



GIVING
THROUGH
CHARITABLE
LEAD
TRUSTS

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and other contact information.]

What if there were a way to make charitable gifts over a period of time using funds that will eventually be returned to you or your loved ones?

Surprisingly, such a plan exists. Through a special planning tool known as a *charitable lead trust* you can achieve a number of what may at first seem to be conflicting goals. You can:

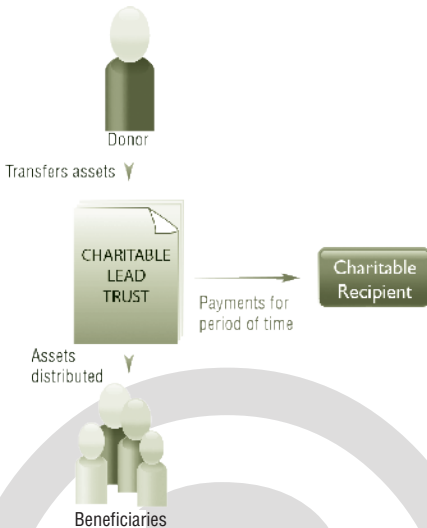
- Make a series of charitable gifts over time.
- Create a gift plan that ensures all or a portion of the assets used to make gifts to charity will be returned to you, your family or other loved ones.
- Provide heirs with a larger inheritance than if you made charitable gifts in other ways.
- Reduce or eliminate state and/or federal estate, gift and possibly income taxes now and in the future.
- Make other tax-free gifts that you may not otherwise be able to deduct for income tax purposes.

How does a lead trust work?

Suppose you would like to make charitable gifts during your lifetime, but you would also like to ensure your loved ones are provided for at the lowest possible after-tax cost. A charitable lead trust may be just the answer.

Recent tax law changes allow for more generous amounts of gifts to be made to loved ones exempt from taxes during lifetime. Lead trusts can offer a way to maximize these exemptions while, in some cases, also providing significant income tax savings.

The following diagram illustrates how this works:



Note the full value of the trust, including any increase in the value of the assets while in the trust, passes to heirs free of any additional gift and estate taxes at a time when they may be more mature and better able to manage their inheritance.

The tax benefits of lead trusts are especially attractive in times of relatively low interest rates.

Example: George and Susan would like to give \$250,000 each to their two teenaged grandchildren, but only at a time when they are mature enough to manage and spend the funds wisely. George and Susan also do not wish to pay gift or estate tax on the amount given to them.

After considering a number of options, they decided to transfer \$500,000 to a charitable lead trust that will provide for charitable gifts of 5% of that amount, or \$25,000 per year, for 20 years. (The donor

chooses the time period and payout rate at the time the trust is created.)

The charitable gifts from this plan will total \$500,000. At the end of 20 years, the remaining assets in the lead trust will be distributed to their grandchildren.

Because George and Susan arranged for a future gift at the time the trust was funded, federal gift tax would ordinarily be due on the entire amount placed in the trust.

Since charitable gifts will be made from the trust over time, however, a deduction based on the value of those gifts is allowed that could greatly reduce or even eliminate gift and estate taxes that might otherwise be due. Any gift taxes owed can be offset by using a portion of the \$11.58 million per person gift and estate tax exemption.

The gifts made from the trust each year are also not considered part of their income and will be made on a tax-free basis whether or not they itemize deductions on their income tax return or have exceeded applicable charitable gift limits.

To summarize:

- George and Susan arranged for charitable gifts of \$500,000 over a period of time.
- Their grandchildren will receive the assets remaining in the trust at the time it terminates.
- Because of generous tax savings, fewer assets were required to accomplish their goals than might have been necessary if they had made gifts directly to their grandchildren and made charitable gifts from other funds.
- They reduced their income tax during the term of the trust as the funds used to make the charitable gifts from the trust are not included in their income.

Expanded exemptions offer opportunities

Many people have been pleased to learn that federal tax laws have been changed so that it is now possible to transfer more to heirs free of gift and estate tax. This can allow for greater flexibility in personal and charitable planning. These exemption amounts can be especially beneficial when used in conjunction with charitable lead trusts. Check with your tax advisors for more information.

