The Lemonade Solution:
Using the Charitable Grantor Lead Trust to Turn Underwater Stock into Something Sweet

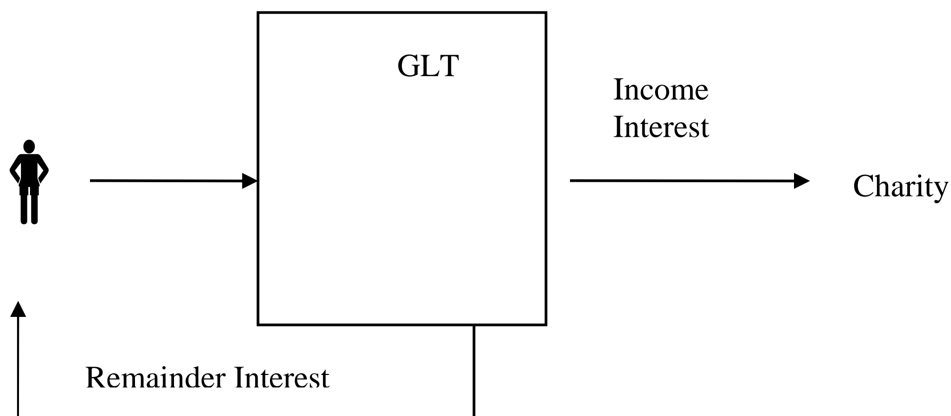
by Lynn McDowell and Erik Dryburgh

If two words can describe the current feelings of potential charitable donors, they are "cautiously optimistic." Post 9/11 "paper losses" have as great an impact on day-to-day spending and giving choices as did previously ballooning but unrealized net worth. While recent positive economic indicators are comforting, instinct tells many potential donors to hold on to what they have, so the challenge is to find ways to let them do that while still benefiting charities. Changes in the market and Applicable Federal Rate (AFR) have made the Grantor Charitable Lead Trust (GLT) a viable gift vehicle that can give donors:

- security (they maintain control of assets "lent" to charity for a defined number of years);
- personal investment flexibility;
- a variety of tax benefits (including income and capital gains benefits);
- what amounts to an interest-free "loan" from the IRS through an immediate income tax deduction that can be used to diversify investments or otherwise spent.

In short, a GLT funded with stock that is below its purchase price can be a bit of lemonade for investors whose portfolios have gone sour.

Finally, a Time to Use the Grantor Charitable Lead Trust



The GLT allows the grantor/donor to:

- lend the benefit of specific assets to charity for whatever time period he/she chooses;
- determine the extent to which the charity will benefit from those assets;
- at the end of the trust period, get back full rights to whatever assets are in the trust;

- get a significant income tax deduction in the year that the GLT is created, and
- potentially leverage capital gains tax advantages.

For tax purposes, any gain or loss on the property in a GLT flows through to the donor, and at the end of the trust period during which charity is the beneficiary, the property reverts to the donor.[1] In the bull market economy with the attendant high AFR that didn't give GLT creators much of a tax deduction, the GLT was a curiosity with no real apparent tax benefit except as a way to reduce the taxes payable in a windfall year.

Now, however, with the shares of so many "good" companies trading at a fraction of what is believed to be their real value and a low AFR that yields a much better tax deduction on lead trusts, there is an incentive for using the GLT to hold on to these securities rather than realize a loss, and see what happens in a market expected to rally. By creating a GLT, one not only has the opportunity to direct tax dollars to a cause in the community by holding "undervalued stock" (for purposes of this discussion, stock that is trading below its perceived value and what the grantor paid for it), one might also realize several other personal advantages (outlined below). In addition to stock, the GLT can hold a variety of assets, thus the options for tailoring by combining undervalued stock with other assets in a GLT are increased.

Unprecedented Circumstances, New Opportunity

Holding a quantity of stock that has fallen significantly below its purchase price is a new experience for most investors. The nature of stockholders seems to be to hold on to what they judge as "good" stocks if there's an expectation that they will rebound, and so a "wait and see" attitude has prevailed with many investors. The GLT allows stock holders to do this while getting a significant tax break—thanks to unprecedented lows in the AFR[2] —for holding on to undervalued stock in a market that is expected to get better.

