CHARITABLE LEAD TRUSTS

A charitable lead trust is an estate planning technique which enables a person to transfer property to younger family members at a substantially reduced transfer cost while providing a designated amount to be distributed to one or more charitable organizations for a specific number of years, or over the lifetime of the Grantor or a designated family member.

A. Typical Transaction

The Grantor transfers income producing property to an irrevocable trust and designates a charity to receive a specified amount for a term of years or over a designated lifetime. Generally, the amount paid to charity is consistent with the amounts that would be paid absent the creation of the trust. After the specified terms of years has expired, the property is distributed to, or held in trust for, family member beneficiaries.

B. Benefits of Charitable Lead Trusts

1. Gift Valued at Substantial Discount

The value of the taxable gift is equal to the value of the remainder interest that is designated to go to family remainder beneficiaries. The amount of the discount primarily depends upon the trust term and the amount of the income stream designated for the charity.

2. Removes Future Appreciation from Grantor's Estate

The amount of the taxable gift is computed based on the value of the property transferred to the lead trust. All subsequent appreciation in value avoids gift and estate tax.

3. Leverage of Generation-Skipping Transfer Tax (GST) Exemption

For a charitable lead unitrust (as opposed to charitable lead annuity trust) it is only necessary to allocate an amount of the GST exemption amount equal to the value of the remainder interest in the trust that passes to family members. Therefore, if a charitable lead unitrust is used, the Grantor can leverage his or her generation-skipping transfer tax (GST) exemption.

4. Gift Valuation Not Based Upon Subjective Discount Valuation

Unlike discounts based upon marketability and minority interest, which are subject to IRS attack, valuation discounts obtained by charitable lead trusts are determined by using actuarial tables published by the IRS.

C. Example

Facts:
Age of Grantor 55 55
Value of securities transferred to trust $500,000 $500,000
Trust provisions:
Type of lead trust annuity trust annuity trust
Term 10 years 20 years
Annual annuity paid to charity (8%) $40,000 $40,000
Remainder beneficiaries - e.g. children (@ 10% income and growth) $660,000 $1,072,000

Result:
Valuation discount (Gift tax charitable deduction) 58.33% 90.28%
Value of gift (assuming 6.2% applicable federal rate) $208,368 $48,500

D. Tax Consequences

1. Income Tax Consequences

a. The Grantor does not receive an income tax charitable deduction upon a transfer of property to such a lead trust; and the Grantor does not receive an income tax charitable deduction when the charitable lead trust makes the annual unitrust or annuity payment to the charity.

b. The income generated from the property transferred to the charitable lead trust is not included in the donor's taxable income.

c. Unlike charitable remainder trusts, charitable lead trusts are not tax-exempt entities. Income earned by the property transferred to the lead trust is taxable to the lead trust. However, the trust receives an income tax charitable deduction for the amounts paid to the charity.

2. Gift Tax Consequences

The Grantor has made a gift of the property transferred into trust but the value of the gift, for transfer tax purposes, may be only a fraction of the fair market value of the property. The amount of the gift for transfer tax purposes is the fair market value of the property which will ultimately go to the family beneficiaries, i.e. the value of the property transferred reduced by the discounted present value of the stream of payments to be made to charity throughout the duration of the trust. The longer the income interest the smaller the value of the gift.

a. Generally, no gift tax will be payable although a portion of the Grantor's unified estate and gift tax credit will be used.

b. The gift takes place at the time the property is transferred into trust. No further gift occurs when the property is distributed to the family member beneficiaries, regardless of any increase in value of the property at that time.

c. The gift that results from the transfer of property to a charitable lead trust does not qualify for the annual gift tax exclusion.

3. Estate Tax Consequences

The entire value of the property transferred to the charitable lead trust, including any appreciation on such property, will be excluded from the Grantor's estate at death.

E. Specific Situations When Charitable Lead Trust is Advantageous

1. Charitable Intentions

A lifetime charitable lead trust is particularly appropriate when the client is already making continuing and regular contributions to charity. In that event, a charitable lead trust will not require any additional contributions to charity and the client will achieve significant estate tax savings.

2. Client Not Expected to Survive Life Expectancy Tables

If an individual is not expected to live to his or her actuarial life expectancy, establishing a charitable lead trust that is designed to pass trust corpus to family remainder beneficiaries upon the death of the Grantor may be particularly advantageous. However, IRS regulations provide that the term of a charitable lead trust may not be based upon the life of an individual who is "terminally ill." The IRS defines a person as terminally ill if there is at least a 50% probability that the individual will die within one year.

Lead trusts based upon life expectancy of an unrelated party with a short life expectancy (a ghoul trust) will not be allowed.

3. Funding Private Foundations

The use of a charitable lead trust with a family foundation named as a permissible beneficiary of the charitable lead interest can be an effective way to reduce transfer taxation and preserve effective family control over the income earned during the lead term. Special provisions regarding distributions from the family foundation will be necessary.

4. Business Enterprises

A charitable lead trust may be an effective way to pass an interest in a closely-held business or family partnership to future generations.

5. Coordinating with Charitable Remainder Trusts

A charitable lead trust may be used in conjunction with a charitable remainder trust to:

a. Hedge against the risk under the charitable remainder trust that the donor may die early; and

b. Provide for the continuity in payments to family members.

