Lead Trusts: What To Do and Not To Do

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Time: 1:00 – 2:30 Eastern Time

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Agenda

- CLT characteristics
- CLTs and the IRS discount rate
- CLTs and taxes
- Funding considerations
- Donor profile
- Cases

Lead Trust Statistics

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

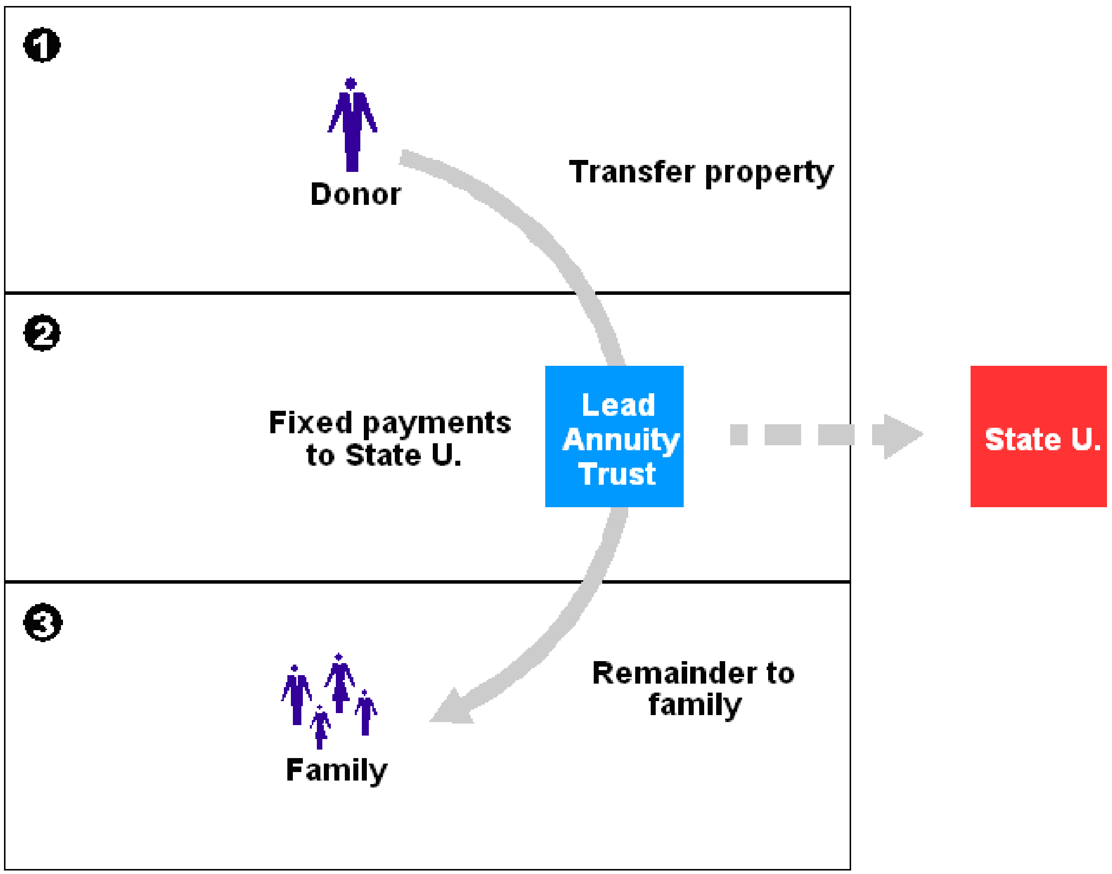
Item	Total	Size of end-of-year book value of total assets (in $1,000s)				
		Under $500,000	$500,000 under $1,000,000	$1,000,000 under $3,000,000	$3,000,000 under $10,000,000	$10,000,000 or more
	(1)	(2)	(3)	(4)	(5)	(6)
CLT Number of returns	6,498	2,658	1,406	1,353	757	324
Change from 2011	-1.798%	-7.193%	-2.089%	3.599%	7.224%	6.230%
CLT Total net assets	23,705,416	413,545	995,305	2,266,958	4,048,280	15,981,328

Lead Trust Statistics

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

	All Trusts		**CRTs**		**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**

How A Non-Grantor CLT Works



Who Is The Lead Trust Donor?

