LEAD TRUSTS - WHAT TO DO AND NOT TO DO

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Lead trusts offer wealthy individuals the opportunity to pass assets to their heirs at substantial tax savings while providing immediate benefits to one or more charities about which they care. What's more, the very low monthly IRS discount rate has made lead trusts especially appealing during the last several years. The Fed is poised to start raising interest rates; however, creating some urgency to turn lead trust prospects into lead trust donors.

You may have only a few legitimate lead trust prospects in your pool of supporters, but it takes only one to make a big difference to your organization. In this Webinar, we will briefly cover the basics of how a lead trust works. The focus of the presentation is on what to look for in a lead trust prospect, what information a lead trust prospect and his or her advisors will find most helpful, and what questions to anticipate. The experience of advisors and gift planners who have been involved in the creation of numerous lead trusts will inform our discussion.

I. DEFINITION OF A CHARITABLE LEAD TRUST

A. Introduction

A typical charitable lead trust ("CLT") is the reverse of a charitable remainder trust ("CRT"). Instead of making payments to one or more individuals and then distributing the remainder to one or more charities, it makes payments to one or more charities, and then distributes the remainder to one or more individuals. By its very nature, a CLT is a gift of an income interest. It derives its name from the fact that the charity's interest leads off, i.e., is paid first.

CLTs usually last for a term of years, but they can last for the lifetime(s) of one or more individuals having a certain relationship to the donor. They can be established during the lifetime of the donor or at the donor's death through a will.

Thus, a CLT – as its name suggests – is simply a trust with one or more charitable organizations as its lead beneficiaries. When a donor establishes a CLT, the trust will usually be a qualified CLT, meaning that it meets requirements that result in various federal tax benefits for both the donor and the trust itself. Accordingly, in the balance of these materials, all references to CLTs will be to qualified CLTs, unless noted otherwise.

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B. Statistics

Split-interest trust statistics from the IRS based on Form 5227s filed in 2012

Item	Total	Size of end-of-year book value of total assets (in $1,000s)				
		Under $500,000	$500,000 under $1,000,000	$1,000,000 under $3,000,000	$3,000,000 under $10,000,000	$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)
CLT Number of	6,498	2,658	1,406	1,353	757	324
Change from 2011	-1.798%	-7.193%	-2.089%	3.599%	7.224%	6.230%
CLT Total net	23,705,4	413,545	995,305	2,266,95	4,048,28	15,981,32
CRAT Number of	14,616	11,944	1,429	912	279	52
Change from 2011	-7.855%	-7.080%	-13.499%	-10.500%	1.455%	-16.129%
CRAT Total net	6,447,09	1,272,02	1,039,87	1,475,70	1,338,53	1,320,951
CRUT Number of	91,250	65,444	13,587	9,012	2,532	675
Change from 2011	-2.748%	-2.629%	-2.231%	-3.780%	-4.164%	-5.330%
CRUT Total net	85,240,0	11,233,5	9,435,93	14,307,8	12,517,9	37,744,78
PIF Number of	1,324	1,011	104	122	64	23
Change from 2011	-5.563%	-5.514%	-10.345%	0.826%	-9.859%	-4.167%
PIF Total net assets	1,254,98	114,910	80,459	199,917	335,990	523,713

Source: http://www.irs.gov/uac/SOI-Tax-Stats-Split-Interest-Trust-Statistics

As you might expect, charitable remainder unitrusts (CRUTs) are by far the most common of the four vehicles listed, outnumbering charitable remainder annuity trusts (CRATs) almost six-fold, CLTs (lead annuity trusts and lead unitrusts combined) over 14-fold, and PIFs 66-fold. CRUTs also hold the greatest value in assets, but here CLTs come in second and CRATs a distant third. In other words, CLTs tend to be very large. The average book value of a CLT filing in 2011 was over $3.6 million, far larger than the average value of a charitable remainder trust or pooled income fund. Nevertheless, a substantial fraction of CLTs, over 40%, had a book value of less than $500,000.

The statistics above are interesting, but they only hint at the benefit each type of split-interest gift provides to charity. The table below shows how much each type of split interest trust distributed to charity in 2010 (5227s filed in 2011).

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Total Charitable Distributions, by Type of Trust and Charity Type, Filing Year 2011[1]
[All figures are estimates based on samples—money amounts are in thousands of dollars]

	All		CRTs[2]		CLTs		PIFs	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
Total	**27,992**	**$3,065,001**	**10,084**	**$1,905,209**	**17,348**	**$1,119,219**	**561**	**$40,573**
Arts, culture, and	2,575	$158,759	632	$118,253	1,937	$39,759	6	$746
Education	6,275	$741,872	2,634	$586,612	3352	$135,481	289	$19,779
Environment, animals	1,789	$30,148	359	$18,010	1,397	$10,189	33	$1,950
Health	3,103	$264,817	971	$234,306	2,068	$29,296	64	$1,216
Human services	4104	$99,460	932	$72,069	3098	$26,292	73	$1,098
International, foreign	827	$21,028	248	$15,801	579	$5,227	0	$0
Public, societal benefit	4,580	$1,492,081	1,262	$683,743	3,268	$796,286	50	$12,052
Religion related	4372	$194,896	2,939	$154,884	1399	$36,297	36	$3,714
Mutual membership	12	$21	0	$0	1	$4	11	$17
Other	354	$61,917	106	$21,529	248	$40,388	0	$0

[1] Values in this table determined by adding values for distributions of principal and distributions of income.
[2] CRT values determined by adding values for distributions from CRATs and distributions from CRUTs.

One fact that jumps out is that in 2010 CLTs distributed nearly 60% as much to charity as CRTs - $1,119,219 vs. $1,905,209 – despite holding less than ¼ the assets. Which is to say, comparing book values overlooks an essential difference between CLTs and CRTs: CLTs distribute funds to charity every year of their existence while almost all CRTs distribute funds to charity just once at their very end.

Interestingly, the same IRS statistics for two years earlier (the 2009 filing year) showed CLTs distributing nearly the same amount to charities as CRTs. What happened to change the relationship so dramatically? Assets recovered a lot of their value after the financial crisis of 2008. The S&P 500 rose 40% over 2009 and 2010, for example. Consequently, the value of the assets distributed by terminating CRTs during 2009 and 2010 also increased substantially, nearly 50%. Meanwhile, distributions from CLTs changed little during the same time span, which makes sense since most CLTs are annuity trusts that make the same payment each year. One lesson to learn from the last few years is that the amount of CRT distributions to charity can change significantly due to economic conditions at the time of termination while distributions from CLTs are less susceptible to the vagaries of timing.

C. **Who is a typical lead trust prospect?**

Someone wealthy! See the attached article from 2014 in Forbes magazine regarding the Walton family's use of lead trusts. Because the lead trust is irrevocable, the donor needs to have considerable assets in addition to those funding the lead trust. Often, the lead trust is being used to transfer assets to heirs with reduced estate taxes. This type of estate planning is only of concern to individuals whose taxable estate exceeds their available unified credit.

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The American Taxpayer Relief Act (ATRA) passed by Congress on January 1, 2013 inaugurated changes to U.S. federal tax rules for transfer taxes, among others. ATRA increased estate, gift and generation skipping tax exemption amounts that are indexed for inflation. ATRA effectively repealed transfer taxes for Americans with modest estates because of the 5,450,000 exemption amount (In 2016 and adjusted annually for inflation.) and the portability of the exemption between spouses that allows $10,900,000 to pass estate tax free. The exemption amount is adjusted for inflation in future years.

