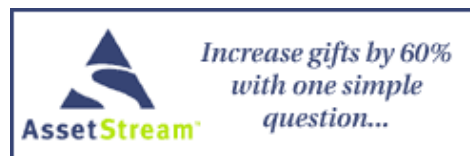


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The Coming Boom In Charitable Trusts

According to Barlow T. Mann and Robert F. Sharpe, Jr. from The Sharpe Group, the popularity of charitable remainder trusts and pooled income funds has flagged over the past several years while charitable gift annuities and charitable lead trusts have enjoyed unprecedented growth. In this article from the June 2007 issue of *Trusts & Estates*, the authors share why they believe a confluence of factors are leading to a resurgence of charitable remainder trusts and the continued popularity of charitable lead trusts.

By [Barlow T. Mann](#) and [Robert F. Sharpe, Jr.](#)



Conditions are ripe for a new surge in growth of charitable trusts-both in terms of number created and the amount of assets transferred to them. During the past several years, the popularity of charitable remainder trusts (CRTs) and pooled income funds (PIFs) has flagged while charitable gift annuities and charitable lead trusts (CLTs) have enjoyed unprecedented growth.

But now, charitably inclined individuals and their advisors should find all types of charitable trusts more attractive as stock market and other asset values rise and interest rates remain relatively low, Baby Boomers approach retirement age, the hope of many for estate tax repeal evaporates, and planners become more sophisticated about these matters.

The elimination or curtailment of other tax-planning opportunities in the mid-1980s led to a subsequent boom in CRTs. The extended bull market of the 1990s further fueled this trend, as many people found themselves with highly appreciated, low-yielding assets.

In recent years, though, fluctuations in stock market values and lower interest rates have dampened interest in CRTs. The number of CRTs filing annual tax returns grew just 9 percent from 106,440 in 2001 to 116,446 in 2005, according to Internal Revenue Service statistics. In contrast, the number of CRTs grew by 26 percent between 1999 and 2001 alone.

But, as of mid-May of 2007, the Dow and broader stock market indices were again trading at record highs, with interest and dividend rates increased substantially from the record lows of a few years ago.

Moreover, demographic trends are once again favorable to CRT formation. After a period of little or no growth in the population of those aged 70 years and older, the aging of the Silent Generation and Baby Boomers (those born between 1936 and 1956) is resulting in the largest number of people ever in the 65-to-85 age range. That is precisely the age range when charitable trusts are traditionally most attractive.

Note, however, that because of the rapid proliferation of gift annuity programs that offer fixed income and tax advantages similar to charitable remainder annuity trusts (CRATs), we may not see as great a growth in CRATs than we will in the number of new charitable remainder unitrusts created. (See "CRT Mechanics," below.)

LEAD TRUSTS

CLTs do not have to play this kind of catch-up. In fact, even while growth in CRTs sputtered these past few years, the number of CLTs grew dramatically: up 35 percent since 2001, according to IRS tax return filing data. And we expect

to see even greater growth in CLTs. (See "Why CLTs Are So Popular," below.)

CLTs offer a way to make significant charitable gifts in the near term while ultimately transferring assets to heirs free of federal estate and gift tax. This advantage remains attractive as total repeal of the federal estate tax seems increasingly unlikely. Keep in mind, however, that the federal gift tax was never scheduled for repeal, and the current \$1 million per person threshold is not slated to rise. Consequently, more people (including many of the Baby Boomers who had children later in life) will now be looking to maximize the amount transferred to heirs during their lives.

Economic factors also favor the lead trust. Since 1989, the federal discount rate used to determine the value of lead trust payments has been based on interest rates paid on midterm federal debt obligations (it's known as the AFMR or "applicable federal midterm rate.") In 1989, for example, during a period of high midterm rates, it was necessary for a charitable lead annuity trust (CLAT) to make annual payments to charity of 11.9 percent a year for 25 years to eliminate gift and estate tax on the amounts placed in the trust. As of May 2007, a CLAT must pay only 7.4 percent to achieve that result.

