

The “Temporary Private Foundation”

With interest rates at historic lows, now is the time for charitable lead trusts. They let clients keep assets while they're alive, provide income for their charities—and give a tax-free inheritance to their children.

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For those who would like to transfer significant amounts of wealth to family or other loved ones during their lifetimes, there are few acceptable alternatives to the payment of what many consider to be confiscatory gift taxes. The Bush administration has promised to eliminate the federal estate tax. Even if that goal is reached, the problem of transferring wealth during one's life is likely to remain, as there are currently no plans to eliminate the gift tax.

are low, there may be a better way for some. The charitable lead trust lets the affluent not only make significant charitable commitments they can see fulfilled during their lifetimes, but also pass unlimited wealth to their heirs on a tax-free basis. The charitable lead trust is a plan whose time has come.

Charitable Alternatives

Since the introduction of the gift and estate taxes, federal laws as well as the laws of most states

through estates is typically accomplished by testamentary transfers utilizing wills, trusts, remainders of life insurance and retirement plans and other similar means. Over centuries, however, more sophisticated tools have been developed that involve splitting interests in property and variously devoting those interests to combinations of charitable and non-charitable purposes

The creation of perpetual charitable foundations is one method the wealthy traditionally have used

Creating a private foundation is very noble. But of course it means effectively disinhering a client's heirs. Right now, though, there is a way to give both to charity and progeny.

To cope with gift and estate taxes, the wealthy frequently create private foundations. While noble, this option permanently separates heirs from assets that they might otherwise receive. Right now, while interest rates

have been designed to reflect widely accepted social policy that would allow voluntary redistribution of wealth to charity in lieu of involuntary redistribution via the tax system. The transfer of wealth for philanthropic purposes

to help shield wealth from transfer taxes. When controlled by the original donors and/or their heirs, these entities are typically referred to as “private foundations.”

The good news for those who establish private foundations dur-

Given a choice, many would decide to temporarily disinherit their children—if at the same time they could eliminate the transfer tax, and teach heirs social and fiscal responsibility.

ing their lifetimes or at their deaths is that no tax is due on the assets used to fund the foundation. The bad news is that heirs are permanently denied ownership of the property transferred to the foundation. While heirs can be paid significant salaries for serving in a management capacity for a foundation, this is small consolation to those who are forever denied access to the foundation funds for their personal use and enjoyment.

As a result, those who have traditionally established private foundations fall into two broad categories: The Purposeful Philanthropist and The Reluctant Philanthropist.

The Purposeful

One group of wealth holders carefully decide to limit how much their heirs will receive, arrange to pay the tax due on that amount, and then leave the balance of their assets either outright to one or more charities or to a private foundation to be controlled by their heirs or others they trust. They often chose to go with a foundation when the amount of wealth is beyond what they want to leave to family members, and also exceeds the amount that person wishes to devote permanently to one or more particular charities.

For example: Harold Weiss (not his real name) inherited \$1 million from his father in 1965 when he was 30 years old. Harold received his inheritance from a trust established by his father 10 years before his death. Through hard work and careful investments,

Harold increased his net worth to some \$100 million.

He decided that he wants his children to have the same start in life that he had by receiving the same inheritance he enjoyed. His will provides that his three children shall each receive an amount equal to \$1 million in terms of 1965 dollars at the time of his death (about \$5.5 million each if he died in 2002). His personal representative is instructed to gross that amount up for taxes, pay the tax due, and use the remainder of the estate to establish a foundation that will be managed by his children for their lifetime and in the future by a self-perpetuating board.

The end result is if he died in 2002, about \$17 million would be transferred to his children, with estate taxes due in the range of \$14 million. The remaining funds, an amount approaching \$70 million, would be used to establish the foundation. When asked if his plans would change in light of proposals to eliminate estate tax, he replied that there was no need to make any changes, the only difference would be that the funds that would be used to pay the transfer tax would be available for the foundation, resulting in an foundation funded with closer to \$85 million.