The impact of ATRA has been to drastically limit the number of donors concerned about the impact of transfer tax and therefore limit the number of donors for whom a lead trust is attractive. To illustrate this point, the number of estate tax returns filed with the IRS declined nearly 74 percent from 45,070 in 2005 to 11,931 in 2014, primarily due to the gradual increase in the filing threshold. The gross estate filing threshold was $5.34 million in 2014, up from $1.5 million in 2005.

That being said, notice from the IRS statistics that 41% (2,658 out of 6,498) of all lead trusts have total assets of under $500,000 and 66% (2,658 + 1,406 out of 6,498) of all lead trusts have total assets of under $1,000,000! Most institutional trustees set a minimum of $1,000,000 for managing a lead trust. It is likely that the donor's own advisors manage many or most of these "small" lead trusts. Additionally, some of these trusts may have begun with assets in excess of $1,000,000 but they have lost book value since funding.

II. Charitable Lead Trust Characteristics

A. Diagram

In many ways, a charitable lead trust is the reverse of a charitable remainder trust, as described in the diagram below.

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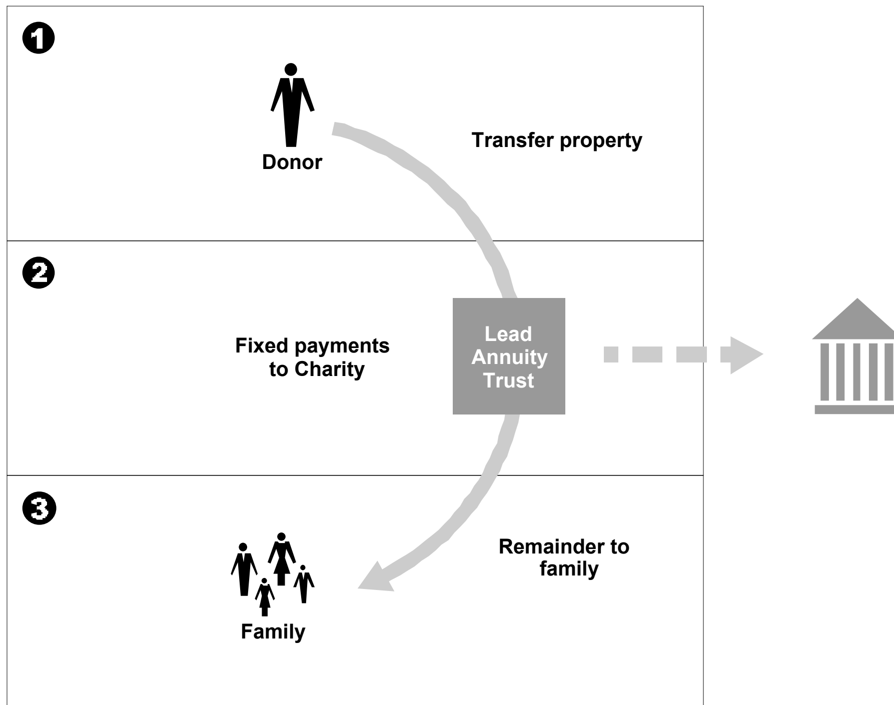

B. Drafting Considerations

Irrevocability
To be a qualified charitable lead trust, the CLT must be irrevocable.

Timing of gift
A CLT may be funded during life – a so-called *inter vivos* CLT – or at death – a so-called testamentary CLT. There are certain financial advantages to funding a CLT during life that we will explore in some detail later on.

Payments
The payments made by a lead trust must be in the form of either (1) an annuity amount, i.e., a fixed dollar amount (a charitable lead annuity trust or CLAT), or (2) a unitrust amount, i.e., a fixed percentage of the net fair market value of trust assets re-valued annually (a charitable lead unitrust or CLUT). Unlike CRTs, CLTs have no minimum or maximum payment percentage. In addition, unlike with charitable remainder unitrusts, qualified CLUTs come in one form only; net income, makeup, and qualified CLUTs may not include flip provisions.

Beneficiaries
Instead of making payments to one or more individuals for the duration of its term and then distributing its remaining principal to one or more charities, a lead trust makes payments to one or more charities for the duration of its term, and then distributes its remaining principal to one or more individuals.

If the donor creates a non-grantor CLT, where the remaindermen of the trust are individuals other than the donor, the charities IRC Sections 2055(a) and 2522(a) must describe the

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benefitting charity. A gift or estate tax deduction is allowed when the income is paid to a foreign charity.

If the donor creates a grantor CLT, which ordinarily means the remainderman of the trust is the donor, the charity must be described in Section 170(c) and must be a domestic charity. A private foundation can be the income beneficiary, but more restrictive limitations on the deduction will apply. To qualify for the higher limitations, the income interest should be paid to a charity described in IRC Section 170(b) (1) (A).

Term

CLTs usually last for a term of years. Unlike CRTs, CLT terms are not limited to a maximum of 20 years. If state law includes a rule against perpetuities, however, the trust term must abide by that rule.

CLTs also can last for the lifetime of the remainder beneficiaries or for the lifetimes of one or more individuals "who, with respect to all non-charitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. Thus, remainder beneficiaries can include step-children and step-grandchildren of the individual who is the measuring life and charitable organizations (described in Internal Revenue Code sections 170, 2055, or 2522)." (See IRS final regulations published in Treasury Decision 8923).

Trust Additions

Although Treasury Regulations are not explicit about the permissibility of making additions to CLATs or CLUTs during their terms, the IRS has issued private letter rulings that suggest that the rules match those for CRATs and CRUTs. That is to say, it is not permissible to make an addition to a CLAT and it is permissible to make an addition to a CLUT. The donor of an addition to a CLUT is eligible for a tax deduction equal to the increase in value of charity's income interest in the trust attributable to the addition.

Private Foundation Rules

A CLT governing instrument must prohibit violation of the private foundation rules described in IRC Sections 4941(d), 4943(c), 4944, and 4945(d). These rules prohibit a trust from engaging in an act of self-dealing or making taxable expenditures. If the deductible value of the CLT's lead interest is 60% or more, it is also subject to the prohibitions against excess business holdings (the trust plus the donor and all other "disqualified" persons must hold less than 20% of a business enterprise) and jeopardy investments.

Sample agreements from IRS

In 2007, the IRS published Revenue Procedures 2007-45 and 2007-46 to provide guidance on how to draft a trust instrument for a qualified CLAT. The revenue procedures address grantor and non-grantor *inter vivos* and testamentary trusts established for a term of years or one measuring life. The guidance provided by the IRS in the revenue procedures takes the form of sample basic wording for a trust instrument, sample optional wording, and certain annotations. In 2008, the IRS published Revenue Procedures 2008-45 and 2008-46 that cover how to draft trust instruments for qualified *inter vivos* and testamentary, grantor and non-grantor CLUTs.

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The IRS will recognize a trust as a qualified CLAT or CLUT if the trust operates in a manner consistent with the terms of the trust instrument, if the trust is a valid trust under applicable local law, and if the wording of the trust instrument is substantially similar to the sample basic wording set forth in the appropriate revenue procedure (with the wording for any alternative provisions likewise reflecting the sample optional wording set forth in the appropriate revenue procedure). A trust instrument that contains substantive provisions in addition to those found in the appropriate revenue procedure (other than those necessary to establish a valid trust under applicable local law that are not inconsistent with pertinent federal tax requirements), or that omits any provision found in the appropriate revenue procedure, will not necessarily be disqualified, but neither will it be assured of qualification under the provisions of the appropriate revenue procedure.

C. Gift and Estate Taxation

One must have a basic understanding of the federal system of gift and estate taxation in order to understand the potential benefits of funding a CLT. The system is based on exemptions and rates, along with some complicated rules about the interplay between gifts made during lifetime and those transfers made a death (which is not covered in this handout).

