Charitable Lead Trusts: Planning Considerations

A charitable lead trust is a type of charitable trust established by a donor either during their lifetime or through their estate plan, where The Mother Church would be the income beneficiary for a period of time, following which the trust terminates and distributes the remainder generally to the donor's family. It is the reverse of a charitable remainder trust, where the donor and loved ones may be the income beneficiaries, and then upon the beneficiaries' passing, the trust terminates and distributes the remainder to the Church. Charitable lead trusts require substantial minimum funding, generally well into a seven-figure amount.

Benefits for the donor, beyond the joy of sharing the income with The Mother Church, can include substantial savings in gift tax, estate tax or generation-skipping transfer taxes that may come due whenever you try to give property to your heirs. If the trust is set up during life, there may be additional tax advantages for the donor.

A period of low interest rates can be an ideal time for these gifts of income to the Church. Deductions are usually high when interest rates are low. The charitable lead trust has interested donors also because it is a gift of income only, maintaining the principal for eventual distribution to family members. Eventually, all of your estate can pass to family members. Here are the basic considerations in arranging a lead trust:

Type of Lead Trust	**Income Tax Advantages**	**Gift/Estate Tax Advantages**
1. Lifetime trust – assets return to donor	Tax deduction – but donor taxed on trust income	None
2. Lifetime trust – assets pass to heirs when trust ends	Donor's taxable income reduced after gift*	Substantial gift tax savings in passing assets to heirs
3. Trust in will – assets pass to heirs when trust ends	Heirs aren't taxed on trust income	Substantial savings in estate tax/generation-skipping transfer tax

* Alternatively, lead trusts can be planned to provide income tax charitable deductions, as in #1, as well as gift tax savings, but the donor will be taxed on trust income.

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Charitable lead trusts pay either a fixed income (annuity trust) to the Church or a variable amount (unitrust). Deductions depend on how many years the trust lasts (the longer payments are made to charity, the higher the deduction) and the amount of charity's income (larger payments mean higher deductions). The charitable lead trust is one of several income tax and estate tax planning tools that should be considered in financial planning. The key elements to remember about lead trusts are simple:

1. A lead trust provides an income stream for the Church's benefit;
2. A lead trust may create significant tax benefits for you and your loved ones;
3. The assets placed in the lead trust are eventually "returned" to family members

Charitable lead trust planning requires a donor to be independently advised by professionals who have expertise in setting up charitable lead trusts.

Planning Inter Vivos Charitable Lead Trusts

Evelyn worked side-by-side with her husband, Raymond, in the printing business for nearly 40 years. They sold the business for $16 million several years before Raymond passed away. Evelyn did not remarry. Evelyn has two middle-aged daughters.

Her attorney never had occasion in the past to recommend charitable lead trusts, but was familiar with their potential benefits, including the charitable deductions available in the present low-interest rate environment. He put together some hypothetical numbers for Evelyn:

"You could transfer, say, $10 million of securities to a trust that will pay exactly $700,000 annually for 18 years to the Church," he began. "At the end of the 18 years your daughters would receive all the trust assets. If the trust investments follow historic patterns, it's possible – but certainly not guaranteed – to have $10 million in the trust by that time, even with the $700,000 payout to the Church."

"There would be a gift tax return to file, but you might not owe any tax because of the current $5.25 million exemption," he continued, "and there may not be estate tax on the trust assets either, even if the children eventually receive more than $10 million."

Evelyn liked the idea of relocating a large part of her estate out of range of estate taxes, especially when it meant a large aggregate gift to the Church ($12.6 million over 18 years). Evelyn realized she would like to continue this gift discussion with her advisors and the Church.

Tax Benefits Hinge on Form of Lead Trust

Charitable lead trusts set up during life can be either nongrantor or grantor trusts. In a nongrantor CLT, the trust pays income to charity – either an annuity or a unitrust amount – then passes the trust principal to children or others. The donor receives a gift tax charitable deduction for the value of charity's interest but does not get an income tax deduction. Income tax savings occur indirectly, however, because the donor is no longer taxed on the income produced by the gift assets. The advantages to the donor are a significant reduction in transfer taxes, thanks to the gift tax charitable deduction, and avoidance of transfer tax on any future appreciation in the value of trust assets. (Remainder beneficiaries take the trustee's cost basis, however, and may face capital gains taxes on any appreciation.)

Grantor trusts result if the donor is treated as the owner of the CLT under the grantor trust rules (IRC §§671-677). A common way to achieve this result is for the donor to retain a reversionary interest of more than 5% [IRC §673(a)]. Other methods of achieving nongrantor status include giving a disinterested person the right to switch assets with the trustee [IRC §675(4)] or empowering the trustee to add one or more charitable beneficiaries (PLR 199936031). Donors receive both gift tax and income tax charitable deductions, but will be taxed on all trust income, even amounts paid to charities. Taxes to the donor can be minimized if the trust is funded with bonds that produce tax-exempt interest or appreciated stocks that can be sold off each year to make the required payout to charity. If the stocks throw off minimal dividends, any income to the donor will be largely taxed as long-term capital gain.

Generation Skipping Transfer Tax (GST)

With the current low interest rate environment, grandparents can lock in sizable gift tax charitable deductions with lifetime lead trusts that reduce or eliminate generation-skipping transfer taxes where grandchildren or other skip persons are the remaindermen. Here is an example:

Sylvia transferred $10 million in stock to a charitable lead unitrust that will pay 4% annually to the Church for 17 years, then distribute all the trust assets to her grandchildren. The present value of the remainder interest gift to the grandchildren was reduced to about $5 million, using an applicable interest rate of 1.4% (donors can elect to use the §7520 rate in effect for the month of the gift, or choose the best available rate from either of the two prior months). Sylvia owed no gift tax or generation-skipping tax, under the applicable credits/exemptions. The $5 million would be an adjusted taxable gift that enters into her estate tax computation. Nonetheless, $5 million will have been removed from her estate. If the trust earns at least 4% annually, $10 million (possibly much more) will ultimately pass to the grandchildren. Incidentally, roughly $6.8 million will go to support our core activities.