Recent studies show an increasing number of our nation's wealthy are deciding to disinherit their heirs beyond a certain level. In fact, many among the very wealthy say that they would never chose to transfer all of their assets to their families, even if there were no estate tax. Bill Gates and

Warren Buffett are among the most famous examples.

The Reluctant

There is another group that ultimately establish private family foundations, but do so somewhat grudgingly.

Experienced planners know that there are those among the wealthy who would like to leave the bulk of their assets to their natural heirs eventually, but want them to first learn fiscal responsibility. They also do not want to pay a transfer tax of up to a dollar for each dollar left to their heirs. The idea of establishing a foundation that eliminates transfer taxes, but also serves to permanently deprive their heirs of the funds transferred to the foundation is small consolation for them, as it results in accomplishing only one of their objectives—the elimination of taxes. Faced with a choice, however, some persons, especially lifelong entrepreneurs with a distinct anti-tax bias, will opt for the private foundation alternative for at least a portion of their wealth, despite the fact that their families will never receive any of the funds. For them, the family foundation is an imperfect solution, despite the assurances by those helping them decide on this course that the foundation can help pass on important values and otherwise play an important role in promoting family cohesiveness and other desirable ends.

In most cases, many of these individuals, given a choice, would decide to temporarily disinherit their heirs—if there was a way to

do so while completely eliminating transfer tax, and giving heirs the lessons in social and fiscal responsibility that involvement in a family foundation are supposed to teach.

The “Temporary”

Today’s economic conditions may be less than favorable for some types of charitable planning arrangements. But they have served to greatly increase the attractiveness of one elegant solution for those who are charitably minded, and also would like to transfer virtually unlimited amounts of property to

the amount used to fund the trust. An offsetting deduction is allowed, however, for the value of the intervening income interest that is devoted to charity. The valuation of this interest is determined by formulas provided for by Congress in the 1969 tax act and later rules and regulations promulgated thereunder. The assumed rate of return (the discount rate) used to value these interests is a vital component of the formula. The interplay of the factors that result in the determination of this rate has served to

that loss can be somewhat mitigated in the case of a foundation by giving the family a continuing role in controlling it. There is, however, a third route to charity which offers just as much in the way of tax saving, and gives a lot more to one’s heirs. In fact, it gives the heirs most of the benefits of complete ownership.”

“The device which produces these marvelous results is known as a ‘charitable front-end annuity trust’ or a ‘charitable lead annuity trust.’” Cooper wrote. “In such a trust, property is held to pay a

Given a 3.6 percent discount rate, estate or gift tax now can be completely eliminated by using a charitable lead trust that is structured to pay 7 percent for just 20 years.

heirs on a totally tax-free basis over a relatively short period of time.

What we now know as the “charitable lead trust” has been used for many years to transfer wealth to heirs, while first serving to devote significant amounts of wealth to charitable use over a period of time.

In essence it’s a very simple plan. Under the terms of a charitable lead trust (CLT) a donor transfers assets to a trust which makes payments to one or more charitable interests for a time period the donors chooses. Unlike its cousin, the charitable remainder trust (CRT), there is no minimum or maximum payout amount or time period prescribed. Like a CRT, however, payments can be fixed at the time the trust is created or can be designed to vary with the value of the trust corpus.

When a donor establishes a lead trust during lifetime or at death, a gift or estate tax return is filed that reports a gift to heirs of

create a silver lining in some of the clouds that may now hang over the economic landscape.

The History

During the late 1970s, at a time when discount rates were fixed by Congress at what was then considered an artificially low rate of 6 percent, lead trusts were widely utilized in estate and gift tax planning. Why was this? In a 1977 *Columbia Law Review* article, “A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance,” George Cooper made the following observations regarding the role of the charitable lead trust in estate and gift tax planning of the time: “This [charitable planning] can, and frequently does, take the form of bequests to existing charitable organizations. Often it results in the creation of a foundation. Both these routes to charitable giving result in a permanent loss of funds to the family, although

fixed sum annually to charity for a period of time (this is the ‘front-end’ or ‘lead’ period), and at the end of that time full ownership of the property and all income therefrom reverts to non-charitable beneficiaries, such as the heirs of the trust’s creator. When property is placed in such a trust, whether by gift or bequest, the creator of the trust receives a charitable deduction for the actuarial value of the front-end annuity interest, determined under Internal Revenue Service tables.”