If investment market performance remains strong and interest rates continue to be relatively low, the low payout amounts and short time periods for CLTs will continue to be attractive.

And that will please charities. As lead trusts result in immediate income to charities, it should come as no surprise that charities are naturally more interested in encouraging donors to fund CLTs than CRTs. Charities that benefit from lead trusts enjoy what may be seen as a "temporary endowment." If they choose to do so, they can save part of the payments to fund a permanent endowment. From the donor's standpoint, it is only necessary to disinherit heirs temporarily rather than permanently deprive them of assets, as would be the case if they left an outright bequest or formed a permanent private foundation.

Through careful planning, it's also possible to combine the use of CLTs and CRTs in ways that meet multiple needs for both clients and their charitable interests. (See "The CRT/CLT Combo," this page.)

While today's economic, demographic and political environment may once again favor certain plans over others, the gift planning toolchest is rich with alternatives. History teaches us that, regardless of the political and economic conditions of a time, there are always ways to help those who wish to invest in society to do so in ways that enable them to satisfy other important priorities, such as arranging for tax-favored income for life.

CRT MECHANICS

How charitable remainder trusts work to everyone's advantage-eventually

Charitable remainder trusts (CRTs) can be an attractive way to create additional income for donors while generating immediate tax benefits for the donor and, ultimately, a gift to a charity.

Take the case of Virginia and William. He's 85 and she's 74. Their net worth is about \$6 million. In recent years, their adjusted gross income (AGI) has averaged \$250,000, including their mandatory withdrawal from their individual retirement accounts (IRAs). They have few income tax deductions and want a way to reduce their taxable income.

William and Virginia have made provisions to leave two middle-aged children \$1 million each at the death of the first spouse, the maximum free of estate tax as of 2007. They want their remaining assets to provide for the survivor for life. At the death of the survivor, they'll leave \$2 million to charitable interests, with any remainder to their children.

The couple also likes the idea of setting aside a portion of their assets to provide regular income, even if their other assets are depleted over time. After meeting with a number of their advisors, they decide a CRT is a good way for them to accomplish this goal.

They fund a charitable remainder unitrust (CRUT) with \$2 million, the amount they've already decided to ultimately devote to charity. They transfer highly appreciated, low-yielding securities to the trust. The CRT then can sell the securities and diversify the sale proceeds free of capital gains tax. The trust will be created at the time as a flip unitrust that will pay them the lesser of the net income of the trust or 10 percent for a period of 10 years. If one or both of them is still alive at the end of 10 years (at which time they'd be 95 and 84 years old, respectively), the trust will "flip" and become a regular 10 percent unitrust. This allows the trust to be managed for growth with relatively little income for 10 years. At any time during the 10-year period, however, the trustee can change the investment policy to yield more income and less growth and make payments of up to 10 percent of the value of the trust each year.

Another important advantage of the higher payout flip trust involves their charitable deduction. If they had created a regular 5 percent unitrust at their ages, William and Virginia would have been entitled to a \$1.1 million charitable

income tax deduction. While that may seem attractive, consider the impact of the 30 percent of AGI limitation on deductions generated by gifts of appreciated property. Supposing their AGI increased by \$100,000 per year as a result of the additional trust income: their total AGI then would be \$350,000. Because of the 30 percent of AGI limit, even if they took a deduction for the year of the gift and five subsequent tax years, they still would be able to use only about \$630,000, with the remaining \$470,000 in deductions wasted.

By structuring the trust as a 10 percent flip trust, they intentionally drive down the charitable deduction to just over \$650,000. As a result of foregoing \$450,000 worth of tax deductions they didn't anticipate being able to use, they've provided for the possibility that their income can be as much as 10 percent of the value of the trust assets, if desired, during the first 10 years of the life of the trust. Their income definitely will rise to that amount thereafter—at a time in life when the additional income may be most welcome. This plan may be a good hedge against the possibility of higher interest rates in the future that could otherwise result in a 5 percent payout rate trapping income inside the trust that they may need for living expenses.