Note: Because of the uncertainty of future trust investments, planners typically employ the charitable lead unitrust where grandchildren are remaindermen, which permits calculation of the GST rate upon funding of the trust. Annuity payouts create uncertain tax results because the GST tax inclusion ratio is not calculated until the trust terminates.

Planning for Large Income Tax Charitable Deductions

Reversionary lead trusts may make sense if the goal is to reduce a client's income taxes in the current year, anticipating that his or her tax rates will go down in the future. Deductions will be relatively high under the current low §7520 interest assumptions. A donor can set up a lead trust that provides either an annuity or a unitrust payout to charity for several years, with reversion to the donor at the end of the trust, and claim an immediate income tax charitable deduction for the present value of charity's future income stream [IRC §170(f)(2)(B)]. The value of the reversionary interest must be worth more than 5% of the value of the trust assets.

Suppose Sherman places bonds paying $50,000 annual interest in a ten-year lead trust benefiting The First Church of Christ, Scientist. Assuming a 1.4% §7520 rate, the value of the right to receive a $1.00 annuity for ten years is $9.3194 (see Table B, IRS Pub. 1457). Since the Church will be receiving $50,000, the value of its income interest is $9.3194 x $50,000, or $465,971. Sherman would be entitled to a charitable deduction of $465,971, while his income tax rates are still high, and is assured of getting the bonds back after ten years.

The major drawback to this plan is that Sherman will be taxed on the income earned by the trust under the grantor trust rules (IRC §§671-677). His tax rates may be significantly lower during this time, however, if tax rates decline, as expected. But donors still may be unhappy about being taxed on this phantom income. One strategy is to fund the trust with tax-free municipal bonds. The question of future taxation on the trust income is moot because of the tax-free nature of the investment. Another idea is to fund the trust 100% with growth stock that has been held more than 12 months. The trustee will be required to sell stock each year to make the payout to charity. The donor will be taxed only on the capital gain portion of the payout – and at a low tax rate. The donor will have realized income tax savings, however, at federal rates as high as 39.6%. Lead trust gifts are considered for the use of charity (gifts of income interests) and are deductible up to 30% of a donor's AGI [IRC §170(b)(1)(B)].

Testamentary Lead Trusts Offer Flexibility

Lead trusts may be set up by will, which is relatively uncomplicated but presents planning challenges due to the unpredictability of §7520 federal interest rates (AFRs) at death, which can greatly affect the charitable deduction. But clients may prefer an arrangement that is wholly revocable during life, perhaps hoping for repeal of federal estate taxes before they die. Regardless of how long a testamentary lead trust is to last, an estate tax deduction will be allowed for the present value of the charitable income interest, so long as the payout takes the form of an annuity or unitrust amount. No one is taxed on the income paid to charity, but excess income is taxed at tax rates for trusts (unless the excess is also paid to charity).

Case: John lives alone, his wife having passed away. John has always been generous in regard to supporting the Church. His net worth is $30 million. John is worried about federal estate taxes – and he's also concerned whether his son and daughter, both in their early 30s, will be able to handle their inheritances responsibly. John wants to do something truly significant for the Church through his estate plan, but also wants to provide for his children.

A testamentary charitable lead trust can pay income to the Church temporarily and ultimately pass all trust principal to family beneficiaries, with significant estate tax savings. Lead trusts are sometimes called "wait awhile trusts." The message to family members is that the principal of the estate will remain in the family, but for the portion of the estate that will fund the charitable lead trust, the family will simply need to "wait awhile" before receiving it. It's a form of charitable giving that is more palatable to surviving family members than outright bequests to charity. So John might leave $10 million outright to the children upon his passing, and $20 million to a charitable lead trust that would eventually benefit his son and daughter 10 or 20 years later.

Tandem Trust Variation: If the children feel they need benefits more immediately after their father's death, he might establish both the 15-year lead trust and a 15-year charitable remainder trust for the children. The Church and the children would receive both income and remainder interests.

How to Proceed

If you are interested in arranging a charitable lead trust, please e-mail, call or write our office.

We are pleased to advise you:

1. The approximate federal transfer tax savings (gift tax, estate tax and/or generation-skipping transfer tax) available from your trust
2. An estimate of the income tax charitable deduction, if the trust is to be structured as a grantor trust
3. The approximate value of trust income payments to the Church
4. The estimated value of the remainder interest to your family

You will need to share with us:

1. Whether you wish to fund the trust immediately or set it up through your estate plan
2. Whether you prefer that the Church receive fixed annual payments (the annuity lead trust) or variable payments (the lead unitrust)
3. The amount of annual payments you wish the Church to receive
4. The value of the cash or assets you would use to fund the trust
5. Your cost basis in investment assets that will be transferred to the trust
6. The number of years you believe the trust should last before distributing principal to you or your family

A charitable remainder trust is a complex arrangement that involves significant assets, as well as tax consequences. You will need to have the assistance of an independent professional who has expertise in working with charitable remainder trusts in working with us on this type of gift.

You can contact our office at philanthropy@csps.com, by phone at 1-800-288-7155, extension 3288, or write to us at the address below. We look forward to hearing from you.

The First Church of Christ, Scientist
Philanthropy, P05-10
210 Massachusetts Avenue
Boston, MA 02115-3195 USA