

Charitable Lead Trusts in the New Tax Landscape

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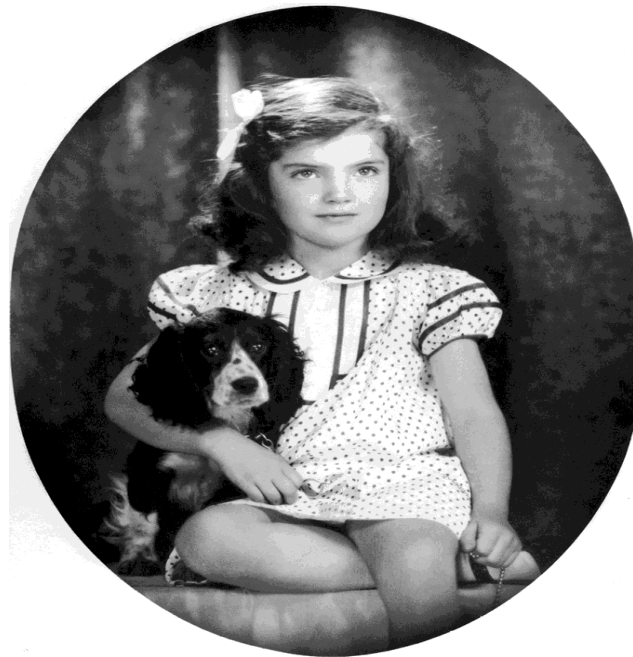
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1. Overview of Charitable Lead Trusts
2. Ideal Situations for a Charitable Lead Trust
3. Impact of the Tax Cuts and Jobs Act of 2017
4. Planning with Charitable Lead Trusts in Light of New Law

- CLTs were rare even before the new tax act
- New transfer tax laws will make them even more rare
- However, they remain a powerful vehicle for the right donor
 - Example: the Jackie O. CLAT



- Irrevocable
- Established during life or at death
- **Lead Interest:** Charitable beneficiary(ies) receive regular payments
 - Unitrust (CLUT) or an annuity (CLAT) payment
 - The Term:
 - In years (no limit); or
 - By the lives of one or more persons (or some combination of the two)
- **Remainder Interest:** Remaining trust assets distributed to non-charitable beneficiaries at the end of the CLT term

- Where does the remaining property go to when the CLT terminates?
- Reversionary CLT:
 - No gift tax
- Non-Reversionary CLT:
 - Present value of remainder interest passing to non-charitable third parties is a taxable gift
 - However, the present value of the charitable lead interest produces a charitable deduction.

- CLTs are not tax exempt
- Grantor CLT:
 - Donor gets charitable income tax deduction when the CLT is funded
 - All income produced by the CLT is taxable to the donor, including annuity or unitrust amount to charity
- Non-Grantor CLT:
 - Donor does not get an income tax deduction
 - Net income taxed at the trust level; distributions to charitable lead beneficiary(ies) are deductible

- Donor is about to experience a liquidity event.
- Donor wants to make a multi-year pledge to a charity but wants to take the charitable deduction in one year.
- Donor wants to provide a gift after a set period of time.
- Donor or Donor's surviving spouse will have a taxable estate.

Examples of CLT Calculations

- Assumptions: Non-reversionary CLT with a **20-year term**, funded in April 2018 (§7520 rate of 3.2%) with **\$1M**. CLT **grows at 5%** per year, with annual payouts. CLATs are “zeroed-out” with an annuity rate of **6.635%** and this rate is used as the unitrust rate for the CLUTs.

	<u>Grantor CLT</u>		<u>Non-Grantor CLT</u>	
	CLAT	CLUT	CLAT	CLUT
Donor Charitable Deduction at Funding (\$)	\$1,000,000	\$746,641	N/A	N/A
Taxable Gift (\$)	\$0	\$253,359	\$0	\$253,359
Estimated Total Charitable Payments During Term	\$1,327,000	\$1,106,021	\$1,327,000	\$1,052,719
Estimated Payout to Beneficiaries at End of Term	\$349,675	\$672,153	\$219,714	\$602,810

*For the purposes of this presentation, we have assumed that of the 5% growth each year, 2% is subject to federal ordinary income tax rates (using 2018 rates). We have assumed the CLTs are subject *only* to federal income taxation; state income taxation has not been taken into account.

