Gift & Estate Planning

Giving Through Charitable Lead Trusts

Stewarding the Giver **and** The Gift℠ >>

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GIVING THROUGH
CHARITABLE LEAD TRUSTS

A charitable lead trust is a helpful giving strategy for individuals who would like their consistent, annual giving to provide them with additional tax benefits. Specifically, in the right interest rate environment, a charitable lead trust can help accomplish one of two additional tax objectives for the giver:

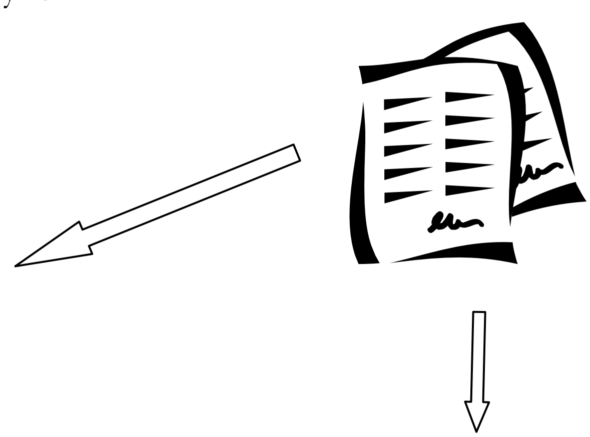
- reduce estate taxes on the future transfer of assets to the next generation; or
- reduce income taxes in a year of unusual spiked income by accelerating future charitable giving deductions into the year in which you need the deductions most.

Though the tax treatment of a charitable lead trust (CLT) can be somewhat technical, the concept of how one works is relatively simple. The CLT is a stand alone trust created by an individual for a specified term. During the term, the trust makes annual payments to a charity or multiple charities. After the trust term has expired, the remaining trust assets are distributed to named non-charitable individuals – usually the giver or the giver's family.

Here's How it Works.

1. John and Mary transfer their income producing, appreciating property into a CLT. The trustee invests the property for growth and steady income.

Charitable Trust



2. The CLT pays an established income payment to the charities of John & Mary's choice throughout the trust's term of existence.

3. After the expiration of the trust's term, the remaining trust assets are distributed to John and Mary's family.

While all charitable lead trusts function in the same general manner, they are not all taxed the same. Different types of charitable lead trusts are appropriate for different tax situations. The most important distinction among lead trusts is whether the trust is a "non-grantor" trust or a "grantor" trust.[1] The most common type of charitable lead trust is the non-grantor trust which is useful in helping to reduce estate taxes.

The Non-Grantor Charitable Lead Trust

A non-grantor charitable lead trust is a separate taxable entity. Because it is not tax exempt, contributions to the trust do not provide a charitable income tax deduction for the giver. The non-grantor lead trust has a completely different use: to help with gift tax and estate tax concerns. Usually, a non-grantor lead trust will make annual payments to charity for a specified term, and at the conclusion of the payment term, the remaining assets (plus appreciation) are distributed to the grantor's children as an inheritance.

> Sam Smith and his wife are in their early sixties and have a $10 million estate. They give about $250,000 annually to their church and other ministries. Recently, their lawyer updated their estate plan and told them they may owe in excess of $2.7 million in federal estate taxes when they pass their estate to their children. Sam would like to reduce this tax and better steward those dollars for Kingdom purposes. Because of this, Sam Smith's lawyer has recommended a non-grantor lead trust for their estate tax problem.

How could the charitable lead trust help the Smith's estate tax problem? Think about this: Would you pay the same amount for an asset you can have immediately as you would pay for the same asset if you had to wait 10, 12 or 15 years to receive it? Certainly not. What if someone else were allowed to use the asset during the time you were waiting to receive it? That would make the asset even less valuable to you. Because of these market realities, the IRS allows the taxable value of the assets the children will ultimately receive to be "discounted" for tax purposes. Though they are the same assets, they are treated as less valuable for gift tax purposes. Less value means less tax.

