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Giving Smarter While Helping Your Estate

Bear Market Provides Boost to a Little-Known Strategy; a Record Low Hurdle Rate

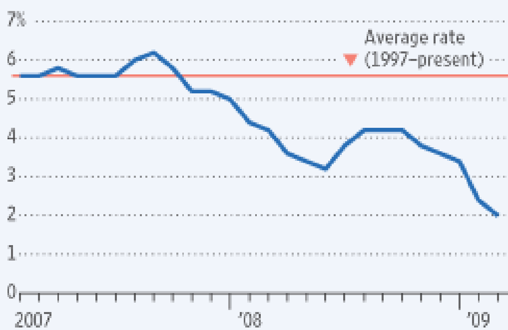
By MIKE SPECTOR

Investors aren't in a giving mood these days. But the deepening recession presents a rare opportunity for some people: By setting up a special trust, wealthy donors can seed favorite charities, pass money to heirs and shelter potential growth from taxes.

Under the strategy, called a "charitable lead trust," you can transfer assets -- cash, stocks and artwork among them -- to a trust for a set term of years. Each year, payments are made from the trust to a designated charity or charities. After the trust's term expires, what's left goes to your heirs. By moving the assets out of your estate, the strategy also shelters their potential appreciation from estate taxes.

Giving and Receiving

Historically low 'hurdle' rates on charitable lead trusts make them an attractive way to pass money to heirs while also giving to charity.



Source: IRS

Because many clients remain shell-shocked from recent market losses, estate planners say they aren't executing a lot of these trusts right now. But because of current bear-market conditions, planners are increasingly advising clients to consider these trusts.

What makes them especially attractive now is an historically low special rate that the Internal Revenue Service uses to predict how much your assets will grow in the trust. Estate-planning lawyers call it the "hurdle" rate because investment gains beyond it can generally pass to heirs tax-free. The rate, which is adjusted monthly, remains locked in for the length of the trust.

February's hurdle rate is 2%, down from 4.2% a year ago. Since many assets, such as securities or businesses, are severely depressed right now, it's likely that they'll appreciate by a margin well beyond the 2% hurdle rate in coming years.

Nancy Ridgley, a 68-year-old real-estate agent in Columbus, Ohio, reaped several hundred thousand dollars in 2004 after selling farmland she inherited from her uncle. Ms. Ridgley wanted to pass that money to her three daughters but also maintain her charitable giving. She also wanted to get the money out of her estate.

John Schuman, a principal at Budros, Ruhlin & Roe Inc., a Columbus-based wealth-management firm, suggested Ms. Ridgley set

up a charitable lead trust. "She wanted to give [the sale proceeds] to her kids, but she also had these charitable goals," Mr. Schuman says. The trust presented an opportunity "to balance those interests."

In July 2004, Ms. Ridgley transferred her money to the trust for a term of eight years. The IRS's hurdle rate at the time was 5%, but Ms. Ridgley took advantage of a rule that allowed her to use the rate from two months earlier, a relatively low 3.8%.

Today, the combination of low interest rates and depressed asset values makes it a "perfect storm of opportunity" for the affluent to execute charitable lead trusts and other vehicles that remove wealth from their estates and pass it tax-free to heirs, says Herb Daroff, an estate-planning lawyer at Baystate Financial Planning, a Boston wealth-advisory firm.

Financial advisers say that's important because the estate tax is likely to remain under a Democratic White House and Congress. The current basic federal estate-tax exemption for 2009 is $3.5 million, with a top rate of 45%.

The tax is scheduled to vanish next year and then return in 2011 with a $1 million exemption and a top rate of 55%. But President Barack Obama said during the presidential campaign that he favors extending the current $3.5 million per-person exemption and 45% top rate into future years.

Two Trust Flavors

Charitable lead trusts generally come in two flavors: charitable lead annuity trusts and charitable lead unitrusts. In an annuity trust, the donor sets a fixed annual gift for charities. In a unitrust, the charitable beneficiaries receive a percentage of the trust's value each year, meaning those benefits will fluctuate based on the trust's investment returns or losses.

Most investors choose annuity trusts, financial planners say, because the charitable payments are fixed. In a unitrust, as assets grow, the percentage going to charity gobbles up more and more money, leaving less for heirs.

When establishing either trust, the donor can opt to take an upfront income-tax deduction based on the trust's payments to charity. Many opt to forgo that deduction, though, because taking it requires that the donor pay taxes on the trust's investment gains.

Avoiding Taxes

That's exactly what Ms. Ridgley, the Ohio real-estate agent, did. To avoid paying taxes on any investment gains, she passed on taking an upfront income-tax deduction on her annual charitable payments. And she structured her annual charitable payments to make sure her children received as much benefit as possible.

Assuming the trust realized returns of at least 5.75% annually over eight years, "my daughters could then be able to each have ... the original amount that was put into the trust," Ms. Ridgley says.

She sends charitable payments from the trust to a donor-advised fund run by the Columbus Foundation. Ms. Ridgley, a part-time minister who has traveled on religious missions to Indonesia, Thailand and Israel, among other places, sends the bulk of her donations to the Christian Broadcasting Network and other Christian organizations.

Ms. Ridgley and her three daughters advise how the fund should dole out the payments. "It's been very meaningful to them as well," Ms. Ridgley says.

Potential Pitfalls

Charitable lead trusts do have some potential pitfalls. They are irrevocable, so once you put assets or cash in, you can't take them out. If the trust's assets go down in value over a long stretch, the benefit for heirs could be less, because the trust must make its charitable payments regardless of market conditions.

In addition, the money passing to heirs is a taxable gift, which in turn lowers your estate-tax exemption.

There is a way to avoid gift taxes in these trusts, a tactic called "zeroing out." This strategy -- in which you structure the trust so the charitable payments made over time equal the amount of principal originally put into the trust -- is generally only effective with charitable lead annuity trusts. By doing this, you avoid gift-tax consequences. But keep in mind that increasing payouts to charity could leave less money for heirs when the trust expires.

Charitable lead trusts can also be executed upon your death. But setting up one now allows you to strike when market conditions are ripe. "Your opportunity to take advantage of the depressed market value of assets and the historically low value of interest rates may have vanished by the time you die if a lead trust is created in your will," says Jeff Baskies, a partner at the law firm Katz Baskies LLC in Boca Raton, Fla.

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