Which Planned Gift Gives Money To Charity Now?

Friday, April 25, 2008, www.OnPhilanthropy.com
By Jonathan Gudema, Esq.

Understanding Charitable Lead Trusts

Which planned gift gives money to charity now? And saves taxes for the donor? This is paraphrasing a question that planned giving professionals hear often.

The answer is that charitable lead trusts typically provide an annual stream of cash flow to charity for a period of years starting within a year of the establishment of the trust. And, lead trusts do offer donors great tax savings, under the right circumstances. So why don't we see a lot of lead trusts?

This article is dedicated to helping everyone (lawyers, fundraisers, non-profit executives, philanthropists, and journalists) understand these very often misunderstood vehicles. There are only around 6,000 lead trusts in existence today. This number includes all existing lead trusts created over the past 20 years or so, not just ones created this year (2006 was the last year reported on the IRS website).

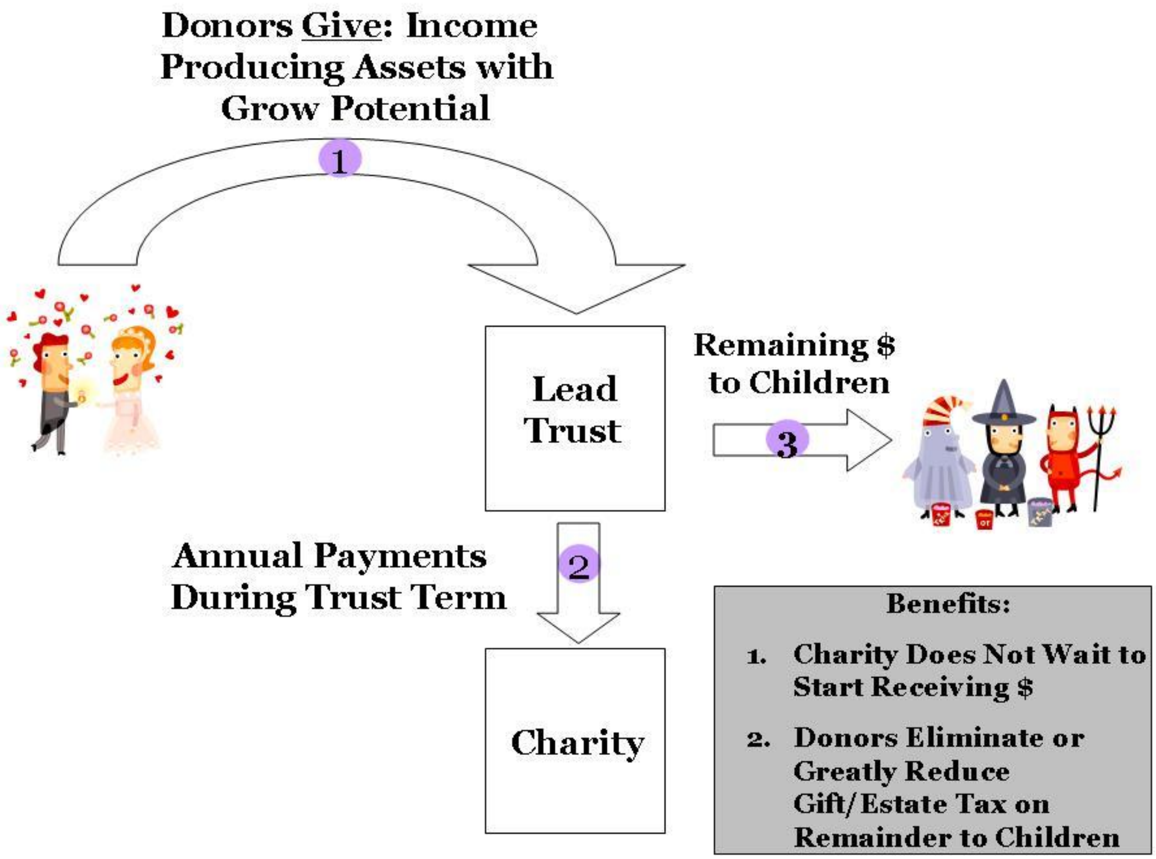
Why do I feel there is a need for greater understanding of these vehicles?