The assets in a person's estate are assessed an estate tax after the person dies. The federal estate tax is assessed against a person's taxable estate, as determined on the federal estate tax return (Form 706). As with gift taxes, if a net estate tax is due, it is usually payable by the estate of the deceased taxpayer.

<u>Gross Estate</u> The total value of a person's estate before any deductions are made for taxes, funeral expenses, attorney's fees or administration costs. The proceeds of life insurance are included in the gross estate if the policies were owned or controlled by the decedent. One-half of property owned jointly with the spouse included.

<u>Basis step-up</u> Appreciated assets passing to heirs are entitled to a step up on bases upon the death of the decedent. This step up increases the value of assets inherited upon the owner's death. The step up in basis erases the potential capital gain associated with an appreciated asset up to the decedent's date of death. Instead, cost basis of appreciated property passing to heirs is increased to its date of death value. If the heirs subsequently sell the property, the taxable gain is calculated based on the fair market value at the time of death, not the fair market value at the time the asset was purchased.

<u>Estate tax marital deduction</u> –The first spouse to die can leave an unlimited amount to the surviving spouse, who is a U.S. citizen, completely free of federal estate tax. The amount passing to the surviving spouse can qualify for this marital deduction if it is given outright or under certain approved trust arrangements. Property passing to a surviving spouse, who is not a U.S. citizen, is not eligible for the marital deduction, unless the property passes to the alien spouse through a qualified domestic trust (QDT).

<u>Deductibility of lifetime gifts to charity</u> - A donor is allowed an unlimited charitable gift tax deduction for lifetime gifts to qualified charities. However, the donor is required to complete a Gift Tax Return Form 709 if a decedent makes a future interest gift of any amount or a present interest gift of more than $14,000 if less than the entire value of the donated property qualifies

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for a gift tax charitable deduction (this can be the case with certain contributions for gift annuities, for example).

Deductibility of bequests to charity - A donor is allowed an unlimited charitable estate tax deduction. If the bequest is in the form of a charitable remainder trust with the surviving spouse as income beneficiary, the deduction is for the present value of the remainder interest. If a surviving spouse is the only income beneficiary, the combination of the marital deduction and charitable deduction will eliminate estate tax on the property.

Calculation of a Taxable Transfer

- $800,000 gift in 2000. No prior taxable gifts at the time and no others made prior to subsequent death.
- Death in 2016
- $10,000,000 estate upon death.

$800,000 Gift Made During Lifetime

Gift in 2000	$800,000
Prior taxable gifts	0
Gift Tax (from 2000 table)	$267,800
Less unified credit (in 2000)	-$220,550
Gift tax paid	**$47,250**

Settlement of $10,000,000 Estate

Estate in 2016	$10,000,000
Prior taxable gifts	+$800,000
Taxable estate	$10,800,000
Tentative tax (from 2016 table below)	$4,265,800
Less 2016 estate tax credit	-$2,125,800
and prior gift tax paid	-$47,250
Estate tax paid 2016	**$2,092,750**

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Gift and Estate Tax Rate Schedule in 2013 - 2016

Taxable Transfer	Tax	% on Excess
0	0	18
10,000	1,800	20
20,000	3,800	22
40,000	8,200	24
60,000	13,000	26
80,000	18,200	28
100,000	23,800	30
150,000	38,800	32
250,000	70,800	34
500,000	155,800	37
750,000	248,300	39
1,000,000	345,800	40

Top estate tax bracket = 40%

D. Funding Considerations

Most any kind of property, theoretically, can be transferred to a CLT. Property with a potential for significant future appreciation is especially appropriate to transfer to a non-grantor CLAT, as the appreciation can be accumulated for heirs and sheltered from gift and estate taxes. Cash is often included as part of the funding assets in order to make payment of the charitable distributions during the early years possible without forcing the sale of other funding assets.

The non-grantor CLT could be used to preserve a closely held business for the next generation. The children would receive the stock at the end of the trust term, possibly with only a fraction of the value having been subject to transfer taxes.

One concern is making the required payments to charity if the stock pays little or no dividends. These payments must be made, since a "net income", CLUT is not permitted. The corporation might be willing to purchase some stock from the trust. Alternatively, the trust could distribute stock to the charity in satisfaction of the required payments. At some future time, the charity would sell the stock to the corporation, to other stockholders, or perhaps to an external buyer to whom all stockholders are willing to sell. When in-kind distributions are made in satisfaction of

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the payment, the trust will be taxed as if it had sold the property and paid the proceeds to charity. The deduction for charitable payments should, however, offset the taxable gain.

Conversely, a non-grantor CLT could be used to replace an appreciated stock with a diversified portfolio over the duration of the trust. The trustee would sell shares of the stock each year such that the realized gain would be offset by the charitable distribution deduction, resulting in no income tax. The sale proceeds in excess of those used to make the charitable distribution would be reinvested in a diversified portfolio. Over the course of the trust term, the appreciated stock could be largely or completely replaced by diversified investments at no tax cost.

As noted earlier, a CLT is prohibited from acts of self-dealing and, if the deductible value of the CLT's lead interest is 60% or more, it is also subject to the prohibitions against excess business holdings (the trust plus the donor and all other "disqualified" persons must hold less than 20% of a business enterprise) and jeopardy investments. In the case of a CLT funded with closely held stock or a family business, however, the restriction against excess business holdings may influence the donor to limit her deduction to less than 60% of the funding amount, or seek other assets with which to fund the lead trust.

III. NON-GRANTOR CHARITABLE LEAD TRUST

A. Description

In a non-grantor charitable lead trust, the grantor (or donor) is not treated as owner of the trust assets. At the termination of the trust, the remaining principal is distributed to individuals other than the donor, typically family members. The purpose of the non-grantor lead trust is to support one or more charities and then pass property to heirs at reduced gift and estate tax cost.

B. Gift and Estate Tax Consequences

Since the donor retains no personal financial interest in the trust, he/she does not receive an income tax deduction. Rather, the donor makes a *taxable gift* to the remainder beneficiaries of the trust. The size of this taxable gift equals the present value of the beneficiaries' remainder interest, which in turn equals the value of the assets transferred to the trust *minus* the present value of the charitable income interest that qualifies for a gift or estate tax deduction.

The method of computing these values is the same as for comparable CRTs, except that the deductible portions are reversed. With a CRT, the remainder interest is deductible. With a CLT, the income interest is deductible, since that is the portion that goes to charity.

The charitable deduction available for a CLT is a function of the following factors:

- Funding amount
- Term length
- Lead trust type
- Payment %
- Payment frequency

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- Payment timing
- IRS discount rate

Importance of IRS discount rate
Unlike life income gifts, such as gift annuities and charitable remainder trusts, the *lower* the IRS discount rate, the *higher* the charitable deduction earned by a lead trust. The size of the effect is minor for CLUTs, but substantial for CLATs.

IRS discount rates are very low right now, as shown below. This means that it is a particularly opportune time for donors with the potential to fund a lead trust to be considering a CLAT.

IRS discount rate range since inception in May 1989: 1.0% (8/2012) - 11.6% (5/1989)
IRS discount rate in August 2016: 1.4%

The following tables show that a CLAT benefits considerably from a low IRS discount rate environment, whereas a CLUT is affected little by fluctuations in the IRS discount rate.

For example, in July 2007, when the discount rate was 6.0%, a 20-year 5% CLAT earned a 56.4% deduction and needed to pay 8.72% of its initial value to earn a 100% deduction. Five years later, in August 2012, the same 20-year 5% CLAT earned an 88.4% deduction and required a payment rate of just 5.54% to earn a 100% deduction.