TAX LAW CHANGES

- Standard deduction doubled for individual taxpayers (\$12,000 per person)
 - For many taxpayers, may reduce incentive to make charitable donations and itemize deductions.
- Federal gift/estate tax exclusion also doubled (\$11.18M per person)
- Increased maximum deduction to 60% of AGI for cash contributions to public charities (from 50%)
- Repeal of the Pease Amendment

Please note that each of these provisions sunsets in 2026

- Doubling of the standard deduction & “bunching”
 - CLTs are a good candidate
- Impact of the doubling of estate and gift tax exclusion:
 - Reduces the number of estates subject to estate tax, making “zero’d out” testamentary CLAT (“T-CLAT”) even less popular
 - For ultra wealthy, limited opportunity to use the increased exemption to make additional lifetime gifts, including with a CLT
 - Sunsetting in 2026
- The income tax planning advantages of CLTs remain intact:
 - The TCJA did not change long-term capital gains and qualified dividend rates
 - Net investment income tax of 3.8% remains intact
- Increase in AGI limitation for cash gifts means the opportunity to make bigger gifts to a CLT

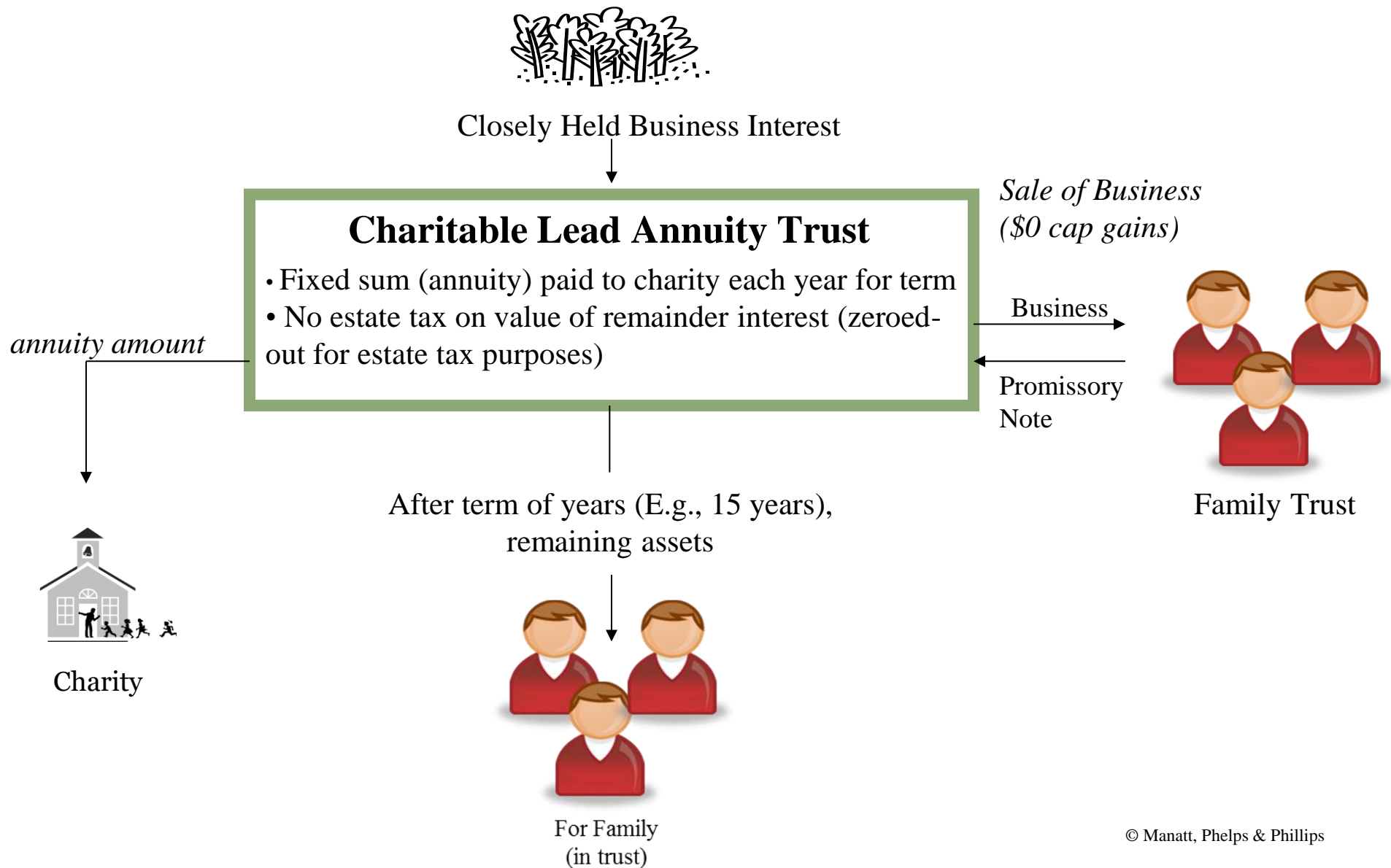
- Interest rates are (slowly) rising.
- The lower the interest rate, the lower the value of the remainder interest in a CLT passing to noncharitable beneficiaries, and therefore less lifetime exemption must be used when establishing the (non-reversionary) CLT.
- Growth of the CLT portfolio in excess of the §7520 rate is a tax-free gift to the noncharitable remainder beneficiaries. The lower the §7520 rate, the better chance of maximizing this gift.

