

## LEAD TRUSTS: A TIMELY OPPORTUNITY

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*This article is designed to introduce donors with substantial assets to the benefits of a non-grantor lead annuity trust, particularly in today's environment. You can find the text in the Resource Center of our Web site. Feel free to adapt the text to your institution and print the article on your letterhead.*

For decades, charities have recommended that individual donors donate appreciated assets rather than cash because of the capital gains taxes saved. So, it is not surprising that recent large declines in the financial markets have caused many individuals to postpone their charitable giving plans. Not only do they feel less wealthy, but there simply are not as many appreciated assets to give. However, there is a charitable giving strategy that is well-suited to today's environment of depressed financial asset values and low interest rates, particularly for those whose estates are large enough to be subject to tax when they die. It is called a charitable lead trust.

A charitable lead trust allows donors to make annual gifts to their favorite charities beginning today, while transferring assets to heirs in the future at a reduced or even zero estate or gift tax cost. To illustrate how this plan might meet a donor's objectives, we will consider the following hypothetical example.

### *Meet the Jacksons*

Steve and Linda Jackson are 75 and 65 years old, respectively. They have three children ages 40, 38, and 35 years. Their estate consists of two residences, some IRAs, and an equity-oriented investment portfolio. The value of their combined estates a couple of years ago was about \$16 million. Given the recent economic turmoil, they estimate the current value of their combined estates to be about \$12 million.

Recently, Steve read an article that suggested the federal estate tax is not likely to be repealed and that the current exemption amount of \$7.0 million per couple might be retained. Steve and

Linda realized the survivor's estate likely will owe estate tax on the transfer of assets to their children. Based on their current estate values, about \$5 million would be subject to federal estate tax at a rate as high as 45%. Steve and Linda are concerned about the large potential tax liability and also realize that the amount of tax could be even higher if the value of their assets recovers from recent market levels. They have considered giving some assets to their children now while values are low, but they are concerned about giving them too much too early in their lives.

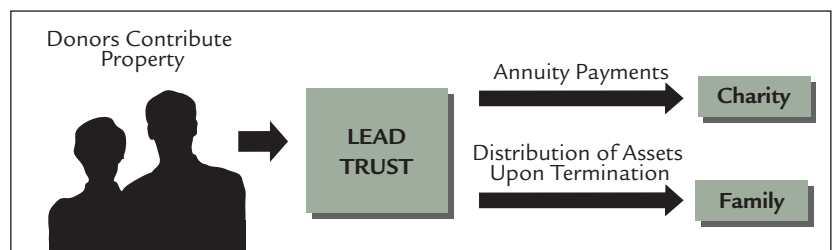
Over the past few years, Steve and Linda have met several times with Bob, the Vice President of Development at State University, where Steve and Linda each received professional degrees. State University is embarking on a capital campaign. Linda had previously indicated to Bob that she and Steve would like to support the campaign, but with their recent financial reversal, they are worried about making a large current gift.

### *Saving Taxes with a Lead Trust*

At a recent meeting, Bob described how a charitable lead trust might meet Steve and Linda's financial and estate planning objectives, while also supporting State University. The University's director of gift planning put together an illustration of a \$2,000,000 charitable lead annuity trust with a 6.5% payout rate for a 20-year term. This means the trust would make an annual payment to State University of \$130,000 per year for 20 years. The trust would then terminate and distribute its remaining assets to the Jackson children. (See Figure 1 for a diagram of how a charitable lead annuity trust works.)

Bob remarked that now is a particularly good time for a lead trust because IRS tables currently assume that the investments in a lead trust will return only 2.4% per year. Just a couple of years ago, that return assumption was 5.8%. The essential effect of this lower return

Figure 1



assumption is a higher charitable deduction that could result in most, or even all, of the trust assets passing to the Jackson children free of gift or estate taxes.

Although Steve acknowledged that recent markets had shaken his confidence a bit, he reasoned that a 2.4% return assumption over a 20-year investment horizon seemed like a fairly easy hurdle to clear. Bob further explained that if the trust earned 6.5% each year (net of expenses) and paid out that 6.5% per year as gifts to State University, the full \$2,000,000 would pass to the children at the end of the trust term. If the trust earned more than 6.5% per year, more than \$2,000,000 would go to the children free of gift or estate taxes.

Linda was not certain she and Steve would want the trust to run for as long as 20 years, and inquired about a shorter term. Bob responded that, under the IRS calculations, a shorter term would result in a greater assumed remainder gift to their children. This might result in federal gift tax being owed, depending on the specific terms of the trust and whether the Jacksons had previously made large gifts to the children or others. Bob indicated that he and State University's director of gift planning would be happy to discuss these specifics with the Jacksons' estate planning attorney.

### *Other Planning Considerations*

Steve found the ability to reduce gift or estate taxes while also making a gift to State University very appealing. But he was not sure they had the right funding assets for a lead trust. Many of their portfolio holdings were priced at a loss, and while their vacation home probably was still appreciated, he and Linda anticipated enjoying the property for at least several more years. Bob then explained that unless someone has an income producing asset they want to pass to heirs, it is often better to fund a lead trust with cash. In fact, the selective selling of portfolio investments at a loss could improve the Jacksons' current income tax picture and also free up some cash to fund the lead trust. Bob further elaborated that they could essentially replace the lost market exposure in their personal portfolio with a broadly diversified portfolio in the lead trust. Any appreciation in the lead trust would be shielded from gift or estate taxes.

This idea prompted Linda to ask whether the gift to the lead trust would generate an income tax charitable deduction. Bob indicated that the type of lead trust they were discussing would not generate an income tax deduction. He pointed out that the investment earnings

(including realized capital gains) would no longer appear on the Jacksons' personal income tax return, but instead on the lead trust's tax return. This would save income taxes for Steve and Linda. Also, if the trust were carefully managed, Bob emphasized, taxes could be minimized for the lead trust as well because it could claim a deduction for the gifts made each year to State University.

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Steve asked about who would serve as trustee of the lead trust. Bob explained that they could serve as trustees of their own lead trust, or Linda and Steve could name a family member, trusted advisor, or State University as the trustee. Alternatively, they could select a professional fiduciary such as a bank or trust company. The important thing, Bob noted, is that the trustee be experienced at handling lead trusts. The lead trust is a separate taxpayer, and the investment decisions made by the trustee would affect the tax positions of the Jackson children when they received the assets at the end of the trust term. Therefore, both investment and tax expertise are important in managing the trust.

At the end of the meeting, the Jacksons agreed to ask their estate planning attorney to contact Bob and the University's director of gift planning so that they could jointly explore the specific benefits of a lead trust in their situation. They expressed sincere appreciation to Bob for bringing to their attention how they might structure a plan to achieve their estate planning goals while also making a meaningful gift to State University. ■