6. Testamentary Charitable Lead Trust

A charitable lead trust may be created upon the Grantor's death through the Grantor's will or living trust. The Grantor's estate will usually receive a significant estate tax charitable deduction for the charitable lead interest. Testamentary charitable lead trusts may be used to reduce estate taxes at death on large estates when there is no need to pass all of the estate to children or grandchildren immediately at death. Life insurance or other assets can be used to provide wealth to the family members until the end of the lead trust term when the family will receive the remaining assets from the lead trust.

F. Caveats

1. Private Foundation Rules.

Charitable lead trusts are subject to the Private Foundation requirements and limitations found in IRC §§ 4940 - 4948. The private foundation rules --

a. Prohibit self dealing (e.g. sales, exchange or lease of property, loans, furnishing of goods and services, payment of compensation, etc.) between the trust and disqualified persons.

b. Prohibit making any proscribed taxable expenditures (e.g. expenditures to influence elections or legislation).

c. Prohibit retention of excess business holdings. Excess business holdings occur if the lead trust, together with all disqualified persons owns more than 20% of the voting stock of a business enterprise. The percentage limitation is 35% if disqualified persons do not have voting control. The trust has 5 years to dispose of excess business holdings if such holdings are acquired by gift or devise.

d. Prohibit jeopardy investments. Any investment which jeopardizes the carrying out of the exempt purpose of the trust.

e. Exceptions: The prohibitions against excess business holdings and jeopardy investments are not applicable if all of the income interest is devoted to charitable purposes and the value of the charitable interest is not more than 60% of the fair market value of all trust assets. This exception is particularly important if a lead trust is funded with closely held stock or certain partnership interests.

2. Restrictive Powers

Controls retained by the grantor as trustee (e.g. discretion re distributions of income) or control of charitable organizations, including private foundations (e.g. where the grantor participates in directing disposition of the property) will cause the assets of the lead trust to be included in the estate of the grantor.

G. Planning Tips

1. Unitrust vs. Annuity Trust

a. Definition of Charitable Lead Annuity Trust.

Charity receives an annuity each year expressed as stated dollar amount or as a percentage of the initial value of the asset placed in the trust. For example, the annual annuity payment to charity can be stated at $100,000 or 10% of an initial $1 million trust transfer. In either case, the charity receives $100,000 annually regardless of any subsequent change in value of trust assets.

b. Definition of Charitable Lead Unitrust.

Charity receives a payout each year equal to a stated percentage of the net fair market value of trust assets determined annually. For example, if the required payout to the charity was stated at 10%, the unitrust payout in the first year will be $100,000 for a trust funded with $1 million, but will increase to $200,000 if the trust assets increase in value to $2 million.

c. Advantages of Annuity Trust

(1) A greater value passes to the remainderman if trust income and/or appreciation exceeds the annual guaranteed amount payable to charity.

(2) No annual valuation required to determine the annual payout to the charity. Especially important if funded with real estate or closely-held stock.

(3) Provides greater certainty of amounts to be paid to charity. May be especially important if charitable recipient is a Grantor established private foundation.

d. Advantages of Unitrust

(1) Allows the possibility of leveraging the Grantor's generation-skipping transfer tax exemption (See discussion at B.3.).

(2) Provides a greater deduction than an annuity trust when the charitable trust is to be funded with assets that produce less than the applicable federal rate.

2. Funding Lead Trust with Discounted Assets

Valuation discounts applied to assets transferred to a charitable lead trust for minority interests, lack of marketability, etc., reduce the value of the remainder interest dollar for dollar. For example, a $500,000 transfer to a 10 year trust with a $40,000 guaranteed payout requirement would result in a taxable gift of $208,368, using an applicable federal rate of 6.2%. However, if a 30% valuation discount for a minority interest could be applied to the transferred property, the calculation of the taxable gift would be based upon a $350,000 value (i.e. the discounted value of the asset transferred to the trust) and with the same $40,000 guaranteed payout, the taxable gift would be only $58,357.

3. Naming Charitable Beneficiary

Once the Grantor has transferred assets to the charitable lead trust, the Grantor cannot retain the power to change the charitable beneficiaries. Upon the creation of the trust, the Grantor must name the charitable beneficiaries. A private foundation created by the Grantor may also be an appropriate charitable beneficiary. In order to preserve maximum flexibility for the Grantor in the selection of the charitable recipients, the trust instrument may also name a community foundation (a publicly-supported charity) as at least one of the trust's charitable income beneficiaries. Distributions from the trust to a community foundation may be credited to a donor advised fund maintained by the foundation in the name of the Grantor.

4. Grantor Charitable Lead Trust

A Grantor Charitable Lead Trust is similar to the trusts described above, except (i) The Grantor is entitled to take an income tax deduction for the value of the charitable interest at the time of contribution; and (ii) The Grantor is taxed on the income from the trust without a deduction for the amounts distributed to charity.

a. A desirable technique for a high tax year if reduced rates are anticipated in the future.

b. Can be beneficial with non-taxable investment assets, e.g. municipal bonds or life insurance products.