> The Smith's non-grantor lead trust would be funded with $3 million and set up to pay $210,000 each year to the Smiths' designated charities for a period of 15 years. Notice that the annual amount the Smiths will be giving to charity has not increased. At the conclusion of the trust term, the remaining trust assets will pass to their children as a significant portion of their inheritance.
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> Because the charities will only receive a temporary income interest from the trust, the Smiths will not receive a full dollar-for-dollar gift tax deduction.

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[1] A non-grantor trust is taxed as a separate, stand alone entity. By comparison, a grantor lead trust is a pass through entity, ignored for tax purposes, in which all of its activity is reported directly on the personal tax return of the person who created the trust, also known as the "grantor."

> However, the Smiths' gift to the trust will still result in a $2.3 million gift tax charitable deduction leaving only $700,000 taxable to the Smiths for the future transfer of trust assets to their children.[2] Though the future gift to the Smiths' children is taxed today as a $700,000 gift, their children will more than likely receive over $4.4 million tax free at the conclusion of the trust due to the assets' growth and appreciation throughout the trust term.[3]
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> The Smiths' lawyer tells them that they each have a $1 million lifetime gift tax exemption, so they will actually owe no taxes as a result of their contribution to the lead trust.
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> Furthermore, despite giving a sizable portion of their estate to the lead trust during their lifetime, the Smiths' financial advisor showed them that their net income for lifestyle costs and savings reinvestment would hardly be affected. He explained that though their assets would now be divided between their personal holdings and the lead trust, their annual charitable giving will come from their lead trust and, therefore, free up the entire income from their personal holdings for their personal use.

By using the lead trust, the Smiths will likely save between $1 million to $2 million in federal estate taxes depending upon the trust assets growth and accumulation during the trust term. Essentially, the non-grantor lead trust allows the Smiths to do their annual charitable giving in a manner that will save their family significant estate taxes. That is smart Christian giving!

The Grantor Charitable Lead Trust

Like the **non-grantor** charitable lead trust, the **grantor** charitable lead trust will also make annual payments to charity and distribute the remaining trust assets to named individuals at the end of the trust term. However, that is where the similarities end. While the non-grantor lead trust helps individuals with their estate tax problems, the grantor lead trust helps people with their income tax concerns.

With a grantor lead trust, the individual who created the trust (also called the "grantor") is also usually the individual who receives the trust proceeds at the end of the trust term – not the individual's children. Because of this, the tax implications are distinctly different.

With a grantor trust, the trust income is taxed to the grantor every year. When the grantor contributes assets to the trust, he receives an upfront charitable income tax deduction for the value today of all the future payments to be made to charity from the trust. However,

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[2] Deductions and taxes calculated assuming a 4.4% Applicable Federal Rate.
[3] Value of future gift to children calculated assuming a 7% ordinary income and 2% capital growth investment performance.

because he will enjoy all of the charitable deduction benefits up front when he creates the trust, he will be responsible for all future taxes on the trust income throughout the trust's term - without the benefit of a deduction for the trust's annual payments to charity.

So, what is the benefit in setting up a grantor charitable lead trust? This type of trust can be very helpful to individuals who are preparing to receive a large spike in income in one calendar year or for individuals who know their annual income will be significantly reduced in future years. In effect, the grantor lead trust allows the individual to accelerate his or her charitable income tax deduction for the trust's future payments to charity into the calendar year in which they need the deduction most. This can be especially helpful for individuals like Mary Miller.

