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Create A New Taxpayer: The Charitable Lead Trust

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Do you wish to receive an income tax deduction for charitable gifts otherwise capped by percentage limitations of adjusted gross income (AGI)? Do you have assets that provide a high cash yield and income taxed at the highest federal and state rates? Would you like to leave these assets to your children at a low (or no) gift estate tax cost? If so, the story below may be of interest.

The Smith Family

Jim and Julie Smith are Minnesota residents. Their self-created wealth far exceeds their family's needs. Dynastic trusts are funded, and a private foundation exists that will receive their wealth at the later of Jim's or Julie's passing. There is no estate tax exposure. Their taxable income and AGI have fallen dramatically in recent years. However, their desire to make large lifetime contributions to their private foundation is rising and will accelerate as their family foundation is staffed and able to receive and distribute larger amounts of capital.

The Smiths are concerned that, absent significant realized capital gains, major charitable donations to their private foundation will not be tax-deductible—at least, not right away. Meanwhile, as for tax problems, their federal and state tax burden on assets producing ordinary income is over 50 percent, and every income tax dollar paid means less money will go to their private foundation. Additionally, their remaining gift-estate tax exemptions are (or soon will be) zero.

A Charitable Lead Trust

A team of CAPTRUST advisors listened and suggested that the Smiths create a new taxpayer to hold certain high cash and income-producing assets, such as commercial real estate and high yield funds. The new taxpayer will be a trust called a charitable lead trust (CLT).

Two different income tax results are possible with the CLT, which depend upon who the taxpayer is. If the trust is not the taxpayer, the grantor (or donor) is; when the trust is funded, the donor receives a charitable income tax deduction based on the present value of the charitable annuity. Then, the grantor is taxed on all the trust income during the term of the trust.

Conversely, the trust can be the taxpayer. If so, the donor does not receive an income tax deduction for the contribution. Instead, the trust is taxed and receives a charitable deduction for the annual payment made to charity. It is possible for a CLT to start as a grantor trust; hence, create a large, upfront charitable deduction, but then change to a tax-paying trust, with the trust entitled to deduct annual contributions to charity.

The CLT will make annual payments to the Smith Family Foundation for a fixed term of years, or for Jim's and Julie's lifetimes (or a combination of the two). The obligation to make a series of future charitable payments is called the lead interest. The trust can be a charitable lead annuity trust (a CLAT), where the foundation receives an annual payment based on a fixed percentage of the initial value of the trust assets or a charitable lead unitrust (a CLUT), where the annual charitable payment to the foundation is a fixed percentage of the fair market value of trust assets, valued at least annually.

When the trust is funded, a remainder interest exists. It is usually gifted to the family of the donor. The lead interest in the trust is valued using a monthly prescribed Internal Revenue Service (IRS) interest rate, currently around 2 percent. In our case, the lead interest will nearly equal the value of the trust assets; hence, when it is subtracted, the gift made to the Smith children or trusts is zero.

The Smiths' financial advisor informs them that using a 2 percent discount rate to value the lead interest creates the opportunity to transfer a significant amount of wealth to their children, free of tax. If the trust portfolio compounds at a rate that exceeds 2 percent per annum, the excess return goes to the children or trusts, free of any exposure to estate taxes. If the return is 2 percent or less, the trust remainder beneficiaries will receive nothing.

Income Tax Savings

The Smiths want to see what their income tax savings might be by setting up a $10,000,000 CLAT holding real estate, high yield debt, and cash. We show a 15-year CLAT that pays $778,333 annually to their private foundation. The trust has taxable income but receives an offsetting charitable contribution deduction—one not limited to a percentage of the Smiths' AGI. Using reasonable asset class assumptions, the income tax savings for Jim and Julie over 15 years is shown in Figure One.