During the period of relatively high interest rates in the late 1970s and early 1980s, one could create a charitable lead trust, and set a relatively high fixed pay out rate, 8.6 percent for example, while the income stream would be valued at the artificially low statutory discount rate of 6 percent. The result was the ability to transfer funds on a tax-free basis in a relatively short period of time. For example, at that time it was possible to elimi-

nate estate and gift tax on any amount one wished by placing the funds in a trust that made fixed payments of 8.6 percent for just 20 years. While that pay out rate may seem relatively high by today's standards, recall that in 1982 long-term treasury obligations paid 12.9 percent.

In 1983, there were a flood of assets passing free of transfer taxes from one generation to the next through the lead trust and other planning techniques designed to "arbitrage" low statutory interest rates that failed to reflect economic reality. Congress reacted by raising the statutory discount rate from 6 percent to 10 percent. In facts described above, this resulted in reducing the charitable gift or estate tax deduction on an 8.6 percent lead trust funded with \$1 million that was set to last for 20 years from \$1 million to some \$765,000, leaving \$235,000 subject to tax. To continue to eliminate gift or estate taxes completely, the pay out rate would have to be raised to 11.7 percent.

Congress achieved its goal. The use of charitable lead trusts was quickly chilled. At the same time, interest rates were beginning to fall and donors and advisors began to be increasingly uncomfortable with the risks they perceived in setting lead trust pay out rates at levels necessary to zero out taxes.

In 1989, Congress took additional steps to recognize that interest rates can fluctuate significantly—and rapidly—over time, and enacted legislative action that resulted in a discount rate that now floats at 120 percent of the federal mid-term funds rate. This methodology remains in effect today. One of the byproducts of historically low interest rates is their impact on the discount rate used to value the income interest portion of split interest charitable gifts. This rate

has fallen to as low as 3.6 percent for Nov. 2002.

While lower discount rates tend to reduce charitable deductions for charitable remainder trusts and similar plans that feature income for donors, lower discount rates now make it possible, as was the case during the late 1970s, to easily eliminate gift or estate tax on an unlimited amount of funds transferred through the use of charitable lead trusts. Given a 3.6 percent discount rate, estate or gift tax now can be completely eliminated by using a charitable lead trust that is structured to pay 7 percent for just 20 years. It was not possible to achieve this result in any period of time using a pay out that low just two years ago. As recently as July of 2001, a period of 40 years would have been required to accomplish the desired outcome! (See, "Lower

Interest Rates Make Lead Trusts More Effective," page 17.)

The 3.6 Percent Solution

Here is an example of how a charitable lead trust might be used in today's environment to eventually transfer funds to family members, while first providing for what might be thought of by wealthy individuals and their advisors as a "temporary family foundation."

A couple, let's call them Ed and Edwina Fischer, at ages 59 and 57 recently have sold their closely held business and now own an investment portfolio and other assets valued at some \$20 million. Their income is now in the range of \$500,000 a year, and they will both eventually be required to make large withdrawals from their retirement plans, so they do not anticipate

the need for additional income.

The Fischers have three children that range in age from 25 to 30 who are in the early stages of their careers. The couple has been advised to begin a gifting program designed to transfer as much as possible to the children on a tax-free basis over time. The pair agrees with this advice in principle, but do not want their children to have uncontrolled access to significant amounts of assets until they are in their mid-40s at the earliest. For this reason, they have not yet made use of the \$1 million per person gift tax exemption to which they are each entitled under provisions of the 2001 tax act, as of January 1, 2002.

