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Lead Trusts: No Time Like the Present



Date: January 28, 2021
Time: 1:00 – 2:30 Eastern
Presenter: Bill Laskin
Vice President,
Product Management
PG Calc



Agenda

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



Lead Trust Statistics

Lead 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
CLT Number of returns	6,498	2,658	1,406	1,353	757	324
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
 [Estimates based on samples—money amounts are in thousands of dollars]

	All Trusts		CRTs		CLTs		PIFs	
	Num	Amount	Num	Amount	Num	Amount	Num	Amount
Total	27,992	\$3,065,001	10,084	\$1,905,209	17,348	\$1,119,219	561	\$40,573



How a Lead Trust Works





Types of Charitable Lead Trusts

- Qualified CLTs
 - ✓ CLATs – pay fixed amount to charity
 - ✓ CLUTs – pay fixed % of value to charity
 - ✓ Grantor – donor is owner of trust assets
 - ✓ Non-Grantor – trust is owner of trust assets
- Non-Qualified CLTs



Characteristics of Qualified CLTs

- Irrevocable
- *Inter vivos* or testamentary
- Annuity trust or unitrust
 - ✓ No net income or flip provision allowed
 - ✓ No lower or upper % limit on payout
- Permissible durations
 - ✓ Typically, a fixed term; no 20-year limit
 - ✓ Life of lineal relations to donor



Characteristics of Qualified CLTs

- Permissible beneficiaries
 - ✓ Individuals, typically children (non-grantor)
 - ✓ Another trust (non-grantor)
 - ✓ Donor (grantor)
- Trust additions
 - ✓ CLUT = yes, CLAT = no
- Private foundation rules
 - ✓ No self-dealing, taxable expenditures
 - ✓ If lead interest > 60%, no excess business holdings



Characteristics of Qualified CLTs

- Sample IRS agreements – Rev. Procs 2007-45/46 and 2008-45/46
 - ✓ Inter vivos and testamentary CLATs
 - ✓ Inter vivos and testamentary CLUs
- Knowledgeable attorney should draft trust



Non-Grantor Lead Trust Offers Double Leverage

Non-grantor charitable lead trust

1. Generous gift tax deduction in year lead trust created (CLAT)
 2. Growth within CLT escapes all transfer tax
- CLT pays tax on income in excess of payments to charity
 - ✓ Character of income taxed proportional to income earned
 - CLT inherits donor's basis, remaindermen inherit CLT's basis
 - If grandchildren, GST applies; GST planning much easier with CLUT than CLAT



Federal Gift and Estate Tax Basics

- Federal gift and estate are unified
- Gift and estate tax rate is 40%
- Lifetime exemption is \$11.7 million in 2021
 - ✓ Indexed for inflation
 - ✓ Portability means \$23.4 million for a married couple
 - ✓ About 0.1% of estates pay federal estate tax
- Exemption scheduled to decrease by ~half in 2026
 - ✓ Biden has proposed decrease to \$3.5 million (2009 level)



Federal Gift and Estate Tax Example

- \$800,000 gift in 2000. Paid \$47,250 gift tax
- \$15 million estate settled in 2021

Estate in 2021	\$15,000,000
Prior taxable gifts	+ <u>\$800,000</u>
Taxable estate	\$15,800,000
Tentative tax (2021 estate tax table)	\$6,265,800
Less 2021 estate tax credit	- \$4,625,800
and prior gift tax paid	- <u>\$47,250</u>
Estate tax paid 2021	\$1,592,750



Elements that Affect CLT Deduction

-) Funding amount
-) Term length
-) Lead trust type
-) Payment %
-) Payment frequency
-) Payment timing
-) **IRS discount rate**
 - ✓ **Extremely low = extremely high CLAT deductions**



Effect of AFR on CLAT Deduction

20-year CLAT

IRS Discount Rate	Deduction % for 5% CLAT	100% Deduction Payout Rate
0.6%	94.0%	5.32%
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 CLAT Deduction

CLAT: Percent of Contribution Deductible @ 0.6%

Payout Rate	Trust Term in Years			
	10	15	20	25
5%	48%	72%	94%	100%
6%	58%	86%	100%	100%
7%	68%	100%	100%	100%
8%	77%	100%	100%	100%
9%	87%	100%	100%	100%
10%	97%	100%	100%	100%
11%	100%	100%	100%	100%



