Estate Planning and Charitable Planning Opportunities

Impact of a Low-Interest Rate Environment and Covid-19

A Guide

Community Foundation
FOR SOUTHEAST MICHIGAN

Table of Contents

Community Foundation

FOR SOUTHEAST MICHIGAN

Note: This material was developed by Community Foundation for Southeast Michigan. It is published with the understanding that neither the publisher nor the author is engaged in rendering legal, accounting, or other professional service.

If legal advice or other expert assistance is required, the services of a professional advisor should be sought.

Estate Planning and Charitable Planning Opportunities

Impact of a Low-Interest Rate Environment and Covid-19

Laura Brownfield, General Counsel, The Community Foundation for Southeast Michigan

This article originally appeared in the Michigan Prob & Est Plan J, Vol. 40, at page 31, and is reprinted with permission

Interest rates that are used to calculate the gift tax deduction in estate planning strategies are at historically low levels in response to the slowdown of the economy and the onset of the pandemic in 2020. As a result, there is a planning opportunity for practitioners who work with charitably inclined clients who wish to transfer significant wealth to their heirs at a reduced gift or estate tax cost. Through a charitable lead trust, clients can benefit charity now and minimize gift and estate taxes in shifting wealth to the next generation.

The drop in asset values - from the stock market, to real estate, to closely held businesses - as a result of the pandemic also presents a unique estate planning opportunity for wealthy families. A client can fund a charitable lead trust with those assets, supporting charity over a stated term and passing the remainder to the younger generations at a lower transfer tax cost. Any subsequent appreciation of the assets passes to the heirs free of gift and estate tax.

From an estate planning perspective, and given the potential for significant changes in tax policy following the election – including Biden's proposed 45% estate tax rate, $3.5 million per taxpayer exemption amount, and repeal of basis step-up on death - wealthy clients should consider taking advantage of existing low interest rates and current tax laws to benefit their favorite charitable causes and their heirs.

Charitable Lead Trusts

For a charitably minded client seeking to reduce his or her taxable estate who possesses income-producing assets sufficient to provide for his or her cash needs, the charitable lead trust ("CLT") is an effective estate planning strategy. The CLT is an irrevocable trust in which an income (the "lead interest") is paid to one or more charitable beneficiaries for a specific period, and at the end of the term, the remainder interest either reverts to the grantor or is paid to one or more designated noncharitable beneficiaries.

Permissible Beneficiaries

Community foundations, private foundations, and other charitable vehicles such as donor advised funds qualify as a charitable beneficiary and can receive the distributions of the CLT lead interest. A client can identify a donor advised fund at a community foundation and designate that fund as the charitable beneficiary. The client's family may then act as donor advisors and recommend grants to the family's favorite charities. A donor advised fund also allows accumulation of distributions for several years in order to facilitate larger grants to multiple charitable causes.The CLT remainder beneficiaries may be the grantor or other noncharitable beneficiaries.

Inter Vivos or Testamentary CLT

Clients can create a CLT either by inter vivos agreement during the lifetime of the grantor or through a testamentary agreement that becomes effective on the date of the grantor's death. A CLT results in a taxable gift upon creation equal to the fair market value of the assets gifted to the trust, reduced by the value of the lead interest. The estate planning objective is to generate a current gift or estate tax charitable deduction that will partially, or even completely, offset the taxable transfer to the non-charitable beneficiaries.

An inter vivos CLT may reduce estate and gift tax on an appreciating asset and provide some income tax savings to the grantor. When the CLT is funded, the grantor makes a charitable gift equal to the present value of the stream of the annuity or unitrust payments to be paid to the charitable beneficiary. Additionally, at the time the grantor transfers property to the CLT, the grantor is treated as having made a noncharitable gift to the remainder beneficiaries, who will receive a carryover basis for assets received from the CLT.[1] The higher the present value of the lead interest to be paid to charitable beneficiary, the lower the present value—and therefore the gift tax value—of the property transferred to the remainder beneficiaries. In effect, the grantor loses the income from the asset contributed to the lead trust, and on expiration of the charitable beneficiary's lead interest, the noncharitable remainder beneficiaries will receive the trust corpus.

