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Families first: Strategic philanthropy and lead trusts

Charles Lowenhaupt - 2 January 2008

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My grandfather was the first federal income-tax lawyer in the U.S., a concentration he took up in 1908 -- five years before there *was* a federal income tax in this country. My father followed in his footsteps; and so, eventually, did I.

In this light perhaps it makes sense that I return now to the theme of strategic philanthropy to explore how it can be encouraged by U.S. tax law and to observe that its value goes well beyond tax laws and is of universal applicability. After all, the most important laws of wealth management are laws of human nature, not just tax or jurisdictional laws.

By "strategic philanthropy" I mean charitable giving to help individuals and families as well as communities. We have **already explored** how charitable giving can help a family redesign public perception of the family's name. But strategic philanthropy can also be used to help families build functionality around their wealth. It can, in other words, be as much a "good" to the donors as to the recipients of largesse.

A nexus

So when people tell me that there is unlikely to be much philanthropy in jurisdictions where it isn't encouraged by tax incentives, I say it can still thrive. In terms of the laws of human nature, philanthropy *works* for families, with or without tax savings.

That's the *human* side of the equation, and it's pretty straightforward.

The *tax-law* side of the equation is more complicated, but the gifting mechanisms it fosters in some jurisdictions can also help families become better adjusted wealth owners.

Take the charitable lead trust. This structure provides that, for a term of years, income (or another kind of payment) goes to charity and then, at the end of the term, the trust remainder goes to private parties, such as the creators' children or grandchildren. The value of the charity interest, computed using present value tables, was once deductible for income and gift tax purposes resulting in an income tax charitable deduction and a gift-tax charitable deduction for the creators of the trust.

If the investments did better than the payouts, benefit went to the private parties.

But in 1969, **Congress** decided that the charitable lead trust was too much of a good thing and moved to eliminate it.

In the 1970s, however, my father and I found a situation where using a charitable lead trust made sense and we asked the **IRS** to approve our plan. Under the 1969 rules we couldn't ask for an income tax deduction, and the annuity couldn't be limited to the trust's income, but the structure still provided clear-cut benefits to the family.

We got a favorable ruling from the IRS, and subsequently we got others. So the first post-1969 charitable lead trusts were our creations, and they have worked well for those of our clients who created them.

Several of these clients had actually told us that they "hated" charity and only established the trusts because we were able to show them that their heirs stood to gain more through the trust and payments to charity than if the assets passed through the creators' estates. However, in each of these cases, the trust creator and his heirs became significant and highly engaged philanthropists because of the personal satisfaction they derived from their charitable works.

We talked several years ago to the parents of three children in their late twenties. The children would be the inheritors of very large trusts created by their great grandparents. Their parents, meanwhile, were dedicated philanthropists. They wanted to prepare their children for the responsibilities of wealth and membership in the community, and at the same time explore ways to save taxes.

So we created a charitable lead trust that, over a 30-year period, would provide an annuity of more than $100,000 a year to charities selected annually by the trustees (the children of the trust's creators and an outside party).

Three lessons

The investment design of the trust called for careful consideration. The trust would require cash each year for the annuity. As a result, several down years could destroy the trust "corpus" -- that is, the amount with which the trust was established. So the children had to learn, in detail, about building reserves and protecting against risk. With investment advice, they concluded that it would be prudent to put the value of several years' annuity payments into cash equivalents and the balance of the trust principal into a classically balanced portfolio. Lesson one for the heirs: planning investment strategy requires understanding and thought, particularly when that strategy is vital.

In the first year of annuity payment, the children decided to make two or three substantial gifts rather than many small gifts; a very wise decision, considering their situation and focus. Somewhat impulsively, they selected charities based on personal relationships. In year two, those charities were dropped. The trustees felt the charities hadn't handled the funds efficiently and hadn't provided adequate reporting. But they selected new charities pretty much as they had done in the first year -- and with pretty much the same results. In meetings leading up to the selection of recipients for year three, the children talked at length about ways to avoid charities they thought insufficiently responsive or responsible. They concluded that *they* should be subject to a set process for selecting charities and that the *charities* should be subject to processes for reporting on their use of the trust's funds and allowing for continuous analysis of it. And they decided to turn to outsiders for help developing these processes. Lesson two: process is important.

One of the children was in a profession that left him open to criticism for having a conflict between the interests of the trust and those of his employer. So he removed himself from any investment decisions for the trust. He and his co-trustees concluded that the "trustee" had two roles: selecting investments and selecting charities. He could continue in the second role, but had to forego the first by resigning as trustee and being "consulted as an advisor" by the remaining trustees. Now when the trustees meet, he's there when matters to do with selecting charities are under discussion, but he leaves before the agenda turns to investments. Lesson three: trustees have distinct roles and can function well by keeping each role in mind.

So charitable lead trusts can work. They can work to save taxes and they can work to build functionality in the family. We will run into philanthropic opportunities often and, as advisors, we should always be ready to help our clients use philanthropy strategically -- by, for example, leveraging their desire for tax savings to introduce forms and plans that can have a broad effect on the family and its relationship to its wealth. -FWR

The illustration for this column is a detail from a Japanese woodblock print in the Charles A. Lowenhaupt Collection.

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