I notice that almost every article, email or promotion piece on lead trusts includes some incorrect fact or misleading statement, often showing how the author doesn't understand these giving vehicles and leading to further confusion.

This is my attempt to offer better understanding of the various details and concepts involved. Read this article: try to understand and please email me if you have questions. If I can positively impact one person, which might even indirectly cause the establishment of one of these trusts, I would have accomplished something very worthwhile.

What does a Charitable Lead Trust do for a charity?

Lead trusts commit to distributing an annual dollar amount to one or more charitable entities for the ***term*** of the trust. The ***term*** could be for a number of years or it could be for someone's life. For example, a 10 year charitable lead ***"annuity"*** trust funded with $1 million dollars could be drafted to distribute $60,000 a year for 10 years to a particular charity. If you change the same lead trust into a charitable lead ***"unitrust"***, then the trust would distribute 6% of the fair market value of the trust assets every year to a particular charity, approximately $60,000 a year depending upon the investment of the trust assets. Generally, lead trusts involve a fixed stream of cash flow to a charity for 10 to 20 years.



What happens to the remaining assets in the trust after its term?

Typically, the assets remaining at the end of a lead trust term are transferred to children of the donor (grandchildren are a possibility but it involves issues that are too complex to be discussed in this article). The trust can be structured in such a way that it reverts its assets back to the donor at the end of the term except that this technique typically defeats the tax benefits (as discussed later in this article) and is not worth discussing. In fact, if you see an article or promotion piece talk about a ***Grantor*** Lead Trust that returns assets back to the donor at the end of trust term, recommend this article to the author.

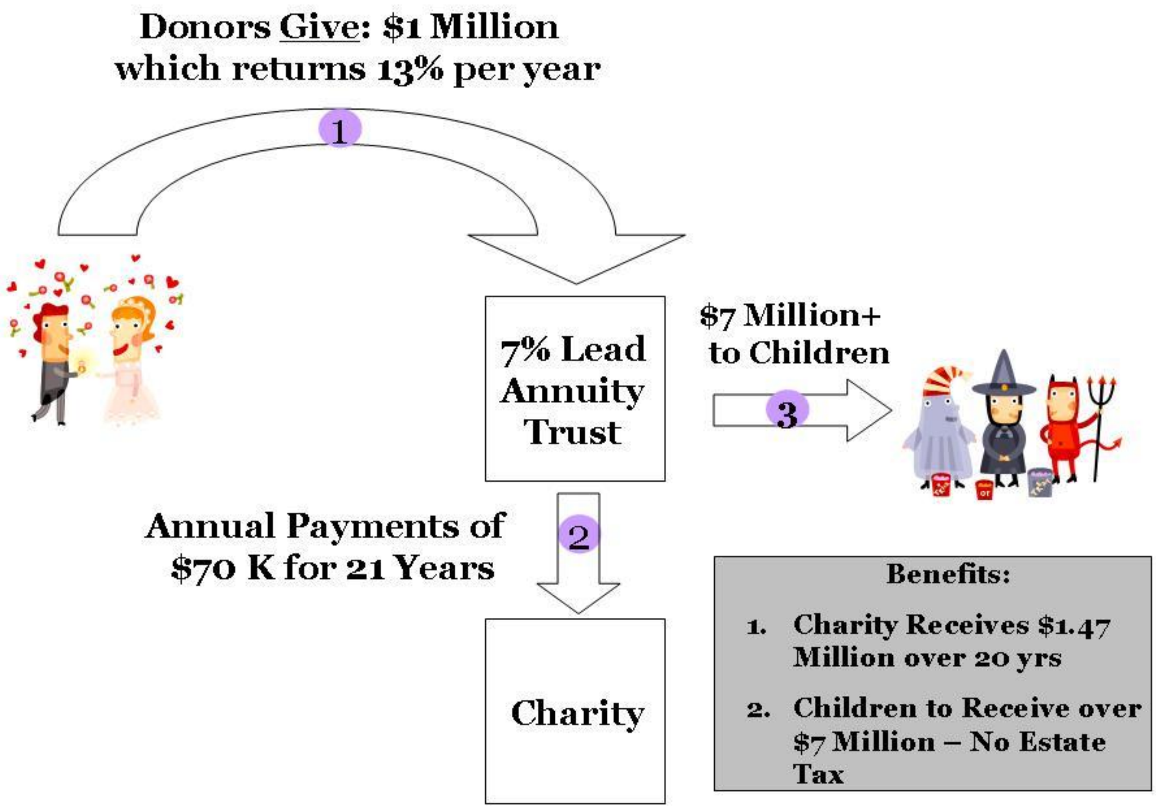
What are the benefits of a Lead Trust to the donor?