The testamentary trust, established at death, may be funded with property passing to the trust on death of the grantor. As the property is included in the grantor's estate, the trust will receive a stepped-up basis (equal to the estate tax value) for the CLT assets, which will eventually pass to the noncharitable beneficiaries receiving the testamentary CLT assets.[2]

To be a qualified CLT[3], the trust instrument must satisfy all of the requirements set forth in IRC §664 and the regulations thereunder. In 2007 and 2008, the IRS published sample inter vivos grantor and non-grantor CLTs and testamentary CLTs. See Rev. Procs. 2007-45 (inter vivos) and 2007-46 (testamentary) as a starting point for drafting a charitable lead annuity trust.[4] See Rev. Procs. 2008-45 (inter vivos) and 2008-46 (testamentary) as a starting point for drafting charitable lead unitrusts.[5]

Term of the Trust

The CLT can provide that the trustee shall distribute the lead interest for a specified term (with no limit to the term) or for the life or lives of an individual(s) who are living

1 IRC §1015(b).
2 IRC §1014(a).
3 Another planning technique is the nonqualified CLT which is an irrevocable charitable trust providing an income interest to charity that does not meet IRC requirements for estate, gift, or income tax deductibility and is taxed as a complex trust. The nonqualified CLT is not the subject of this article.
4 See https://www.irs.gov/irb/2007-29_IRB#RP-2007-45
5 See https://www.irs.gov/irb/2008-30_IRB.

and ascertainable on the transfer date. The CLT can specify the duration of the payments by a combination of a life span and a term of years. This can provide an opportunity to plan for young children or grandchildren using an appropriate term and by thoughtfully selecting assets that produce adequate growth to accomplish the preservation of the remainder beneficiaries' interest in the trust assets while satisfying payment of the lead interest during the trust term.

Annuity or Unitrust Interest

The trustee of a CLT must make fixed "annuity" payments or variable "unitrust" payments to the charitable beneficiary which must be paid by the trustee at least annually. Although similar, the annuity trusts and unitrusts function in different ways, and can meet different planning objectives. Both trusts are structured to preserve the original principal and some growth of principal for the remainder beneficiaries.

Annuity Trust. In an annuity trust, the amount payable to the current income beneficiaries is measured as a fixed dollar amount or a fraction or percentage of the initial fair market value of property at the time of funding and the creation of the trust. For those clients who want their charitable beneficiary to receive a fixed income stream, regardless of the income generated by the trust, the annuity trust may accomplish their intentions. In an annuity trust, generally no additional contributions can be made because the trustee must be able to ascertain the payout amount which is determined by the initial value of the trust. As the annuity interest remains constant over the term of the trust, the remainder beneficiaries will benefit from growth of the trust principal.

Unitrust. The payout of a unitrust is tied to the value of the property each year. The charitable beneficiary has an irrevocable right to receive payment of a fixed percentage of the net fair market value of the assets determined annually. Although the percentage remains fixed throughout the trust term, the unitrust amount may vary from year to year as the trustee determines the payment based on the annual net fair market value of the trust assets. As the value of the assets increases, so does the unitrust amount. The grantor can make additional contributions to a unitrust if the trust instrument permits the same. Unitrusts are appropriate for trust property that is easy to value annually, such as stock or securities.

Grantor or Nongrantor Trust

Another planning issue to consider is whether to draft the CLT as a grantor or nongrantor trust. Depending on how the trust is structured, either the grantor or the trust will receive a charitable tax deduction. Under a "grantor charitable lead trust," the grantor receives an immediate income tax deduction for the total net present value of the future distributions to charity in the year the CLT is established. Under a "non-grantor charitable lead trust," none of the income produced by the trust is taxable to the grantor, instead the trust is an independent taxable entity that is responsible for its own taxes.

