# Scripps Heritage Planner

An Income, Estate and Gift Tax Newsletter for Professionals
from the Office of Gift Planning at Scripps Health Foundation

Summer/Fall 2015

## Leading Questions (and Answers): The Role of the Lead Trust in Charitable Planning

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scrippsheritage.org

## Our Services

The Office of Gift Planning at Scripps Health Foundation is available as a resource to estate planning professionals. Our office will provide these services at no cost or obligation:

- Immediate Telephone Consultations
- Charitable Deduction Calculations
- Summary of Benefits
- Flow Charts and Graphs
- Private Client Meetings
- Presentations at Your Office
- Seminars for Clients

## Our Website - Resources for Estate Planning Professionals

Please visit us online at scrippsheritage.org and click on the link for Professional Advisors to find helpful tools and information.

- Access complimentary charitable gift planning research sources with Crescendo Gift Law Pro™ by clicking on the link to **Charitable Law References**.
- Access the **Deduction Calculator** from Crescendo Gift Law Pro™ to run your own personalized illustrations for clients (or call us and we'll be happy to do it for you).
- Read **Advisor Articles** to spark creative charitable gift planning ideas for your clients.
- Keep up to date with the link to **Washington News**

## Upcoming Gift Planning Seminars

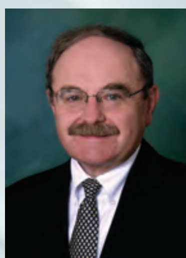
**Representing Beneficiaries During Post Death Trust Administration When to Press, and When to be Patient**
Thursday, September 10, 2015

**IRA Beneficiary Designations**
Wednesday, October 7, 2015

**Avoiding Pitfalls on the Path to the Rewards of Charitable Remainder Trusts**
Wednesday, November 4, 2015

**New Year Laws & Developments and Year End Tax Planning Tools**
Wednesday, December 2, 2015

All presentations will take place from noon to 1:30 pm at the Founder's Room, Schaetzel Center for Health Education. See back page for more details.



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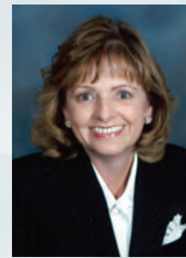

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# Leading Questions and Answers: The Role of the Lead Trust in Charitable Planning

One of the hottest topics in the financial news today concerns the Federal Reserve and the historically low interest rates that have fueled a stock market surge—a rise of about 200% since bottoming out in 2009. Interest rates around the world, both short-term and long-term, are exceptionally low these days. Mortgage interest rates remain particularly attractive. As a fundamental force in the world economy, prevailing interest rates affect virtually all aspects of planning.

Today's historically low rates are not only good news for investors and home buyers, they make giving by way of a charitable lead trust an extremely attractive option. For clients who intend to take advantage of these low rates, now is the time to take a closer look at lead trusts—especially since the Federal Reserve is widely expected to raise interest rates later this year (though exactly when this will happen is a matter of speculation).

While other charitable trusts provide an income stream to donors and leave remaining assets to charity, charitable lead trusts do the opposite, paying an annual income to the charity for a period of years and then passing the remaining trust principal to family members or other non-charitable beneficiaries. The methodology for calculating the "present value" of the charity's income stream and the remainder interest of non-charitable beneficiaries gives rise to significantly greater tax deductions in these times of low interest rates.

## A Legacy Plus an Inheritance

A charitable lead trust (CLT) is a trust where charitable contributions precede (or "lead") the disbursal of the trust remainder to non-charitable beneficiaries. Specifically, a CLT:

1. Pays an annual income to a qualified charitable organization for a specified period of years
2. Passes the remainder of the trust assets back to the grantor or to non-charitable beneficiaries (typically family members) at the end of the trust term

This arrangement allows the grantor to make a temporary gift of income to a charitable cause before making a permanent gift of trust assets to family members or other beneficiaries. In addition to accomplishing these dual goals, the donor receives a significant charitable income tax deduction in the year the trust is established.

