Extreme Makeover: Charitable Lead Trust Edition

October 1, 2005

LANI STARKEY, JD, LLM, CPA
Associate Director of Gift Planning
University of Hawaii Foundation
Honolulu, Hawaii

© 2006-2020, CPC Holdings, LLC. All rights reserved.

Extreme Makeover: Charitable Lead Trust Edition

I. Charitable Lead Trusts – So what's the big deal anyway?

With proper planning, it is entirely possible and perfectly legal for an individual to transfer $5M, $10M or even $100M to family with little or no gift and estate tax. While providing substantially for family, the individual could also become a philanthropist to a level never thought possible. The tool – charitable lead trusts (CLTs).

Despite this powerful potential result, charitable lead trusts are still underutilized. The reason for this I believe is twofold. First, because very few people have taken part in the implementation of a CLT, there is a general lack of expertise and "comfort level" on the part of professionals and/or gift planners. Second, "traditional" CLT donor marketing materials have been ineffective at "grabbing" and keeping the attention of prospects and professional advisors. Therefore, CLTs are in desperate need of an extreme makeover!

This session will focus on some exciting new and sometimes simple ways to think about CLTs and creative new ideas on marketing them and making them understandable to donors and professionals alike. While not the primary goal of this session, I will also focus on the technical tax and legal rules as necessary to illustrate the CLT discussion.

II. Charitable Zero-Estate-Tax Planning Strategies

A. Leave Your Estate to Your Private Foundation

Private foundations have been a popular and effective method for wealthy families to create a family legacy of philanthropy. Many of the richest families in the U.S. have created foundations, and, by doing so, they have side-stepped the estate tax on those amounts transferred to their foundation. Because there is no limit on how much can be given to one's foundation, some foundations literally hold over a billion dollars in assets.

Private foundations are generally founded by an individual, a family or a group of individuals, and are organized either as a nonprofit corporation or as a charitable trust. One common form of a private foundation is a family foundation. Families sometimes use a family foundation as a forum in which family members can work toward common goals, or as a way to instill the value of charitable giving in future generations of the family.

While there are many positives about foundations, there are some important challenges as well. First, there is a considerable expense in creating and running a foundation. For example, legal counsel must be obtained to create a foundation, and the start-up and administrative costs for creating a private foundation may be quite high. There is also an annual excise tax on net investment income.

Second, there is a great deal of administrative work involved with a foundation. For instance, the foundation is responsible for record keeping and tax return preparation, and detailed reporting and allocation of expenditures/grant-making are required. In addition, prohibited transactions must be avoided, such as self-dealing, failure to meet distribution rules, excess business holdings, speculative investments, and lobbying efforts or other non-charitable distributions. While reasonable compensation is permitted for services rendered, the foundation may not make personal or non-charitable distributions to family members, e.g. additional inheritance distributions.

B. Leave Your Estate to a Charitable Lead Trust

A charitable lead trust is a planned gift where a donor irrevocably transfers cash or property into a special type of trust. Because of the potentially enormous charitable deduction produced, charitable lead trusts are an incredible gift and estate tax saving vehicle. [The Grantor CLT is discussed later in the outline.] With

© 2006-2020, CPC Holdings, LLC. All rights reserved.

proper drafting and structure, donors and estates may pay little and even no estate tax. Accordingly, donors with large taxable estates should look closely at the charitable lead trust as an alternative to the private foundation.

The operation of a charitable lead trust is rather straightforward, and its administration costs are quite reasonable in comparison to a foundation. Legal counsel will draft the trust agreement, which generally requires less time and money in comparison to a foundation. Afterwards, a trustee will manage the trust assets, make periodic distributions to charity, and file the annual tax returns. Again, the administration will in most cases be less cumbersome for a CLT than for a foundation.

Once the trust fulfills its charitable distributions and terminates, the donor's family and friends will receive all of the trust assets, plus any growth in the trust assets. This is in stark contrast to the foundation option, which specifically prohibits such private transactions. The CLT beneficiary charity may be a public charity, a donor advised fund, a supporting organization, or a private foundation.

