



The Planned Giving Council of Palm Beach County

Send Your Estate Tax to Charity with a Lead Trust

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Summary:

A Charitable Lead Annuity Trust (CLAT) helps a donor pass assets to heirs while avoiding much of the onerous, even punitive, federal estate and gift taxes. A certain amount of principal is placed in the trust. The CLAT operates almost like a mirror image of the better-known Charitable Remainder Trust (CRT). A CRT makes regular payments to individuals, then distributes the remaining assets to charity at the end of the term. The word "Remainder" in the name of the instrument is a description of the part that eventually goes to charity. A CLT makes regular payments to charity, then distributes the remaining assets to individuals at the end of the term. The word "Lead" in the name of the instrument describes the charity's benefit which comes ahead of the remainder benefits to heirs. (I call the principal "corpus" in my charts and equations to avoid inventing different abbreviations for principal and percentage.)

This session examines the Non-Grantor Charitable Lead Annuity Trust, and its usefulness as a tool to meet a charitable mission while reducing or eliminating gift and estate taxes on trust assets passed to children.

Participants will learn to manipulate the formula of "Benefit to Charity equals Corpus times Term times Percentage." Each variable in this equation will be manipulated, based on the donor/client's main motivating factor for consider this type of gifting instrument.

Since donors/clients are motivated by a variety of factors, which include advancing the mission of a charity, providing for children, receiving recognition, avoiding taxes, and others, the formula will be manipulated so that each primary factor can control the other parts of the equation.

This session deals *only with a Charitable Lead Annuity Trust* with the remainder going to children. It does not include a discussion of generation skipping tax avoidance. A Charitable Lead Unitrust would ordinarily be used to reduce death taxes to grandchildren, but IRS Discount Rate does not impact a Lead Unitrust as dramatically as a Lead Annuity Trust.

Learning Objectives:

By the end of this session, participants should:

1. understand and articulate why periods when assets are depreciated and the investment environment is terrible provide the best financial incentives for funding a Charitable Lead Annuity Trust (CLAT).
2. determine the exact percentage needed to zero out the estate and gift tax on a CLAT.
3. be familiar with manipulating the simple formula that relates the principal (called corpus in this presentation), percentage gift to charity and charitable objective.

4. see this favorable gift technique from the perspective of donor, donor advisor, fundraiser and heir.
5. be comfortable with the concept behind the numbers so that they can discuss the donor/client motivation and write a proposal addressing the donor/client's leading concerns.

What's so good about a CLAT?

The IRS Discount Rate is hovering near historic lows (2.0% in February 2009, and 3.2% in March 2010), which makes the tax deductions for Charitable Gift Annuities much less attractive. However, this same dynamic makes the numbers for CLATs much more enticing.

Still, most planned giving officers don't answer their phones and hear eager donors asking which instruments make the most sense given the current IRS Discount Rate. Donors have many reasons why they consider different gifts. Taxes and tax rates figure into the equation, but they are not usually the prime motivating factors.

Table 1: 2.0% IRS Discount Rate:

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Federal Estate Tax |
|--------------------|----------|-------------------------|--------------------|
| \$1 to \$Trillions | 25 | 5.15% | \$0.00 |
| \$1 to \$Trillions | 20 | 6.15% | \$0.00 |
| \$1 to \$Trillions | 15 | 7.80% | \$0.00 |
| \$1 to \$Trillions | 10 | 11.15% | \$0.00 |

Table 2: 3.0% IRS Discount Rate

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Federal Estate Tax |
|--------------------|----------|-------------------------|--------------------|
| \$1 to \$Trillions | 25 | 5.75% | \$0.00 |
| \$1 to \$Trillions | 20 | 6.75% | \$0.00 |
| \$1 to \$Trillions | 15 | 8.40% | \$0.00 |
| \$1 to \$Trillions | 10 | 11.75% | \$0.00 |

Table 3: 4.0% IRS Discount Rate

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Federal Estate Tax |
|--------------------|----------|-------------------------|--------------------|
| \$1 to \$Trillions | 25 | 6.40% | \$0.00 |
| \$1 to \$Trillions | 20 | 7.40% | \$0.00 |
| \$1 to \$Trillions | 15 | 9.00% | \$0.00 |
| \$1 to \$Trillions | 10 | 12.35% | \$0.00 |

This session helps you look at the CLAT from the perspectives of the donor, financial advisor and fundraiser. A basic mathematical equation helps see it from different perspectives, depending on motivation.