The Fischers also have expressed a desire to make significant charita-

THE LOW-INTEREST-RATE BONANZA

The time period required to eliminate gift and estate taxes using lead trusts has dropped along with prevailing interest rates.

Payout Rate	Federal Discount Rate	Last Date Rate Was Applicable	Years to Eliminate Tax
7%	10.6%	Nov. 1990	Not Possible
7	9.6	Feb. 1995	Not Possible
7	8.6	May 1995	Not Possible
7	7.6	Sept. 2000	Not Possible
7	6.6	July 2001	40
7	5.6	July 2002	28
7	4.6	Sept. 2002	24
7	3.6	Nov. 2002	20

ble gifts.

Their advisors have informed them that unless they take steps to minimize their potential tax burden, their estates eventually may pay taxes of \$10 million or more—depending on what year they die, congressional action on the estate tax, the future growth in value of their assets and other factors. The Fischers believe it is unlikely that Congress will totally eliminate the estate tax, even if the rates are lowered significantly and/or the thresholds at which the tax applies are raised over time.

Like many entrepreneurs, the Fischers are very conservative politically and do not like the idea of making the largest gift of their lives to the federal government. They feel they have earned their wealth, and should be allowed to pass it on to their heirs. But they also feel very strongly that their children should become financially responsible, learn to provide for themselves, and develop philanthropic habits before receiving a significant inheritance.

After careful consideration, the Fischers reluctantly plan to create a private foundation during their lifetimes, and to begin gradually

transferring their assets to it. They decide to sit on the foundation board with their children, and use the earnings of the foundation to make their charitable gifts for the remainder of their lives. After their demise, their children are to be trustees of the foundation. The couple has been told that their children could be paid reasonable salaries to run the foundation, and have significant influence in the community through their ability to direct what could be large amounts in grants.

The Fischers remain vaguely uneasy about this plan, even though it serves to meet a number of their planning objectives, while totally eliminating their estate tax burden. In the final analysis they are not comfortable with the idea of largely disinherit their children. They have, however, acquiesced to the fact that this may be the best they can do for their children without paying what they consider to be an exorbitant amount in estate taxes.

Today's Solution

But there is something more they can do. There is the charitable lead annuity trust option.

The charitable lead trust can be used either alone or in combination with a family foundation or donor-advised fund. Other variations feature income to charity that fluctuates with the value of the trust assets and may result in income tax savings.

After learning about this possibility, the Fischers decide to create such a trust, and fund it with assets worth \$10 million. They believe that a total return of 7 percent a year over the next 15 years is a reasonable assumption. Based on this belief, they direct that the lead trust will pay an annual fixed amount equal to 7 percent of the value of the assets initially transferred. The trust will thus pay \$700,000 per year for 15 years, resulting in an income stream of some \$10.5 million available to fund charitable gifts.

Assuming an applicable discount rate of 3.6 percent, the Fischers would enjoy a gift tax deduction of some \$8 million, leaving a taxable gift of \$2 million in the year the trust is created. Their combined estate tax exemption amounts of \$2 million would be sufficient to offset the entire taxable gift, resulting in a gift of \$10 million (more or less depending on the performance of the trust assets) to their children in just 15 years when they are in their mid to late 40s.

The net result is to retain \$10 million in other assets for the Fischers' use for the remainder of their lives, provide an income stream of \$10.5 million to charities of their choice, and give a tax-free inheritance for their children at a time when they want them to receive it. They have, in effect, temporarily disinherited their children in a way that fulfills their charitable intentions and eliminates \$5 million or more in potential transfer tax liability under the

rates in effect today.

As an added benefit, it is likely that one or both of the Fischers will be alive in 15 years, and will be able to see their children receive and enjoy their inheritance.

If they wish, they can continue their annual giving program to their children, and leave the remainder of their estate at death to a testamentary lead trust if conditions are favorable at that time. A testamentary lead trust eventually could transfer additional funds to their children and/or grandchildren on a tax-free basis, making maximum use of generation-skipping exemptions if applicable at the time. The net result would be to transfer their entire fortune to their heirs—completely free of tax.

