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Estate Tax Catch All: The Incredible, Flexible TCLAT

Certainly, estate tax law will be addressed by the new administration over the next few years. Many planners have predictions about how the law and exemption limits will look once legislative action is taken. While the administration tends to other priorities (too many to name here), you may want to consider a powerful, flexible, revocable estate tax planning tool.



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Planning Idea:

The testamentary charitable lead annuity trust (TCLAT) is a trust created under a living trust or will document. One idea behind adding it to a family's planning is to avoid federal estate taxation should husband and wife die prematurely. Typically, the trust is funded upon second death and a flexible formula directs those funds that would be subject to taxation (i.e. wealth in excess of the available exemptions) into the TCLAT. This trust pays a stream of payments to charity over a term of years (or a life) and receives a corresponding tax deduction. The heirs would receive whatever assets are left in the trust at the end of the term. The trust may be funded in such a way as to "zero out", meaning even though the total capital used to fund the trust was part of the donors taxable estate, an equal charitable deduction can be obtained to eliminate the federal estate tax. For many wealthy families, especially small business owners, creating a revocable fail-safe to avoid taxation (and possible forced liquidation of a business or real estate) upon premature death becomes a powerful planning tool.

How It Works:

The charitable lead annuity trust creates the charitable deduction upon funding using a formula based upon the term of the trust and the 7520 interest rate (set each month by the IRS). The lower the rate in effect at the establishment of the CLAT, the less the annual payout rate to charity needs to be to obtain the same tax deduction to the estate and the higher the likelihood of the heirs receiving a significant inheritance. Because the rate will not be known until the donor's death, the CLAT may use a formula in its provisions to create a "zero out" scenario. The trust may provide a fixed term and a variable payout or a variable term using a fixed payout rate.

The trust is not a charitable entity and therefore taxed as a complex trust. It receives an unlimited income tax deduction for the income paid to charity each year. However, for the trust to obtain this deduction, the assets of the trust must produce taxable income equal to or in excess of the annual payout. Any trust income from capital gains and dividends taxed at 15% would reduce the benefit of the deduction. In situations where the trust has income of different categories, it is recommended that it contain a provision that states the income will be made from ordinary income first, then capital gain, unrelated business taxable income, and finally, from trust corpus. This would allow the trust to avoid wasting the deduction.





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Because a successful CLAT depends upon assets that produce a yield in excess of the 7520 rate, care must be taken in the funding. Obviously, certain assets that produce taxable income in excess of the payout rate would be ideal, but this may or may not be possible given the environment when the trust is actually funded.

One idea to combat the funding issue is to utilize closely held entities (such as family partnerships or LLC's) to "leverage" the return through the use of discounts. By funding the trust with noncontrolling interests, the discount lowers the required yield to produce successful results. For example, if \$1,000,000 of a family limited partnership yielding 6% were used to fund the CLAT and a reasonable discount of 20% could be obtained, the yield to the trust would increase to 7.5% ($\$1,000,000 \times 80\% = \$800,000$; $\$60,000 \text{ income} / \$800,000 = 7.5\%$). The leveraging effect could produce the desired yield necessary to produce a successful result without adding investment risk by chasing higher yields in the marketplace.

Sample Case:

As an example of how this type of trust could be deployed, let's walk through a simplified example case. Joe Client and his wife Jane, both age 45, have a net worth of \$10 million and face significant estate tax upon second death. Their two children are 18 and 22 years old. Joe owns a business worth \$4 million; they own \$1 million of real estate and personal property, and \$5 million of commercial real estate and financial assets.

Joe and Jane meet their demise in 2008 and have properly sheltered their collective exemptions of \$4 million. The remaining \$6 million would be directed into a CLAT with a term of twenty years. In the current low interest rate environment, the 7520 rate (3.6% November) would produce excellent results. However, we are at the low end of a ten year average of about 5.2%, so to represent an average CLAT scenario, we'll use that average 7520 rate. We will assume the assets in the trust yield 8.5% annually and the term of the trust is twenty years. The required annual trust payout to charity is \$481,000, or about 8% of trust assets. At the end of the twenty year trust term the children (now ages 38 and 42) would receive the remaining assets in the trust of \$6,258,000. While the trust value grew a little, assuming inflation averaged 3.5% over the trust term, the children receive \$3,145,000 in current dollars (in addition to the \$4 million they received upon second death through exemptions). The charitable beneficiary of the annual payments (which may include a private foundation or donor advised fund) received a total of \$9,629,000 over the trust term.

What has been accomplished? First, federal estate tax of approximately \$3 million has been avoided. Secondly, no family assets (the business, business real estate) had to be sold to pay the estate tax. While the children receive a nice inheritance, instead of maximizing this value, those funds are redirected to charity and may continue to be controlled by the children if desired.



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Conclusion:

Without even using any advanced techniques, the sample case above illustrates the power and flexibility of a testamentary charitable lead annuity trust. This tool could be a temporary, revocable element in a client's estate plan that protects the family in many ways. In contrast, this type of plan may form a longterm solution for many charitably inclined clients. The elements of tax avoidance, charitable payments, and delayed inheritance may fit many client scenarios you see in your own practice.

We believe strongly that the client is best served through a collaborative planning effort of multiple professionals. We welcome any inquires you may have. Please contact us at 440-740-0130.

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