



Diocese of Providence

TECHNIQUES FOR TIMING TRANSFERS TO HEIRS

Estate planning requires a number of different and important decisions, starting with who gets what. A more subtle but significant issue is determining the desirable time for a specific heir to receive all or portions of his or her inheritance.

GIFT TAX EXCLUSION

For estates subject to federal estate tax, the simplest and most cost-effective transfer tool is the annual federal gift tax exclusion of up to \$12,000 per recipient.

To qualify, gifts must be considered a present interest, so the recipient must receive the gift currently. When spouses make gifts jointly, or a spouse “joins in” a gift, the maximum exclusion is \$24,000 per donee.

If started soon enough, over a period of several years very significant portions of a large estate can be distributed to heirs free of tax. With Congress looking for revenue sources, such programs (if appropriate) should not be delayed.

USE OF CHARITABLE TRUSTS TO CONTROL TIMING

When philanthropic distributions are part of the plan for a substantial estate, the available charitable giving methods offer opportunities to control the timing of transfers to individuals.

Split-interest trusts—those that have personal and charitable beneficiaries—offer opportunities for flexible and creative planning. The tax benefits rest on the fact that such trusts include an irrevocable, measurable and tax-deductible charitable interest.

Charitable remainder trusts (CRTs).

CRTs provide payments to one or more individuals before the charitable organization has full use of the assets. Payment recipients can be the grantors only, grantors and successor income beneficiaries, or only recipients other than the grantors.

The term of a CRT set up for individuals can be measured by a life (or lives) in being at the time the trust is created, by a fixed period of time not to exceed 20 years, or by a combination of lifetime(s) and a subsequent term of up to 20 years.

Because the principal of CRTs eventually will pass to one or more charitable remaindermen, the benefit to individuals primarily is income improvement. Tax incentives include income tax charitable deductions for the grantors, avoidance of up-front capital gains tax by the grantors and the trust itself, and reduction or even elimination of a future estate tax.

Charitable lead trusts (CLTs). In contrast, CLTs first provide a stream of payments to

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The simplest and most cost-effective transfer tool has nothing to do with charitable giving. It is the annual federal gift tax exclusion of up to \$12,000 per recipient.

If started soon enough, over a period of several years very significant portions of a large estate can be distributed to heirs free of tax.

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qualified charitable entities and then leave the remaining assets to heirs. The term can be measured by specified lifetimes, but it is most frequently a fixed period that is *not* limited to a total of 20 years.

Another important difference is that the stated payout rate of a lead trust can be less than the 5 percent minimum permitted for a remainder trust. This can make it feasible to fund a CLT with low-yielding assets that are likely to appreciate in value before the remainder passes to heirs. A potential major benefit is that the federal transfer tax is based on the value of the assets at the time they are placed in trust, and subsequent appreciation generally is not subject to further tax. The value of the assets taxed is only the value of the remainder interest.

For other than grantor-owned lead trusts, the tax incentive is either a gift tax or estate tax charitable deduction, depending on whether the trust is funded during life or at death. The trust entity is itself a taxpayer, whereas the CRT is tax-exempt. A CLT, therefore, is primarily a tool for cost-effective and timely estate distributions for affluent families.

CHARITABLE REMAINDER TRUST TIMING EXAMPLES

A donor funding a charitable remainder trust typically prefers to retain an initial lifetime income interest for self, or for self and spouse. An added option is to provide a successor income interest for one or more other family members. The value of the income interests to others is a taxable gift.

If the recipients are much younger, successor life income interests also materially reduce the initial income tax charitable deduction and resulting savings. This increases the net cost and lowers the effective rate of return.

One way to provide some future income to family members younger than the grantor(s) is to limit the successor interest

to a fixed term not to exceed 20 years. This does not reduce tax savings to the extent done by including younger lifetime income interests. It also provides assurance of added family benefit in case the primary income beneficiaries (grantors) have untimely deaths.

Some CRT grantors do not need the income produced by the trust but wish to provide assistance to others at a particular time. During the term of a remainder trust, for example, financial support coming from payments made to the income beneficiaries can be made during the period of years when an adult child will be in college and graduate school, after which the charitable organization benefits.

In a different situation, a grantor may feel some degree of financial responsibility for a parent or older sibling without wishing to add to that person's estate. Adding a successor life income interest for a person older than the grantors may not significantly reduce the deduction and tax savings.

For multiple and younger income beneficiaries, a fixed term remainder trust can still provide a significant income tax deduction. For example, using an applicable federal midterm rate of 5.8 percent, a charitable remainder unitrust with a 5 percent payout in quarterly installments for the *lifetimes* of three grown children ages 38, 41 and 44 would be only 10.2 percent deductible for the grantors. The same trust, with a 20-year term, making payments to a noncharitable trust for the children would be 37.2 percent deductible, and the charitable organization should receive the gift sooner.

If a grantor's spouse is an income beneficiary of a remainder trust that has a successor interest for others, planners should be aware that the additional interest will cause loss of the estate and gift tax marital deduction. An alternative is to use separate charitable remainder trusts for income to the surviving spouse and

to the other heirs. The CRT for other heirs can be in the surviving spouse's estate plan.

