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Charitable Lead Trusts: The Time Is Right Now

By Morris W. Banks

Today's historically low interest rates create a unique opportunity for individuals with significant wealth to create a trust that will not only benefit the charity of their choice, but have long term benefits for their estate as well.

Known as a charitable lead trust, it is a vehicle in which a donor funds a trust that makes fixed payments to a charity over a specified period of time. The designated charity receives the benefits in the early years while the donor's heirs, or non-charitable beneficiaries, receive the trust assets at the conclusion of the charitable term. A charitable lead trust produces both an unusually high income tax deduction in the year of the gift and also a substantially discounted gift to family members at the conclusion of the charitable interest.



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This is accomplished because the value of the delayed gift to the family is discounted for the "time cost" of waiting until the expiration of the charitable term. In a low interest environment, the IRS Section 7520 rate from which the IRS annuity tables are derived increases for income tax purposes the valuation of the front-end charitable gift while decreasing for gift tax purposes the back-end gift to the family.

The implications for both high net worth families and their charitable donees are nothing short of dynamic. The following

case study demonstrates how this works:

Let's assume that an individual would like to make a \$1 million gift to his or her favorite charity, while at the same time the donor does not want to deprive his or her family of the entire value of the gift.

If the donor were to simply make the gift outright to a public charity, he would get a \$1 million charitable deduction in the year of the gift (limited to the appropriate percentage of his or her contribution base for that year), but no portion of the donation would ever be available for the donor's family.

By using a charitable lead trust, the amount of the donor's charitable deduction would be reduced, but a significant portion of the \$1 million gift would revert back to the family at the conclusion of the charitable term.

Let's assume that the donor transfers \$1 million in December, 2010 to a charitable lead trust providing that the charity will receive an annual annuity of 5 percent of the trust assets valued as of the date of the transfer (\$50,000 per year) for 15 years, and at the conclusion of the 15 years the trust will terminate and the remainder will be delivered to the donor's children.

The value of both the charitable gift and reversionary interest going to the charity is determined by the Internal Revenue Service Section 7520 rate of 1.8 percent for the

month of December, 2010.

To give you some perspective, three years ago the Section 7520 rate was 5 percent.

However, given today's rate, if the charitable lead trust was established in December, the value for tax purposes of the charitable annuity and therefore the charitable deduction on the donor's income tax return would be \$652,180, while the value of the remainder interest going to the

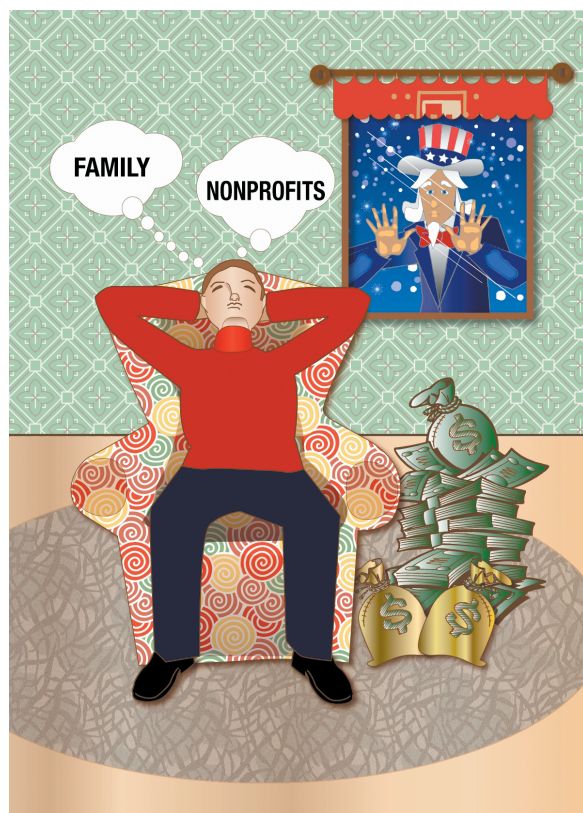


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donor's children subject to gift tax would equal \$347,820. So the donor's deduction would equal 65.2 percent of the amount transferred while the gift to the family at the conclusion of the 15-year period for gift tax purposes would be 34.8 percent of the amount transferred.

But how much will actually be sitting in the trust at the end of the 15 years for the benefit of the family members?

If the amount on hand wasn't invested at all during the 15-year period, the amount actually available for the donor's family for distribution would be equal to \$250,000 (\$1 million, minus \$50,000 per year for 15 years), while the value of the gift for gift tax purposes as of December, 2010 would be \$347,800. This would not be a great result.

But suppose the trust invested in tax-free municipals paying 3.5 percent over the same 15-year period (taxable investments would result in the donor recognizing the income therefrom). No tax would be due and payable by the donor during that time, but at the conclusion of the 15-year period, while the tax results would remain the same, \$710,564 would actually be on hand for distribution to the family, again contrasted with the value of the remainder interest for gift tax purposes pegged at \$347,820. This is a dynamic result.

If this result were to be compared with a gift based upon the same circumstances as above but made in 2007 when the Section 7520 rate was 5 percent, the value of the charitable gift would have been \$518,985 instead of \$652,180 (a \$134,000 smaller

charitable deduction in 2007) and the value of the taxable gift to the donor's family would have been \$481,015 (\$133,000 higher than the gift subject to gift tax in 2010).

Given this month's historically low 7520 rate utilized by the IRS, charities and their development officers should be in touch with the professionals in their rolodexes who they know represent high net worth and high income individuals and ensure that they are aware of the potential of charitable lead trusts formed in December, 2010 to benefit both their donor clients and charitable organizations. ■

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