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Lead Trusts: What To Do and Not To Do



Date: July 28, 2016
 Time: 1:00 – 2:30 Eastern Time
 Presenter: Jeff Lydenberg
 Vice President, Consulting
 PG Calc Incorporated




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Agenda

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

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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

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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

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How A Non-Grantor CLT Works

The diagram illustrates the process in three steps: 1. A Donor transfers property to a Lead Annuity Trust. 2. The Lead Annuity Trust makes fixed payments to State U. 3. The remainder of the property is distributed to the family.


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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


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Types of Charitable Lead Trusts

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

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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!

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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

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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%

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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

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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


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Generation Skipping Tax and CLTs

- Definition of "skip person"
- Lifetime GST exclusion = FET exclusion
- Paid by trustee at termination
- Inclusion ratio
- $GST = IR \times \text{top estate tax rate} \times \text{end value}$


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GST Treatment Differs Between CLTs

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


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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


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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


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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.


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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


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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


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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

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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

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Case Study A: Mrs. Gomez

Solution:

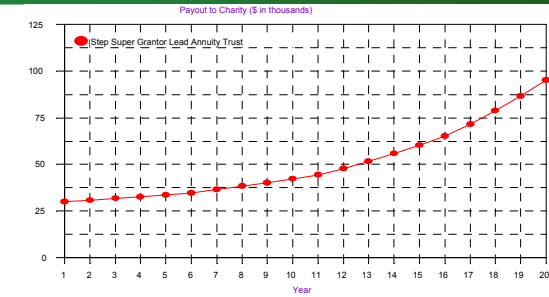
- Sell appreciated stock and incur capital gain
- Fund 5% super CLT with \$1M cash
- \$833,570 gift tax and income tax deduction (83% discount!)
- Income tax savings of \$330,094 to offset capital gain
- 2% income, 4% appreciation, \$167,380 tax due from donor
- Benefit to charity = \$1,000,000
- Benefit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

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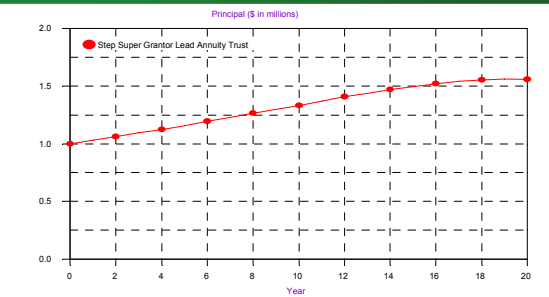
Case Study B: Mrs. Gomez/ Step lead trust

- 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

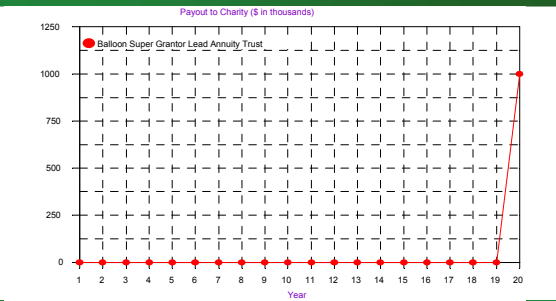


Case Study C: Mrs. Gomez/ Shark fin trust



- 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


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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

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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

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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

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Questions and Answers



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Still Have a Question?

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