What is in it for the donor? Again, assuming we are talking about a lead trust that will distribute its remaining assets at the end of its term to children (referred to in legalese as a ***Non-Grantor*** Lead Trust), why is the donor doing this (besides wanting to support a particular charity)? The answer is that the remaining assets of a lead trust will often be distributed to the children at significantly reduced or eliminated gift tax rates (i.e. maybe no gift or estate tax at all!).

For example, a donor contributes $1 million in March 2008 to a ***Non-Grantor Lead Annuity Trust*** paying $70,000 a year to charity for 21 years, remainder to his children. The donor would report a "gift" to his children in the year the trust is set up of $0 (yes, zero dollars) to the IRS. If the trust investment returns 13% per year, the children will receive over $7 million at the end of the 21 years with no further estate or gift tax due. Note: this sample calculation assumes a gift in March 2008 since the federal interest rates for these calculations is very favorable. Lower federal interest rates make lead trusts more attractive (discussed later in this article).

Understanding the Tax Benefits

In the above example, we see that the donor avoided Federal and State **Estate** tax on the $1 million contributed to the trust. In New York, for example, the combined Federal and State estate tax rates are still well over 50%. In other words, the donor was able to convert $1 million today (worth only around $500,000 in his estate should he die) into total giving to charity of $1.47 million dollars over 21 years and over $7 million to his children after the 21 year period expires with no gift or estate taxes. Even assuming that the same $1 million could have been invested to grow in a similar fashion, income and estate tax would still have bitten into that money enough that we can honestly say that the family might do better by giving to charity (I say that cautiously because estate planning attorneys are always coming up with new tricks. Rather, with the satisfaction of giving to charity coupled with avoiding estate taxes, I can honestly say the family is much better off).



How did we stiff the government of its piece of the pie?

I always tell people to think of a lead trust as first and foremost a gift to your children. It is a gift to your children ***less*** the value of the income stream to charity. And, how the IRS lets you value the income stream is a crucial point to understand.

Ask yourself the following question for the above assumption of the lead cash flow to charity of $70,000 a year for 21 years: how much money do I need today to invest to cover the entire 21 year cash flow? Remember, $1.47 million is the total charity will receive but I don't need that amount in the bank since I will be investing the money. To figure this out, I need to have an investment assumption. By the way, the investment assumption for lead trusts calculations is the called the Applicable Federal Rate or AFR, which for our example is 3.6%. The answer to the question above is that I need $1,000,000 today, earning exactly 3.6% a year for the next 21 years, to produce the $70,000 a year cash flow for 21 years. If I did the same gift in February 2008 (with a 4.2% AFR investment assumption), I would need only $964,200 to produce the same 21 year cash stream. Since my investment assumption is higher in February, I need less money today to produce the same cash flow.

Those two amounts needed to produce a cash flow of $70,000 a year for 21 years, under their respective AFRs, are in fact what is referred to as the ***present value*** of the income stream. The way we value the taxable gift to your children is we subtract the ***present value*** of the income stream (the charitable interest) from the initial funding amount. Back to our example, the donor put $1 million into the trust. If the gift was made in February, we would subtract $964,200 (present value of charitable income stream) from $1 million (gross value of gift to children) to determine the reportable gift of $35,800 (potentially subject to gift tax immediately or will go against your federal lifetime estate tax exemption). If the gift was made in March, we just subtract $1 million from $1 million and that's how you get a zero gift to your children!

Understanding What Just Happened

Assuming our lead trust example above was done in March 08, technically a zero gift to children, let's understand what really happened. First, the donor put $1 million into a lead trust entity that has its own tax ID number and presumably its own investment account. Based on the date of the transfer, the donor's accountant or attorney needs to calculate the value of the gift to the children (see above paragraph). When the donor files his or her income tax return, a gift tax filing (attorneys and accountants recommend at least a very small gift so there can be something to report to the IRS) will be attached showing what was done.