5% CLAT, 20-Year Term, Payments Annual at End

IRS Discount Rate	Deduction %	100% Deduction Payout Rate
1.0%	88.4%	5.54%
2.0%	81.8%	6.12%
3.0%	74.4%	6.72%
4.0%	68.0%	7.36%
5.0%	62.3%	8.00%
6.0%	57.3%	8.72%

By increasing the payout to charity and lengthening the trust term, the amount of the taxable gift can be reduced. In the case of a CLAT, it is even possible to earn a 100% deduction, thereby reducing the taxable gift can to zero, an attractive outcome for many lead trust donors. As shown in the table below, a CLUT cannot earn a 100% deduction.

5% CLUT, 20-Year Term, Payments Annual w/12 months delay

IRS Discount Rate	Deduction %	100% Deduction Payout Rate
1.0%	63.8%	n/a
2.0%	63.4%	n/a
3.0%	63.0%	n/a
4.0%	62.7%	n/a
5.0%	62.3%	n/a
6.0%	62.0%	n/a

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The following charts show the percent of a contribution to a charitable lead trust qualifying for a gift or estate deduction, based on various payout rate and trust term combinations, using the August 2016 IRS discount rate of 1.4 percent, and assuming annual payments at the end of the year.

CLAT: Percent of Contribution Deductible

Payout Rate	Trust Term in Years			
	10	15	20	25
5%	46%	67%	87%	100%
6%	56%	81%	100%	100%
7%	65%	94%	100%	100%
8%	74%	100%	100%	100%
9%	83%	100%	100%	100%
10%	93%	100%	100%	100%
11%	100%	100%	100%	100%
12%	100%	100%	100%	100%

CLUT: Percent of Contribution Deductible

Payout Rate	Trust Term in Years			
	10	15	20	25
5%	40%	53%	64%	72%
6%	46%	60%	70%	78%
7%	51%	66%	76%	83%
8%	56%	71%	81%	87%
9%	61%	75%	84%	90%
10%	65%	79%	87%	93%
11%	68%	82%	90%	94%
12%	72%	85%	92%	96%

Note: In the case of a grantor charitable lead trust, these percentage amounts would qualify for an income tax charitable deduction rather than a gift tax deduction.

CLT growth escapes gift and estate tax

The federal gift and estate tax structure we have just reviewed is important to understanding the tax benefits of CLTs.

1. The gift tax charitable deduction available for funding a CLT makes it possible for a donor to leverage his or her remaining gift tax exclusion to transfer funds in excess of the exclusion amount to heirs. This is particularly true in the current environment of extremely low IRS discount rates. As already noted, for example, it is even relatively easy to construct a CLAT of sufficient payment rate and duration to "zero-out" the taxable gift altogether.

2. Furthermore, once a donor transfers assets into a non-grantor CLT, these assets are out of the donor's estate. This means that they will not be subject to further gift or estate taxation (generation skipping tax, when it applies, is a different story that we will get to

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later). Consequently, one of the great tax planning benefits of the CLT is that asset appreciation that occurs within the trust escapes gift and estate taxes.

For example, if a CLT is funded with $1,000,000 and the CLT principal is worth $1,500,000 when the CLT terminates, the $500,000 increase in value will have escaped both gift tax when the trust was funded (the value didn't exist yet so it couldn't be taxed) and estate tax when the trust terminated (the trust is out of the donor's estate so the final distribution is not subject to estate tax).

CLATs are generally preferred over CLUTs for transferring wealth because all growth in excess of the required charitable payments accumulates for heirs only. In contrast, a CLUT shares its growth with its charitable lead beneficiaries in the form of larger recalculated annual payments. Under current very low IRS discount rates, a CLAT can now accumulate even more for heirs because the desired gift tax deduction is obtainable with lower charitable payments.

Generation Skipping Tax

The generation skipping tax (GST) applies to transfers between a donor and "skip" persons. It is intended to prevent taxable transfers from skipping a generation of taxation.

A "skip" person includes a donor's lineal descendants who are two or more generations below the donor – grandchildren, great grandchildren, etc. – or non-lineal descendants who are 37 ½ years or more younger than the donor. There is an exception available to "skip" persons where the intervening generation has died prior to the creation of the CLT. For example, a CLT that terminates in favor of a donor's grandchild is not subject to GST if it was funded after the donor's child who parented the grandchild has died.

GST applies at the termination of a lead trust and at the top estate tax rate then applicable.

GST Exemption

There is a GST lifetime exemption available for transfers subject to GST. The American Taxpayer Relief Act of 2012 unified the GST exemption amount with the Estate tax exemption, including indexing. Therefore, for 2016 the GST exemption is equal to the estate exemption, $5,450,000.

Computing the GST

The proportion of a CLT's final distribution that is subject to GST depends on a number of factors that feed into the computation of an "inclusion ratio." Among these factors is the allocated GST exemption amount. An inclusion ratio ranges from zero to one, where zero means 0% of the final distribution is subject to GST and one means 100% of the final distribution is subject to GST.

At the funding of a CLUT the inclusion ratio is determined. The inclusion ratio for a CLAT is determined when the CLAT terminates. The value of the assets in the CLAT at termination are subject to GST. Since the value of CLAT assets upon termination is difficult to predict, it is also difficult to determine how much GST exemption to allocate in order to minimize a CLAT's GST exposure. With a CLUT, a donor can be precise in this allocation, but with a CLAT a donor will almost certainly either allocate more GST exemption than necessary or not enough. Consequently, many planners prefer the CLUT when GST is a concern.

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GST Adjusted Exemption
The GST exemption amount is adjusted for lead annuity trusts. No adjustment is made for lead unitrusts. The adjusted exemption equals the exemption amount entered compounded annually over the tern of the trust by the IRS discount rate used to compute the deduction. For example, the adjusted exemption for a 20-year lead annuity trust calculated using a 1.8% IRS discount rate to which a $5,450,000 exemption is allocated would be:

$\$5{,}450{,}000 \times (1+.018)^{20} = \$7{,}786{,}675.25$
[Note: you can do this calculation in Excel using the formula = **5,450,000*(1.018^20)**

GST Inclusion Ratio
The factor by which transferred property is multiplied to determine the amount subject to generation skipping tax (GST) is called the inclusion ratio. The inclusion ratio (IR) is calculated as follows:

CLUT: IR = 1 – (GST exemption used / (net principal placed in trust – gift tax deduction))

CLAT: IR = (principal value at termination – GST adjusted exemption) / principal value at termination

Note that the inclusion ratio for a CLUT will be zero whenever the GST exemption allocated at the time of transfer to the CLUT equals the taxable gift. If the inclusion ratio is zero then you know the GST assessed at trust termination will be $0, no matter how much the CLUT distributes to its final beneficiaries.

For a CLAT, the inclusion ratio will be zero only if the GST adjusted exemption is equal to or greater than the trust principal at termination, but there is no way to know what that principal value will be so there is no way to allocate the precise amount of GST exemption needed to make the inclusion ratio (and GST) zero.

Generation Skipping Tax
The generation skipping tax (GST) is assessed at the time assets are transferred to the heirs.

The GST is calculated as follows:

GST = IR x principal after num years x top estate tax bracket. *

* In 2016, the top federal estate tax bracket is 40%.

Who pays generation skipping tax?