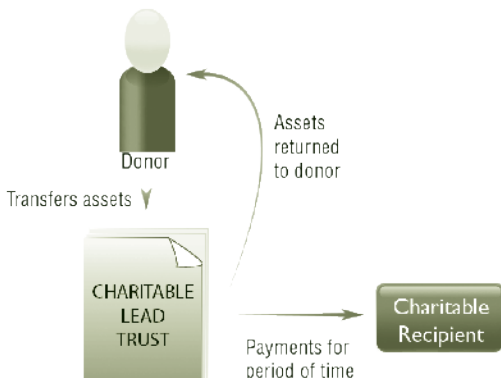
When assets return to the donor

You can also transfer cash or other property to a charitable lead trust that provides for gifts to charity for a period of time and then returns assets to you.

As with the lead trust that eventually transfers assets to your heirs, you determine how long the trust lasts (often between 10 and 20 years) and you decide the amount of the gifts and whether they will vary each year.

At the end of the period during which charitable gifts are made, the assets remaining in the trust are returned to you.

The following diagram illustrates how this type of charitable lead trust works:



Income tax benefits

Since you make a substantial charitable gift commitment at the time a lead trust is created, you are entitled to an immediate income tax deduction for the present value of the payments to charity. While the gifts will actually be made over a number of years, you receive tax benefits in the year you fund the trust.

Because you receive a tax deduction in advance of future trust earnings, you will report the income of the trust each year as it is actually realized by the charitable recipient. This can be advantageous if you believe you may be in a lower income tax bracket in the future due to retirement, the nature of your income or other factors.

If a lead trust is invested in tax-exempt investments or if trust assets are used to make the payments, no tax will be due. In this case, you will enjoy an up front deduction with no future tax liability.

Your immediate tax savings can be invested to grow for your future benefit. Another option might be to use the income tax savings to purchase a life insurance policy for the benefit of your heirs. In that way, it could be possible to provide a future gift to them free of any applicable federal and/or state gift and estate taxes.

Example: Elizabeth, age 55, is considering a gift of \$250,000 to fulfill a charitable commitment. She would like to complete the gift in the near term, but is concerned that she may need assets to help fund her retirement in 10 years.

In consultation with her advisors, Elizabeth decides to transfer \$850,000 worth of tax-exempt bonds to a charitable lead trust that will make fixed annual payments totaling \$250,000 over a 10-year period.

She is entitled to an income tax deduction which will eliminate tax on up to \$770,000 in the year of the gift and for up to five subsequent tax years, resulting in federal tax savings of \$285,000 and possibly more in state income tax savings.* She decides to use this amount to fund a life insurance policy on her life. The insurance is made payable to her nieces and nephews and passes outside her taxable and probate estate.

At the end of 10 years, the assets remaining in the trust will be returned to her for use during her retirement years. If the trust continues to be invested in the tax-exempt securities, she will owe no income tax on the amount paid to charity each year.

Through careful planning, Elizabeth has:

- Completed the charitable gifts she wished to make over time using tax-free earnings from the trust.
- Enjoyed immediate income tax savings which can be used to provide for a significant amount of life insurance proceeds for her heirs.
- Made possible the return of her property to meet future personal needs.

Who manages the assets in the trust?

You may be trustee of your lead trust and manage the assets in the trust or you may

*The tax deduction and resulting savings depend on prevailing interest rates and income tax rates. Example based on federal discount rate of 2.6%. Ask your advisor for rates at the time of a proposed gift.

choose others to manage the assets. You may also appoint someone else to serve as trustee who will choose the asset managers.

Each year, the trustee will file a tax return listing income and distributions from the trust. Very little additional administration is required in order to properly manage a charitable lead trust.

A flexible tool

Through the charitable lead trust, it can be possible to make gifts in ways that balance your needs with those of loved ones and charitable entities you wish to support.

Thanks to plans like these, you don't need to choose between making charitable gifts or leaving an inheritance to your loved ones. It can be possible to do both.

Consult with your advisors about how a charitable lead trust may be advantageous in your situation. Please contact us if we can be of assistance when you are considering the charitable dimension of your financial and estate plans.

You may wish to share the following technical advisory section with those who assist you in your planning.

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Technical Advisory Section

Historically, the charitable lead trust has been used not only to make very substantial charitable gifts, but also to pass wealth to family members, partially or entirely free of estate and gift taxes.

To aid planners, the Internal Revenue Service has issued sample forms for drafting inter vivos and testamentary charitable lead trusts. See Rev. Proc. 2007-45, 2007-46, 2008-45, and 2008-46.