**Example:** Elizabeth Penaire, age 53, heads a successful architectural and engineering firm. She recently received a $1.5 million bonus for completing a bridge renovation project three weeks ahead of the scheduled opening and under budget. Since the bonus is currently taxable, Elizabeth wants to generate a substantial tax deduction this year. She also wants to donate some of the money to Scripps Whittier Diabetes Institute—a cause very close to her heart, since her daughter suffers from juvenile diabetes.

Elizabeth's financial advisor suggests a CLT as a way to do both. She agrees, and uses the full bonus amount to fund a charitable lead annuity trust (CLAT) for a period of five years. The trust will pay Scripps Whittier Diabetes Institute 5% annually, or $75,000 per year. Her advisor suggests investing trust assets in municipal bonds that are exempt from federal and state taxes since Elizabeth will be taxed on all of the trust income.

Elizabeth benefits because…

- She receives a current charitable income tax deduction based on the present value of the income stream to the foundation over five years. Using an Applicable Federal Rate of 1.8%, the deduction amounts to over $350,000.
- She gets the trust assets back at the end of the five-year term to use in caring for her daughter.
- She has the personal satisfaction of assisting Scripps Whittier Diabetes Institute, a meaningful cause.

## Lead Trust Variations

Charitable lead trusts are divided into two broad categories:

- A testamentary CLT (or nongrantor or nonreversionary CLT) can be established through a will and is designed to take advantage of the gift and estate tax deduction to minimize transfer taxes.
- A grantor CLT (or reversionary CLT) is an inter vivos trust in which assets revert back to the donor or pass to the donor's spouse when the payments to charity terminate. It is designed to produce an immediate income tax deduction to the grantor.

Variations can be further categorized according to whether:

- the trust is qualified or nonqualified under federal tax law
- the income payout to the charity is an annuity interest or a unitrust interest
- the grantor is considered to own the trust for federal income tax purposes

Let's take a closer look at the differences.

### Qualified vs. Nonqualified: A Taxing Matter

A qualified CLT is eligible for gift, estate or income tax charitable deductions by virtue of meeting the following tax law requirements. The trust must:

- Be irrevocable
- Have a term of either a fixed number of years (most common) or for the life or lives of one or more living persons
- Make income payments to charity that represent either a guaranteed annuity or unitrust interest
- Refrain from making payments to non-charitable beneficiaries during the trust term
- Forbid certain prohibited activities and transactions specifically in the trust instrument

A nonqualified CLT, then, is any trust that fails to meet these qualification rules and is therefore taxed as a complex trust.[1]

### Annuity vs. Unitrust: Determining the Payout

An annuity payout is a fixed percentage of the initial value of the trust principal, establishing a fixed dollar amount that must be paid to charity each year regardless of trust performance. This type of trust is known as a charitable lead annuity trust or CLAT.

A unitrust payout is a fixed percentage of trust principal as it is revalued annually, resulting in an annual payout that fluctuates in amount based on trust performance. This type of trust is known as a charitable lead unitrust or CLUT.

To be qualified, a CLT must not only select one of these two authorized payout methods, it must adhere to the selected method for the entire trust term.

#### Different From a CRT...

Charitable remainder trusts and charitable lead trusts differ in important ways. Unlike a CRT, a CLT has no:

- tax-exempt status (the trust income is taxed to the grantor or to the trust itself)
- minimum percentage payout (whether paid as an annuity or unitrust)
- minimum interest that must go to charity

A charitable lead trust also does not offer the same variations that a CRT does, such as "net income" trusts (where the trustee distributes all trust income if less than the regular percentage payout) or "flip trusts" (where the trustee switches from one type of payout to another upon the occurrence of some contingency).

### Grantor vs. Nongrantor CLTs: The Benefits of Ownership

The grantor can only take a charitable income tax deduction upon the creation of a qualified inter vivos CLT if it is considered a "grantor trust" for federal income tax purposes.[2] The trust's net income is included in the grantor's gross income each year and the grantor can deduct the present value of the charity's income interest in the year of the gift (subject to the percentage limitations).[3]

A grantor is treated as the owner of the trust if the present value of the grantor's reversionary interest in the trust exceeds 5% of the trust's value.[4] So, unless the grantor creates a CLT with an extremely high payout percentage and/or a very long term (so that the present value of the charity's interest is 95% or more of the trust's value), the donor's retention of a reversionary interest will make the CLT a grantor trust for income tax purposes.