Direct skip: executor if by will, transferor if during life

Taxable distribution: transferee (e.g., income beneficiary pays GST on CRT distribution)

Taxable termination: trustee (e.g., trustee pays GST on CLT corpus distribution to heirs)

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Example One: Ms. Falcone transfers $5.45 million to a charitable lead unitrust having a duration of 20 years and a payout rate of 7%. The applicable IRS discount rate is 1.8% and pays charity annually at the end of the year. Her granddaughter is remainderman of the trust. Ms. Falcone allocates $1,310,997 of her lifetime exemption to the transfer. Generation-skipping transfer tax due upon termination of the trust will be:

Inclusion ratio equals $1 - \frac{972{,}900}{5{,}450{,}000 - 2{,}805{,}320} = 0$

$$0 \times 40\% = \$0 \text{ GST}$$

Example Two: Instead of transferring the $5.45 million to a charitable lead unitrust, she transfers it to a charitable lead annuity trust. This time she allocates her entire $5.45 million lifetime GST exemption to the transfer. The applicable discount rate when the trust is established is 1.8 percent. When the trust terminates the trust property has appreciated to $7,944,027. Generation-skipping transfer tax due upon termination of the trust will be:

Adjusted exemption = 5,450,000 x 1.018^20 = $7,786,675

Inclusion ratio equals= (7,944,027-7,786,675)/7,944,027= 0.01981

0.01981 x 40% = .007924 (GST tax rate)

7,944,027 x .007924 = $62,940 (generation-skipping transfer tax)

C. Income Tax

A non-grantor CLT, unlike a CRT, is not tax-exempt and taxed as a complex trust under IRC Sec. 661. Trust tax rates on earned income, such as bond interest, match the rates for individuals, but apply at much lower taxable income levels. In 2016, a CLT will be in the 39.6% income tax bracket once it has taxable income in excess of $12,400. Compare that to an individual, who does not reach the 39.6% bracket until he or she has more than $466,950 of taxable income. See below the income tax tables for trusts and married couples filing jointly for more detail.

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Federal estate and trust income tax schedules 2016

Taxable Income*	Tax	% on Excess
0	$0	15%
2,550	382.50	25
5,950	1,232.50	28
9,050	2,100.50	33
12,400	3,206	39.6

Source: Revenue Procedure 2015-53

Married Filing Jointly Income Tax Schedule: 2016

Taxable Income*	Tax	% on Excess
$0	$0	10
18,550	1,855	15
75,300	10,367.50	25
151,900	29,517.50	28
231,450	51,791.50	33
413,350	111,818.50	35
466,950	130,578.50	39.6

Source: Revenue Procedure 2015-53

As with individuals, a CLT pays a 15% tax on qualified dividends, such as dividends from publicly traded securities.

Unlimited income tax deduction for distributions to charity
Unlike individuals, whose charitable deductions typically are limited to 50% (cash gifts) or 30% (appreciated property gifts) of adjusted gross income, a CLT can take an unlimited charitable deduction for amounts paid to a qualified domestic charity. Thus, if a CLT distributes all of its income in satisfaction of its charitable payments, it will not need to pay any income tax.

Order in which CLT income is distributed
The order in which a CLT distributes different categories of income becomes important in years when the CLT has more income than it distributes to charity. In these years, what the CLT distributes also determines what kind of income it has retained and therefore the tax it will pay on that retained income.

The IRS position is that regardless of any ordering provisions set forth in the trust instrument, the character of income distributed by a CLT reflects proportionally the character of all income

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earned by the CLT. For example, if a CLT has $100,000 of taxable income in a year -- $80,000 in capital gain from the sale of stock, $15,000 of interest income, and $5,000 of qualified dividends -- and distributes $60,000 to charity that year, it will be deemed to have distributed $48,000 of capital gain, $9,000 of interest income, and $3,000 of qualified dividend. The CLT will owe tax on the retained income as follows:

$32,000 of capital gain income x 15%	=	$4,800
$6,000 of interest income	=	$1,290
$2,000 of qualified dividends x 15%	=	$300
		$6,390

Some commentators believe that the IRS is on shaky ground here and that ordering provisions in the trust should be valid. In this case, the following order of distribution would be desirable, as it would minimize the income tax owed be the CLT:

1. ordinary income, including short-term capital gain and non-qualified dividends, but excluding UBTI
2. 50% of UBTI
3. capital gain other than short-term capital gain
4. qualified dividends
5. balance of UBTI
6. tax-exempt income
7. principal

D. Capital Gains Tax

A CLT inherits the donor's cost basis in the assets contributed to fund the trust, increased by any gift taxes paid that were attributable to the property's appreciation. What if the CLT sells appreciated property?

When a CLT sells appreciated property, it is taxed on the realized gain. As with earned income, the taxable gain is offset by the income tax charitable deduction to the extent that this realized gain is distributed to the charity in the year it was realized.

Beneficiaries inherit cost basis of CLT
When an *inter vivos* CLT terminates, the remaindermen inherit the donor's cost basis in the CLT assets, with adjustments. There is no step-up in cost basis as there is for assets that pass through a benefactor's estate. In contrast, when a *testamentary* CLT terminates, the cost basis inherited by the remaindermen equals the value of the assets at the time of the donor's death (that is, there is a step-up in cost basis at the time of funding, but not at termination).

Since the top gift and estate tax rates are considerably higher than the capital gains tax rate, it is usually advantageous to shelter appreciation from gift or estate tax and have it taxed as capital gain instead. Still, in discussing the tax consequences of a CLT with a prospect, it is important to point out that beneficiaries could receive CLT assets that will trigger significant capital gains tax if sold.

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IV. Grantor CLT

A. Description

A CLT is a "grantor" trust if the grantor (or "donor") is treated as owner of the trust under the grantor trust rules of IRC Sections 671 through 677.

In particular, the grantor will be treated as owner if he or she retains a reversionary interest in the trust having an actuarial value exceeding five percent of the value of the trust corpus at the time the trust was established.

In almost all cases where the trust principal will be returned to the grantor, the grantor will be treated as owner. Only in cases where the payout to charity is relatively high and the trust term relatively long would the actuarial value of the reversionary interest be five percent or less. For example, using a discount rate of 3 percent, a grantor CLAT with a 7-percent payout rate making payments at the end of each year for 18 years would produce a reversionary interest of 3.7 percent.

Certain other powers, such as the right of a non-adverse person to exercise a non-fiduciary right to substitute property of equal value, may also cause the grantor to be treated as owner. The right to designate charitable remainder beneficiaries will not, by itself, make the grantor the owner of the trust for income tax purposes, although it might well do so for gift tax purposes.

B. Income, Gift and Estate Tax Consequences

The grantor of a grantor lead trust is entitled to income tax and gift tax charitable deductions for the present value of the income interest.

A gift in the form of a grantor lead trust is considered to be "for the use of" a charity. Consequently, the contribution is subject to a 30-percent deduction limitation, so long as each charitable beneficiary of the trust (whether named in the trust instrument or selected by the trustee pursuant to the trust instrument) is required to be a public charity. Interestingly, the 30-percent limitation applies to the deduction associated with a contribution of long-term appreciated property, as well as the deduction associated with a contribution of cash or ordinary income property. If, however, a charitable beneficiary is or may be an entity other than a public charity, a 20-percent limitation will apply in the case of long-term capital gain property contributed to the trust. In any event, a five-year carryforward is allowed.

The donor is taxed on all of a grantor trust's income, even on the income paid to the charity. Likewise, the donor is taxed on realized capital gains, even if they are accumulated within the trust. If appreciated property is distributed in-kind to the charity in satisfaction of the annuity trust or unitrust amount, the property will be considered to have been sold and the cash distributed, thereby causing the grantor to recognize the gain. In light of these considerations, a donor will sometimes use cash to fund a grantor CLT, at least in part, with the trustee then drawing upon the cash to purchase tax-free municipal bonds in order to decrease the amount of income that is generated by the trust yet taxable to the donor (or the trust will simply be funded with such bonds if the donor owns enough of them).