With this plan, William and Virginia have effectively removed \$2 million or more from their taxable estate while accelerating tax savings through \$650,000 in charitable income tax deductions. They also have diversified their investments in a tax-free manner and provided for significant tax-free growth in the trust assets before providing a very generous income for their future when it may be needed.

At the death of the survivor, William and Virginia provide that one half of the trust corpus be distributed to charities they wish to support and the balance be transferred to donor-advised funds that their children and grandchildren can direct to charities in future years.

WHY CLTS ARE SO POPULAR

Charitable lead trusts give to charity immediately and benefit heirs considerably

Charitable lead trusts (CLTs) let donors give now to charity and transfer assets to heirs free of federal estate and gift tax.

Consider the case of John, age 80. His wife recently passed away and he's revisiting his estate plan. His estate is currently valued at \$8 million. John's plan in recent years has relied heavily on the use of the marital deduction and his own personal belief that the estate tax would ultimately no longer be a concern.

He and his wife also had planned gifts to their favorite charitable interests at the death of the survivor. John was recently told it's increasingly likely that a 45 percent estate tax rate on amounts over \$2 million could be due on his estate. He is beginning to think of ways to minimize his estate. There are a number of steps he could take. For example, he has not yet made use of his lifetime gift tax exemption of \$1 million.

As part of his planning, John has decided he would like to fund an endowment in memory of his wife during his lifetime rather than at his death. He believes he can afford to do so and would like to see the gift completed while he's still alive. The program he would like to endow requires \$80,000 per year to be fully funded. He's told that it would require an outright gift of more than \$2 million to permanently endow the program.

After conferring with his advisors, John instead decides to fund a charitable lead annuity trust (CLAT) with \$3 million. The CLAT will make fixed payments of 6.5 percent or \$195,000 to the charitable beneficiary per year for 15 years. When the trust terminates, the trust corpus will be distributed to his three teenaged grandchildren in equal shares.

The first year, the charity plans to spend \$80,000 of the lead trust payment to fund the program in memory of John's wife. It anticipates 3 percent per year inflation adjustments over time, resulting in an increased payment obligation of \$121,000 in the 15th year. In the meantime, the amount of the annual payments not required to fund the inflation-adjusted expenditure each year would be placed in a permanent endowment. If that endowment earned a total return of 8 percent, at the end of 15 years, the balance would be \$2.711 million. At a 5 percent spend rate, the payout that year of \$135,550 would be more than sufficient to replace the inflation-adjusted amount received each year from the CLT. This will assure that the endowment is fully funded not only during the 15 years the CLT is in existence, but also in perpetuity when the CLT comes to an end.

At the termination of the CLT in 15 years, each grandchild will receive \$1 million assuming the trust earns at least the 6.5 percent necessary to protect the corpus of the trust. After-tax earnings above the 6.5 percent payout amount would be accumulated in the trust and the grandchildren would receive the total amount remaining in the trust free of federal estate and gift tax.

But what about the gift tax liability on the \$3 million that was transferred to the trust for the benefit of the grandchildren? At the time the trust is funded, John would report a \$3 million gift to his grandchildren. Under today's lower discount rates, the value of the intervening payment stream to charity results in a gift tax charitable deduction of \$1.985 million, leaving a taxable gift of \$1.015 million. After offsetting this liability with his previously unused

lifetime gift tax exemption amount of \$1 million, under the assumptions underlying the transaction, John effectively transfers \$3 million or more to his grandchildren in 15 years at a gift tax cost of less than \$7,000 at most.

John has, in effect, created a permanent endowment just as if he had immediately transferred \$2 million to the charity. Had he then given \$1 million to his grandchildren using his gift tax deduction, his total net worth as a result of the two gifts would have been reduced by \$3 million and he would owe no gift tax.