When the grantor is not treated as the owner for federal income tax purposes, then the trust is considered a nongrantor CLT. This means that the grantor does not have any of these rights or powers:

- a reversionary interest exceeding 5%
- power to revoke the trust
- power to control its beneficial enjoyment
- a right to receive trust income or to have trust income applied for the grantor's benefit (e.g., to discharge the grantor's obligations or to pay insurance premiums on the life of the grantor or the grantor's spouse)
- administrative powers over the trust (e.g., the power to borrow from the trust on favorable or "sweetheart" terms)

The donor does not earn a charitable income tax deduction for the creation of a nongrantor CLT, although the trust itself can deduct its annual payouts to charity during the trust term.

The grantor is not taxed on trust income or allowed a charitable income tax deduction if other beneficiaries are entitled to the remainder interest. However, federal gift taxes still apply because of the gift of a future interest to a noncharitable third party. It is the present value of the charitable portion that is sheltered by the gift tax charitable deduction (assuming the CLT is qualified).

### Inter Vivos vs. Testamentary CLTs: Saving on Income or Transfer Tax

A grantor may set up a charitable lead trust during life or through provisions in a will or trust.

- When the primary motive is current income tax savings, the grantor should set up a grantor CLT during life.
- When the primary motive is transfer tax savings, the grantor should choose to establish a testamentary CLT. An important side benefit of passing assets to beneficiaries at death is a step-up in tax basis to the estate tax value of trust assets.

An inter vivos CLT can also produce transfer tax savings. The gift tax charitable deduction (for a qualified CLT) applies because of the gift to the noncharitable remaindermen in the case of a nongrantor CLT. However, unlike a testamentary CLT, the grantor's basis in the trust property carries over to the remaindermen at the end of the trust term.

If the grantor dies before all payments have been made to the charity, the present value of the remaining payments can be deducted for purposes of the estate tax if the CLT is included in the grantor's gross estate.

Finally, the appreciation in value of the trust principal after trust creation escapes transfer tax entirely (unless the generation-skipping tax is triggered upon trust termination).

## Qualified Nongrantor CLTs: Sheltering an Inheritance

Qualified nongrantor charitable lead trusts shelter property that passes to family members from gift or estate taxation. These trusts have an interesting mix of characteristics. The donor:

- does not receive a charitable income tax deduction upon the transfer of property to the trust
- does not owe taxes on trust income
- does not owe capital gains tax on the transfer of the assets to the CLT, even though the property may have appreciated substantially in value
- may deduct the present value of the charitable interest for federal estate tax (testamentary trust) or gift tax purposes (inter vivos trust)

If the donor deducts the present value of the charitable interest for federal gift tax purposes, the gift tax deduction is unlimited if the donor files the applicable gift tax returns (unlike the charitable income tax deduction, which is subject to annual limits). The exact amount of the gift tax charitable deduction depends on:

- the annual dollar amount payable to charity
- the number of annual payments
- the applicable federal midterm interest rate (AFR) at the time of the transfer

Historically low interest rates make a CLAT an effective strategy for maximizing wealth transfer goals while benefiting a charity. A simple example illustrates the power of a low AFR (the rate used to calculate the present value of the charity's interest).

**Example:** Ruth Martin is recently widowed. She has a net worth of approximately $15 million, so she is concerned that estate taxes will diminish her children's inheritance. She also wants to leave a legacy by donating to Scripps Health, an institution that her late husband, Dr. Charles Martin, helped establish.

After consulting her attorney, Ruth decides to use $4 million to fund a charitable lead annuity trust (CLAT).