Grantor Trust. For income tax purposes, the grantor, and not the trust, is taxed on the trust income. A grantor charitable lead trust must be established as an inter vivos trust. A grantor CLT provides the grantor with an immediate charitable income tax deduction for the present value of the annuity or unitrust amounts to be paid to the charitable beneficiary. The price of the income tax deduction at inception is that the grantor must include the income of the trust in his or her income in all years that it is being paid to a charitable beneficiary. Furthermore, the deduction cannot exceed thirty percent (30%) of the grantor's adjusted gross income if the lead interest is payable to a public charity as described in IRC §170(b)(1)(A)) and only twenty percent (20%) of the grantor's adjusted gross income if the lead inter

While the grantor charitable lead trust may seem to be onerous from a tax perspective, a client may wish to use a grantor CLT to obtain a one-time income tax deduction for the charitable gift of the lead interest. For example, if a client experiences a large gain such as from the sale of a major asset, the proceeds can be used to fund a grantor CLT in order to create a lump-sum deduction for the client in the same year in which he or she has an unusually high level of income. The resulting charitable income tax deduction will offset income otherwise taxable at the client's maximum marginal rate. Although the client must recognize taxable income distributed to the charitable beneficiary from the CLT in the following years, that income will generate less tax.

Nongrantor Trust. Nongrantor CLTs are an effective estate and tax planning tool for clients who are maximizing their charitable deductions which remain subject to percentage limitations and the maximum five-year carryover period, which may mean that a portion of their charitable contributions may never be deductible for income tax purposes. A nongrantor charitable lead trust may allow them to effectively increase the amount they can deduct for their gifts to charity as charitable distributions from the nongrantor CLT are 100% deductible by the CLT and are not taken into account in the grantor's own contribution limits.

A grantor of a non-grantor CLT is entitled to a gift tax charitable deduction for the present value of the charitable lead interest. The greater the deductible charitable income interest, the lesser the estate or gift tax consequence on transfer of the remainder interest. The value of both the lead interest and the remainder interest is affected by the interest paid to charity each year, the term of the trust, and the Section 7520[6] interest rate in effect when the CLT is funded, as discussed below. In addition, for closely held business interests, the nongrantor CLT offers additional discount for lack of control or lack of marketability which will reduce the deemed value of the remainder directed to heirs, with the result that the grantor incurs a smaller gift tax liability, providing the grantor with the ability to transfer a significant amount of wealth to younger generations at a lower tax cost.

The trust receives a charitable tax deduction each year that it makes distributions to charity. A nongrantor CLT is allowed an unlimited fiduciary income tax charitable

6 All section references herein are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

deduction for the amount it pays to charity each year.

Funding the Trust

When a client establishes a CLT, he or she can fund it with cash or with other assets, e.g. real estate, securities, and qualifying closely held business interests, which can be either income-producing or non-income-producing property. The contribution of non-income-producing property presents a problem for the trustee if the trust principal will not generate income sufficient to meet the guaranteed annuity or unitrust payment requirements, forcing the trustee to sell a portion of the principal, borrow against it, or distribute a portion of the principal to meet the distribution requirements.

From the standpoint of the noncharitable remainder beneficiary, the ideal asset to transfer to a CLT is property appreciating at or above the general rate of inflation. Clients should consider assets that have declined in value but are expected to appreciate in the future increasing the value of the assets passing to the remainder beneficiaries free of gift or estate tax at the end of the lead interest term. This strategy is further enhanced where the asset is a minority or fractional interest that may be entitled to a valuation discount, including discounts for lack of marketability and lack of control.

Gift Tax Consequences

When the grantor funds the CLT, he or she makes a taxable gift equal to the fair market value of the assets contributed to the trust, reduced by the present value of all charitable interests (e.g. annuity or unitrust interest). The value of the charitable interest is equal to the total payments the charitable beneficiary will receive over the trust term, discounted to present value using what is commonly referred to as the "Section 7520 rate." The Section 7520 rate is set forth in a monthly IRS revenue ruling, and is equal to 120% of the mid-term applicable federal rate, compounded annually, for the month in which the valuation date falls.