III. Lead Trust Planning Strategies – which one to pick and when to create it?

A. Annuity or Unitrust Payout

A charitable lead annuity trust (CLAT) must pay a guaranteed annuity amount to one or more qualified charities at least annually. Reg. 20.2055-2(e). Reg. 25.2522(c)-3(c). The annuity must be paid in all events. It is not permissible to create a lead trust in which the payment to charity is determined by the income earned by the trust.

A charitable lead unitrust (CLUT) must make a payment equal to a fixed percentage of the net fair market value of the trust property, determined annually. Normally, the lead trust is valued on January 1 of each year and, to simplify administration, the trust will make an annual payment at the end of the calendar year. However, it is permissible to value the trust at any date or even to use a combination of dates. Reg. 20.2055-2(e)(2). Reg. 25.2522(c)-3(c)(2).

The lead unitrust must be a "straight" trust and make the mandatory payment to charity. Unlike the charitable remainder unitrust, it is not permissible to write a net income only or net income with makeup lead unitrust. It is permissible to make additional contributions to a lead unitrust, but not to a lead annuity trust.

As a rule of thumb, a common approach is CLAT for children and CLUT for grandchildren. While there are no prohibitions against using a CLUT for children and a CLAT for grandchildren, there are some cautions against following such a strategy.

B. CLAT for Children

While there are some varying reasons why a donor may or may not want a CLAT, the primary reason a CLAT is my preferred type of CLT is because you have the ability to "zero-out" the gift and take advantage of a low AFR with a CLAT. In other words, whatever value of property you transfer into the CLAT, you can through proper CLAT structure receive an equal value in the form of a charitable deduction. Thus, your gift is a "wash," i.e. $5M into CLAT and $5M deduction on your gift or estate tax return.

Taking into account the ultra low AFRs during the past three years, it has never been easier to zero-out transfers to CLATs. For example, you can currently (July 2005) zero-out a transfer to a CRAT with an 8% payout and a term of about 18.5 years. This translates into a simple marketing message to donors and professionals – transfer as little or as much as you want with this payout/time frame and pay no gift or estate tax, without limitation on the amount transferred to the trust and eventually distributed to family!

© 2006-2020, CPC Holdings, LLC. All rights reserved.

This same approach is not possible with a CLUT. Simply put, a CLUT cannot zero-out the transfer, because actuarially a CLUT cannot produce a 100% deduction value equal to the property value transferred into the trust. For example, the same payout and term as used in the CLAT example would produce only a 78% deduction when using a CLUT. With a 25 year term, the deduction barely gets to an 87% deduction. Using a 35 year term, the deduction reaches 94%. At this point, the trust term becomes very lengthy and the increase in deduction incrementally small, so it is hard to justify this to a donor and especially an estate planning attorney.

Additionally, a low AFR does not materially increase a CLUT deduction. Indeed, a CLUT deduction calculated with both a low and high AFR changes only slightly. During periods of high AFRs, a CLUT may look more attractive since the CLAT would lose some of its deduction "punch" in a high AFR environment. Finally, in the event, a zero-out plan or maximum deduction strategy is not the primary motivator, then a CLUT for children can work out very nicely.

C. CLUT for Grandchildren

The reason for this general approach deals with GSTT or generation skipping transfer tax. A full explanation of why a CLUT is preferable in most cases over a CLAT when dealing with GSTT is beyond the scope of this session – it is a highly technical and complex explanation. However, there are many excellent planned giving resources that cover the nuances of this issue in excellent detail (see appendix). Plus, I am happy to discuss this issue with any attendees during or after the conference.

D. Intervivos or Testamentary CLT

Once the decision is made to create a CLT, one of the next important decisions is, "should I fund it during life or at death?" The answer depends on several factors that will depend on the facts and circumstances of each donor and family situation. Here is a good list of those factors.

1. Freeze Asset Value – Is the asset likely to appreciate greatly over time? If so, maybe an intervivos CLT should be created to freeze the asset value for transfer tax purposes and, therefore, allow that future appreciation to pass to family outside of the gift/estate tax regime.

2. Carryover vs. Step Up Basis – Does the asset have a very low cost basis? What is the life expectancy of the donor? With a testamentary CLT, the assets transferred into the CLT will receive a step up in basis, whereas assets into an intervivos CLT will have a carryover basis. If there is a low cost basis and the donor is quite senior, then waiting until death to fund a CLT can provide a very nice step up in basis on those transferred assets. This benefit means the non-charitable beneficiaries will receive the trust property with a higher cost basis and less potential capital gains tax due upon disposal of the property.