When the lead trust ends, all remaining assets of the trust are transferred to the children with no gift and estate taxes (under typical circumstances).

Important Assumptions

The above example makes a few assumptions that are important to understand at this point. The example assumes that the donor is facing the highest estate tax brackets. Under current law, an individual would need to be leaving this world with roughly over $2.5 million dollars left to noncharitable and non-spouse beneficiaries in his or her estate to be facing the highest estate tax brackets. Any money left to charity or a spouse is not subject to estate tax (spouse's estate will may be subject to estate tax). In other words, your prospects for a lead trust are people who have exhausted standard methods of reducing one's taxable estate and are in need of removing large amounts of assets for fear of a whopping estate tax.

Gift/Estate Taxes vs. Income Taxes vs. Capital Gains Taxes

If you noticed in this article, I have only referred to reducing ***gift and estate taxes***. What about other taxes? This where I start finding problems in various promotions of lead trusts.

Fact: **Lead trusts are NOT a vehicle for avoiding income tax or capital gains tax**. Please read that statement again and think about it. Lead trusts are a vehicle for avoiding estate and gift taxes, not income or capital gains taxes. Why?

Firstly, for the standard, ***non-grantor lead trust*** there is no income tax deduction for the donor. There goes your income tax incentive. Later, we will discuss the ***grantor lead trust*** which does provide an immediate income tax deduction but with a big caveat.

Secondly, low basis property (stock or real estate) in a lead trust will not avoid capital gains. It may be delayed but definitely not avoided.

Technically, lead trusts are not exempt charitable trusts. As I mentioned earlier, you are making a gift to your children first and foremost so the IRS has never granted these trusts status as tax-exempt entities. Therefore, all investment income (capital gains or otherwise) in the trust could be subject to income or capital gains tax. Under the standard, non-grantor lead trust, the trust is entitled to offset its taxable income with its distributions to charity. When things go smoothly, the charitable distributions offset the gains of the trust. If the non-grantor trust earns more than the amounts distributed to charity, the trust pays taxes on its excess gains (reducing anything left for children).

If a non-grantor lead trust is funded with low basis property and the trust sells that property to be reinvested, the trust could incur a gain much greater than its annual distribution to charity and be liable to pay taxes (at trust rates not individual capital gains rates) on the gain. And, if the trust holds the low basis asset until it passes to children, the children receive the property with the original basis, even if their parents are deceased.

As a side point, usually when property is inherited, there is a so-called "step-up in basis" which wipes out any pre-death capital gains. Not so with lead trust assets. This is not such a terrible problem since you are avoiding an over 50% estate tax in exchange for a 15% capital gains tax (which is only incurred when the asset is sold). The results are still favorable for the family but definitely not geared for avoiding capital gains taxes as is the case with charitable remainder trusts.

Aren't There Lead Trusts That Do Involve Income Tax Charitable Deductions?

Yes, they are known as ***grantor lead trusts***. Why the term "grantor"? Because it means that the donor as the grantor to the trust is keeping ownership of the trust. A plain vanilla grantor lead trust means that the donor puts property in the trust, it pays charity for the term, and then the assets revert back to THE DONOR! No estate/gift tax benefits here but it does allow the donor/grantor to take an immediate charitable income tax deduction for the present value of the income stream to charity for the term (using same present value concepts discussed above). Sounds good. Why not for campaigns, multi-year commitments? Didn't our father's accountant always say cash in your pocket today is better than tomorrow? Why not take the tax saving of a multiyear commitment this year and invest it? And, you get your principal back at the end of the trust! Keep reading:

As a grantor trust, the grantor is also responsible for paying the taxes on all investment income and realized capital gains of the assets in the grantor lead trust. And, there are no offsetting charitable deductions because you took them all upfront when you created the trust. Yes, you get to eat your cake up front but you get it in your face during the term of the trust. In other words, in year 1, donor is happy. In years 2 and beyond, donor is very unhappy unless the donor doesn't mind paying phantom taxes (tax on earnings not actually received).

One of my friends in planned giving just went through this scenario. One of the charity's leaders sold a donor on a short term grantor lead trust. He told the prospect what a great deal this is. Donor gets a deduction upfront. Donor gets his money back at the end of 5 years.