Planned giving officers can generate illustrations that demonstrate how these taxes can be eliminated or greatly reduced on the leading software packages we employ. Tables 1-3 show the percentage donation needed to eliminate all estate and gift taxes at various IRS Discount Rates.

The numbers presented in Tables 1-3 above are fairly easy to generate using your planned giving software. Since this presenter uses PGCalc, the instructions are written based on that software package. However, it is my belief that similar calculations can be made using other planned giving software packages.

Since it makes sense to pass assets to heirs when they are at a lower assessed value, the *ideal candidate* will also have assets which include those that have suffered substantial depreciation. Since this session is focused on the Charitable Lead *Annuity* Trust which has greater tax advantages when used to pass assets down one generation, and since the typical trust terms are from ten to 25 years, the *ideal candidate* for this gifting instrument will have children between the ages of 35 and 55. Since the only people benefit from a reduction in estate and gift taxes are those whose assets and estates are large enough to trigger these taxes, the *ideal candidate* for this type of trust is someone with estate of at least \$5,000,000.

Only the assets above the exclusion amount would ordinarily be subject to federal estate taxes. The following chart which shows estate tax exclusions as they currently stand. It gives a general perception of the assets which could be protected from taxation using this gifting instrument, although the author makes no prediction about the actual estate exclusion amount or tax rate in the future. For that, see <http://www.plannedgiving.com/answers/taxdetails>.

Table 4:

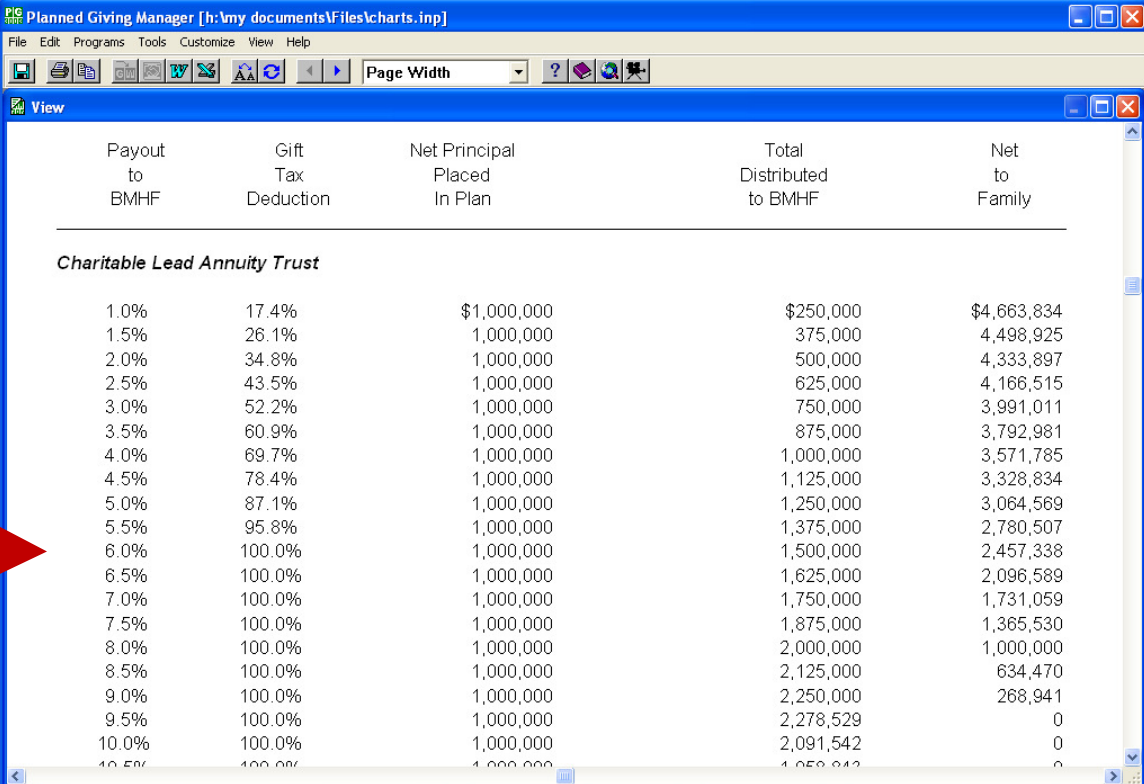
| Year | Exclusion Amount | Maximum Tax Rate |
|-------------|-------------------------|-------------------------|
| 2008 | \$2 million | 45% |
| 2009 | \$3.5 million | 45% |
| 2010 | Repealed | 0% |
| 2011 | \$1 million | 55% |

How do you calculate the benefits?