3. Donor Control – How important is this asset to the donor? Does the donor need it to ensure his/her financial security? Obviously, a testamentary CLT will allow a donor full use and control of the assets during his/her life. On the other hand, an intervivos CLT would require the donor to relinquish control and enjoyment of the assets transferred into the trust.

4. Timing of Gifts and Distribution – Is there a charitable program or purpose that needs funding now? What are the ages of the children and grandchildren? What is the desired age of inheritance from the CLT? All these questions will help guide a donor and his/her advisors to the right answer.

IV. Basics of Lead Trusts

A charitable lead trust is a planned gift where a donor irrevocably transfers cash or property into a special type of trust. Almost any type of asset may be contributed to a CLT, however, cash, stock, and income-producing real estate are the most common and desirable.

© 2006-2020, CPC Holdings, LLC. All rights reserved.

The duration and payout of the charitable lead trust will depend greatly on a donor's goals and objectives. For example, charitable lead trusts usually last anywhere between 5 and 25 years. So, the longer the trust lasts the greater the charitable deduction, and the greater the benefit to charity. The same logic applies to the payout percent, i.e. the higher the payout, the larger the deduction, the more to charity.

The charity receiving payouts must be a qualified exempt charity and thus be able to receive charitable transfers under Sec. 2055 for estate tax or Sec. 2522 for gift tax purposes. It is permissible to retain the power to name the charitable recipients after the trust is created. Normally, this power is not retained by the trust grantor to avoid estate inclusion if he or she passes away prior to the expiration of the lead trust. Sec. 2036(a). However, it is permissible for the children of the trust grantor to select each year the qualified exempt charities. See PLR 200029033. This provision is an excellent way to include children in family philanthropy as is the case with family foundations.

At the end of the trust term, the CLT will distribute all of the trust assets to the remainder beneficiaries, e.g. family and friends. In general, the trust distribution of assets will not trigger any income or estate tax liability to the family and friends, i.e. remainder beneficiaries. However, the remainder beneficiaries may now be holding appreciated assets which when sold would trigger capital gain income.

V. Lead Trust Types and Deduction Produced

1. Grantor Lead Trust – Income Tax Deduction

2. Family Lead Trust – Gift or Estate Tax Deduction

3. Super Lead Trust – Income & Gift Tax Deduction

VI. Grantor Lead Trust

There are two primary characteristics of a grantor lead trust. First, at the end of the trust term, the trust assets revert back to the grantor. Second, the grantor lead trust qualifies for an income tax deduction. Therefore, this type of planned gift is generally geared toward income tax planning, not gift and estate tax planning.

The income tax deduction will be equal to the present value of the annuity or unitrust payouts to charity for the selected term of years. However, in order to benefit from the income tax deduction, the trust must be a grantor trust. Thus, while the trust annual distributions are transferred to charity, the grantor must report any trust income on his or her Form 1040 income tax return. Accordingly, a donor and his or her advisors must carefully consider the future as well as the current income tax ramifications associated with a grantor lead trust.

Traditionally, many grantor lead trusts were funded with cash to minimize the income tax liability associated with the grantor trust status of the grantor lead trust. Unfortunately, even though funded with cash, the charitable income tax deduction is deemed "for the use of the charity" and thus qualifies as a 30% type deduction instead of the normal 50% type deduction. Sec. 170(b)(1)(B).

VII. Grantor Lead Trust Examples – Legal and Investment Marketing Solutions

A. Cash and Municipal Bonds Case Study

Lynn Burrows, 40, is a partner in her law firm and a very successful trial attorney. Lynn mainly represents class action lawsuits against large multinational corporations. As a result of the high stakes and high dollar amounts involved, it is not uncommon for a jury to award a judgment of $100+ million. In fact, Lynn is among a select group of attorneys with 10 or more successful $100+ million judgments. Accordingly, Lynn is an extremely wealthy woman. Her firm represents most class action lawsuits on a contingency basis. In

© 2006-2020, CPC Holdings, LLC. All rights reserved.

other words, the firm receives between 15% and 40% of any favorable judgment (plus costs). As a result, the firm's share of a victory is very substantial - and Lynn receives a portion of that in addition to her salary.

