

STEFFENSEN, HERMAN & DOGGETT, LLC
COUNSELLORS AT LAW

OLD CITY HALL
45 SCHOOL STREET
BOSTON, MASSACHUSETTS 02108-3204

JON E. STEFFENSEN
LOUISE F. HERMAN
ANDREW T. DOGGETT

TELEPHONE (617) 523-7935
FAX (617) 523-4917
WWW.SHDLAWYERS.COM

JENNIFER TAKACS FLEMING
JENNIFER Z. FLANAGAN
LAURA T. GODINE

Timely and Creative Trust Vehicle: Charitable Lead Trusts Second in a Series of Three Features

By Jennifer T. Fleming, Associate
Steffensen, Herman & Doggett, LLC

Following our discussion on grantor retained annuity trusts (or “GRATs”), this feature focuses on the charitable lead trust as an effective estate planning option/gifting technique that serves to reduce your taxable estate and, more importantly, transfer assets to your chosen beneficiaries at a greatly reduced transfer tax (estate and gift tax) cost.

If you anticipate having a taxable estate and if you are charitably inclined, you may wish to create a charitable lead trust. There are two types of charitable lead trusts: charitable lead unitrusts (“CLUTs”) and charitable lead annuity trusts (“CLATs”). Each is a split-interest trust that makes distributions at least annually to a designated charity or charities for a set term of years. The CLUT pays out a fixed percentage of the fair market value of the trust assets revalued annually. The CLAT pays out a fixed annuity that is based on original funding value of the trust. When that term is up, the remainder passes to noncharitable beneficiaries, such as your children. The charity has the lead interest in the trust and the noncharitable beneficiaries have the remainder. This feature focuses on the CLAT because it is especially attractive in a low interest rate environment and like a GRAT, a CLAT enables the donor to make a “leveraged gift”; i.e. a gift at a discounted value.

A CLAT offers the opportunity to make a current gift to charity and a future gift to family members or other beneficiaries at a reduced future transfer tax cost. The CLAT is particularly effective when interest rates are low. Like the GRAT, a CLAT uses the “applicable federal rate,” an interest rate set by the IRS pursuant to Code Section 7520 for the month in which the CLAT is established. Ideally, that § 7520 rate is low (as it is now; the rate for May is 3.2%) and you have assets that you believe are currently valued below their true worth and will appreciate at a rate higher than the 7520 rate.

*With a CLAT, you can
benefit charities while
at the same time
preserving the assets
that generate income
for ultimate distribution
to your children.*

If you were to establish a CLAT that called for the assets to pass to your children, you would be making a gift to them at a substantially reduced transfer tax cost because the gift tax assessed against that gift is not based on the whole value of the assets involved. Instead, the gift tax is calculated against that whole value reduced by the present value of the annuity interest in the trust that is dedicated to the charity/charities of your choice. The value of the children's interest is discounted by the cost of waiting to receive the assets while the charitable organization reviews distributions from the trust.

With this type of gift, you can benefit charities while at the same time preserving the assets that generate income for ultimate distribution to your children. While your family members must wait to receive the assets, in the interim the charitable purposes you want to see fulfilled are being met.

Example of a CLAT: Giving to Charity while Minimizing Transfer Tax

A wealthy surgeon has some securities that will likely appreciate over time. He can afford to part with some of that future income and he would like to pass the appreciation on to his two adult children, one a teacher and the other an artist, to "seed" their retirement. He is able to take \$2,000,000 of assets and dedicate this amount to a 25-year CLAT that calls for a 3.0% annuity (\$60,000 per year) to be paid to and among charities of his choice in quarterly installments of \$15,000 a quarter. At the end of the 25-year period, the assets then held in the trust are to be distributed to his two sons who at that point are considering retiring. By attaching to the gift the 25-year income interest for charities, he is able to reduce the gift's value by the \$1,034,044 present value of the charitable income interest (calculated by formula), thereby reducing the value of the gift from \$2,000,000 down to \$965,956, which is covered by his \$1,000,000 exemption from gift tax. If, as expected, the investment return is greater than 3.0%, that appreciation goes to his sons free of transfer tax at the end of the 25 years. Assuming a modest annual return of 7% with the 3% payments to the charity, this donor would be able to get \$6,960,306 out to his children at the end of the 25 years at an assessed gift tax of only \$965,956 while getting \$1,500,000 to the charities of his choice – compelling numbers that make a strong case for a CLAT!

Like a GRAT, a CLAT could also be set up to "zero out" by making higher payments to the charity, thereby reducing the taxable gift to less than \$1.

For someone who can afford to part with some income, the advantages of a lifetime CLAT are as follows:

- It provides significant benefits for charities now while you are living;
- The principal value of the securities dedicated to the trust remains with the family, though distribution to family members is postponed until the expiration of the term of the trust;
- You are transferring significant value to your issue at a greatly reduced transfer tax cost; and
- It is something you can do now without worrying about income tax charitable deduction carryforwards, because a CLAT affords no income tax charitable deduction; rather, it is founded upon obtaining a gift tax charitable deduction.

You can also establish a CLAT to take effect at your death. With a testamentary CLAT, the value of the charity's annuity stream is deductible for estate tax purposes. The savings in estate tax on the charity's portion can be invested for growth during the continuing term of the trust. That investment income will be applied to pay the annuity to the charity and any surplus will be compounded for your heirs to pass to them free of transfer tax when the trust ends.

If the ultimate beneficiaries of the charitable trust are grandchildren a CLUT, as opposed to a CLAT (see the distinction noted above) must be used.

To sum up, if you anticipate having a taxable estate, if you or your heirs are able to part with the value of an asset or its income stream for a period of time, and if you would like to do some good by benefiting a charity or charities, a CLAT is a great way for you to move value out to the next generation at a discount. Moreover, CLATs are especially attractive in the current low interest rate environment.

To hear more about this estate planning device, please contact your Welch & Forbes LLC portfolio manager who can guide you in the appropriate questions to ask your estate planning attorney or put you in touch with one of the attorneys at Steffensen, Herman & Doggett, LLC.

Steffensen, Herman & Doggett, LLC is an independent law firm with long historical ties to Welch & Forbes LLC.

The information contained herein is general in nature and is not meant as and should not be construed as investment, legal or tax advice, nor does its appearance imply an endorsement by Welch and Forbes LLC of any specific investment, legal or tax strategy. It is provided for educational purposes only and is not intended to serve as the primary or sole basis for your investment, financial or tax planning decisions. An investor's best course of action must be based on individual circumstances. Consult an investment, legal or tax professional as to how this information applies to your specific legal, financial or tax situation.