Without running any calculations, I can say with confidence that but for the costs and hassle of setting up the grantor lead trust or not using a lead trust at all, there is no difference at the end of the day for the donor either way. No extra benefit except that he gets a bigger deduction now but a bigger tax hit over the term of the trust. If the donor knew that this year, for some special reason, he needed and could use the deductions now and the extra income in future years was not a problem, then yes, a grantor lead trust could help. But, in this case, the donor was a professional athlete signing his first multi-year contract; the deductions now make no difference for him. So why bother?

By the way, I polled a few top planned giving attorneys from the around the country about whether anyone does grantor lead trusts. The answer was unanimous: almost no one does these because there is really very little benefit to it.

Advanced Planned Giving (it gets a little more complicated)

There is a variation on the grantor lead trust, known as the "***defective***" grantor lead trust, that combines the benefits of both the non-grantor and grantor lead trusts. These don't return the principal to the donor but rather pass the remainder to children (like the standard, non-grantor trust) at the same reduced or avoided gift and estate tax. And, the defective grantor lead trust gives the donor the upfront income tax deduction. The donor will still have to pay taxes on all income in the trust assets during the term which under the regular grantor trust was a bad thing. But, with a defective grantor lead trust, paying the income tax is actually a good thing! If your goal is to pass on as much assets to your children without gift or estate tax, and you consider money in your hands worth only fifty cents on the dollar (due to potential estate tax), you should actually be happy paying the taxes from your pocket and not your children's. This is one of those accountant ideas which the rest of the world has trouble with even though I agree with them on this point. Needless to say, I would still not sell the defective lead trust as a way to avoid income tax. Rather, the primary family benefit is the estate and gift tax avoidance. And, as mentioned earlier, the children may actually inherit a capital gains burden on the property of the trust but that is still better than surrendering upwards of 60% of the property in estate taxes.

Conclusion

After reading this article, your brain is probably spinning a bit. And, all of the great tax breaks may not seem so attractive anymore. Well, if the complexity hasn't turned you off, keep reading.

One factor I alluded to earlier in the article is the rate of return needed to make these work really well for everyone. In my example early on, I assumed a fixed annuity payout of 7% and total return on investment of 13%. What investments today will guarantee that kind of total return? And, if you earn much less, there won't be anything left for the children. You would have been better off making direct gifts to charity (at least you'll avoid some income tax) and finding other ways to pass assets to children.

There are some tricks that attorneys use to alleviate the need for a 13% return but they are too complicated for this article (they usually involve funding the lead trust with a limited partnership interest). In any case, even if I convince a donor that this is a great device, that he or she needs to avoid some estate tax, I am always left with the problem of "what will we put in the trust?"

That question is really the biggest challenge of establishing lead trusts. The perfect funding asset may be income producing real estate held in a clean limited partnership with no mortgage (not a burned out tax shelter like so many people want to give away). And, the last lead trust I worked on was just that and it was a fantastic deal for the donor and the charity.

But, the next one wasn't so successful. This "lead trust" prospect I worked with agreed that it was a great option for him and even sent me to his accountant to figure out which assets worked best. We came away empty because of how his limited partnership interests were leveraged with mortgages. I had the right donor, he understood the vehicle, he had the need, he had the desire to help the charity, and I thought he even had the perfect properties. Alas, I was off on the property question and the gift went nowhere (he still did a new CRAT so all was not lost).

Finally, if you read about lead trusts enough, you will eventually hear that Jackie Onassis did one. Not true! Her will (these can be done during life or set up in your estate plan) called for setting up a lead trust to transfer assets after over 20 years of charitable distributions to her grandchildren. But, somewhere along the line, the Onassis Lead Trust was never actually funded and might have actually caused a tremendous generation skipping tax (remember the grandchild complications).

I wish lead trusts were the vogue because I would be very busy with them if that were true. But, they are complicated, and they are not a planned giving vehicle in which charities should be overly involved in. Charity should never serve as trustee and the donor's estate planning attorney needs to draft and implement the trust as part of an overall estate plan.

Still, it is worthwhile for fundraisers and nonprofit executives to understand leads trust enough to spot real opportunities.

Jonathan Gudema, Esq. is planned giving expert and a Managing Director at Changing Our World, Inc., a philanthropic consulting firm advising nonprofits, philanthropists and foundations on effective strategies. He can be reached at jgudema@changingourworld.com