Recently, Lynn won a major trial against a financial institution. The jury awarded her clients $20 million, and the firm's share was approximately $6 million. As a result of the successful conclusion, Lynn received a $1 million bonus. While extremely pleased with this large bonus, Lynn shuddered at the thought that over $400,000 would go to Uncle Sam and the state.

In addition to her bonus, Lynn regularly earns about $500,000 a year, which places her in the highest federal and state income tax brackets. Not surprisingly, Lynn desperately wants to minimize her tax liability. She therefore meets with her tax advisor, Frank Thomas, to discuss her options.

Lynn's primary goals are tax reduction and some basic retirement planning. Lynn is also open to charitable giving if it can help her accomplish her primary goals. Lastly, because Lynn receives a large annual salary, she does not have any immediate need for the $1 million bonus.

What plan may accomplish Lynn's goals? Does it fit within her parameters? What are the upsides and downsides to the plan?

Frank suggested that Lynn fund a grantor charitable lead annuity trust (CLAT) for a period of 10 years with the $1 million bonus. The payout rate on the trust would be 5%, or $50,000 per year, which would be payable to her favorite charities. The creation of such a trust would produce a charitable income tax deduction of approximately $400,000. With adjusted gross income of $1.5 million (bonus plus salary), Lynn may deduct up to $450,000 or 30% of AGI the year she makes the gift. Therefore, assuming a combined tax rate of 40%, Lynn would save $180,000 in taxes!

Since this was a grantor trust for income tax purposes, Lynn would be taxed on all the trust income. However, if the trust investments were municipal bonds (which are exempt from federal taxes), all the income from the trust would be tax-exempt income. This tax-free investment decision would allow Lynn to avoid any taxable phantom income problem during the trust's 10-year term.

Frank further explained that at the end of the 10-year term the trust assets would return to Lynn. The $1 million original contribution may rise or fall depending on investment performance. The return of a significant portion of the $1 million would provide Lynn with a wonderful retirement nest egg. The money could then be invested for future use or accessed immediately if Lynn so desired. Again, the CLAT provided Lynn with great flexibility. Finally, $500,000 would be distributed to Lynn's favorite charities. She was amazed at this enormous additional benefit.

In the end, Lynn was completely happy with Frank's plan. She would cut her tax liability significantly, retain flexibility and much of her wealth and contribute a generous gift to her favorite charities. While Lynn was always philanthropic, her CLAT would make her a major donor overnight, a title that brought a very warm smile to her face.

B. Growth Stocks (or Value Stocks) Case Study

Same facts as above.

What plan may accomplish Lynn's goals? What trust investments should be selected? Which trust investments would produce more overall wealth for Lynn - tax-free municipal bonds or a balanced portfolio of stocks and taxable bonds?

Frank suggests that Lynn fund a grantor charitable lead annuity trust (CLAT) for a period of 10 years with the $1 million bonus. The payout rate on the trust would be 5%, or $50,000 per year, which would be payable to her favorite charities. The creation of such a trust would produce a charitable income tax deduction of approximately $400,000. With adjusted gross income of $1.5 million (bonus plus salary),

© 2006-2020, CPC Holdings, LLC. All rights reserved.

Lynn may deduct up to $450,000, or 30% of AGI, the year she makes the gift. Therefore, assuming a combined tax rate of 40%, the $400,000 charitable income tax deduction could save Lynn $160,000 in taxes!

Lynn knows that if the trust investments were municipal bonds (which are exempt from federal taxes), all the income from the trust would be tax exempt. This tax-free investment decision would allow Lynn to avoid any taxable phantom income problem during the trust's 10-year term. However, Lynn also knows that there would be little, if any, trust growth during the 10-year term with municipal bonds. In fact, it is possible that the trust corpus would diminish. Therefore, she wonders if investing in stocks and bonds would prove more fruitful.

Since this was a grantor trust for income tax purposes (*i.e.*, not tax-exempt), Lynn would be taxed on all the trust income. Not surprisingly, Lynn's stock and bond investments would produce taxable phantom income each year. The trust would pay $50,000 a year to charity. Thus, the trust would need to sell some stock and realize some bond income each year to satisfy its financial obligations. These actions would generate capital gain income and ordinary income to the trust, which would then flow through to Lynn's Form 1040. Unlike the non-grantor CLT, Lynn's trust is not entitled to a charitable income tax deduction for the $50,000 gift each year, because she already claimed all the gifts to charity in year one, *i.e.*, the $400,000 initial charitable income tax deduction.