- The charity will benefit. The CLAT will make 10 annual payments to the hospital of 4% of the trust's initial value ($160,000 per payment). Total payments over 10 years will come to $1.6 million.
- Her children will benefit. All remaining assets will pass to her children. These assets count as a gift and are subject to the gift tax. (The gift tax only applies to the present value of the assets that pass to the children, not to the entire $4 million.)

To determine the taxable gift to the children, we subtract the present value of the charity's interest from the total assets contributed to the CLAT. In this example, the present value of the charity's interest over the 10-year period is equal to $1,452,368, so the taxable gift is $2,547,632 ($4 million - $1,452,368). Ruth will need to pay the gift tax or use part of her lifetime gift tax exemption. Ruth takes a current charitable tax deduction in the amount of the present value of the charity's interest ($1,452,368).

The annuity interest is calculated using the applicable federal interest rate (AFR), which, at 1.8% in May 2015, is near historic lows. This factor produces a higher present value for the charitable contribution and therefore provides increased gift tax savings. Contrast this to using an AFR of 5%, which would reduce her tax deduction by over $200,000.

Let's assume that the assets in Ruth's CLAT grow at a rate greater than 1.8%—say 5%. The appreciation will pass to her children free of gift or estate tax. The hospital will still receive a total of $1.6 million, and the remainder interest going to her children will be nearly $4.3 million—a significant tax savings for the family and a generous gift to charity.

It is important to emphasize that appreciation in the value of the property after the transfer to the trust will not be subject to either a gift or estate tax.

### Present Value and the Desirability of Low Interest Rates

Present value is the current value of a sum of money that will be received over time, given a specified interest rate. We can understand the present value of a future interest by asking: "Assuming an interest rate of X%, how much money would need to be invested today to achieve $Y over a given period of time?"

Obviously, the lower the interest rate, the slower the growth, and therefore the greater the amount of money currently needed to achieve the desired result. For purposes of determining the current value of a charity's future interest (and the size of the charitable deduction) in the case of a CLT, the benefit of a low interest rate is significant.

The donor must use the applicable federal interest rate (AFR) specified under IRC §7520. Selecting the lowest AFR will maximize the deduction, other factors being constant. Recent AFRs have been as low as 1.8%.[5]

A charitable lead unitrust (CLUT) produces a larger charitable deduction than a charitable lead annuity trust (CLAT) if the payout rate to the charity is less than the assumed (federal) interest rate. If the payout rate is greater than the assumed interest rate, a charitable lead annuity trust will produce a larger deduction. A low AFR leads most people to choose an annuity trust approach.

## Qualified Grantor CLTs: Taxes and Deductions

A CLT treated as a grantor trust for federal income tax purposes has special tax consequences. The typical grantor lead trust provides that at the end of the trust term, the trust property reverts to the grantor or the grantor's spouse. Because of this reversionary right, the grantor is treated as the owner of the trust (assuming the value of the reversion exceeds 5%, as it usually does). The grantor is taxed on all the trust income, but the present value of the charitable interest is immediately deductible for income tax purposes.

### The Income Tax Charitable Deduction

While the grantor can claim an upfront deduction for the present value of the guaranteed annuity or unitrust interest that will go to the charity, the deduction in the year of the transfer cannot exceed 30% of the donor's adjusted gross income. This is true even if the grantor funds the trust with cash, which is normally subject to a 50%-of-AGI limitation (the charitable interest is considered a gift *for the use of* a charity, not *to* a charity,[6] which triggers the special 30%-of-AGI limitation). The donor can carry over any excess deduction for up to five succeeding years (subject, again, to the 30% limitation).

After the year the donor takes the charitable deduction, the donor is taxed on all trust income. If the donor of a grantor CLT ceases to own the trust at any time (typically due to death), the donor must recapture a portion of the charitable deduction that was previously obtained, and is required to include it in income.

### Gift and Estate Tax Considerations

There is no taxable gift when a donor transfers property to a grantor lead trust because the grantor retains the remainder interest. The only completed gift is the charity's income interest, which will qualify for a gift tax charitable deduction equal to the present value of the charity's future income stream.