Effect of AFR on CLUT Deduction

20-year CLUT

IRS Discount Rate	Deduction % for 5% CLAT	100% Deduction Payout Rate
0.6%	63.9%	n/a
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



Donor Profile – Non-Grantor CLT

- Net worth in excess of gift and estate tax exemption
 - ✓ \$15 million? \$30 million? \$60 million?
- Goals
 - ✓ Pass assets to heirs at low tax cost and give to charity
- Typical donor ages
 - ✓ 30s – 50s: entrepreneurs, hedge fund, Wall Street
 - ✓ 60s +: accumulated wealth to pass to kids/grandkids
- Own assets expected to appreciate exceptionally



Non-Grantor CLAT Example

- Mr. Timothy: \$10 million estate
 - ✓ Leave portion of estate to two children in their 20s
 - ✓ Make charitable gifts
- Solution: \$2 million 20-year CLAT
 - ✓ Set payout rate to earn 100% deduction: 5.321%
 - ✓ Assume 3% income, 5% appreciation
 - CLAT benefit to heirs depends on investment performance
 - ✓ IRS discount rate = 0.6%



Standard CLAT Example

If 2017 exemption amount applies:

	5.321% Non-Grantor Lead Annuity Trust	No Trust
Estate Tax on No Trust (paid 2041)		\$2,968,677
Benefit to Family (ending principal less taxes)	\$4,440,183	\$4,453,015
Total Distributed to CHARITY	\$2,128,400	\$0
Total Benefit	\$6,568,583	\$4,453,015

- Leverage: 166:1



Standard CLAT Example

If current exemption amount applies:

	5.321% Non-Grantor Lead Annuity Trust	No Trust
Estate Tax on No Trust (paid 2041)		\$1,488,677
Benefit to Family (ending principal less taxes)	\$4,440,183	\$5,933,015
Total Distributed to CHARITY	\$2,128,400	\$0
Total Benefit	\$6,568,583	\$5,933,015

- Leverage: 1.43:1



Standard CLAT Example

If current exemption amount applies and estate = \$20 million:

	5.321% Non-Grantor Lead Annuity Trust	No Trust
Estate Tax on No Trust (paid 2041)		\$2,968,677
Benefit to Family (ending principal less taxes)	\$4,440,183	\$4,453,015
Total Distributed to CHARITY	\$2,128,400	\$0
Total Benefit	\$6,568,583	\$4,453,015

