing their positions as the leader/influencer to an outside source.

I urge consideration of an approach similar to that championed by the late Scott C. Fithian[2] through his consideration of the charitable/social capital "buckets." Explore charitable planning with every single client. Too many advisors simply do not ask probing questions about charitable intent.

We can think of charitable advising the nontaxable estate client as akin to estate planning for unmarried people who consider themselves a couple. Unmarried couples exist unfettered by nettlesome family-targeted tax rules/doctrines such as prohibited transactions, losses on sales between related parties (see IRC Sec. 267), family attribution rules, and Chapter 14, among others.

How about a lead charitable interest for part of the nontaxable estate?

The assets in a charitable lead trust revert to the family at the end of the charitable lead interest, which almost always is far preferable to a family than a charitable remainder trust (CRT), where the assets pass to the charitable beneficiary(ies) on termination of the CRT.

The beauty of the formula T-CLAT for the nontaxable estate is that the formula need not (and should not) be tied to the estate tax, which is not applicable anyway. While the formula for the nonqualified (NQ) T-CLAT contains some of the same variables, it usually is quite different because it is not important for an NQ T-CLAT to be in the form of a nonqualified charitable lead trust.

Exploring T-CLAT formula factors and differences between qualified T-CLAT and NQ T-CLATs.

Like the qualified T-CLAT, the NQ T-CLAT is not required to have a minimum (5 percent) or maximum (50 percent) payout rate as do qualified charittable remainder trusts. But unlike qualified T-CLATs, the NQ T-CLAT is not restricted to qualified charities.

Qualified charitable lead trusts are limited to two forms: unitrust (CLUT) and annuity trust (CLAT).

Conversely, the NQ T-CLAT has no such constraints. However, for income tax purposes, there are a few key differences between qualified charitable remainder trusts and qualified charitable lead trusts.

While the qualified charitable remainder trust (whether inter vivos or testamentary) is exempt from most direct federal income tax, a qualified inter vivos nongrantor charitable lead trust is not exempt from federal income tax in any event. However, for inter vivos qualified grantor charitable lead trusts, the income tax attributes (e.g., income, gain, loss, deduction and credit) and the resulting income tax liability attributable to a grantor qualified charitable lead trust are reported on the grantor's federal income tax return for the grantor qualified charitable lead trust. The NQ T-CLAT generally will be a taxable trust. Although it could be made into a grantor trust for federal income tax purposes, perhaps to make it into an eligible S corporation shareholder.

Unlike a qualified charitable remainder trust, which cannot come in a grantor trust version, as noted above, the qualified charitable lead trust can come in a grantor trust version. The NQ T-CLAT can be either a tax-

able trust, a partially grantor trust, or a wholly grantor trust.[3] Qualified charitable remainder and qualified charitable lead trusts, as well as NQ T-CLATs, can be formed during lifetime or at death.

A qualified charitable lead trust can be for a term of years (which, unlike the qualified charitable remainder trust, can exceed 20 years) or for a life or lives. The NQ T-CLAT has no specific limitations, save those under applicable state law. The remainder beneficiaries of both qualified charitable lead trusts and NQ T-CLATs are usually family members or trusts for their benefit.

Drafting the T-CLAT formula.

For either the qualified T-CLAT or the NQ T-CLAT, drafting the formula is not as easy as it looks. The goal of the qualified T-CLAT formula is usually easy to state: Make the size of the charitable share large enough to reduce the estate tax to zero or to some specified amount or percentage. But a simple statement such as for the marital deduction might not work (see PLR 201216045), and periodic reviews are a must. However, the NQ T-CLAT is not so constrained or preordained, even as to the basic codal requirements. The no transfer tax deduction requirement is important, but one should make sure that the NQ T-CLAT instrument expressly permits the NQ T-CLAT (if a taxable trust) to use IRC Sec. 642(c).

A qualified T-CLAT charitable payout and term must be determinable [Treas. Reg. Sec. 20.2055-2(e)(2)(vi)]. However, the NQ T-CLAT is not so constrained because the estate tax charitable contribution deduction is not important.

Tip: After you insert your formula into the instrument, I strongly encourage you to add an example of how the testator/settlor intends the formula to operate. It also serves as a check on whether the formula makes sense and is free from ambiguity.

Caveat: The formulae for the qualified T-CLATs usually presuppose a taxable estate. Modifications will be necessary when the available estate ultimately is not large enough to have to file an estate tax return or fund the qualified charitable lead trust (reportedly, the qualified T-CLAT used in Jacqueline Onassis' estate plan was not funded), or the qualified T-CLAT will not be funded. Conversely, the NQ T-CLAT is not so constrained. The simplest way to draft an NQ T-CLAT formula is to tie the T-CLAT formula to a percentage of the total probate (and/or nonprobate) estate.

Except as noted below, the basic parameters for both the qualified charitable lead trust and the NQ T-CLAT include the lead charitable annuity percentage, when the payments are made, the frequency of the annuity payments, and the applicable federal rate (AFR). But only for the qualified charitable lead trust will the donor be able to use the "best of three" election.[4] Remember that IRC Sec. 7520 nevertheless applies to all charitable lead trusts for valuation purposes.