Basic tax law rules

Payout. In order for the charitable interest in a lead trust to qualify for income, gift or estate tax charitable deductions, the payout must take the form of a guaranteed annuity interest or a unitrust interest. See Internal Revenue Code (IRC) section 170(f)(2)(B).

A guaranteed annuity interest is basically the right to receive a fixed dollar *payment* at least annually (for example, \$50,000 a year, regardless of trust income). A unitrust interest is the right to receive a fixed *percentage* each year of the annually determined value of trust assets (for example, 5% of the annual value of trust assets).

The regulations do not allow for a “net income” lead unitrust, i.e., a lead unitrust that pays out the lesser of its net income for the year or the specified unitrust percentage amount.

Unlike charitable remainder trusts, charitable lead trusts are not subject to minimum or maximum payout rates or to a time limit of 20 years if they are for a term of years rather than for the lifetime of one or more persons.

Tax status of the trust. Ordinary income or realized capital gains not distributed to charity but accumulated by a lead trust are taxed to the trust at normal trust rates except in the case of a grantor lead trust where income is taxed to the grantor.

Non-grantor lead trusts. A non-grantor trust is treated for federal income tax purposes as a separate taxpayer, as discussed in the preceding paragraph. An individual who establishes a non-grantor trust is not considered the owner of trust assets or income. Therefore, income distributed by the trust to a charity is effectively shifted from the individual to the charity (a tax-exempt entity, which pays no tax on the income it receives). This can be especially advantageous if a donor

does not normally itemize their tax deductions or have exceeded charitable gift adjusted gross income limits.

Under IRC section 170(f)(2)(B), an individual receives no federal income tax charitable deduction for the gift of an “income” interest in a charitable lead trust unless he or she is considered owner of the interest under the grantor trust rules.

In the case of a non-grantor trust, the donor is not considered the owner of the charitable “income” interest and is thus not entitled to an income tax charitable deduction with respect to the charitable interest.

Grantor lead trusts. It is possible to set up a lead trust as a grantor trust—for example, by the donor retaining a reversionary interest in the trust. In this case, the income tax consequences to the donor are essentially the opposite of those resulting from the creation of a non-grantor lead trust.

1. The donor receives an up-front federal income tax charitable deduction for the initial present value of the payments to be made by the trust to charity. The computation of this present value is discussed below.

2. The donor, not the trust, reports and pays tax on all trust income, including the income distributed to charity, with no offsetting yearly charitable deduction for this income. It should be noted that if the trustee voluntarily holds just tax-exempt bonds, there will be no taxable income for the donor to report with respect to the trust.

Determining the present value of the charitable payout

The initial present value of the payout to charity from a lead trust is the amount of the donor’s gift to charity for income, gift and estate tax purposes.

AFMR. This present value is determined using IRS tables based on the adjusted federal midterm rate (AFMR) in effect for the month the trust is created or, at the donor’s election, for either of the two preceding months. See IRC section 7520(a).

Effect of the AFMR on annuity and unitrust payouts. In a relatively low interest rate climate, the charitable lead annuity trust becomes more attractive. The charitable lead unitrust also gains popularity during times of low interest rates, but only slightly because the present value of a unitrust type of payout is basically independent of any assumed discount rate.

Example: A donor establishes a \$500,000 charitable lead annuity trust that is to pay 6%, or \$30,000 per year, to a charitable organization for 20 years. The present value of the annuity payout is equal to \$463,000 assuming a 2.6% AFMR.

If the AFMR is assumed to be 4%, the present value of the annuity payout is approximately \$407,000.

It should be noted that if the lead trust in question is a grantor lead trust, the donor can claim the \$463,000 or \$407,000 present value, as the case may be, as a charitable contribution for federal income tax purposes, subject to the percentage limitations on the income tax charitable deduction. The donor will, however, be subject to income tax on the amount of the payments to charity as they are received unless they are tax-exempt or paid from principal. See IRC section 170(b).

The same amount also qualifies for the federal gift tax charitable deduction.

Estate and gift tax considerations

A closer look at the federal gift tax charitable deduction. The gift to charity of a guaranteed annuity interest or a unitrust interest in a lead trust qualifies for the gift tax charitable deduction.

To put the gift tax charitable deduction in perspective, consider a lead annuity trust, funded with \$500,000 that is to pay \$25,000 per year to charity for 20 years. The gift tax charitable deduction for such a trust is approximately \$386,000, assuming a 2.6% AFMR.

