ADVISOR'S QUARTERLY

Lead Trusts: A Timely Opportunity

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Despite changes in tax law that raise the amount that can be left to heirs without estate tax consequences, individuals with large estates might still face estate tax issues. For those who wish to support charity, a charitable lead trust might be a good solution. A charitable lead trust allows donors to make annual gifts to their favorite charities now, while transferring assets to heirs in the future at a reduced or even zero estate or gift tax cost.

One of the main factors that affects the attractiveness of charitable lead trusts is the interest rate that is used to calculate charitable deductions for planned gifts. Over the past few years, interest rates have steadily dropped and are now at historical lows. For many types of charitable gifts, this means a smaller income tax charitable deduction; however, for charitable lead annuity trusts, low rates have the opposite effect, opening up an opportunity for increased tax savings. To illustrate how a lead trust 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 $20 million. Given the recent economic turmoil, they estimate the current value of their combined estates to be about $16 million.

Recently, Steve read an article about the increased gift and estate tax exemption amount of $10.24 million per couple. 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 $6 million would be subject to federal estate tax at a rate as high as 35%. 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 lows, or if Congress fails to extend the $5.12 million (per individual) gift and estate tax exemptions beyond 2011. 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.

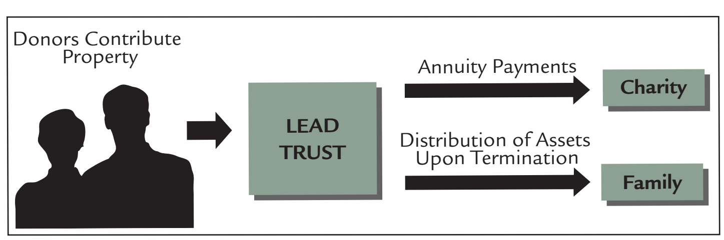
Over the past few years, Steve and Linda have met several times with Bob, the Vice President of Development at Universal Charity, where Steve and Linda each volunteer. Universal Charity is embarking on a capital campaign. Linda had previously indicated to Bob that she and Steve would like to support the campaign, but with their recent financial reversal, they are reluctant to make a large outright 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 Universal Charity. The Charity's director of gift planning put together an illustration of a $2,000,000 charitable lead annuity trust with a 6.0% payout rate for a 20-year term. The trust would make an annual payment to Universal Charity of $120,000 per year for 20 years, and then would 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 to establish a lead trust because IRS tables currently assume that the investments in a lead trust will return only 1.4% per year. Just a few years ago, that return assumption was 5.6%. An important effect of this lower return assumption is a higher gift tax charitable deduction for the value of the charity's lead interest, which could result in most, or even all, of the trust assets passing to the Jackson children free of gift or estate taxes. In fact, with

Figure I



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today's low rate, the Jacksons could choose a payout rate as low as 5.75% and still eliminate all transfer taxes. (See Table 1 for a comparison of the impact of today's interest rate compared to prior years.)

Although Steve acknowledged that recent market volatility had shaken his confidence, he reasoned that a 1.4% return assumption over a 20-year investment horizon seemed like a fairly easy hurdle to clear. Bob further explained that if the trust earned 6.0% each year (net of expenses) and paid out that 6.0% per year as gifts to Universal Charity, the full $2,000,000 would pass to the children at the end of the trust term. If the trust earned more than 6.0% per year, more than $2,000,000 would go to the children free of gift or estate taxes.

Table I

$2,000,000 6% Lead Annuity Trust for 20 Year Term			
	February 2007 (CFMR=5.6%)	February 2010 (CFMR=3.4%)	February 2012 (CFMR=1.4%)
Gift Tax Deduction	$1,422,220	$1,721,020	$2,000,000
Taxable Portion	$577,780	$278,980	$0

CFMR is the Charitable Federal Midterm Rate that is used in calculating charitable deductions for planned gifts. The taxable portion assumes the donor's lifetime gift tax exemptions have been fully exhausted. In 2012, the exemption is $5,120,000 per individual and $10,240,000 per couple.

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 Universal Charity'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 Universal Charity 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 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 a current income tax deduction. However, 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 is carefully managed, Bob emphasized, taxes could be minimized for the lead trust as well because it could claim a deduction for the payments made each year to Universal Charity.

Steve wondered about who would serve as trustee of the lead trust. Bob explained that Steve and Linda could serve as trustees of their own lead trust, or they could name a family member, trusted advisor, or Universal Charity 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 in handling lead trusts. The lead trust is a separate taxpayer, and the investment decisions made by the trustee will affect the tax positions of the Jackson children when they receive the assets at the end of the trust term. Both investment and tax expertise are therefore 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 Universal's director of gift planning so that they could jointly explore the specific benefits of a lead trust in their situation. They expressed 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 Universal Charity.