Example: Jackie O's "poorer" cousin Janie and husband John

- Made gifts to child John of \$11M prior to 2017.
- Total estate value: \$11M.
- On second death, estate plan provides that: "such amount of trust assets will be distributed to a CLAT so that estate tax is \$0. Remainder of assets not funded in CLAT goes to kids."
- **Question: If Janie and John both die this year, how much goes in the CLAT?**
- **Answer: \$0!**
- **Question: If Janie and John both die in 2026, how much goes to CLAT?**
- **Answer: the entire estate of \$11M.**

T-CLATs and the Jackie O's of the World

- For ultra-high net worth clients, T-CLAT planning is very compelling
- Can “zero-out” estate tax burden
- Get stepped-up income tax basis
 - Bequest of closely-held business interests, but watch out for private foundation rules



- Self-Dealing - sale of business interests to CLT & promissory note
 - Estate Administration Exception Treas. Reg. Sec. 53.4941(d)-1(b)(3)
 - (i) Fiduciary of estate has power of sale over property or power to allocate to any beneficiary, or is required to sell the property under the terms of an **option**, and
 - (ii) the transaction occurs during the estate's administration period, and
 - (iii) the transaction is approved by the probate court, and
 - (iv) the estate receives an amount which is at least equal to the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, and
 - (v) the transaction (a) results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up, (b) results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or (c) **is required under the terms of any option** which is binding on the estate.

- Excess Business Holdings
 - CLT and DQPs cannot own more than 20% of closely held business if “controlled” by DPQ (35% if DQP’s do not control).
 - 5 year holiday for bequests of closely held business by bequest (or gift)

- Generation-Skipping Tax Issue
 - CLUT: Can create 100% GST Tax Exempt Trust
 - CLAT: Can’t create a GST Exempt Trust, but will likely pass more to family members

- Advantage to Grantor CLT
 - Traditionally, donor's payment of the CLT's income tax may leave more to remainder beneficiaries.

- Advantage to Non-Grantor CLT
 - Trusts are not subject to \$12K state and local income tax limitations under new law
 - Does donor have enough income to offset deduction with 5 year carry-forward?

- Even more reason that it will be important to run the numbers.

- Evaluating the CLT
- \$22M gift & estate tax exemption.
 - Does the charitable deduction even matter?
- Solution: Simultaneous CLT
 - Charity is benefitting along side non-charitable beneficiaries
 - New law and standard deduction
 - Non-Grantor Trust: IRC Section 642(c) – not subject to limitations
 - Generation-Skipping Transfer Tax
 - If grandchildren + charity are simultaneous beneficiaries, may avoid imposition of GST tax
 - To avoid GST Tax, the charitable interest must be (i) mandatory, (ii) significant in amount, (iii) the primary purpose cannot be to avoid the GST tax, and (iv) cannot be able to segregate the charitable/non-charitable interests. IRC Section 2652(c), Reg. §26.2654-1(a)(1)(i).

- Example 1: “Moderately wealthy” donors are not likely to have an estate tax on second death. Husband is an emeritus professor, and has recently established a fiscal project, which is a think tank that seeks to promote a “moral economy.” He does not know whether it will take off, nor does he know whether the project would continue after he dies. On the second death, trust established for the benefit of donor’s children, with a provision that distributions can be made to the fiscal project, as determined by the trustees.
 - Since estate taxes are not an issue, doesn’t matter that there will be no charitable deduction from estate tax
 - Children’s trust will qualify for charitable income tax deduction (no limit)
 - Provides for flexibility on making distribution to the fiscal project, as needed at the time

- Example 2: Ultra high net worth donors have made significant gifts to charity including establishing a private foundation and donor advised fund. They also made significant gifts to their children during life. Their estate plan provides that on second death, specific gifts made to charity and the residue of their estate will be distributed to a trust for the benefit of grandchildren. The grandchildren's trust also provides that 20% of the trust's net income must be distributed to charities chosen by grandchildren, plus additional principal as they decide.
 - Donors want vehicle for grandchildren's giving from their personal pool of assets
 - Generation-skipping transfer tax avoided when trust created
 - Trust will qualify for charitable income tax deduction (no limit)

- PLR 201730012
 - Conversion of non-grantor charitable lead trust to grantor trust – no income tax deduction.
- PLR 201713003
 - Settlor of CRT willing to forego tax deduction to avoid PF excise rules.

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