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No deduction is allowed each year for payments to charity unless the donor did not receive a deduction at the outset because the trust was not a qualified grantor CLT. In that rather unlikely event, the donor would be taxed on trust income but would get a deduction for amounts paid to charity.

A portion of the donor's income tax deduction will be recaptured if he or she ceases to be owner of the trust before the expiration of the trust term. For example, if a donor establishes a 15-year grantor CLT, receives an income tax charitable deduction, and dies after 10 years, part of the deduction will be recaptured. The amount recaptured is the amount of the deduction less the discounted value of amounts actually paid to charity. In computing the discounted value, each amount paid to charity is treated as a contribution of a remainder interest after a term of years. (See Table B in IRS Publication 1457.)

C. Applications

The combination of the exceedingly low discount rate and the continuation of low maximum tax rates on qualified dividends and on most capital gains has breathed new life into the grantor CLAT. In the past, such trusts generally did not make economic sense unless the grantor was subject to a much higher income tax rate in the year the trust was funded than he or she would be in ensuing years. Consequently, non-grantor CLTs have been far more common than the grantor variety.

A grantor CLAT will be particularly appealing to donors who, for various reasons, have very high income this year and can use a sizeable charitable deduction, but do not want to surrender ultimate control of assets. An example of a grantor CLAT to fulfill a campaign pledge is shown in a case study later in this paper.

V. Intentionally Defective Grantor Trust

It is possible to create a charitable lead trust that has both grantor trust and non-grantor trust characteristics. The trust will distribute its remaining principal to the donor's heirs when it terminates. However, the donor retains just enough rights in the trust for the trust to be considered a grantor trust for income tax purposes and a non-grantor trust for gift and estate tax purposes. As a result, the donor pays tax on the trust's taxable income, but the trust's assets are out of the donor's estate. The donor receives both an income tax deduction and a gift tax deduction in the year the trust is created.

Drafting Considerations
In the majority of cases, donors want to establish a lead trust as a non-grantor trust so as to avoid the recognition of income earned by the lead trust term. There are situations, however, where a lead trust donor may want an income tax charitable deduction upon funding a lead trust even though the donor will have to recognize income and realized capital gain during the term of the trust. To be treated as a grantor trust for income tax purposes, the trust has to include provisions so that the donor is treated as the owner of the trust, which triggers the grantor trust rules for income tax purposes. The trust has to be carefully drafted to trigger this grantor status. If not properly structured, the grantor trust status could cause the trust to be included in the donor's

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estate. That would defeat purpose of the favorable estate and gift tax benefits of a lead trust if the donor dies during the term of the lead trust. Drafting the language to cause the lead trust to be treated as a grantor trust for income tax purposes and a non-grantor trust for estate and gift tax purposes is referred to as creating an "intentionally defective grantor trust." To prevent confusion on the part of donors the term "intentionally defective" is generally disfavored. Charities sometimes market these trusts as "Super CLTs" or "Double Deduction CLTs".

Funding Considerations

Since the donor receives an income tax and gift tax deduction upon establishing an intentionally defective grantor lead trust, there are additional funding opportunities that would not be as attractive with a non-grantor or grantor lead trust. A donor may have highly appreciated securities they would like to use to fund a lead trust. Unless these securities generate sufficient income to satisfy the lead interest, the trustee will generate significant capital gain tax by selling appreciated securities inside either a non-grantor or a grantor lead trust.

A donor could sell appreciated securities and use the cash proceeds to fund an intentionally defective grantor lead trust. The income tax charitable deduction generated by the funding of the intentionally defective grantor lead trust could offset the capital gain tax on the sale of the securities.

VI. Cases

The basis for the following cases are actual lead trusts derived from interviews with gift planners and estate planning attorneys. All of the estate planning attorneys interviewed reported their client's net worth averaged in excess of $100 million. Two of the attorneys reported creating two lead trusts each in their 40+ years of practice. The third attorney had created between 70 and 80 lead trusts in the last seven years. The three gift planners interviewed had completed seven lead trusts in the last two years.

There is little doubt that inexperience with lead trusts make gift planners and estate planners wary of the vehicle. The more comfortable the advisor or fundraiser is with lead trusts, the more likely the gift is to be completed. The lead trust is a powerful tool for high net worth donors to solve a variety of income tax and estate tax problems.

A. Double deduction lead trust / Super CLT / Intentionally defective CLT:

An important distinction between the grantor lead trust and non-grantor lead trust is that the grantor trust produces an income tax deduction, whereas the non-grantor trust produces a gift tax deduction. The intentionally defective CLT is a planning technique that blends the characteristics of both trusts to generate an income tax charitable deduction **and** a gift tax deduction (see *Intentionally Defective Grantor Trust* above for more discussion).

Mrs. Gomez wants to make a gift of $1,000,000 to her favorite charity. She and her husband have three children ages five, three, and one. Mrs. Gomez sold her technology company in 2008 for millions. She invested the sale proceeds in the stock market at the low point of the Great Recession. She now holds stock with significant appreciation. She sells a stock that generates cash proceeds of $1,000,000 and a capital gain of $669,467.

She funds a double deduction 20-year CLT with a 5% payout funded with the $1,000,000 cash proceeds from the sale of her stock. Because of the drafting of the lead trust, she qualifies for an

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income tax charitable deduction of $833,570, which is the present value of the payments the trust will make to charity. The deduction will save her over $330,094 in income taxes assuming she is in the 43.4% income tax bracket (39.6% plus 3.8% net investment surtax). She also is entitled to a gift tax deduction of $833,570. That means she is making a taxable gift of $166,240 to her children. However, she can use her gift tax exemption to offset the taxes on the gift. Assuming a modest 6% investment return inside the lead trust, the family would receive over $1,400,000 when the trust terminates in 20 years. That is to say, Mrs. Gomez used only $166,240 of gift tax exemption to transfer $1.4 million to her family.

This example assumes the donor contributes cash that the trust invests to generate the $50,000 of income to pay the income interest to charity. If the donor uses appreciated securities to fund the lead trust and the trustee has to sell the securities to generate income, keep in mind that Mrs. Gomez will have to report all of the capital gain realized inside the lead trust on her personal income tax return. Likewise, if the lead trust invests in assets that generate taxable dividends and interest, all of that income will be included on Mrs. Gomez income tax return with no offsetting income tax charitable deduction. Asset selection with this kind of trust is critical.

Also, keep in mind that unlike a non-grantor CLT, the assets in a double deduction lead trust remain part of the grantor's estate during the trust term. Should Mrs. Gomez die prior to the end of the trust's twenty-year term, the assets in the trust at the time of her death will be includable in her estate for estate tax purposes.

	5% Super Grantor Lead Annuity Trust
Principal Placed in Plan	$1,000,000
Annuity to Charity	$50,000
Gift Tax and Income Tax Deduction	$833,570
Taxable Gift	$166,430
Gift Tax (paid 2016 by donor)	$0
Income Tax Savings	$330,094
Total Income Tax Paid Over Term by Donor	$167,380
Benefit to Family	**$1,463,998**
Total Distributed to Charity	**$1,000,000**

B. Step lead trust:

Let’s say that Mrs. Gomez in the first case funds a double deduction CLAT, but the payout begins at 3% of the trust principal. In the first year, the lead trust will distribute 3% of its value or $30,000 to charity. For the first five years following establishment of the trust, the payout to charity increases by 3% a year. In years six through ten the payout increases by 5% a year, in years eleven through fifteen the payout increases by 8% a year, and in years sixteen through twenty the payout increases by 10% a year. By the last year of the trust, the payout is 9.55% of the original $1,000,000. The table below details the growth of the trust principal and payout to charity year by year.