To determine the exact payout percentage required for a CLAT to eliminate all gift and estate taxes, open Tab 4 “Lead Trust Projections.” Choose the “Payout Comparison Survey” presentation. Make sure the IRS Discount Rate, Principal, Basis, and Term are all correct. The “Range of Payouts to Survey” defaults to “1% to 11%.” For example, with a 3.0% Rate, a 25 year CLAT, reaches the 100% deduction at 6.0% in the default display. (See Illustration 1)

Once you see that gift tax deduction reaches 100% at a certain number, choose a one-digit range that includes that number. (For example 5.5% to 6.5%.) Then you will see the more precise percentage, which in this case is 5.75%. This number is shown in the chart above, and in the printout on the following page. (See Illustration 2)

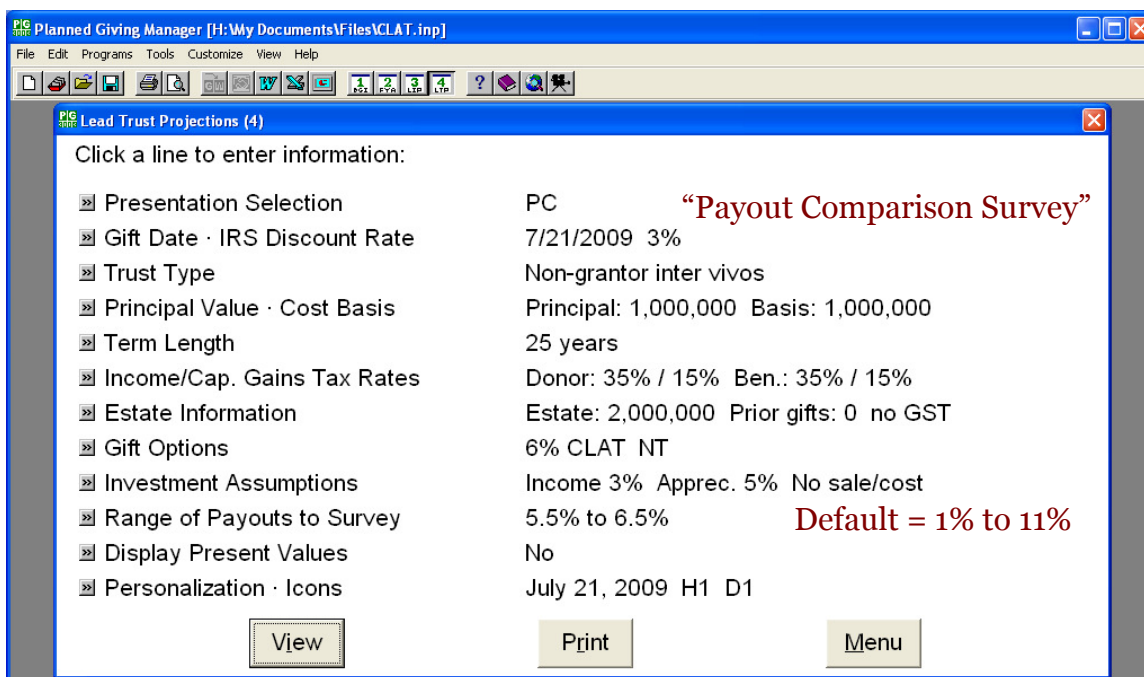
Illustration 1:*



| Payout to BMHF | Gift Tax Deduction | Net Principal Placed In Plan | Total Distributed to BMHF | Net to Family |
|--------------------------------------|--------------------|------------------------------|---------------------------|---------------|
| <i>Charitable Lead Annuity Trust</i> | | | | |
| 1.0% | 17.4% | \$1,000,000 | \$250,000 | \$4,663,834 |
| 1.5% | 26.1% | 1,000,000 | 375,000 | 4,498,925 |
| 2.0% | 34.8% | 1,000,000 | 500,000 | 4,333,897 |
| 2.5% | 43.5% | 1,000,000 | 625,000 | 4,166,515 |
| 3.0% | 52.2% | 1,000,000 | 750,000 | 3,991,011 |
| 3.5% | 60.9% | 1,000,000 | 875,000 | 3,792,981 |
| 4.0% | 69.7% | 1,000,000 | 1,000,000 | 3,571,785 |
| 4.5% | 78.4% | 1,000,000 | 1,125,000 | 3,328,834 |
| 5.0% | 87.1% | 1,000,000 | 1,250,000 | 3,064,569 |
| 5.5% | 95.8% | 1,000,000 | 1,375,000 | 2,780,507 |
| 6.0% | 100.0% | 1,000,000 | 1,500,000 | 2,457,338 |
| 6.5% | 100.0% | 1,000,000 | 1,625,000 | 2,096,589 |
| 7.0% | 100.0% | 1,000,000 | 1,750,000 | 1,731,059 |
| 7.5% | 100.0% | 1,000,000 | 1,875,000 | 1,365,530 |
| 8.0% | 100.0% | 1,000,000 | 2,000,000 | 1,000,000 |
| 8.5% | 100.0% | 1,000,000 | 2,125,000 | 634,470 |
| 9.0% | 100.0% | 1,000,000 | 2,250,000 | 268,941 |
| 9.5% | 100.0% | 1,000,000 | 2,278,529 | 0 |
| 10.0% | 100.0% | 1,000,000 | 2,091,542 | 0 |
| 10.5% | 100.0% | 1,000,000 | 1,058,842 | 0 |

