

CLIENT STRATEGIES:
USING A CHARITABLE LEAD TRUST TO REDUCE YOUR TAXES

The Small Business Jobs Act of 2010 (H.R. 5297) was signed into law by the President last month. The law creates some new tax incentives for businesses and may provide opportunities for both existing and new businesses. The key provisions of the new law include:

- The current expensing limit for capital expenditures was increased from \$250,000 to \$500,000 for tax years beginning in 2010 and 2011.
- A 100 percent (up from 75 percent) exclusion from gain is provided for the sale of qualified small business stock that is acquired between September 27, 2010 and January 1, 2011 and held for at least 5 years after acquisition.
- The holding period to avoid corporate-level gains tax for appreciated assets of a corporation converting to Subchapter S tax status is reduced to 5 years (from 10) in some circumstances.
- The deduction limit for business start-up expenditures is increased to \$10,000 (from \$5,000) in 2010.
- Business owners will be able to deduct 100 percent of the cost of health insurance in 2010 for the purposes of calculating the self-employment tax.

This month's Tax Letter discusses the use of charitable lead trusts to reduce taxes.

Sincerely,

John Meisenbach,
President

USING A CHARITABLE LEAD TRUST TO REDUCE YOUR TAXES

CHARITABLE GIVING IN THE UNITED STATES

Americans contributed almost \$304 billion to charity in 2009 according to the Giving USA Foundation. The total numbers are slightly lower than prior to the recession, but remain strong. However, there is concern in the charitable community about the effect of the repeal or reform of the federal estate tax on future charitable bequests. A repeal or reduction of the estate tax is expected to be detrimental to charitable giving from estates.

Virtually all donations are (and should be) motivated by philanthropic desires. However, there are other benefits of charitable giving, such as income or estate tax deductions, which can be achieved through the use of a contribution to a charitable lead trust (CLT).

WHAT IS A CHARITABLE LEAD TRUST?

A charitable lead trust provides current payments to charities. The trust continues for a fixed or ascertainable period of time (such as a term of years or a time period measured by an individual's life). After the trust terminates, its assets pass to one or more individuals or to other non-charitable interests, such as a family trust. A charitable lead trust can be a living trust creating a lifetime donation, or it can be a testamentary trust created at the donor's death through his or her will or from the donor's revocable living trust. (Note that the division at death of a living trust into a charitable lead trust makes the transfer nonprobate and thus removes the publicity, if this is desirable.)

WHAT SIZE ARE THE CHARITABLE DEDUCTIONS?

The tax rules limit lead trusts to two types of charitable payments; otherwise no charitable deductions will be available under the income, estate, or gift tax laws. Lead trusts must provide charities with either a "guaranteed annuity interest" or a "unitrust interest." Thus, the two types of qualified charitable lead trusts are called *charitable lead annuity trusts* (CLATs) and *charitable lead unitrusts* (CLUTs). The applicable requirements resemble the rules that govern the more well-known charitable remainder trusts (CRTs), but they are not identical. One notable distinction is the CLTs do not have the 5 percent minimum distribution requirement of CRTs and the CLT is permitted to provide an annuity that increases over the term of the trust.

According to rules as set forth in the tax regulations, a CLAT must provide payments to the selected charities in annual stated annuity amounts. According to IRS Revenue Procedure 2007-45 (2007-29 I.R.B. 89), the annuity payments are not subject to a minimum and can increase during the term of the CLT. A CLUT also provides for annual payments, but payments are based on a fixed percentage of the net fair market value of the trust's assets, determined annually. Therefore, a charitable lead unitrust's payments will vary in size each year with the value of the principal.

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WHO SHOULD CONSIDER A CHARITABLE LEAD TRUST?

Like most planning techniques, the CLT is not for everyone, but many individuals who have accumulated wealth and charitable goals will find them useful. The following circumstances might indicate a charitable lead trust as an advantageous estate planning strategy:

- The donor has charitable goals.
- The donor wishes to donate a temporary income interest to charity but doesn't want his or her family to give up the property permanently.
- The donor has a large estate and would like to make lifetime gifts of appreciating property to younger generation family members at a minimum transfer tax cost.
- The donor faces a substantial estate tax cost and would like to remove significant value from his or her gross estate for tax purposes.
- The donor (or his or her family) can live comfortably without the trust property during the charitable term of the trust.
- The donor needs a large income tax deduction in the current year and is willing to incur taxable income during the term of a living charitable trust.
- The donor has appropriate property and is optimistic with its appreciation possibilities.
- The donor would like to take advantage of the currently low federal interest rate to maximize the charitable deduction and the CLT's benefits for the family. The appreciation on the property in excess of the Sec. 7520 interest rate (2 percent in October 2010) provides family benefits that are not subject to gift or estate taxes.

AN EXAMPLE OF HOW IT WORKS

David and Dolores Donor are contemplating a CLAT to benefit Metropolis Children's Hospital, which recently cared for their daughter. They plan to transfer \$5 million of assets to a 20-year lead annuity trust. The annuity trust will provide for a \$300,000 annual payment to the hospital to be made at the end of each year. The remainder of the CLAT will be distributed to a trust for their children. Under the current valuation interest rate (2 percent in October 2010), they will receive an income and gift tax charitable deduction of \$4,905,520 for the charitable lead interest provided to the hospital for 20 years. Thus, the remainder will provide a taxable gift of only \$94,580. If the assets of the CLT appreciate at 7 percent, the remainder distributed to the family trust after the 20-year term will be \$7,049,775.

OTHER CONSIDERATIONS

The CLT can either be a grantor or nongrantor trust. To receive the upfront income tax deduction described in the example above, the CLT would have to be a grantor trust. The drawback of this approach is the grantor will remain subject to income taxes on the CLT's income, even if it is distributed to a charity. For this reason, the grantor CLT could be funded with municipal bonds or a universal life insurance policy. This technique would require a significant amount of planning for the design of the CLT and selection of the investment.

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In addition, the rules for applying the GST exemption to a CLAT are not favorable if grandchildren are the remainder beneficiaries. The GST exemption cannot be applied to a CLAT until the trust terminates. Hence, a CLUT is more favorable if grandchildren are remainder beneficiaries.

Since a CLT diverts the principal from the donor's family for a potentially long period of time, how can the donor take care of the family's needs? The CLT should not be considered unless the donor is able and willing to part with the assets. In addition, the remainder's value is uncertain since its size is dependent on the performance of the CLT's investments over a long time horizon. There may ultimately be a large or small transfer to the remainder beneficiaries. In the case of a CLAT, poor investment performance might even cause the trust to be exhausted before the family receives the remainder. One way to replace the donated assets is a life insurance trust. If the donor is healthy, life insurance can be placed in a trust to provide for the family's immediate needs at the donor's death and avoid estate taxes on the death benefits.

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