Charitable Lead Trust Planning in a Down Market

by Russell A. Willis III, J.D., LL.M.

They were talking over coffee at the local roaster.

"It's a nightmare," North was saying. "The market has gone to pieces, unemployment rates are rising, mortgages are going into foreclosure . . . people are calling it a recession, but it may be worse."

North is on the boards of several charities. "The needs we try to address -- homelessness, hunger, poverty, substance abuse, disease -- are becoming more urgent, but the money may be drying up," he said. "Donors are getting skittish.

"Take my own situation," North said. "Just a few months ago I was talking with my lawyer about tax planning, putting together a trust for my daughter. We were going to set up a foundation, get Cordelia involved. Now everything is on hold.

"And it's not just social services," he continued. "We can't neglect funding for the arts, education, the environment, even -- or especially -- in lean times, and expect society to hold together."

Kendra spoke up. She does development work for one of the charities on whose board North sits.

"Actually," she said, "strange as it may sound, this could be a moment of opportunity for someone in your situation to make significant, ongoing contributions to these charities and plan for transfers to children and grandchildren at the same time."

"Explain," said North.

"A lot of stocks are undervalued right now," Kendra began, "and with interest rates on Treasury notes at record lows, you could get some serious leverage on gift tax values through a charitable lead annuity trust.

"The estate tax is not going away," she noted. "Apparently we can expect to see the 2009 levels kept in place -- an exclusion amount of $3.5 million and a marginal rate of 45 percent. The lifetime gift tax exclusion may or may not stay at $1 million."

North shrugged. "So much for restoring progressivity," he said.

"Bottom line," Kendra continued, "leveraging the gift tax value of a transfer to Cordelia still matters -- a lot."

"Leverage," North repeated. "My lawyer, Robert, talked with me about this. If the gift to Cordelia does not take effect for some years, and in the meantime there are payments coming out on an annuity or an installment note, the remainder is discounted to its present value by some factor."

"Yes," Kendra agreed, "and that factor is linked to rates on Treasury notes at the time the trust is set up. When those rates are down, a fixed payout is of course worth more, and the present value of the remainder gift is lower.

"Right now," Kendra continued, "the rates on Treasuries are lower than they have ever been -- more than four points off where they were just eighteen months ago. And since you would be funding the trust with stuff that is going to recover its value and grow faster than the payout rate, you would get even more leverage."

She pulled out a pocket calculator. "Let's put some numbers to it."

"Say you want to postpone the gift to Cordelia twenty years. And to keep the numbers simple, let's talk about funding the trust with $1 million. Two or three years ago, when the rate IRS uses to value a trust remainder was at six percent," Kendra jabbed her finger at the calculator, "you would have had to pay an annuity of over $87k in order to bring the remainder value close to zero.

"But with the rate all the way down to two percent, which is where we were in February," punching in more numbers and turning the readout to face North, "an annuity of about $61k can get you a zero remainder gift.

"If we assume the trust assets will grow eight percent per year over twenty years, you are still looking at something like $1.4 million going to Cordelia at the other end. And in the meantime, that $61k per year is doing some good in the community -- and Cordelia can be involved in that."

North raised a hand. "Is there an income tax deduction for the annuity to charity?" he asked.

"Short answer yes," said Kendra, "but there are two ways to set this up, and you might choose to forgo the deduction.

"If you set this up as a so-called 'grantor' trust, you get a deduction in the first year for the present value of the entire annuity stream -- the entire $1 million if we are zeroing out the remainder gift, with a five-year carryforward. But then you will pay tax on trust income going forward, even though you yourself are not receiving the income. The tradeoff is, the money used to pay those taxes will reduce your taxable estate, while not depleting the remainder gift to Cordelia.

"If on the other hand you set it up as a 'nongrantor' trust, there is no income tax deduction, but then trust income is not taxed to you. The trust itself will have an unlimited charitable deduction, and typically it will distribute most or all of its income to charity in any given year, so it will not be paying much or any income tax.

"So you have a choice: if you have an unusually large, non-recurring income event in the current year, or if you expect to be in a lower marginal rate bracket in coming years, you might go with the 'grantor' trust. But if you are bumping up against your contributions limits or your deductions are

limited by phaseouts or the alternative minimum tax, you might choose the 'nongrantor' trust instead."

North had a thought. "Robert was telling me about discounts on minority or nonvoting interests in a limited partnership . . ."

"Excellent point," Kendra nodded. "If the discount was, say, 25 percent, you could bring the annuity payout down below $46k. In fact, you could fund the trust with over $1.75 million and still bring the remainder gift in under the $1 million gift tax exclusion."

"I am going to have another talk with Robert," North said.

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About the author

Russell A. Willis III, J.D., LL.M., is a freelance writer and a consultant to lawyers on tax and nontax issues relating to wealth transfers. He practiced law in St. Louis, Missouri for more than twenty years, chaired various committees of the probate and trust law sections of the state and local bar associations there, and taught courses in future interests and tax-driven estate planning as an adjunct to the faculty at St. Louis University School of Law.

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