If the donor dies before the termination of the trust, the full value of the trust will be included in the gross estate, but a charitable deduction will be allowed for the present value of any remaining payments of the charitable income interest.

Transferring property to an inter vivos charitable lead trust provides the additional advantage of avoiding estate and gift taxes on trust property appreciation between the date of the gift and the date of death.

## Restrictions on Charitable Lead Trusts

Lead trusts are restricted by the same rules applicable to private foundations under the Internal Revenue Code. In particular, IRC §4941 outlines restrictions on self-dealing, prohibiting the following actions between the CLT and a disqualified person (i.e., a substantial trust contributor, manager, or 20% owner of a business enterprise, including family members):

- selling, exchanging, or leasing property
- lending money or extending credit
- furnishing goods, services, or facilities
- paying compensation
- transferring income or assets
- making payment from the CLT to a government official

IRC §4945 imposes an excise tax on amounts paid by a CLT:

- to influence legislation or the outcome of a public election, or
- for any purpose that is not within the usual religious, charitable, scientific, literary, and educational purposes as contemplated in the Code

## Excess Business Holdings and Jeopardy Investments

With respect to "excess business holdings" and "jeopardy investments," significant exceptions are allowed for charitable lead trusts that are important for transfer planning.

A charitable lead trust has excess business holdings if it owns, along with any disqualified persons, more than 20% of the voting stock of a business. In general, when a CLT acquires excess business holdings by gift or bequest, the CLT has five years from the date it acquires such holdings to dispose of them.[7]

The Code imposes an excise tax on a charitable lead trust for "jeopardy investments"—investments that jeopardize its exempt purposes.[8]

The trust is relieved from the restrictions of the excess business holdings and jeopardy investment rules if:

- all of the income interest (and none of the remainder interest) is devoted solely to the charitable purposes described in IRC §170(c)(2)(B), and
- the value of the deductible charitable lead interest at the time of trust creation is not more than 60% of the value of the assets transferred to the CLT (a particularly important exception when planning the estate of a donor who desires to keep a highly valued family business or real estate holdings within the family.)[9]

## Lead Trust Opportunities

### The Intentionally Defective Nongrantor CLT

A donor may obtain an income tax deduction at the inception of a charitable lead trust and also obtain a gift tax deduction for a gift to noncharitable remainder beneficiaries by establishing an "intentionally defective" CLT. To do this, a grantor:

1. Establishes a trust with nongrantor remainder beneficiaries (children, for example).
2. Intentionally chooses power over the trust to make it a grantor trust for federal income tax purposes without the "retained strings" that would cause inclusion in the gross estate. The IRC §675(4)C power to swap assets is a safe and easy power to retain (and therefore the most commonly used). This code section authorizes any person not acting in a fiduciary capacity and without the consent of a fiduciary to exchange trust assets for full and adequate consideration.

The upshot is that the donor:

- Removes the trust property from the gross estate
- Secures an immediate income tax charitable deduction
- Owes taxes each year on the trust income
- Does not receive a charitable deduction for the annual annuity or unitrust amounts paid to charity

### The "Shark Fin" CLAT

The "shark fin" CLAT is gaining in popularity as a method to increase the amount of assets the donor can pass to beneficiaries in a tax favored manner. Shark fins are lead trusts in which lower initial payments to charity balloon over time to fulfill the promise of the annuity obligation. There is no specific IRS guidance on these trusts, but there is a private letter ruling permitting a lead trust to increase payments by 20% each year of the term.[10]

Donors who adopt this strategy hope assets will compound and appreciate significantly during the term, thereby maximizing the amount passing to family members. A concern, of course, is that trust income may far exceed the charitable distribution, resulting in substantial taxable income.

## Conclusion

Current low interest rates should prompt donors to seriously consider a charitable lead trust to accomplish twin goals: creating a charitable legacy and providing a substantial inheritance for family members. Low interest rates that favor this strategy will not last forever—as the economy continues to recover, rates will rise and this historic opportunity will pass. There is simple truth in the saying that "time is money," and charitable lead trusts are one way to put that maxim to work.