- Net worth well in excess of gift and estate tax exemption
  - $15 million? $30 million? $60 million?
- Younger donors
  - 30's entrepreneurs, hedge fund, Wall Street
  - 50's and 60's with cash events
- Own assets expected to appreciate exceptionally

Types of Charitable Lead Trusts

- Qualified CLTs
  - CLATs
  - CLUTs
  - Grantor
  - Non-Grantor
- Non-Qualified CLTs

Qualified CLTs

- Irrevocable
- *Inter vivos* or testamentary
- Annuity trust or unitrust
  - No net income or flip allowed
- Permissible durations
- Permissible beneficiaries
  - Trust remainder can go into another trust!

Qualified CLTs (cont.)

- Trust additions
- Private foundation rules
- Sample IRS agreements
  - Inter vivos and testamentary CLATs
  - Inter vivos and testamentary CLUs
- Knowledgeable attorney should draft trust

Basics of Gift and Estate Taxation

- American Taxpayer Relief Act (ATRA) 1/1/2013
  - Set top estate, gift, and generation skipping tax rate at 40%
  - Increased estate, gift, and generation skipping tax exemption amounts and indexed for inflation
  - In 2016 exemption amount is $5,450,000 per person and $10,900,000 for married couple
  - Estate tax returns down 74% since 2005

Effect of 1.4% AFR on CLAT Deductions

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%

Effect of AFR on CLAT Deductions

20-year term

IRS Discount Rate	Deduction % for 5% CLAT	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%

Effect of AFR on CLUT Deductions

20-year term

IRS Discount Rate	Deduction % for 5% CLUT	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

Tax Benefits of CLTs

- *Inter vivos*
  - Gift tax deduction
  - Asset growth escapes all gift/estate tax
  - Reduce/eliminate generation skipping tax
- Testamentary
  - Estate tax deduction
  - Reduce/eliminate generation skipping tax

Generation Skipping Tax and CLTs

- Definition of “skip person”
- Lifetime GST exclusion = FET exclusion
- Paid by trustee at termination
- Inclusion ratio
- GST = IR x top estate tax rate x end value

GST Treatment Differs Between CLTs

- CLUTs: inclusion ratio determined *up front*
  - 1 – (allocated GST exemption / taxable gift)
  - Can allocate exemption precisely
- CLATs: inclusion ratio determined *at end*
  - (End value – GST adjusted exemption) / end value
  - Likely will under-allocate or over-allocate exemption
- Planners favor CLUTs when GST applies

Income Taxation of Non-Grantor CLTs

- CLTs are taxable trusts
- 100% deduction for payments to charity
- CLT distributes income to charity in same proportion as it is earned
- Excess income taxed at trust rates
  - Trust rate is 39.6% on taxable income > $12,400
  - Married rate is 39.6% on taxable income > $466,950

Cap. Gain Taxation of Non-Grantor CLTs

- CLT inherits cost basis of donor
  - Adjustment for gift tax paid
- CLT pays capital gains tax on realized gain in excess of charitable distribution
- CLT remaindermen inherit cost basis of CLT

Grantor Lead Trusts

- Differences with non-grantor trusts
- Acceleration of income tax deduction
- Income and capital gain realized in trust taxable to donor
- Recapture
  - Triggered if donor dies before lead trust ends
  - Equals income tax deduction less discounted value of amounts paid to the charity.