*Note: All graphic illustrations contained in this paper are generated from PGCcalc’s Planned Giving Manager, and provided with the permission of PGCcalc.

Illustration 2:



However, since the most important reason people make charitable gifts is usually the good the gift will do, the planned giving officer cannot merely show the exact percentage needed to “zero out” the estate taxes. CLATS were used by wealthy, philanthropically-minded individuals when the IRS Rate was much higher, and the chance of zeroing out the estate tax was very slim.

Through the discussions in the session, participants will become familiar with the non-tax-related considerations people bring into the consideration of funding a CLAT. People who do not attend the session should be able to come to this type of understanding on their own time schedule.

Before going deeper into the numbers, please take a few moments to think about your organization’s mission, or the mission of the charity your client wishes to support. Think of two projects that your charity or client would be able to fund through a guaranteed funding stream lasting between 10 and 25 years. (Participants will discuss projects they suggest at their tables.)

- 1.
- 2.
- 3.

Table 5:

| Paoli Hospital Foundation | | | | |
|--------------------------------------|---------------------------|-----------------------------------|------------------|------------------|
| July 21, 2009 | | | | |
| Lead Trust Projections | | | | |
| Payout Comparison Survey | | | | |
| Payout to PHF | Gift Tax Placed Deduction | Net Principal Distributed In Plan | Total to PHF | Net to Family |
| <i>Charitable Lead Annuity Trust</i> | | | | |
| 5.50% | 95.8% | \$1,000,000 | \$1,375,000 | \$2,780,507 |
| 5.55% | 96.6% | 1,000,000 | 1,387,500 | 2,751,012 |
| 5.60% | 97.5% | 1,000,000 | 1,400,000 | 2,721,200 |
| 5.65% | 98.4% | 1,000,000 | 1,412,500 | 2,691,355 |
| 5.70% | 99.3% | 1,000,000 | 1,425,000 | 2,661,140 |
| 5.75% | 100.0% | 1,000,000 | 1,437,500 | 2,630,256 |
| 5.80% | 100.0% | 1,000,000 | 1,450,000 | 2,596,164 |
| 5.85% | 100.0% | 1,000,000 | 1,462,500 | 2,561,722 |
| 5.90% | 100.0% | 1,000,000 | 1,475,000 | 2,527,206 |
| 5.95% | 100.0% | 1,000,000 | 1,487,500 | 2,492,352 |
| 6.00% | 100.0% | 1,000,000 | 1,500,000 | 2,457,338 |
| 6.05% | 100.0% | 1,000,000 | 1,512,500 | 2,422,084 |
| 6.10% | 100.0% | 1,000,000 | 1,525,000 | 2,386,575 |
| 6.15% | 100.0% | 1,000,000 | 1,537,500 | 2,350,926 |
| 6.20% | 100.0% | 1,000,000 | 1,550,000 | 2,314,982 |

Are there reasons that a definite income stream for this project could be preferable to raising new money each year or endowing the project?

You can probably think of the reason a guaranteed income stream is preferable to raising new money each year. The regular stream of funding is dependable, it does not require annual expenditures of staff time to raise the funds each year, it can be counted on in hard years (like fiscal year 2009) as well as normal years, the organization can budget for a recurring project with confidence. But why would the guaranteed income stream for a specific period of years be preferable to a perpetual endowment? Most years development professionals would not think of

the fact that endowment income can decline during a period of economic uncertainty, but that could be everyone's first response this year.