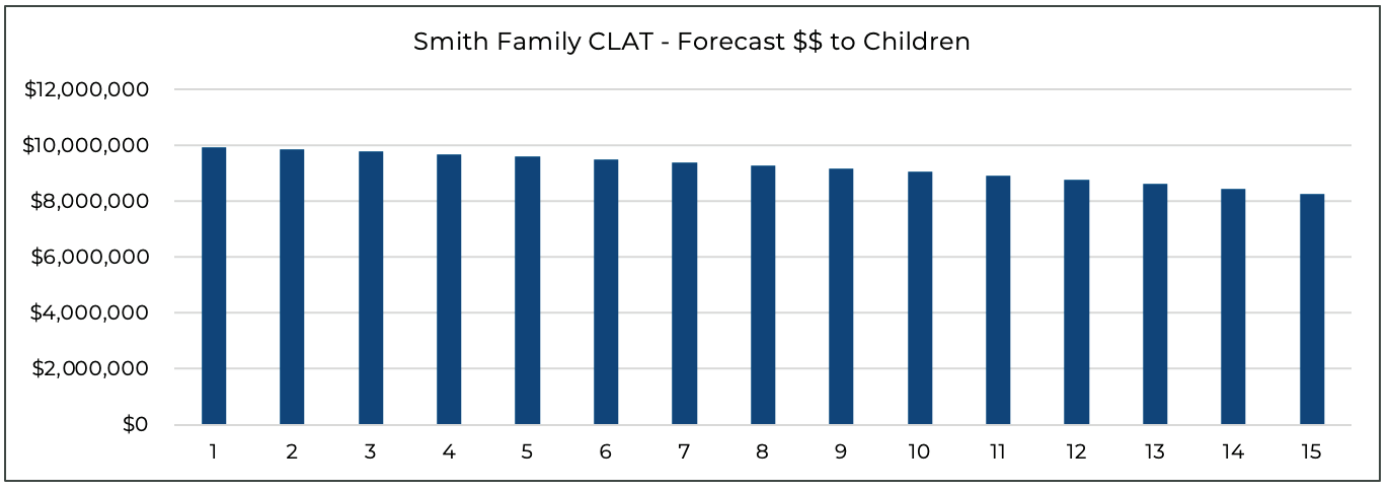
Figure One: Income Tax Savings over 15 Years

3%	Trust Taxable Income	Tax Saving From Charitable Deduction		Present Value $ (Income Tax Saving)		
		Fed	State	Fed	State	
				2,975,691	786,608	$3,762,298
1	$710,000	264,560	69,935	264,560	69,935	
2	$705,148	262,752	69,457	247,669	65,470	
3	$699,952	260,816	68,945	238,684	63,095	
4	$694,387	258,742	68,397	229,889	60,770	
5	$688,427	256,521	67,810	221,278	58,494	
6	$682,044	254,143	67,181	212,841	56,263	
7	$675,207	251,596	66,508	204,570	54,077	
8	$667,885	248,867	65,787	196,458	51,933	
9	$660,043	245,945	65,014	188,497	49,828	
10	$651,645	242,816	64,187	180,678	47,761	
11	$642,650	239,464	63,301	172,994	45,730	
12	$633,017	235,874	62,352	165,438	43,733	
13	$622,699	232,030	61,336	158,001	41,767	
14	$611,649	227,913	60,247	150,677	39,831	
15	$599,815	223,503	59,082	143,458	37,922	

Source: CAPTRUST Research

As mentioned, the trust is formed gift tax free: no estate tax is due when it ends. Using a total return of 7.1 percent for trust assets, the children's remaining interest in the trust is projected to be just over $8,000,000, as shown in Figure Two.

Figure Two: Smith Family CLAT–Forecast Monies to Children



Source: CAPTRUST Research

Is 60 percent Exposure to Real Estate Prudent?

Conventional wisdom and modern portfolio theory might say no—a more diversified, more liquid, higher growth-oriented portfolio should be considered. While Jim sees wisdom in holding assets with different risk and return characteristics, he is comfortable being overweight real estate and high yield debt in this trust. Annual variance in price, to him, means little, especially when his purpose in creating the trust is to save income taxes. As such, pairing high-income assets with a stream of offsetting charitable contributions makes great after-all-tax sense.

As always, if you're considering making charitable giving part of your estate plan, consult with your tax and estate planning advisor to determine the best vehicle and strategy for your situation.