Intentionally Defective Grantor Lead Trust

- Also known as Super CLT or Double Deduction CLT
- Generates both income tax and estate tax deduction
- Special drafting by experienced professional critical
- Income and capital gain taxable to donor

Intentionally Defective Grantor Lead Trust

- Dangers!!!!!!
- Lead trust income taxable to donor
- Recapture of income and estate tax benefits upon death of donor during lead trust term
  - Triggered if donor dies before lead trust ends
  - Equals income tax deduction less discounted value of amounts already paid to the charity
  - If not properly drafted, could also be included in donor's estate

Possible Funding Assets

- Cash and/or publicly traded securities
- Closely-held stock
- Family business
- Considerations
  - Sufficient income or liquidity to make payments to charity
  - Self-dealing
  - Excess business holdings

Case Study A: Mrs. Gomez

Situation:

- Wealthy- Assets north of $30M
- Children ages 5, 3, and 1
- $1M gift to charity
- Sold company, assets with significant appreciation
- Lead trust with appreciated assets subject to tax

Case Study A: Mrs. Gomez

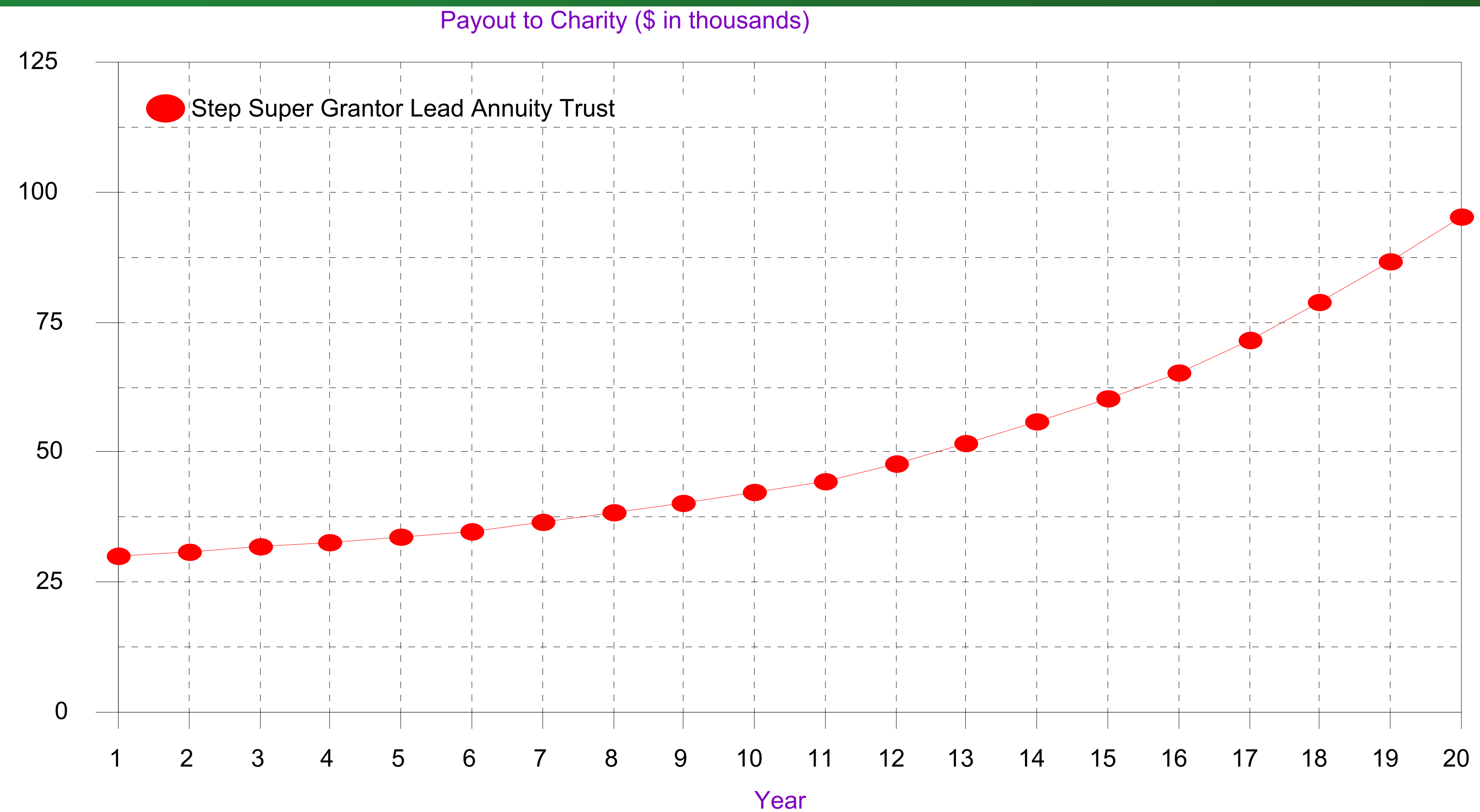
Solution:

- Sell appreciated stock and incur capital gain
- Fund 5% super CLT with $1M cash
- $833,570 gift tax <u>and</u> income tax deduction (83% discount!)
- Income tax savings of $330,094 to offset capital gain
- 2% income, 4% appreciation, $167,380 tax due from donor
- Benefit to charity = $1,000,000
- Benefit to kids = $1,463,998 (at cost of $166,430 exemption)

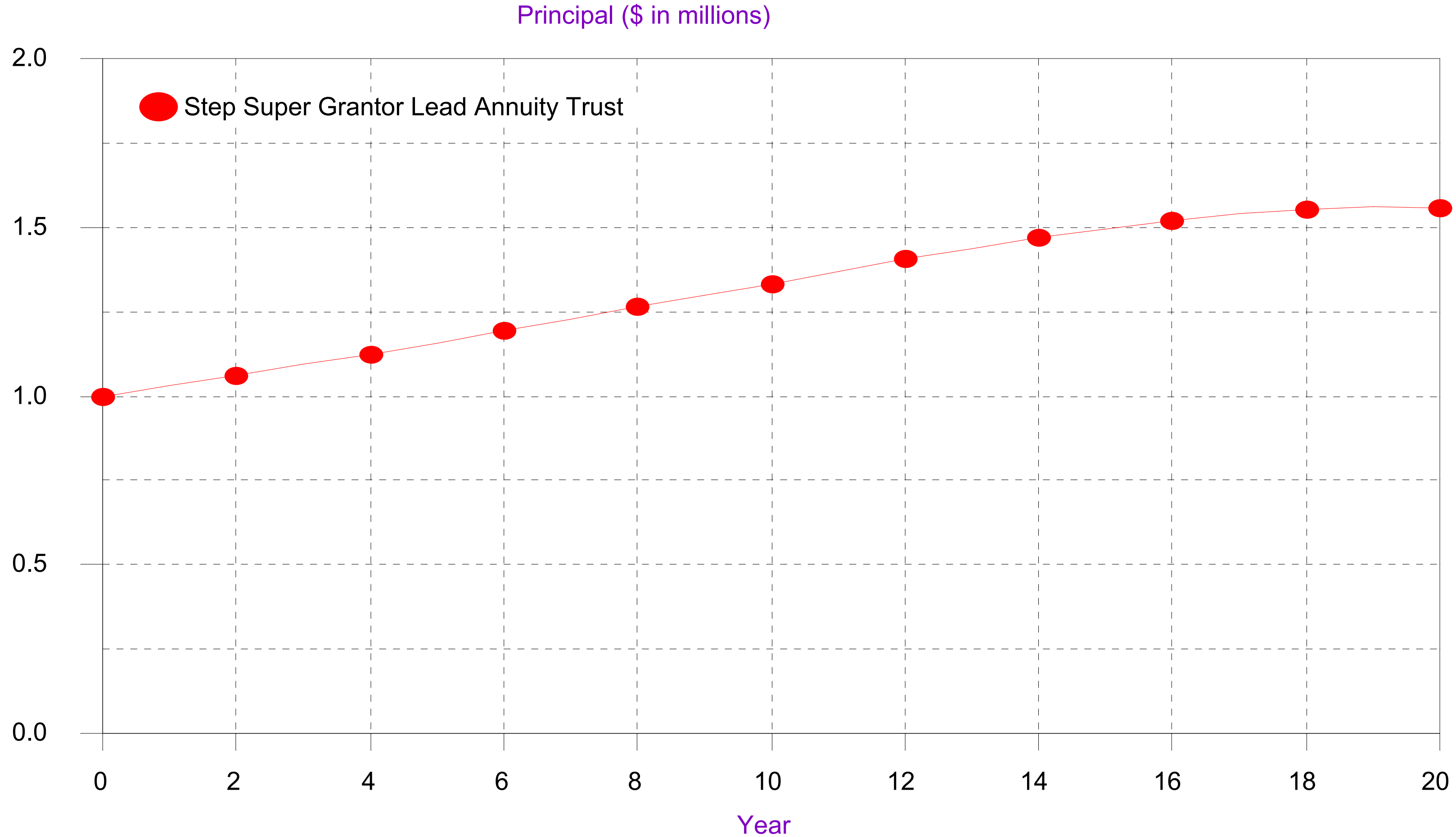
Case Study B: Mrs. Gomez/ Step lead trust