There is another important consideration: A donor/client may be able to fund a guaranteed cash flow for a specific period of years, but not have sufficient resources to fund an endowment which would provide that same level of funding. The fundraiser may think immediately of the charity's funding guideline's which may state that an endowment may be funded for as little as \$50,000. But at most charities, that endowment will only produce a 4.5% funding stream. This means that a \$1,000,000 endowment fund will produce approximately \$45,000 each year. If the investment portfolio produces a steady increase every year, this fund will increase in perpetuity to offset inflation. But financial advisors, development officers and donors all understand that investment portfolios do not always rise from year to year.

For example, a physician brought a major donor to the development department's attention. The physician's impressions and independent research indicated that this donor had more than \$1,000,000 which he might be willing to use as some sort of donation. We believed that he was capable of funding a \$1,000,000 endowment. However, the physician felt that the research project needed about \$100,000 per year in funding. If the donor had funded an endowed fund, the proceeds of \$45,000 per year would not provide the funding which the physician felt was necessary. Therefore, from the point of view of one very important person at the charity, a ten-to-fifteen-year funding stream of \$100,000 per year was more desirable than a \$1,000,000 endowment, which would generate less money during that period. You can imagine how other factors, such as the physician's age or a project that is expected to produce a breakthrough in the research related to a particular disease within a period of 10 to 25 years, might also impact the desirability of obtaining a larger stream of funding for a less-than-perpetual period of time.

Participants will list a number of projects at the charities they represent, and/or those they support with a scope of cash stream needs in the \$50,000 to \$100,000 per year range.

- 1.
- 2.
- 3.
- 4.
- 5.

Some Important Questions That Can Be Solved Using Simple Equations:

1. How do you manipulate the basic information provided by gift planning software in order to address the primary concerns of the donor/client?

The following table displays the benefit to charity for a \$1,000,000 CLAT at the percentages which would eliminate all estate taxes for the specific terms. In the One-Year Benefit column, the first row is intentionally left blank so participants can do this one calculation. Simply multiply the Corpus by the Percent ($B = C * P$). The Term Benefit to Charity is calculated by simply multiplying the Corpus by the Percent and the Term, or simply multiplying the previous column by the Term.

Table 6: \$1,000,000 Sample:

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Estate Tax | One-Year Benefit (B) | Term Benefit to Charity (TB) |
|-------------|----------|-------------------------|------------|----------------------|------------------------------|
| Chosen | Chosen | Based on Software | \$0.00 | $B = C * P$ | $TB = C * P * T$ |
| \$1,000,000 | 25 | 5.75% | \$0.00 | \$ | \$ |
| \$1,000,000 | 20 | 6.75% | \$0.00 | \$67,500 | \$1,350,000 |
| \$1,000,000 | 15 | 8.40% | \$0.00 | \$84,000 | \$1,260,000 |
| \$1,000,000 | 10 | 11.75% | \$0.00 | \$117,500 | \$1,175,000 |

This table is based on the current 3.0% Discount Rate and the percentages needed to “zero out” the estate tax on CLAT assets. Actual numbers may vary depending on the then current Discount Rate.

Although this is simple math, it should help the student to learn the concept with some very brief practice. Please solve for the One-Year Benefit in the following table. Multiply the Benefit by the Term to solve for the last column.

Table 7: Solve for Benefits of a CLAT funded with \$2,000,000 Corpus:

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Estate Tax | One-Year Benefit (B) | Term Benefit to Charity (TB) |
|-------------|----------|-------------------------|------------|----------------------|------------------------------|
| Chosen | Chosen | Based on Software | \$0.00 | $B = C * P$ | $TB = C * P * T$ |
| \$2,000,000 | 25 | 5.75% | \$0.00 | | |
| \$2,000,000 | 20 | 6.75% | \$0.00 | | |
| \$2,000,000 | 15 | 8.40% | \$0.00 | | . |
| \$2,000,000 | 10 | 11.75% | \$0.00 | | . |

2. If you know the desired Benefit and Term, how do you solve for the required Corpus?

A donor/client may have identified a specific project for funding, or the development officer may wish to present the CLAT as an option for funding a specific project. If the cost of the project is known, then this number can be the starting point for the discussion. The question is, “How much money must be invested to fund a CLAT that will adequately fund the identified project?”

The answer is found in the formula: $C = B/P$. The required Corpus may be determined by dividing the Benefit by the required Percent. Illustrating from the 20-year row in the \$2,000,000 table above, when you divide by a percentage, as \$67,500 divided by 6.75% ($\$67,500/0.0675$) you can end up with a relatively large number, such as \$1,000,000.