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Year	Principal	Payout	% Annual Increase	Payout %
1	1,030,000	30,000	3%	3.00%
2	1,060,900	30,900	3%	3.09%
3	1,092,727	31,827	3%	3.18%
4	1,125,509	32,782	3%	3.28%
5	1,159,274	33,765	3%	3.38%
6	1,194,052	34,778	5%	3.48%
7	1,229,178	36,517	5%	3.65%
8	1,264,586	38,343	5%	3.83%
9	1,300,201	40,260	5%	4.03%
10	1,335,940	42,273	5%	4.23%
11	1,371,710	44,387	8%	4.44%
12	1,406,074	47,938	8%	4.79%
13	1,438,666	51,773	8%	5.18%
14	1,469,071	55,915	8%	5.59%
15	1,496,828	60,388	8%	6.04%
16	1,521,419	65,219	10%	6.52%
17	1,540,963	71,741	10%	7.17%
18	1,554,506	78,915	10%	7.89%
19	1,560,971	86,806	10%	8.68%
20	1,559,142	95,487	10%	9.55%
Total	**1,559,142**	**1,010,014**		

What is the advantage to Mrs. Gomez of beginning with a low trust payout of 3% and increasing the payout over time? Since the trust payout in the early years is lower than the anticipated investment returns of the trust, the principal has the opportunity to grow. This relieves the pressure on the trustee to realize investment returns that outperform the trust payout every year.

The total amount distributed to charity is nearly the same as the 5% annual payout. Assuming a constant net return of 6% from the trust investments, the benefit to the family increases from $1,463,998 assuming an annual payout of 5% a year to $1,559,142 with the step lead trust. While the increased benefit to the family from the step lead trust is modest, fluctuations in investment returns will tend to have less effect on the amount left for the donor's heirs than on a similar straight 5% CLAT. The income taxes due from this step trust are modestly higher than the straight 5% payout because of the need to sell principal in the later years of the trust.

How is such a trust possible? The annuity amount as described in the Internal Revenue Code does not have to be the same amount each year. It only has to be a fixed payment that may not change during the term of the trust. Mrs. Gomez's trust agreement will specify the schedule of payments described in the table above. Lead trusts are not subject to the minimum 5% payout rule applicable to remainder trusts.

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	Step Super Grantor Lead Annuity Trust
Principal Placed in Plan	$1,000,000
Average Annuity to Charity	$50,501
Gift Tax and Income Tax Deduction	$811,158
Taxable Gift	$188,842
Gift Tax (paid 2016 by donor)	$0
Income Tax Savings	$321,219
Total Income Tax Paid Over Term by Donor	$193,497
Benefit to Family	**$1,559,142**
Total Distributed to Charity	**$1,010,013**

C. Balloon (Shark Fin) Lead Trusts

The step lead trust relies on modest annual increases in the payout that are back-loaded to give the trust principal time to grow. A similar approach is for the lead trust to make token annual distributions to charity with a single balloon payment in the last year of the trust. How can the trust afford the balloon payment? The illustration below assumes average investment returns of 6% per year. The trust makes small payments of only $1,000 for years 1 through 19. The trust invests the principal for growth and since the payments are so small in years 1 through 19, the trust has the opportunity for growth without having to make significant payments to charity. Nonetheless, the trust cannot guarantee even the modest returns illustrated. If the investments fail to perform as expected, there could be insufficient assets to satisfy the balloon payment to charity in year 20 and there could be no remainder left for donor's family.

	Balloon Super Grantor Lead Annuity Trust
Principal Placed in Plan	$1,000,000
Average Annuity to Charity	$50,950
Gift Tax and Income Tax Deduction	$715,885
Taxable Gift	$284,115
Gift Tax (paid in gift year by donor)	$0
Income Tax Savings	$283,491
Total Income Tax Paid Over Term by Donor	$302,299
Benefit to Family	**$2,171,350**
Total Distributed to Charity	**$1,019,000**

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The payment schedule below illustrates the 19 annual $1,000 payments and a $1,000,000 balloon payment:

YR	Principal	Payout to Charity
1	1,059,000	1,000
2	1,121,540	1,000
3	1,187,832	1,000
4	1,258,102	1,000
5	1,332,588	1,000
6	1,411,544	1,000
7	1,495,236	1,000
8	1,583,951	1,000
9	1,677,988	1,000
10	1,777,667	1,000
11	1,883,327	1,000
12	1,995,327	1,000
13	2,114,046	1,000
14	2,239,889	1,000
15	2,373,282	1,000
16	2,514,679	1,000
17	2,664,560	1,000
18	2,823,434	1,000
19	2,991,840	1,000
20	2,171,350	1,000,000
TOT	**2,171,350**	**1,019,000**

D. Leave assets to children in a tax-efficient manner

Mr. Timothy has a $50 million estate. Mr. Timothy is planning his estate and is looking for ways to reduce estate taxes, leave a large portion of the estate to his two children, who are in their 20s, and make charitable gifts to his favorite causes.

Mr. Timothy's attorney proposes contributing $12,500,000 in assets to a limited liability company. Mr. Timothy donates a partial interest in the LLC units to a 10-year double deduction lead annuity trust. The beneficiary of the lead interest is Mr. Timothy's donor advised fund.

Planners often suggest using techniques such as funding a limited liability company, limited partnership, or family limited partnership and then giving a partial interest in the entity instead of giving the underlying assets. By giving partial interests in these business interests, donors may take advantage of valuation discounts for lack of control, lack of marketability,

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and other factors that are associated with the ownership of an asset with restricted rights. Gifts of interests subject to valuation discounts is a widely used planning technique that permits transfers of wealth at reduced transfer tax cost.

The economic benefit of using an asset subject to a valuation discount when funding a CLT is that the discount reduces the initial value of the interest transferred to the trust. The discounted value of the interest drives the calculation of the value of the taxable gift.

Valuation discounts for lack of control or marketability vary widely from as low as 10% and as high as 40%. For purposes of this discussion, assume that the $12,500,000 worth of LLCs units receive a 20% discount to $10,000,000. Therefore, the value of the lead trust used to compute the gift tax deduction in the example below is $10,000,000 even though value of the assets in the trust is $12,500,000.

	5% Super Grantor Lead Annuity Trust
LLC Interests Placed in Plan	$12,500,000
Discounted Value of LLC units	$10,000,000
Annuity to Charity	$500,000
Gift Tax and Income Tax Deduction	$4,538,700
Taxable Gift	$5,461,300
Gift Tax (paid in gift year by donor)	$4,520
Income Tax Savings	$1,797,325
Total Income Tax Paid Over Term by Donor	$837,613
Principal after 10 Years	**$14,147,599**
Total Distributed to Donor Advised Fund	**$5,000,000**

E. Short-term CLAT to pay off campaign pledge

You have solicited Mr. Watson, Chairman of your Board, for a $500,000 capital campaign gift to support a building campaign at your charity. Mr. Watson is prepared to make a gift at this level if he can pay it off in installments over the 5-year period of the campaign.

During discussions about how Mr. Watson might do this, you learn that he is in the process of reviewing his estate plan and how he might pass on assets to his three children, who are all in their 50s.

The examples below assume the trust earns 3% income and 5% appreciation each year.

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Solution #1

One possible solution would be for Mr. Watson to create a non-grantor CLAT with a 5-year term and an annual payment amount of $100,000. Given the brief duration of the trust, a 10% CLAT funded with $1 million should allow more than half of the funding amount to go to his kids.