Assuming a balanced portfolio producing 2% ordinary income and 6% capital growth, Lynn's tax liability each year on the $50,000 distribution is approximately $8,500, or a blended tax rate of 17%. Because $1 million cash is contributed to the trust, the basis in the subsequently purchased appreciating stocks is very high. Consequently, there is little capital gain income to report each year when the stocks are sold. The bond's ordinary income of $20,000 each year will account for most of Lynn's tax liability. Thus, in exchange for the upfront $400,000 charitable income tax deduction, Lynn will pay approximately $8,500 a year in taxes, or $85,000 over the 10-year period.

Despite this bad news, there is significant good news to this "taxing plan." Assuming an annual trust return of 8%, the trust will grow to $1,434,597. That is a potential $434,597 increase over the traditional tax-free CLAT. With a more modest annual trust return of 7%, the trust still grows to a healthy $1,276,329. In the event of stronger growth at 9%, the trust may balloon up to $1,607,717. Therefore, Lynn's trust may return 27% to 60% more than the traditional tax-free CLAT.

In this instance, this potentially significant increase in wealth comes at a cost of $85,000 to Lynn over a 10-year period. Therefore, the decision between the traditional tax-free CLAT and the appreciating taxable CLAT is based on market risk and tax strategy. After reviewing the options carefully, Lynn elects the "tax-me-richer" trust. For Lynn, the payment of $8,500 a year in taxes is not overly burdensome. Yet the return on this plan greatly exceeds the overall outlay of $85,000. Namely, she will receive a $400,000 charitable income tax deduction and receive between $1.2 and $1.6 million after 10 years.

Furthermore, the return of $1,000,000+ would provide Lynn with a wonderful retirement nest egg. The money could be invested for future use or accessed immediately if Lynn so desired. Again, the CLAT provides Lynn with great flexibility. Finally, $500,000 would be distributed to Lynn's favorite charities. She was amazed at this enormous additional benefit.

In the end, Lynn was completely happy with Frank's plan. She would cut her current year's tax liability significantly, retain flexibility, increase her wealth and contribute a generous gift to her favorite charities. While Lynn was always philanthropic, her CLAT would make her a major donor overnight a title that brought a very warm smile to her face.

C. Unrealized Capital Loss Stocks

Same facts as above plus:

© 2006-2020, CPC Holdings, LLC. All rights reserved.

Despite her good litigation skills, Lynn is not so fortunate with her stock investments. Specifically, she invested $1.5 million in many technology stocks several years ago. However, when the stock market bubble burst, her $1.5 million portfolio sank to $1 million within one year. Dreading the thought of realizing $500,000 in losses, Lynn continued to hold the stocks.

Now, several years later, Lynn is coming to terms with the fact that her stock portfolio will not leap back to $1.5 million any time soon. Therefore, it makes sense for her to reevaluate her stock holdings and reposition some of her investments. Lynn's primary goals are tax reduction, investment planning and some basic retirement planning. She is also open to charitable giving if it can help her accomplish her primary goals.

What plan may accomplish Lynn's goals? How can Lynn take advantage of her stock losses to accomplish her goals in the most tax-favored manner?

Frank, her tax advisor, suggested that Lynn fund a grantor charitable lead annuity trust (CLAT) for a period of 10 years with the $1 million of stocks. The payout rate on the trust would be 5%, or $50,000 per year, which would be payable to her favorite charities. The creation of such a trust would produce a charitable income tax deduction of approximately $400,000. With adjusted gross income of $1.5 million (bonus plus salary), Lynn may deduct up to $450,000 or 30% of AGI, the year she makes the gift. Therefore, assuming a combined tax rate of 40%, the $400,000 charitable income tax deduction could save Lynn $160,000 in taxes!

Since this is a grantor trust for income tax purposes (*i.e.*, not tax-exempt), Lynn would be taxed on all the trust income. Any capital gain income and ordinary income to the trust flows through to Lynn's Form 1040. More importantly, any capital losses also flow through to Lynn's 1040. (The carryover basis rules apply, so the trust takes Lynn's basis in the stocks.) Thus, through proper trust management, Lynn may utilize her stock losses to offset part of the trust capital gains and income.