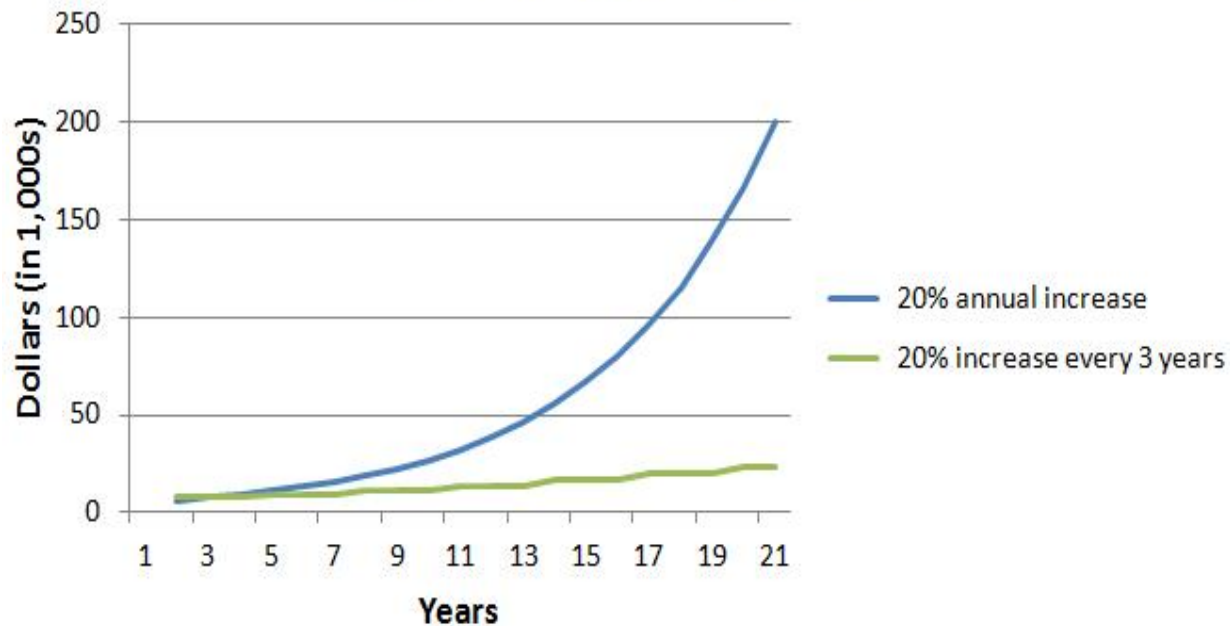
- Leverage: 166:1



Step Lead Annuity Trust

- CLAT payments can increase over time – “step” lead trust (see Rev. Proc. 2007-45)

Step Lead Trust Payments





Step Lead Trust Options

- Step lead trust protects trust value in early years.
 - ✓ Appealing to donors worried about investment performance in near term
 - ✓ In some situations, can be used to pass value of closely-held business to heirs
 - Dividends in early years can accumulate and be used to make payments to charity in later years
 - Can minimize taxes by reducing closely-held stock gradually
 - Pass growth in value tax-free
 - Beware of rule against excess business holdings



Step Lead Trust Example

If current exemption amount applies:

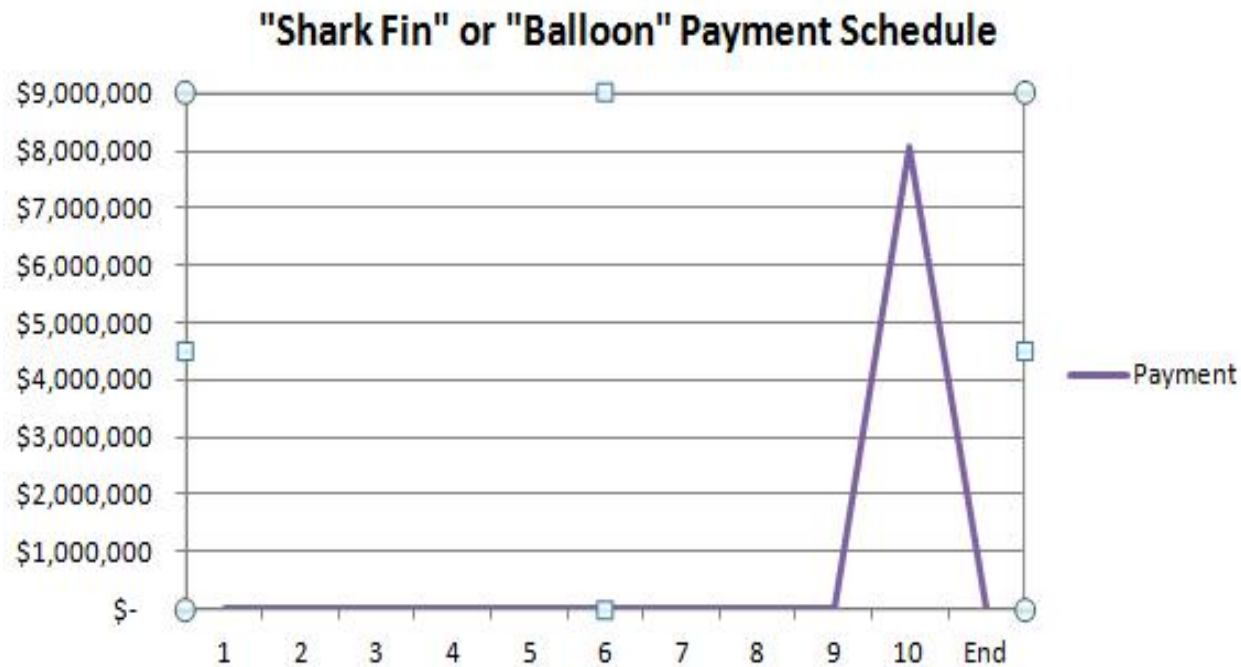
	Step Lead Annuity Trust	No Trust
Benefit to Family (ending principal less taxes)	\$5,399,539	\$5,933,015
Total Distributed to CHARITY	\$2,194,028	\$0
Total Benefit	\$7,593,567	\$5,933,015

- Leverage: 4.11:1 (compare to 1.43:1)



“Shark Fin” Lead Trust

- “Shark fin” trust - extreme form of step lead trust
 - ✓ Makes minimal payments until final year, then one very large payment