CHARITABLE LEAD TRUST CONSIDERATIONS

When the leading income interest is for a charitable organization and the lead trust is established by grantor(s) during life, the timing of realization of the remainder value by heirs can be targeted. The trust can be established with a term of years designed to end after a period set to the approximate time when these state-of-life events (such as forming a family, education and retirement) are expected to occur, assuming heirs are about the same age. When the amounts involved are large enough and there is a range of ages and needs, separate CLTs can be customized to suit the situations.

Delay in receiving inheritances, in whole or in part, through the remainders of lead trusts may not be entirely pleasing to recipients, or even technically the most economical for the family, when considering the time value of money. It can, however, be preferred by grantors who want to allow time for young heirs to mature before receiving large inheritances.

COMPLEMENTARY CHARITABLE REMAINDER AND LEAD TRUSTS

A frequent estate planning problem is that of a widow or widower facing serious estate taxation because of lack of planning before the first spouse's death. Although there was no estate tax payable at the time because of the marital deduction, the first unified credit was wasted. One answer is the use of two *complementary* split-interest charitable trusts, one a remainder trust and the other a lead trust.

To illustrate the obtainable results, assume a widow has a projected adjusted gross estate of \$6 million. Her children are successful, but she wishes to ensure

adequate funds for educating grandchildren and for their future financial security. Her advisors point out that with no planning beyond the existing simple bequest in her will, the heirs only receive 70 cents per dollar of estate value:

Adjusted gross estate	\$6,000,000	100%
Less federal estate tax	(1,800,000)	(30%)
Net inheritance of family	\$4,200,000	70%

Asked to suggest something better for her family while satisfying some substantial philanthropic interests, the advisors propose using a combination of testamentary charitable lead and remainder annuity trusts to improve the timing of the distributions of income to each beneficiary. In this instance, the trusts are mirror images with fixed 12-year terms and a 7.5 percent annuity rate.

Spreading the distributions to family over a 12-year period improves their total after-tax inheritance and makes possible nearly \$4 million of philanthropy. Combined income taxes and federal transfer taxes are reduced by \$270,000. Although the grandchildren eventually receive \$2 million, the delay reduces the

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Combining a remainder trust and lead trust can provide funds to heirs when they will need them most.

Distributing More Than \$8 Million From a \$6 Million Estate

	Projected adjusted gross estate	\$6,000,000	
Distributions:	\$2,000,000	\$2,000,000	\$2,000,000
	Outright bequest to family	7.5%, 12-yr. REMAINDER Trust	7.5%, 12-yr. LEAD Trust
To family:	Bequest: \$2,000,000	Income*: \$1,800,000	Remainder: \$2,000,000
	Less income tax: 0	(630,000)	0
	Less estate tax: (900,000)	0	0
	\$1,100,000 to children	\$1,170,000 to children	\$2,000,000 to grandchildren
To charity:		Remainder: \$2,000,000	Income: \$1,800,000
Total to family and charity: \$8,070,000 — UP \$2,070,000			

This calculation assumes annual payments and a 5.8 percent federal midterm rate.

*Assumes a 35 percent income tax bracket.

If you or your clients have plans to fulfill philanthropic objectives, please remember that we would be happy to be involved in planning a gift that will meet your clients' expectations.

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taxable gift to \$728,520. This permits additional gifts of up to \$1,271,480 in present value without a generation-skipping transfer tax.

POSSIBLE VARIATIONS

A number of variations can be used to meet personal and charitable objectives. The complementary trusts can be funded during life instead of at death. This makes it possible to improve the lifetime income of grantors as well as that of heirs. If an appreciated marketable asset (such as stock otherwise to be sold by the grantor for more favorable investment) is used to fund the charitable remainder trust, there are additional savings from avoidance of up-front capital gains tax.

When the trusts are to be funded from the grantor's estate at death, an advantage of exactly balancing the two trusts is that the combined charitable transfer tax deductions will be less than half of the total value involved, regardless of changes in the applicable federal midterm rate in effect at the time of death. However, the complementary lead and remainder trusts do not need to be equal in size or have

the same type of income interest or payout rate to realize significant tax savings and advantages compared with outright gifts.

For growth in the remainder value of the lead trust, its term can be increased and its income interest changed from a fixed annuity to a unitrust. The unitrust payout can be set at or below 5 percent instead of matching the annuity trust rate to increase the potential for untaxed appreciation in the amount ultimately received. Near-term income can be emphasized by increasing the funding of the trust, producing income for the grantors or heirs, likely through an annuity trust.

When heirs in different age brackets are to benefit and the amount involved is sufficient, separate trusts can be used to achieve the different timing desired.

This planning technique is not limited to multimillion-dollar estates. In smaller taxable estates, there can be a slight cost to heirs, although still an increase in total desired distributions, including the charitable benefit. This, however, may be acceptable depending on the relationship of the grantor to heirs and their financial needs.

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