Perhaps the biggest problem for a formula T-CLAT, either the qualified or NQ T-CLAT variety, is that the charitable payout determined by the formula may be so big that it forces the T-CLAT to fail, leaving nothing for the remainder beneficiaries at the end of the T-CLAT term.

The reason for this possibility is that the big unknown for a T-CLAT is the AFR at the time that the T-CLAT of either variety is put into effect. The rules applicable to qualified charitable lead trusts are different and potentially more advantageous than the rules attributable to the so-called "prior month election" set forth in Treas. Reg. Sec. 20-7520-2(a)(2).

The qualified T-CLAT remainder amount could be tied to the size of the remaining AEA, the size of the charitable interest, or to some other target (e.g., the total net estate). Clearly, the formula for an NQ T-CLAT is not so constrained. But this requires careful intentional thought in the selection of the ultimate desired result in the NQ T-CLAT formula, which also sets the charitable lead payout. Remember that the family members will not get any distributions attributable to the charitable front payments during the charitable term. However, nothing constrains the trustee of an NQ T-CLAT from making distributions to family members during the term of the NQ T-CLAT if the trustee has available resources.

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For both the qualified charitable lead trust and the NQ T-CLAT, both the term and charitable annuity can be subject to either a cap, a floor, both a cap and a floor, or neither. The 12 possible permutations of a qualified T-CLAT formula for taxable estates are as follows:

- Fixed Term; Variable Payout with no cap and no floor.[5]
- Fixed Term; Variable Payout with a cap and a floor.
- Fixed Term; Variable Payout with a cap but no floor.[6]
- Fixed Term; Variable Payout with no cap but a floor.[7]
- Fixed Payout; Variable Term with no cap and no floor.[8]
- Fixed Payout; Variable Term with a cap but no floor.[9]
- Fixed Payout; Variable Term with a cap and a floor.
- Variable Payout with no cap and no floor; Variable Term with no cap and no floor.
- Variable Payout with a cap but no floor; Variable Term with a cap but no floor.
- Variable Payout with no cap but a floor; Variable Term with no cap but a floor.
- Variable Payout with a cap and a floor; Variable Term with a cap and a floor.

Forecasting the cash flow from T-CLAT assets is important.

In the T-CLAT design phase, irrespective of whether it's a qualified charitable lead trust or the NQ T-CLAT, it is imperative that you at least try to estimate the cash flow from the assets going into the T-CLAT to see if the projected cash flow can cover a range of possible T-CLAT payouts. Remember that the T-CLAT is a taxable trust, meaning that the distribution of appreciated assets to the charitable beneficiary would be a taxable event (i.e., Kenan[10] gain). One way I always found illuminating is to start with a "death today" scenario, and then one should project ahead to actuarially expected death.

In the design phase, it is imperative that you consider what types of assets may go into the T-CLAT. Irrespective of whether it is a qualified charitable lead trust or the NQ T-CLAT, one must ascertain whether the projected cash flow from those assets can cover a range of possible T-CLAT payouts. The asset mix that would go into a T-CLAT in the future may be quite different than the current asset mix of the client's current estate.

For example, there may be a planned sale of a business in the future, either a direct sale of a company or a sale pursuant to a buy-sell agreement. Or the estate might also be holding cash at death, either due to life insurance swapped with the estate or cash proceeds from a sale of an asset either before or after death. Other factors include the then existing AEA, including the effect of portability, as well as whether there is even an estate tax at death or whether it is converted into an inheritance or wealth tax.

There is a major income tax consideration with qualified T-CLATs that must be acknowledged, although it's probably of little relevance to NQ T-CLATs. Some zeroed-out qualified T-CLATs have such a large charitable payout that it exceeds the gross income of the T-CLAT, meaning that T-CLAT principal will have to be distributed, for which there will be no additional income tax charitable contribution deduction because all income has already been deducted in the analysis. This is inefficient from an income tax standpoint and will cause Kenan gain to the extent that the property distributed has a higher fair market value at the time of distribution than its adjusted basis for income tax purposes. The NQ T-CLAT could suffer a similar fate.

Conclusion.

The rumors of the effective demise of the T-CLAT have been greatly exaggerated. T-CLATs for the other 99.8 percent of persons who are alive and well should be encouraged.

Endnotes

1 Saint Augustine of Hippo (354-430 AD).

2 Valued-Based Estate Planning: A Step-By-Step Approach to Wealth Transfer for Professional Advisors (Wiley 2000).

3 But without the penalty of grantor qualified charitable lead trusts because no charitable deduction is taken on creation and funding of an inter vivos NQ CLAT.

4 IRC Sec. 7520(a).

5 See, e.g., PLRs 9128051 and 201216045.

6 See, e.g., PLRs 199947022 and 199927031.

7 See, e.g., PLR 8946022.

8 See, e.g., PLRs 9118040 and 201933007.

9 See, e.g., PLR 9840036 (CLUT).

10 Commissioner v. Kenan, 145 F.2d 568 (2nd Cir. 1944).