The grantor may elect to use the Section 7520 rate for the month in which the trust is funded or either of the two months preceding the month of the transfer. This allows the practitioner to determine the approximate value of the gift at least two months before it occurs and to plan for establishing and funding the trust based on the rate. As of this writing, the Section 7520 rate has fluctuated between 2.0% in January 2020[7] to 0.4% in November 2020[8], and as of December 2020 the Section 7520 rate is 0.6%[9] .

A CLT works better in a low interest rate environment because a lower Section 7520 rate will cause the present value of the annuity paid to the charitable beneficiary to be higher, which in turn produces a larger charitable contribution deduction and a smaller taxable gift to the remainder beneficiaries. If trust assets outperform the applicable Section 7520 rate, the trust will produce wealth transfer benefits as the noncharitable

7 Rev. Rul. 2020-01.
8 Rev. Ruling 2020-22.
9 Rev. Ruling 2020-26.

remainder beneficiaries will receive assets in excess of the grantor's taxable gift, free of transfer taxes.

Illustration

Tom and Tallulah Taxpayer are a wealthy couple in their early 60s with two children in their early 30s. Tom is a tech guy who recently received a windfall when he sold a mobile application he developed. A year ago, Tallulah's grandmother passed, leaving a substantial inheritance to Tallulah. Tom's app success and Tallulah's' inheritance have allowed them to give generously to their donor advised fund (DAF) at the community foundation, from which they have been able to support a variety of charities to address needs in the community and their charitable interests as they evolve over time. In an effort to involve their family in philanthropy, Tom and Tallulah have named their children as the successor advisors to the DAF, so that their children will be able to advise the community foundation regarding charitable uses of the funds Tom and Tallulah have gifted to the DAF.

Tom and Tallulah have three problems. They have been maximizing their contributions to charity, and as a result significant portions of their charitable gifts are not qualifying for deduction due to the percentage limitations. Also, they have done little planning for their two children. Finally, the charities they support are in need as they have been impacted by the pandemic.

Tom and Tallulah meet with their attorney to establish a grantor charitable lead annuity trust (CLAT), funded with $10 million, primarily in highly-appreciated stocks that pay an annual dividend, and designed to pay out $1,000,000 annually to their DAF for a period of ten years. At the end of the ten-year period the trust will terminate, and its assets will be distributed equally to their two children. They would like their children to benefit from the growth in the portfolio that the parents anticipate over the next ten years.

Using the November 2020 Section 7520 rate of 0.4%, Tom and Tallulah will receive a charitable gift tax deduction of $9,783,500. Tom and Tallulah have made a taxable gift of $216,500, which may be offset through the use of their gift tax exemption. Assuming that the CLAT assets earn a total return of 8% on average over its ten-year term, the distribution to the children will be over $7.1 million at the end of the CLAT term. Utilizing the CLAT has allowed the parents to transfer over $17 million in assets between charitable and non-charitable beneficiaries over the term of the trust, while reducing their taxable estate and incurring a nominal gift tax on the distribution to their children.

Conclusion

In the current climate of low interest rates and at a time of need for charities during the pandemic, clients who wish to give to charity should explore the role that charitable lead annuity trusts can play in helping them accomplish their philanthropic objectives while minimizing gift and estate taxes in shifting wealth to the next generation. For a client who is charitably inclined, exploring a charitable lead trust as a strategy in his or her estate plan could preserve assets for the next generation, by significantly reducing the potential transfer tax on amounts passing to non-charitable beneficiaries, while providing support to charity.

Community Foundation

FOR SOUTHEAST MICHIGAN

The Community Foundation is experienced in accepting gifts of all kinds and we can work with you and your clients to make the gifting process straightforward and efficient, consistent with your clients' business and estate planning goals.

We know southeast Michigan's needs and the nonprofits working to address them. We can work with you and your clients to advise you about grantmaking to organizations locally and nationally.

Call 313-961-6675 or visit **CFSEM.org/Advisors** for more information on how the Community Foundation for Southeast Michigan can be your partner in philanthropy.