“Shark Fin” Lead Trust

- “Shark fin” trust can be used in same situations as step lead trust
 - ✓ Give assets maximum time to grow before significant payment to charity
 - ✓ Can time sale of closely-held stock to coincide with year of balloon payment – shelter large capital gain



“Shark Fin” Lead Trust Example

If current exemption amount applies:

	Shark Fin Lead Annuity Trust	No Trust
Benefit to Family (ending principal less taxes)	\$5,335,355	\$5,933,015
Total Distributed to CHARITY	\$2,253,033	\$0
Total Benefit	\$7,588,358	\$5,933,015

- Leverage: 3.77:1 (compare to 1.43:1)



Grantor CLT to Pay Pledge

- Grantor lead trust
 - ✓ Donor earns income tax deduction for present value of lead trust payments
 - ✓ Deduction limited to 30% of donor's AGI, whether funded with cash or long-term capital gain ("for the use of," not "to")
 - ✓ Deduction limited to 20% when funded with ltcg and payments go to private non-operating foundation
 - ✓ All income earned during trust term is taxable to donor
 - ✓ Remaining assets returned to donor (grantor) at end of trust term



Donor Profile – Grantor CLT

- Top federal income tax bracket
- Enough wealth to “loan” gift asset for trust duration
- Goals
 - ✓ Offset income in specific year and gift to charity
 - ✓ Fulfill multi-year pledge
- Donors of wide age range
 - ✓ Significant cash event – sell business, big bonus, stock sale
 - ✓ Major gift donors



Grantor CLT to Pay Pledge

- Mr. Watson solicited for \$500,000 campaign gift
- Willing to make pledge of \$100,000/yr x 5 years
- Wants income tax deduction
- Solution:
 - ✓ \$1 million grantor 5-year CLAT paying 10%



Option #1: Grantor CLT to Pay Pledge

Mr. Watson wants to fulfill pledge and receive income tax deduction in year of gift

Funding amount in February 2021	\$1,000,000
Annuity to Charity	\$100,000
Income Tax Deduction	\$491,120
Income Tax Savings (37% bracket)	\$181,714
Total Income Tax Paid by Donor	\$69,994
Principal Returned to Donor ⁽¹⁾	\$882,668
Total Distributed to Charity	\$500,000

⁽¹⁾ Assumes an investment return of 3% income and 5% appreciation.



Option #2: Non-Grantor CLT to Pay Pledge

- Mr. Watson wants to fulfill pledge and transfer assets to children

Funding amount in February 2021	\$1,000,000
Annuity to Charity	\$100,000
Gift Tax Deduction	\$491,120
Taxable Gift	\$508,880
Gift Tax	\$0
Principal to Family ⁽¹⁾	\$882,668
Total Distributed to Charity	\$500,000

(1) Assumes an investment return of 3% income and 5% appreciation.



“Super” Grantor CLT

- Defective grantor lead trust, aka Super Grantor Lead Trust
 - ✓ Grantor trust for income tax purposes, non-grantor trust for transfer tax purposes
 - ✓ Donor earns gift tax deduction and income tax deduction for present value of lead trust payments
 - ✓ All income earned during trust term is taxable to donor
 - ✓ Remaining assets go to heirs at end of trust term; all growth inside trust is tax-free
 - ✓ Various ways to achieve, none without some risk



Option #3: "Super" Grantor CLT to Pay Pledge

- Mr. Watson wants to fulfill pledge, get income tax deduction, and transfer assets to children

Funding amount in February 2021	\$1,000,000
Annuity to Charity	\$100,000
Gift Tax and Income Tax Deductions	\$491,120
Taxable Gift	\$508,880
Gift Tax	\$0
Income Tax Savings (37% bracket)	\$181,714
Total Income Tax Paid by Donor	\$69,994
Principal to Family ⁽¹⁾	\$882,668
Total Distributed to Charity	\$500,000

(1) Assumes an investment return of 3% income and 5% appreciation.



Conclusion

- **Non-grantor CLTs:** tax-efficient way for wealthy donors to make big charitable gifts and transfer assets to heirs
- **Grantor CLTs:** an attractive way for major donors to fulfill a pledge
- **Extremely low IRS discount rate:** makes CLATs especially attractive right now
- **Possible reduced estate tax exemption / increased estate tax rate:** could motivate lead trust donors to act in 2021



Questions?





Still Have a Question?

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