If the lead trust provides an irrevocably vested remainder interest to the donor's daughter, upon creating the trust, the donor is deemed to make a gift to her equal to \$114,000 (\$500,000 minus \$386,000).

This gift does not qualify for the annual gift exclusion (\$15,000 as of 2018) under IRC section 2503(b), because the gift is of a future interest.

Federal gift tax on the gift, however, may be avoided to the extent the donor has any remaining gift tax exemption amount. Creating a lead trust to fund gifts to charity before assets are transferred to heirs can be an excellent way to use unified gift and estate tax amounts during lifetime. In the example above, only \$114,000 worth of exemption must be used, while heirs will receive \$500,000 or whatever other sum remains in the trust at its termination. It would require growth of

7.7% per year for the \$114,000 exemption amount to be worth \$500,000 in 10 years, while the trust must only distribute 6% to preserve that amount for heirs.

When trust assets appreciate. To take this example one step further, assume that over the course of the 20-year trust term, the value of the trust assets increases from \$500,000 to \$750,000 due to capital appreciation, reinvestment of after-tax income or both.

The \$250,000 of growth in the value of trust assets passes to the donor's daughter without being subject to federal gift or estate taxes. In this way, the lead trust has served to accomplish an "estate freeze."

The donor's daughter will take the trust's basis in the assets she receives from the trust. If the basis is relatively low, the daughter will owe any capital gain tax due if/when she sells the assets. To put this capital gain in perspective, however, one must compare the capital gains tax rate the daughter is likely to pay with the gift or estate tax rate that would have been applicable to the appreciation had the lead trust not been created. The highest federal capital gains tax rates have historically been substantially less than the highest estate tax rates, thereby adding to the attractiveness of the lead trust as a planning tool in certain circumstances.

Expanded gift tax exemptions

Tax legislation enacted in 2011 set the lifetime gift tax exemption amount at \$5 million per person, indexed for inflation beginning in 2012. In 2017 Congress acted to double this amount. The exemption adjusts to \$11.58 million per person for 2020. Check for current exemption amounts.

As noted earlier, the charitable lead trust can be an excellent way to make charitable gifts while maximizing the benefit of lifetime exemptions currently available.

For example, assuming a 2.6% AFMR, a charitable lead annuity trust funded with \$20 million that makes fixed charitable gifts of 5.1% per year for 10 years results in a charitable gift tax deduction of \$8.9 million, leaving a \$11.1 million taxable gift. If the donor has the full \$11.58 million exemption available it will serve to completely shield the gift amount from gift tax. He will have made charitable gifts totaling over \$10 million, while effectively transferring \$20 million or whatever other amount remains in the trust in 10 years. This plan nearly doubles the amount of an \$11.58 million gift tax exemption while making a very

substantial charitable gift. A couple could transfer up to \$40 million tax free using the assumptions of this example.

Miscellaneous planning considerations and questions

Generation-Skipping Transfer (GST) tax considerations. If a lead trust, upon termination, distributes its assets to one or more “skip persons,” the distribution is considered a taxable termination for federal (and possibly state) GST tax purposes. The federal GST tax rate applicable to the amount distributed depends on whether the trust is a lead annuity trust or a lead unitrust.

If a lead unitrust, the GST tax rate (under current law) is basically equal to:

$$TR (1 - E/[FMV - CD])$$

“FMV” is the value of the assets transferred to the trust, determined as of the date of transfer. “CD” is the gift or estate tax charitable deduction allowed with respect to the trust. “E” is the amount of the donor’s GST tax exemption allocated to the trust. “TR” is the highest applicable federal tax rate.

In the case of a lead annuity trust, the GST tax rate (under current law) is equal to:

$$TR (1 - [(E \times F)/FMV])$$

“E” is the amount of GST tax exemption allocated to the trust. “F” is the compound interest factor corresponding to the length of the trust term and the IRS discount rate applicable to the trust at the time the trust is created. The quantity “FMV” is the fair market value of the assets passing from the trust at the time of its termination.

Conclusion

The descriptions here of tax and financial considerations inherent in the design of a lead trust are intended as a starting point to identify some of the issues a professional planner may wish to explore in advising a client on the potential benefits and risks of creating a lead trust. Donors and their advisors should always check for the latest legislation and regulations prior to completing a charitable lead trust or similar charitable gift.

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