In particular, the trust each year makes a $50,000 payment to charity. In order to generate the $50,000, the trust will need to produce income and sell assets. Since the entire portfolio at inception possesses significant declines, each time the trust sells stocks it will realize capital losses. These losses can be used to offset capital gains and up to $3,000 of ordinary income. This realization of capital losses can easily remove any negative income tax problems normally associated with grantor CLATs (*i.e.*, phantom income).

In addition, the trustee may sell and reinvest trust assets at any time during the 10-year term. This allows the trust to diversify some of its holdings out of technology. Moreover, the realization of capital losses may be carried forward to offset against future capital gains. Therefore, it would be likely that the trust will diversify and grow without any phantom income tax problems.

In conclusion, Lynn's CLAT would produce a $400,000 deduction and potentially return $1,000,000+ at the end of the 10 years. The money could then be invested for future use or accessed immediately if Lynn so desired. Also, the trust would diversify and grow with little to no income tax liability. Finally, $500,000 would be distributed to Lynn's favorite charities. She was amazed at this enormous additional benefit.

Lynn was completely happy with Frank's plan. She would cut her current year's tax liability significantly, retain flexibility, diversify her investments and contribute a generous gift to her favorite charities. While Lynn was always philanthropic, her CLAT would make her a major donor overnight, a title that brought a very warm smile to her face.

D. Incentive Stock Options (or NSOs) and Unrealized Capital Loss Stocks

Same facts as above plus:

Despite her good litigation skills, Lynn is not so fortunate with her stock investments. Specifically, she invested $1.5 million in many technology stocks several years ago. However, when the stock market bubble burst, her $1.5 million portfolio sank to $1 million within one year. Dreading the thought of

© 2006-2020, CPC Holdings, LLC. All rights reserved.

realizing $500,000 in losses, Lynn continued to hold the stocks.

Contrary to Lynn, Jeff Burrows (Lynn's husband) has had success in the stock market. During the mid-1990s, Jeff exercised a block of incentive stock options (ISOs) provided by his company to top-level executives. Despite the ups and downs of the market during the past decade, Jeff held onto the stock because he believed strongly in the financial future of his company. Confirming his belief, Jeff's company stock rose significantly during that time. For example, he exercised the options for $150,000, yet the current market value for his stock is $500,000.

Believing that the stock will start to level off, Jeff wants to begin locking in his gains over the next several years. However, Jeff does not like the idea of realizing $350,000 of capital gain income during that time. Jeff also does not like the idea of paying a lot of income tax on Lynn's earnings the year she received the bonus (Lynn and Jeff file joint income tax returns).

What plan can Lynn and Jeff implement to significantly minimize the tax liability on the $1 million bonus and the sale of Jeff's ISOs? How would it work?

Frank Thomas, Lynn and Jeff's tax advisor, suggested that they fund a grantor charitable lead annuity trust (CLAT) for a period of 10 years with the $1 million of fallen stocks. The payout rate on the trust would be 5%, or $50,000 per year, which would be payable to their favorite charities. The creation of such a trust would produce a charitable income tax deduction of approximately $400,000. This tax deduction could be used to directly offset a portion of the $1 million bonus. Therefore, assuming a combined tax rate of 40%, the $400,000 charitable income tax deduction could save Lynn and Jeff $160,000 in taxes!

Next, the CLAT could generate capital losses each year to offset the capital gains produced from Jeff's yearly sale of his appreciated stocks. For instance, the trust each year makes a $50,000 payment to charity. In order to generate the $50,000, the trust will need to produce income and sell assets. Since Lynn's entire portfolio at the trust's inception possesses significant declines (*i.e.*, $500,000), each time the trust sells stocks it will realize capital losses. These losses can be used to offset Jeff's capital gains and up to $3,000 of ordinary income. Therefore, this realization of capital losses each year by the CLAT can work in conjunction with the systematic sale of Jeff's appreciated stocks. The ideal strategy would result in no capital gains tax paid on Jeff's sale of appreciated stocks.