Under this scenario, he has used his \$3 million to create the intended endowment on a permanent basis while still leaving \$3 million to his grandchildren on a virtually tax-free basis. His grandchildren must wait 15 years for their inheritance. In any event, that was okay, because he did not want them to receive their inheritance until they were in their 30s.

THE CRT/CLT COMBO

Use both a charitable remainder trust and a charitable lead trust so that donor and charity are served immediately yet, ultimately, heirs also are helped

Donors and charities can benefit enormously when both charitable remainder and lead trusts are used.

For example, a major university recently named one of its professional schools after a donor who made his gift through such a combination.

The donor, aged 78, transferred \$10 million to a charitable remainder unitrust (CRUT) that would make payments to him of 5 percent of the value of the trust corpus each year for a term of 20 years or his lifetime, whichever was shorter. He thus created a stream of income for himself that would last until his death, but in no event would the university have to wait more than 20 years to enjoy the remainder of the trust.

The donor funded the trust with highly appreciated, low-yielding securities. The trust subsequently sold the securities and reinvested them, assisted by those who had given the donor investment advice in the past.

If the CRUT earned a total return of 8 percent and the donor lived for his 10-year life expectancy, his income would grow from \$500,000 the first year to some \$671,000 over that time, and the university would receive more than \$13 million at his death. Because of the future charitable gift, the donor was entitled to an immediate income tax deduction of more than \$6.5 million.

At the same time the CRUT was funded, the donor transferred \$10 million to a charitable lead annuity trust (CLAT) that will make annual payments to the university of 8 percent, or \$800,000 a year for 20 years. At the end of 20 years, the balance of the CLAT will be transferred to the donor's nieces and nephews at its then market value. While the donor must report a gift of \$10 million to his heirs at the time the trust is created, he is entitled to an offsetting charitable deduction of \$9.6 million, leaving a taxable gift of just \$400,000. This amount can be offset by a portion of his \$1 million lifetime gift tax exemption, resulting in no tax on the transfer of the trust assets to his nieces and nephews. If he had already used the \$1 million gift tax exemption, his income tax savings from the charitable deduction produced by the unitrust gift would over time more than offset the amount of any gift tax owed.

When the dust settles, the university will have named the professional school in exchange for this so-called "temporary endowment" in the form of the CLAT that pays \$800,000 per year for 20 years. If university policies called for a 5 percent spend rate on its endowment, this amount would be equivalent to immediately increasing its endowment by some \$16 million.

If the donor lives to his life expectancy of 10 years, the university will receive over \$13 million from the remainder of the CRUT at his death. Remember that in no event will the university have to wait more than 20 years for the CRUT to terminate. Whenever the CRUT terminates, even if it's not for 20 years and it terminates at the same time as the CLAT, the temporary endowment represented by the lead trust would be replaced by a permanent fund consisting of the amount received from the CRUT's termination. At the end of 20 years, the CRUT balance would be more than \$18 million.

At a 5 percent spend rate, the university would then have \$900,000 in annual earnings to replace the lead trust payments. Because it is statistically likely that the CRUT will terminate as much as 10 years before the CLAT, for a period of time, the university can expect to have both the payments from the CLAT and the earnings from the remainder received from the CRUT.

The donor is pleased that his advisors will continue to manage the funds in both trusts, and he will continue to benefit from their expertise as will the university and his heirs. The university enjoys the security of knowing that its payments from the lead trust are fixed for 20 years and the risk of managing the remainder for the heirs is in the hands of others.

From a fundraising perspective, the university will have named the professional school in exchange for a "pledge" of

\$16 million, payable at a rate of \$800,000 per year for 20 years. As a bonus, a permanent multimillion dollar endowment is being provided in the form of the CRUT remainder at the death of the donor or 20 years, whichever is sooner.

This is but one example of the countless ways that donors, their advisors, and representatives of their philanthropic interests can work together to make gifts in ways that meet the needs of all of the parties.

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