- Step Lead Trust - Same facts as above
  - IRC only requires annuity amount be subject to a fixed schedule that does not change during term
- **Example:**
  - $1,000,000 principal/20 year term
  - 3% initial payout
  - Increases in 5 year increments by 3%, 5%, 8%, 10%
  - Benefit to charity $1,010,000
  - **Benefit to family $1,559,142**

Case Study B: Mrs. Gomez/ Step lead trust



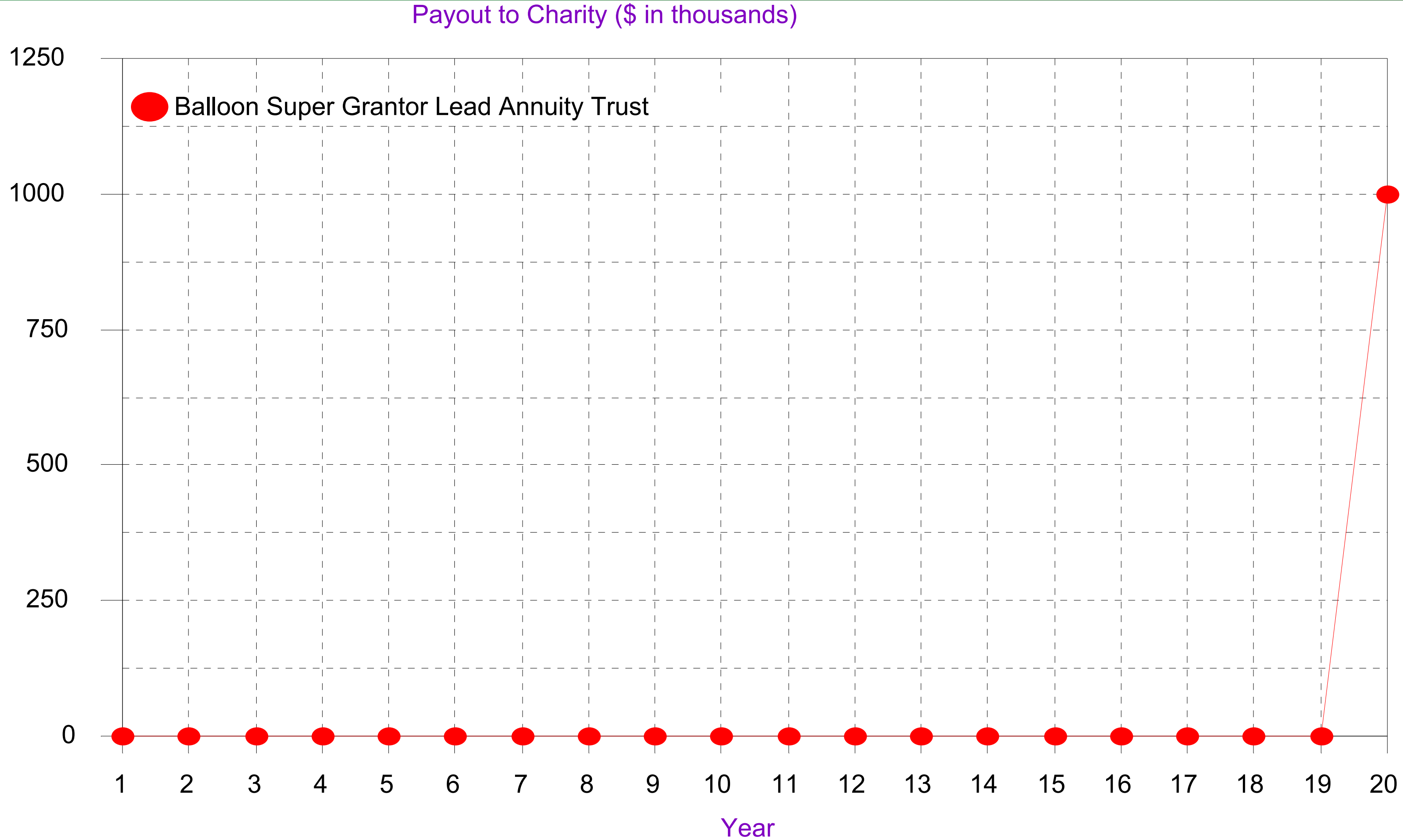
Case Study B: Mrs. Gomez/ Step lead trust