> Mary is a successful corporate executive in her early fifties. Mary has an annual income of $250,000, and she gives $50,000 each year to her church and other ministries. After years of faithful service, and approximately $800,000 in deferred compensation owed to her, Mary is leaving the company to devote herself to missions work and Christian philanthropy. While she is looking forward to the next chapter in her life, Mary is not looking forward to paying $360,000 in income taxes on her deferred compensation payment.[4] Her professional advisor recommended that she create a grantor charitable lead trust and fund it with her $800,000 deferred compensation payment.
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> Mary's lead trust would pay $60,000 each year for 12 years to the charities of her choice. The charitable deduction resulting from Mary's contribution to the trust would be over $550,000. This deduction will save Mary almost $250,000 in income taxes on the receipt of her deferred compensation payment that she could keep and reinvest or give away to the charities of her choice.
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> Plus, after twelve years, Mary's financial advisor estimates that she will still receive over $1 million - her initial contribution plus growth and accumulation during the trust term.

If you find yourself facing an unusual spike in income or a future reduction in income, please seek professional advice on how a grantor charitable lead trust could help you to best use the charitable deduction for your regular, annual charitable giving.

[4] Taxes calculated assuming a combined federal and state income tax rate of 45%.

What else should I know about charitable lead trusts?

Annuity vs. Unitrust Payments - The payments made to charity through a charitable lead trust can be made in the form of a fixed payment amount (called an annuity payment) or in the form of a fixed percentage of the trust as valued annually (called a unitrust payment). The benefit of an annuity trust arrangement is that despite increases or decreases in the trust value over time, the payments to charity will remain constant. In most cases, this will allow a greater portion of trust appreciation to accrue to the benefit of the grantor or the grantor's family. With a unitrust, the annual payments to charity will fluctuate depending upon the value of the trust assets each year. As the assets grow over time, the fixed percentage payment to charity also increases. Because most people prefer for the asset appreciation to accrue to the benefit of the family, most people prefer the annuity payment structure.

The differences between an annuity payment and a unitrust payment can be seen in the following example illustrating the payment impact in rising and falling economic climates:

Year	Value of Trust Assets	6.5% Annuity Interest	6.5% Unitrust Interest
2008	$500,000	$32,500	$32,500
2009	$510,000	$32,500	$33,150
2010	$536,000	$32,500	$34,840
2011	$564,000	$32,500	$36,660
2012	$495,000	$32,500	$32,175

What type of asset is best suited for a charitable lead trust? First and foremost, the asset must be able to reliably produce enough income to make the annual payments to charity and cover the costs of administration. Next, the asset should have the potential to grow in value over time in order to take advantage of the trust's ability to pass the asset appreciation to your loved ones at the end of the trust term. Finally, if you have a family limited partnership or a family limited liability company, you may find these assets are uniquely effective for charitable lead trust planning.

Why do family limited partnerships work so well with charitable lead trusts? Family limited partnership planning (FLP) is often used to help families pass their wealth to the next generation at less estate tax cost. The fundamental concept behind FLP planning is to bundle the underlying partnership assets into partnership interests that have restrictions on the shareholder's control and ability to transfer their interest. This allows the value of the underlying partnership assets to be discounted in value – sometimes as much as 30% or more. Because the non-grantor charitable lead trust also works to discount the value of assets that will ultimately be transferred to the children, when you put FLP interests into the lead trust they work together to "double discount" the taxable value to be inherited by your children.

Consider the additional benefit if Sam Smith funds his charitable lead trust with FLP interests that have already be discounted 30% in value.

	Assets Outside FLP	**Assets Inside FLP**
Assets Contributed	**$3,000,000**	**$3,000,000**
FLP discounted value	**n/a**	**$2,100,000**
Charitable Deduction	**$2,300,000**	**$2,100,000**
Taxable Gift to Heirs	**$700,000**	**$0**

Can I make more than one contribution to the trust? Most charitable lead trusts are structured as annuity trusts and, therefore, you cannot add to the trust after the initial contribution. However, if the trust is structured as a unitrust, you can make additional contributions over time.

How can I find out more about charitable lead trusts? Please contact Focus on the Family Gift & Estate Planning Services at (800) 782-8227. We welcome the opportunity to answer your questions, and we will gladly prepare a personal charitable lead trust proposal for you to discuss with your professional advisors.