Undervalued Stock as the GLT Currency of Choice

Stock that is valued below what the donor paid for it (basis) but which is expected to rebound with the economy is an ideal property for constituting a GLT. To understand why, one must look at the fundamental structure of a GLT.

The GLT allows the grantor/donor to lend the benefit of specific assets to charity for whatever time period he/she likes, determine the extent to which the charity will benefit from those assets, and at the end of that time, get back full rights to the whatever assets are in the trust. In exchange for the gift to charity, the grantor/donor gets a significant tax deduction in the year that the GLT is created. The deduction represents the present value of the projected amount that will be paid to charity over the term of the trust, based on the value of the trust at the date of creation and other assumptions. One

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[1] See IRC Sec. 170(f)(2)(B) and 671 et seq. For purposes of this article, GLT refers to reversionary lead trusts.

[2] An AFR of 4.2, used for this illustration, yields a deduction of about 90 cents on each dollar projected to be realized by a charity over the term of the trust.

assumption is the Applicable Federal Rate ("AFR"), an interest rate provided by the IRS. The lower the AFR, the greater the deduction. In the annuity version of a GLT, the annual payment is a fixed amount rather than a percentage of the trust's annual value, which lends certainty to planning. Any growth that is not paid out to charity is a benefit to the Grantor. Accordingly, when the asset is sold, whether during the term of the trust or after the trust is concluded, any gain or loss is realized by the grantor.

The following illustration shows how a grantor might implement an annuity-style GLT:

Assumptions:

Trust Amount:	$500,000
Annual Trust Payout:	5% of present value
Averaged Growth:	7%
Term of Years:	5
AFR:	3.6
Stock Basis:	$700,000

Results:

Income Tax Deduction:	$110,675
Annual income to Charity:	$25,000
Total to Charity:	$125,000
End trust amount to Grantor:	$557,507 (tax-free)

The GLT and the flexibility it affords the grantor could put the grantor, the charity, and the community it serves in a better position than if the grantor had simply held or sold the stock. Further, if the grantor reinvested his tax savings generated by the deduction in the same stock, the grantor would have stock worth an additional $54,329 at the termination of the trust (assuming 35% tax rate, 7% growth, and a 5-year term). The grantor might, however, be in an even better position if the grantor diversified by investing the tax savings in other investments.

In the illustration, no tax is payable on the stock sold below the grantor's basis. Only the amount of stock required to finance the annual payout to charity is sold, and until that stock rises above basis, no tax is triggered. As the stock in the trust appreciates in value, the value of the stock that the donor will get back at the end of the trust term increases, but until it is sold above basis, there will be no tax payable. Undervalued stock in a GLT thus provides several advantages:

Advantage 1: The Luxury of Time and Odds

The grantor defines the length of time for the trust as well as the amount to be paid to the beneficiary. A potential donor who still holds stock after 9/11 is probably doing so because he or she believes it will rebound. In setting the term of the GLT, the grantor will no doubt factor in when the stock is likely to rebound, what he/she paid for it, and his/her personal goals. Is the intent to do a little good and get a tax break while at

the same time "starting the clock" on stock one might sell if performance doesn't improve by a certain date? Is it to increase one's holdings in the corporation or to implement any of the various other practical applications (set out in the next section)?

Since the donor also sets the amount to be paid annually to the chosen charity, the donor can assume a conservative growth rate and set that as the amount (it could be more or less than growth) to be paid annually to charity. If growth is more rapid, fewer shares will be sold to make the annual payment. That means more for the grantor at the end of the term. And if the stock soars, the grantor may be able to pay the charity the amount it would have received over the full term, then terminate the trust early and deal with the stock as he/she wishes.[3] Of course, if the stock price drops, an increasing number of shares will have to be sold to meet the annuity obligation, and fewer shares will ultimately be distributed to the grantor on the termination of the trust.

Advantage 2: A Double Tax Benefit

Until the value of the stock surpasses the donor's basis, the donor reports a loss on the small portion of stock sold to meet the annual payout (any portion of the stock may be sold at any time, however)[4]. In addition to the tax deduction when the trust was created, a realized loss—even if the stock has actually appreciated from the date the trust was created—creates a second tax benefit for the same stock. Of course, any income earned by the trust (such as dividends) will also flow through and by taxed to the grantor.