### Endnotes

1 A complex trust can provide for charitable gifts, an income stream, or other types of wealth distribution. Unlike a simple trust, distributions under a complex trust are discretionary in amount and the trustee need not pay current income to trust beneficiaries. See, IRC §662 and Reg. §1.662(a)-1.

2 IRC §671

3 IRC §170(b)(1)(B)

4 IRC §673(a)

5 The charitable deduction is for the present value of the charitable interest using the discount rate under IRC §7520. The discount rate under section 7520 equals 120% of the federal midterm rate under IRC §1274(d)(1) for the month of transfer or either of the two months preceding the month of transfer, if so elected.

6 Reg. §1.170A-8(a)(2)

7 IRC §4943

8 IRC §4944

9 IRC §4947(b)(3)(A)

10 See PLR 201216045

## Upcoming Gift Planning Seminars

Complimentary lunch and validated self-parking provided.
MCLE credit is offered and available for those who qualify.

**All presentations will take place at:**
Founder's Room, Schaetzel Center for Health Education
Scripps Memorial Hospital La Jolla
9888 Genesee Avenue La Jolla, CA 92037

**To make a reservation:**
email giftplanning@scrippshealth.org
or call 858-678-7120

### Representing Beneficiaries of Trusts in Post Death Trust Administration When to Press and When to be Patient

Thursday, September 10, 2015 Noon – 1:30 pm

Presenters: Linda P. Spuck, CTFA and Vice President/ Trust Officer, Union Bank of California, the Private Bank and Janet H. McDonough, Esq., Director of Gift Planning, Scripps Health Foundation

Your client is a beneficiary of a trust. Now what? Learn the responsibilities of the trustee and when your client has a right to request information. How much information are you entitled to receive? Can you request information for transactions that occurred prior to death? What information must an accounting include? How can you compel an accounting? Is it worth it to file court proceedings against the trustee or executor? Will your actions trigger a no-contest clause? How long should you expect to wait to receive the distribution after a death? How can you establish realistic expectations to plan for receipt of your gift?

Reservation deadline: Friday, September 4, 2015

### Nuts and Bolts of Estate Planning for Retirement Benefits

Wednesday, October 7, 2015 Noon – 1:30 pm

Presenter: Susan Mercure, Partner, Esq., Higgs Fletcher & Mack, LLP

So you want to designate a trust as the beneficiary of your client's IRA. Wait! Learn the tax consequences and the nuts and bolts of planning for retirement benefits.

- Difference between plans; Beneficiary designations; Drafting considerations;
- Inherited IRA rules: how to maximize their benefit;
- Special rules and special uses: distributions to charities and special needs trusts, self-trusteed IRAs.

Reservation deadline: Friday, October 2, 2015

### Avoiding Pitfalls on the Path to the Rewards of Charitable Remainder Trusts

Wednesday, November 4, 2015 Noon – 1:30 pm

Presenters: Kenneth G. Coveney, Esq.,Partner, Dostart Clapp Hannink & Coveney, LLP and David E. Williams, Senior Director of Gift Planning, Scripps Health Foundation

Charitable remainder trusts (CRTs) are versatile gift planning vehicles for your clients to achieve a variety of estate planning goals, but are there potential pitfalls to watch for and avoid? Attorney Ken Coveney will address some issues that arise in the formation and administration of CRTs. He will address issues that may arise and need to be addressed such as conflicts of interest, self-dealing, mortgages, valuation, etc. Mr. Coveney and Mr. Williams will share from their experience how to successfully create and administer CRTs and how they can establish your clients' charitable legacies.

Reservation deadline: Friday, October 30, 2015

### Recent Developments in the Law and Year End Planning

Wednesday, December 2, 2015 Noon – 1:30 pm

Presenter: Meredith G. Alcock, Esq., Partner, Abbene & Alcock, APC

Reservation deadline: Wed, November 25, 2015

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La Jolla, CA 92037

Please visit us online at **scrippsheritage.org** where you will find many helpful tools and links to tax laws and articles. If you are not already receiving our weekly eNewsletter, you may sign up easily on our web site.