	10% Non-Grantor Lead Annuity Trust
Gross Principal	$1,000,000
Annuity to Charity	$100,000
Gift Tax Deduction	$474,090
Taxable Gift	$525,910
Gift Tax (paid in gift year by donor)	$0
Principal after 5 Years	$882,668
Benefit to Family	**$882,668**
Total Distributed to Charity	**$500,000**

You learn after further discussion that Mr. Watson's company has had a banner year and he is expecting to receive a very large bonus approaching seven figures this year. Hence, a large income tax deduction may be of particular interest this year.

Solution #2

A possible solution would be for Mr. Watson to create a 10% grantor CLAT with a 5-year term and an annual payment amount of $100,000. A lead trust is a fully taxable trust. In the case of a grantor lead trust, the grantor must pay income and capital gain tax generated by the lead trust. The illustration below assumes the lead trust principal earns 3% annually in interest income. That would generate $62,136 in income taxes to the grantor spread over the 5-year term of the trust. Since the income earned is insufficient to meet the payment to charity, the trust also would have to sell some principal. Even though this trust was funded with cash, it is invested for growth and the donor will pay some capital gain tax on the sale of principal to meet the charitable payout.

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	10% Grantor Lead Annuity Trust
Gross Principal	$1,000,000
Annuity to Charity	$100,000
Income Tax Deduction	**$474,090**
Income Tax Savings	**$187,740**
Total Ordinary Income Tax Paid by Donor	$62,136
Total Capital Gain Tax Paid by Donor	$11,446
Principal returned to Donor	**$882,668**
Total Distributed to Donor	**$500,000**

Solution #3

Mr. Watson can realize his income tax savings goal and pass wealth to his children using the double deduction or super grantor lead trust. Once again, this is a grantor trust, therefore he will owe tax on the ordinary income earned by the trust and the capital gain realized as in the solution above.

	10% Super Grantor Lead Annuity Trust
Principal Placed in Plan	$1,000,000
Annuity to Charity	$100,000
Gift Tax and Income Tax Deduction	**$474,090**
Taxable Gift	$525,910
Gift Tax (paid in gift year by donor)	$0
Income Tax Savings	**$187,740**
Total Ordinary Income Tax Paid by Donor	*$62,136*
Total Capital Gain Tax Paid by Donor	*$11,446*
Benefit to Family	**$882,668**
Total Distributed to Charity	**$500,000**

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VI. Conclusion

The charitable lead trust is a powerful charitable planning tool that can be effectively adapted to fulfill a variety of donor objectives, but it must be carefully and prudently drafted, administered, and invested to ensure the desired outcome. Under the right circumstances, a charitable lead trust can provide dramatic tax benefits to the donor and impressive financial support to charity at the same time. It can take just one charitable lead trust to make a year or more of effort worthwhile. Moreover, with the IRS discount rates below 2%, this is an especially advantageous time to encourage lead annuity trust gifts.

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Appendix

How the Waltons Got So Wealthy

Andrea Spiegel
Clare O'Connor
Forbes Staff

http://www.forbes.com/sites/clareoconnor/2014/06/03/report-walmarts-billionaire-waltons-give-almost-none-of-own-cash-to-family-foundation/

Report: Walmart's Billionaire Waltons Give Almost None of Own Cash to Foundation

The Walton family is America's richest, worth some $140 billion between them and longtime fixtures of the Forbes 400 list thanks to their approximate 50% ownership of Walmart, the world's largest retailer.

Their Walton Family Foundation, established by the late Sam and Helen Walton in 1988, is considered a heavyweight in the world of nonprofits with just under $2 billion in assets.

In 2013 alone, the Foundation invested $325 million across three key areas: education reform, the environment and the family's home region of northwest Arkansas. One of the Foundation's major recipients has been Alice Walton's stunning Crystal Bridges Museum of American Art, funded to the tune of $1.2 billion.

However, almost none of this largesse is the result of donations from the Waltons themselves, according to a report released on Tuesday by Walmart 1 Percent, a project of union-backed Making Change at Walmart.

Says the study, which can be viewed in full here: http://www.scribd.com/doc/227917109/Walmart-1-Percent-Report

The central finding of this report is simple: Our analysis of 23 years' worth of the Walton Family Foundation's tax returns shows that Rob, Jim, Alice and Christy Walton—the second generation Walmart heirs—have contributed almost none of their personal fortune to the foundation which bears their family name.

Specifically:

- Rob and Alice Walton made zero individual contributions to the Foundation during the 23 years we examined;

- Jim Walton made a single personal contribution of $3 million to the Walton Family Foundation, more than 15 years ago;

- Rob, Jim, and Alice Walton and the family holding company they control (Walton Enterprises) have been responsible for only .13% of all contributions to the Walton Family Foundation ($6.4 million);

- Among the second generation Walton heirs, it is the in-law, Christy, who has been responsible for the largest share of contributions to the Foundation;

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- The four Walmart heirs and Walton Enterprises combined have been responsible for only 1.2% of all contributions to the Walton Family Foundation.

The combined lifetime contributions of the second generation Walmart heirs and their family holding company to the Walton Family Foundation come to $58.49 million, or:

■■ About .04% of the Waltons' net worth of $139.9 billion;

■■ About .34% of the estimated $17.1 Billion in Walmart dividends that Rob, Jim, Alice and Christy received during the years we analyzed;

■■ Less than one week's worth of the Walmart dividends the Waltons will receive this year;

■■ Less than the estimated value of Rob Walton's collection of vintage sports cars.

The report goes on to detail how the Foundation has been funded over the years, namely by tax-avoiding trusts established with assets provided by the late Sam, Helen and John Walton or their estates. The study found that 99% of the Foundation's contributions since 2008 have been channeled through 21 Charitable Lead Annuity Trusts. These CLATs, as they're known, are specifically designed to help ultra-wealthy families avoid estate and gift taxes.

While using foundations to thwart the tax man is nothing new for the very rich, Walmart 1 Percent describes the family's philanthropic activities as less a tax dodge and more another "outpost in the vast Walton family business empire":

"The Walmart heirs have built one of the largest and most powerful private foundations in the country—at almost no cost to themselves. They have done so with the assistance of financial experts who manage the family holding company, Walton Enterprises, and the Walton Family Foundation with a keen eye toward maximizing the family's wealth. In addition, the Waltons are exploiting complex loopholes in the tax code in order to avoid billions of dollars in estate taxes by funding their Foundation with special trusts."

This table below illustrates how the Waltons have "gamed the system," in the words of Walmart 1 Percent:

The report goes on to compare the Walton family's philanthropic activities to both those of other billionaires and the charitable donations of average Americans. Walmart 1 Percent finds the Waltons "far less generous" than other wealthy philanthropists and everyday donors alike.

Whereas Bill Gates and Warren Buffett have given 36.2% and 26.9% of their respective wealth to charitable causes, the Walmart heirs have between them given 0.04% of their fortune, per the report.

Meanwhile, the average middle class earner with a salary of $50,000 to $99,000 contributes 6% of their discretionary income to charity, says the report, basing this figure on data from The Chronicle of Philanthropy.

The team behind the analysis is aware of the limitations of their data, namely that the Waltons may well "make charitable contributions to entities other than the Walton Family Foundation." However, the group "did not find evidence of major, sustained giving by the Waltons to charitable organizations" other than their foundation.

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A representative of the Walton Family Foundation reviewed the report and provided the following statement to Forbes:

"Since 1987, the Walton family has contributed more than $5 billion to charitable organizations and causes. Family members living and deceased have provided generously for the foundation. The family has planned for the continued growth of the foundation and intends for grant making to progressively increase over time."

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