Table 8: Assume you want a \$100,000 per year Benefit to the charity:

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Estate Tax | One-Year Benefit (B) | Term Benefit to Charity (TB) |
|-------------|----------|-------------------------|------------|----------------------|------------------------------|
| $C = B / P$ | Chosen | Based on Software | \$0.00 | \$100,000 | TB = B * T |
| | 25 | 5.75% | \$0.00 | \$100,000 | |
| | 20 | 6.75% | \$0.00 | \$100,000 | |
| | 15 | 8.40% | \$0.00 | \$100,000 | |
| | 10 | 11.75% | \$0.00 | \$100,000 | |

3. If you know the desired Benefit and Corpus, how do you solve for the required Term?

The answer depends on the Percentage Payout to Charity of the CLAT. The formula for this is $P = B/C$. Table 9 is the most basic, and easiest to calculate table in this presentation. The first row is completed, showing that \$50,000 divided by \$1,000,000 equals 0.05 or 5.0%. At first, this may seem unrelated to the concept of a CLAT. Especially if you are only looking at CLATs which completely eliminate federal estate tax.

Consider the question, “Does your client always require a ‘zeroed out’ gift tax when considering a CLAT?”

CLATs have been funded by wealthy, charitably-minded individuals for many years. During most of that time, the IRS Discount Rate was not nearly as favorable to this instrument as it is today. We have already established that tax avoidance is not the only motivating factor for this gifting instrument. Planned giving officers need to be able to show and discuss illustrations for this instrument which reduce, rather than eliminate the federal estate tax.

Table 9: Assume a \$1,000,000 Corpus and an annual Benefit to charity of \$50,000:

| Corpus (C) | Term (T) | Annual Gift Percent (P) | Estate Tax | One-Year Benefit (B) | Term Benefit to Charity (TB) |
|-------------|----------|-------------------------|------------|----------------------|------------------------------|
| $C = B / P$ | Chosen | $P = B/C$ | \$0.00 | \$50,000 | $TB = B * T$ |
| \$1,000,000 | 25 | 0.05 or 5.0% | \$0.00 | \$50,000 | |
| \$1,000,000 | 20 | | \$0.00 | \$50,000 | |
| \$1,000,000 | 15 | | \$0.00 | \$50,000 | |
| \$1,000,000 | 10 | | \$0.00 | \$50,000 | |

Assuming that the client/donor wishes to establish a 5% CLAT, Table 10 illustrates the percentage of the assets used to fund the instrument that would avoid the gift and estate taxes. If the selected Annual Gift Percentage is 5%, the Term will be an important factor in determining the percentage of assets that are protected from these taxes. For example, a 25-year Term will protect 87.1% of the assets, while a ten-year Term will shield only 42.7%. The remaining assets could be applied toward the exemption, or taxes could be paid on their transfer.

Table 10: Percent of Gift and Estate Tax Deduction for a 5% CLAT with 3.0% IRS Rate:

| Corpus (C) | Term (T) | 5% CLAT Reduces x% | Estate Tax | One-Year Benefit (B) | Term Benefit to Charity (TB) |
|-------------|----------|--------------------|------------|----------------------|------------------------------|
| $C = B / P$ | Chosen | From Software | \$0.00 | \$50,000 | $TB = B * T$ |
| \$1,000,000 | 25 | 87.1% | \$0.00 | \$50,000 | |
| \$1,000,000 | 20 | 74.4% | \$0.00 | \$50,000 | |
| \$1,000,000 | 15 | 59.7% | \$0.00 | \$50,000 | |
| \$1,000,000 | 10 | 42.7% | \$0.00 | \$50,000 | |

A Final Question:

Imagine an ideal candidate with a \$20,000,000 estate who is considering a \$5,000,000 CLAT with children as beneficiaries. This person is also considering giving this money directly to their children. With the help of what you learned in this session, how might you explain this plan to their heirs? How would a guaranteed term of 10 to 25 years with a charitable component be viewed by money managers, wealth advisors, charity’s program officer and others?

Summary:

A significant gift can be made in support of the charity you represent or for the mission your client holds dear using the uniquely tax-advantaged CLAT. During this current economic downturn, conditions, including the IRS Discount Rate and the depreciated state of many assets, favor the creation of a CLAT. This gift plan allows your donor/client to transfer assets to family and reduce or eliminate gift and estate taxes while making a generous gift to an important charity, possibly supporting a specific program for a specific period of years.

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