If Ed and Edwina Fischer were not sure how they wanted all or a portion of the payments from the lead trust to be distributed, they still could establish a permanent family foundation (or a donor-advised fund at a community foundation) that would receive the payments from the trust. Let's assume they then distributed 5 percent a year; the funds earned a total return of 7 percent; and the excess earnings over the charitable payments accumulated over time. At the end of the 15 year term of the lead trust, a balance of more than \$8 million would remain—even after distributions of nearly \$4 million to charity over the 15 year term of the lead trust.

If they took this approach, they will have, in effect, transferred \$10

million to their children tax free while still providing for more than \$8 million in a donor-advised fund or foundation that they and/or their children can advise or manage.

The Variations

One can see why an increasing number of wealthy individuals are choosing to make use of a charitable lead trust, either alone or in combination with a family foun-

dation or a donor-advised fund, as a central component of their wealth transfer planning.

The charitable lead trust is a powerful and versatile tool. In this article we have touched on only one of many uses for this plan. Other variations feature income to charity that fluctuates with the value of trust assets and may result in income tax savings for donors along with the eventual return of the assets to the donor rather than being passed to heirs. These possibilities can make the lead trust especially attractive to wealthy persons who wish to make gifts of income for a period of time without sacrificing ultimate control over assets.

Another arcane, but potentially valuable planning potential inherent in the use of lead trusts is the fact that they can afford a means of avoiding the 50 percent of adjusted gross income limita-

USING A LEAD TRUST TO CREATE A PRIVATE FOUNDATION.

It is possible to use payments from a lead trust to make charitable gifts over time while also building a permanent gift fund through a private foundation or a donor advised fund.

End of Year	Contribution To Gift Fund	7 Percent Growth	5 Percent Payout	Gift Fund Balance
1	\$700,000	\$49,000	\$37,450	\$711,550
2	700,000	98,809	75,518	1,434,841
3	700,000	149,439	114,214	2,170,065
4	700,000	200,905	153,549	2,917,422
5	700,000	253,220	193,532	3,677,109
6	700,000	306,398	234,175	4,449,331
7	700,000	360,453	275,489	5,234,295
8	700,000	415,401	317,485	6,032,211
9	700,000	471,255	360,173	6,843,293
10	700,000	528,030	403,566	7,667,757
11	700,000	585,743	447,675	8,505,825
12	700,000	644,408	492,512	9,357,721
13	700,000	704,040	538,088	10,223,673
14	700,000	764,657	584,417	11,103,914
15	700,000	826,274	631,509	11,998,679
Total	10,500,000		4,859,352	11,998,679

One arcane, but potentially valuable, planning potential inherent in the use of lead trusts is that they can afford a means of avoiding the 50 percent of adjusted gross income limitation that can be such a vexing challenge for wealthy philanthropists.

tion that can present a vexing challenge for wealthy philanthropists. This is especially useful in times when lower returns may be depressing adjusted gross income and, as a consequence, the ability to deduct charitable contributions. Never receiving income in the first place is essentially the same as receiving the income before giving the income to charity. The lead trust allows income to bypass the donor's tax return and various deduction limitations that might otherwise be encountered.

For a Limited Time Only

To some, the charitable lead trust may seem to be good to be true. That is not the case. Despite the leverage that can be achieved with this plan, it is an example of how federal tax policy has intentionally been constructed to give citizens a choice.

The federal gift and estate tax system is designed to result in the involuntary redistribution of wealth. The lead trust has been built into the system to allow taxpayers a choice of voluntarily redistributing wealth over a peri-

od of time to charitable interests that they favor, while still preserving an inheritance for their heirs.

How long this window of opportunity will last however is anybody's guess. But economic history tells us that that once it begins to close, this window may not be open as wide again for many years to come. When interest rates rise, planners once again will have to face more limited choices that may not readily provide the satisfaction of meeting so many seemingly impossible goals

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