In conclusion, Lynn's CLAT would produce a $400,000 income tax deduction, which would substantially reduce her income tax liability on the $1 million bonus. Also, Lynn's depreciated stock portfolio may reduce or even eliminate all capital gain income resulting from the sale of Jeff's appreciated stocks. Finally, $500,000 would be distributed to Lynn and Jeff's favorite charities over the 10-year term. Afterwards, the trust principal would revert to Lynn and Jeff.

Lynn and Jeff were completely happy with Frank's plan. They would cut their current year's tax liability significantly, diversify their investments, lock in significant gains and contribute a generous gift to their favorite charities. While Lynn and Jeff were always philanthropic, their CLAT would make the Burrows major donors overnight, a title that brought a very warm smile to their faces.

E. Mixed Approach May Yield Best Results

The best tax and investment solution may combine the above ideas into one custom strategy. For example, a combination of municipal bonds, growth stocks, capital loss stocks, and value stocks may provide the best synergy of low-tax and safe-growth to a donor.

VIII. Family Lead Trust

There are two primary characteristics of a family or non-grantor lead trust. First, at the end of the trust term, the trust assets pass to someone other than the grantor, e.g. family and friends. Second, the family lead trust qualifies for a gift or estate tax deduction. Therefore, this type of planned gift is generally geared toward gift and estate tax planning, not income tax planning.

© 2006-2020, CPC Holdings, LLC. All rights reserved.

The gift or estate tax deduction will be equal to the present value of the annuity or unitrust payouts to charity for the selected term of years. If the family lead trust is created during the donor's life, then a Form 709 charitable gift tax deduction is generated. If the family lead trust is created upon the donor's death, then a Form 706 charitable estate tax deduction is allowed.

IX. Family Lead Trust Income Taxation

In contrast to a tax-exempt charitable remainder trust, the family charitable lead trust is a taxable trust. As such, it must file Form 1041 and pay taxes on its ordinary income and capital gain. For intervivos family lead trusts, the trust assets must be selected carefully. Normally, since the trust is taxable, it is undesirable to sell, pay capital gain tax on the sale of the asset and then invest after-tax proceeds (as is the common strategy with charitable remainder trusts).

Usually, the most favorable investment strategy is to hold the assets contributed to the trust and attempt to generate the desired annuity or unitrust payout to charity with the income and appreciation of the contributed assets. If there is no diversification of the assets contributed to the trust, the investment risk is greater. This higher risk with an undiversified portfolio must be understood by the lead trust grantor and the trustee prior to funding the lead trust.

With a testamentary family lead trust, there is a step up in basis on most property in the decedent's estate. This result will normally allow diversification of trust assets without any accompanying tax liability. The trustee of the family lead trust may then select a diversified portfolio designed to produce maximum return.

Even if a family lead trust produces some taxable income each year, in most cases, the trust will never have to pay any income tax, because there is an unlimited income tax deduction for distributions to qualified charities. Sec. 642(c). However, this unlimited deduction is reduced if the trust generates UBTI. For this reason, it is important to make certain that the lead trust does not have UBTI under Sec. 512, or it will be restricted to a 50% charitable income tax deduction under Sec. 170. See Sec. 681.

X. Zero Gift/Estate Tax Lead Trusts

A. Simple formula: Property Value - Deduction = Taxable Gift

B. Apply Exemption Equivalent and Deduction to Wipe Out Taxable Gift

C. Gift/Estate Tax Exemption Schedule

Yr	Estate	Rate	Gift		
2005	$1.5 million	47%	$1 million		
2006	$2 million	46%	$1 million		
2007	$2 million	45%	$1 million		
2008	$2 million	45%	$1 million		
2009	$3.5 million	45%	$1 million		
2010	Estate Tax repealed	35% (Gift tax)	$1 million		Modified Basis Step up
2011	$1 million	55%	$1 million		Estate Tax Restored

D. Ways to Increase Deduction
1. Increase Payout
2. Lengthen Trust Term
3. Select Lowest AFR
4. Increase Payment Frequency

© 2006-2020, CPC Holdings, LLC. All rights reserved.

XI. Super Lead Trust

At some point in time, a creative group of professionals figured that a lead trust that produced both an income tax deduction and a gift tax deduction would be a good planning tool for their clients. So, the super lead trust or defective lead trust was born.