Advantage 3: Leveraging the Deduction

If stock is sold after basis has been regained, the gain that isn't distributed to charity is taxed at a favorable rate. Even though the grantor gets a tax deduction that's applied against ordinary income, any tax payable on the sale of appreciated stock is calculated at capital gains rates.

Advantage 4: Growing the Corpus while Enjoying a Deduction

Since the tax deduction is based on the amount to be paid to charity, lengthening the term of the trust could result in greater gain to the grantor. If stock appreciates, fewer shares will be sold to meet payments; some cash could also be put into the GLT at creation for use in a year when one might want to avoid selling shares. And if, for example, the stock rebounds to basis in three years, a ten-year term would mean that some tax would be due on stock sold (part of the tax deduction money might be set aside for that possibility), but fewer shares would be sold to make the annual payment, and more stock would be returned to the grantor at the end of the trust term.

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[3] IRS ruling have allowed an early termination of a CLT, but have not allowed a discounting of the amount due to the charity (see PLR 200225045).

[4] See IRC Sec. 671, 673. An individual's ability to deduct capital losses is limited – see IRC Sec. 1211.

Advantage 5: An Interest-free Loan from the IRS

Since the tax deduction for the trust is allowed in full at the creation of the GLT, this can equate to significant cash in hand in exchange for money that one does not have to part with immediately. The grantor can deal with this "windfall" or loan as he/she wishes. In this way, the "cost" of owning fewer shares, which the grantor was unsure about retaining, is compensated to a greater or lesser degree (depending on how the grantor uses the deduction).

Advantage 6: Flexibility

In an uncertain economy, many investors want to explore new options. Having the GLT tax deduction gives them more room to maneuver without letting go of what they currently hold.

Advantage 7: Temporary Separation from Assets, but Ultimate Control

Distance may make the heart grow fonder—or less so. The degree of separation provided by a GLT for a defined period may provide a valuable change of perspective on the asset before a final decision is made. The degree of separation is at the discretion of the grantor: he/she may elect to remain in control as trustee and decide on the timing of asset sales.

Some Practical Applications for Undervalued Stock GLTs

Rebalance an Investment Portfolio—With the money realized by the tax deduction, a grantor can invest in different securities and diversify his/her holdings.

Convert a capital loss into a charitable deduction that can offset other income— By creating a charitable deduction with capital assets that will be sold in installments, the grantor is able to use his gift against any income, not just capital gains.

*Stretch capital loss limitations—*A second deduction is available: stock sold at a loss to meet annual payments to charity generates a capital loss that can be carried forward. By staging the sale of undervalued stock in installments, the grantor may be able to get the full benefit of the deduction limits for capital losses and can time the sale of whatever proportion of stock he deems most advantageous to his overall portfolio.

Increase holdings in undervalued corporations—With the money from the tax deduction, the grantor may wish to buy more of the same stock. He/she might want to replace the shares that are expected to be sold or increase his/her share in the corporation.

Enhance undervalued corporation's image by buying more shares— This may be particularly attractive where the corporation is essentially the grantor's corporation. In such a situation, the grantor may not wish to divest himself/herself of his/her shares for PR and business reasons, or may simply want to gain more control of the corporation.

Create a temporary foundation as a test balloon for philanthropy—The GLT can be used as a "temporary" private foundation. The grantor can involve his/her heirs in decision making about the trust, such as the length of the term, the assets to be included, and the charitable beneficiary(s), and in monitoring the way in which the annual disbursements are used by the charity. As a result, the GLT can be a significant educational tool in both business and philanthropy. Used in this way, the GLT has the advantage of being for a defined term rather than forever. And should the grantor be less than delighted with the way the charity uses the funds, the main body of assets will be coming back to him/her and can be granted elsewhere or not at all.

Conclusion

The market and economic climate have changed dramatically since September 11, 2001. With the change, the GLT presents itself as a valuable tool for personal financial planning as well as for benefiting one's community through charitable giving. While the stock market is beyond investor control, GLTs can be used in the current economic climate to maximize the opportunity for investment diversification and tax benefits without permanently disposing of promising assets.

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