Case Study C: Mrs. Gomez/ Shark fin trust

- Shark Fin Trust
  - Trust makes small payments in years 1 to 19
  - In year 20, makes balloon payment to charity
- **Example:**
  - $1,000,000 principal/20 year term
  - $1,000 a year for years 1 to 19
  - $1,000,000 balloon payment in year 20
  - Benefit to charity $1,000,000
  - **Benefit to family $2,171,350**

Case Study C: Mrs. Gomez/ Shark fin trust



Case Study D: Mr. Timothy

Mr. Timothy

- $50M estate
- Owns $12.5M assets in a Limited Liability Company
- Value of LLC discounted 20% to $10M due to lack of majority or control
- 5% 10-year term Super CLAT with LLC assets
- Charitable distribution goes to Mr. Timothy's donor advised fund

Case Study D: Mr. Timothy

- For gift tax purposes, assets valued at $10M
- Market value of assets is $12.5M
  - Uses entire $5.45M exemption to offset transfer tax
- Assets grow at 6% for 10 years
- Distributions to donors DAF $5M
- Family receives $14.1M in 10 years
  - Cost of $14M gift was $5.45!!

Case Study E: Mr. Watson

- Objectives:
  - Make $500,000 gift to charity,
  - Transfer wealth to children, ***and/or***
  - Offset considerable income tax bill
- Three solutions
  - Non-grantor CLAT to benefit children
  - Grantor CLAT to benefit donor
  - Super CLT to benefit donor **and** family

Case Study E: Mr. Watson

Solution 1: Assets to Children (Non-Grantor Trust)

- 5-year, $1 million 10% Non-Grantor CLAT
- Funded with cash
- Donor earns gift tax deduction
- Assets removed from donor's estate
- All trust income and capital gain taxable to trust
- Income and capital gain tax offset by distributions to charity

Case Study E: Mr. Watson

Solution 1: (Non-Grantor Trust)

- Gift Tax Deduction $474,090
- Exemption used $525,910
- Income and capital gain tax paid by trust
- Principal for Family $882,668
  - Assets passed at 50% discount
- Total to Charity $500,000

Case Study E: Mr. Watson

Solution 2: (Grantor Trust)

- 5-year, $1 million 10% Grantor CLAT
- Funded with cash
- Donor earns income tax deduction
- 30%/20% AGI limit, 5-year carry forward
- Assets remain in donor's estate
- All trust income and capital gain taxable to donor

Case Study E: Mr. Watson

Solution 2: (Grantor Trust)

• Income Tax Deduction	$474,090
• Income tax savings @ 43.4%	$187,740
• Ord. income tax paid by donor	$62,136
• Cap. gain tax paid by donor	$11,446
• Principal Returned to Donor	$882,668
• Total to Charity	$500,000

Questions and Answers

Still Have a Question?

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