To enjoy this "double benefit," the super lead trust must qualify as a grantor trust for income tax purposes but also qualify as a completed gift for gift tax purposes. Thus, a super lead trust resembles a family lead trust in that family or friends (not the grantor) will be the remainder beneficiaries. Furthermore, a super lead trust resembles a grantor lead trust in that any income the trust earns will be taxed to the grantor.

The income and gift tax deduction will be equal to the present value of the annuity or unitrust payouts to charity for the selected term of years. With a super lead trust, the donor will enjoy an income tax deduction on his or her Form 1040 and a charitable gift tax deduction on his or her Form 709.

Advanced planning tip: To qualify as a super lead trust, it will be necessary to create a trust that is not included in the taxable estate of the grantor. See Sec. 2033-2038. For this reason, the grantor may not retain a reversion or control over the distribution of income. Sec. 2036(a). However, the grantor must retain a power that does cause the trust to be deemed a grantor trust. The preferred retained power, the power to reacquire assets under Sec. 675(4), when held by a non-adverse party and exercised in a non-fiduciary role, causes the trust to become a grantor trust. In some circumstances, the trust grantor has retained that power. While it would seem unlikely that the trust grantor would exercise that power, since that could be construed to be a violation of the self-dealing rules under Sec. 4941, it is still a potential power that does require grantor trust status. The grantor retaining such a power could maintain that this exercise would be permitted under the "incidental exception" to the self-dealing rules. Reg. 53.4941(b)-3. Alternatively, a brother or sister of the donor may hold the Sec. 675(4) power to reacquire assets. Since the Sec. 4941 disqualified persons category includes spouses, children, grandchildren and their spouses, but not brothers or sisters, this provision does not violate self-dealing. Sec. 4946(d). The brother or sister would also need to be able to exercise this power in a non-fiduciary capacity to cause the lead trust to be a grantor trust. See PLR 200010036.

XII. More Lead Trust Examples (Based on True Stories)

A. Dr. and Mrs. Z's CLT

$2.5M to 20-year Lead Trust
$2.5M Endow Chair & Building
$~4.5M to Heirs; No Estate Tax

B. Mr. & Mrs. W's CLT

Real Estate Developer
Build New Hospital Wing
$15M CLT for 18 Yrs
$18.9M to Hospital Foundation
Over $20M to Children/Grandchildren
No Gift or Estate Tax

C. Qwest Communications

Phil Anschutz, Founder
Created CLT in 2003
Funded with $70M

© 2006-2020, CPC Holdings, LLC. All rights reserved.

$75M to Denver Charities
Remaining Assets Revert Back

XIII. More Advanced and Creative Lead Trusts (as time permits)

A. Multi-Layer Lead Trust – Creating multiple lead trusts to maximize tax savings and stagger inheritance to children, grandchildren, and great-grandchildren.

B. Double Discount Lead Trust – Coupling family limited partnership discounting with lead trust "discounting" to achieve ultra-low-term lead trusts.

C. Tandem Lead Trust and CRT – Coupling lead trusts and remainder trusts to work together to provide income for a period of years and then corpus distribution at the end of the term of years. By doing so, family and friends receive an uninterrupted inheritance over a period of time.

D. Lesser of Life or Term Lead Trust – Drafting lead trusts to end at the death of the donor should he or she not live the full term of the lead trust. By doing so, a family's inheritance is more closely tied to the actual passing of the donor.

XIV. Two Final Marketing Ideas

A. Every major outright gift prospect is a potential lead trust donor. Every major outright gift donor was a potential lead trust donor prior to making the major gift.

B. Any existing lead trusts are excellent candidates for: 1) early termination and acceleration of the charitable interest (see PLR 199952093), and 2) charitable remainder trusts for the remainder beneficiaries.

Lani Starkey, JD, LLM, CPA
Associate Director of Gift Planning
University of Hawaii Foundation
2444 Dole Street, Bachman Hall 101
Honolulu, Hawaii 96822
Lani.Starkey@uhf.hawaii.edu
808-956-8994

Appendix

Lead Trust Presentation Resources:

Tax Economics on Charitable Giving, 2004/2005, WG&L.

The Harvard Manual on Tax Aspects of Charitable Giving, 1999, Osteen and Hall.

GiftLaw Pro, 2005, Crescendo Interactive, Inc.

© 2006-2020, CPC Holdings, LLC. All rights reserved.