

When the Market and Interest Rates spell “Opportunity” for Donors and Non Profits

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Somebody pinch me. It doesn't happen very often, but it's happening now. Yes, I know all of the news of “doom and gloom” on the US and indeed global financial fronts in this late January 2008: slashing of discount and federal funds rates by the Federal Reserve, predictions of recession, inflation.

But if you look at it from just a little bit different angle, the stars just might be aligning in a very, very positive way...if one happens to have goals that include:

- minimizing gift/estate/generation skipping and maybe even income taxes, and
- seeking to fulfill charitable intent.

And if you're a non profit organization that could use a “shot in the arm” for your endowment as you work to ensure your sustainability, these circumstances are fantastic.

No, I'm not warping reality. I'm thinking of fairly common areas of financial and estate planning that involve such things as Section 7520 of the Internal Revenue Code, the “CFMR” and “CLT's” but that are especially powerful in a low interest rate environment. I'm envisioning devalued portfolios, real estate and business interests that have a very good chance of appreciating over the next 20 years, folks who like the idea of immediately benefiting charity while transferring significant assets to the next generation at a substantially reduced tax.

I'm thinking of “zeroed-out CLAT's” and families that are happy to have a savvy financial advisor show them how they could help a charity with significant gifts towards that charities endowment while passing assets on to heirs with minimal tax cost to heirs in the future who will presumably then be in a better position and level of maturity to steward them as adults.

Let's take a closer look at each of the “stars” in this constellation that provide such a valuable opportunity for donors and the charities that are the objects of their community passions. They are, generally speaking:

- The Market
- Interest Rates
- the Charitable Lead Trust
- Donors with charitable intent and appreciating assets they'd like to transfer to the next generation, with minimum transfer tax liability
- Informed Professional Advisors

The Market - The recent loss of value in the US equities market has been the most severe since the losses in the wake of the bursting of the “tech” bubble and the news of corporate scandals of Enron, WorldCom and the like. Now we also recognize a world market. Over the Martin Luther King holiday weekend this January, the world markets suffered unprecedented losses.

So what many of us had in our portfolios at the end of 2007 is less valuable. The market has dropped from around 13,000 to just over 12,000 in three weeks. But if history repeats itself, markets will at some rate rebound to new record levels like those experienced (briefly) in 2007, following steady growth since early 2003, when the Dow was just about 8,000.

Interest Rates - What is meant is the “7520 Rate” set the Internal Revenue Code. In simple terms, it’s 120% of the Federal Midterm rate, and is also known as the CFMR. What is significant about it is that it is the rate that is used to apply to charitable gifts in calculating specifically the value of the assets that will pass in the future from a trust created for charitable purposes - in the case of a Charitable Lead Trust – to the donor’s beneficiaries. The lower the CFMR rate, the lower the value **for transfer tax purposes** that those assets are valued by the IRS. From a donor’s perspective, a low rate is the optimal rate, because it is almost certain that assets chosen to put into such a trust will appreciate at a rate higher than the CFMR. To that extent, the donor is not having to pay the transfer tax on the real eventual appreciated value of those assets, but rather the value of those assets with the rate the IRS prescribes, the CFMR.

Market in Relation to Interest Rates. The Market opened at 10,409 in 2004, when the CFMR was 4.2%, the level set for February 2008. In other words, we are in a discount rate environment similar to that of four years ago. But since that time, the Dow appreciated almost 30%. The significance of the comparison cannot be overstated when you understand that the IRS essentially predicted growth of 4.2% through its CFMR.

Historically, the rate has been as low as 3.0% briefly in 2003, close to the time of the market low in early 2003. It has risen steadily since that time, but not exceeding 6.2% in August 2007 when the market began the month at 13,100. The percentage market increase over that period (March 2003 Dow at 7,400) to August 2007 at 13,100 is approximately 40%.

The Charitable Lead Trust – this is an IRS-sanctioned vehicle – often overlooked by planners – that can accomplish the goals of a donor in minimizing transfer taxes as they pass assets to the next generation while providing annual payments to a charity during the term of a trust before the assets so pass. The reason it works so well when the CFMR is low may be obvious by now. When the trust is established and funded by the donor, the CFMR is applied to determine how much gift tax the donor will pay for the privilege of having the asset eventually pass from the trust to heirs. The lower the rate, the lower the tax liability. The terms of the trust will specify whether the charity receives a fixed amount of money each year from the trust (Charitable Remainder Annuity Trust) or a

fluctuating value that is a percentage of the value of the trust (Charitable Remainder Unitrust) which is known as the “lead” interest.

Donors with charitable intent and appreciating assets they’d like to transfer to the next generation, with minimum transfer tax liability – these are not as rare as you might think: and, in fact, a declining stock market and a low interest rate environment spawns them. The Gift Tax remains in effect under current tax law – despite the possible one-year hiatus of the Estate Tax in 2010 – when one gifts more than \$1M during their entire lifetime. The Estate Tax currently applies to asset exceeding \$2M, \$3.5 in 2009. After 2010, it may effect estates at just above \$1M.

Informed Professional Advisors

The key is for their professional advisor to make the recommendation knowing that their clients have these circumstances, i.e., feel it desirable to pass on assets that are likely to appreciate in 20 years or so to their heirs at a reduced transfer tax cost. Any business person or retiree with a portfolio could fit into that category.

The non profit that is keyed into who those advisors are – and mentions this phenomenon to them – appears not only to be proactive in their planned giving department but also proactive about facilitating the best opportunities for gift arrangements for their donors. Advisors can help their clients see the potentially extraordinary transfer tax savings involved, as well as the opportunity to teach the next generation about philanthropy. Depending on the asset’s value, the length of the trust and the CMFR, there may be no transfer tax payable at all as a result of using a CLT. It’s a win-win all around.

An Illustration might be helpful, as well as instructive, using the current rate of 4.2% for February 2008:

Phil N. Thropic is in his late 70’s, he lost his wife to cancer recently. He is revisiting his plans, and wants to fund a research chair in oncology at the local medical school. He meets with his professional advisor that explains that while he has the ability to use his \$1,000,000 gift tax exclusion to get assets to his 3 children, his estate is \$6,000,000, so he has 45% in estate tax exposure on anything over 2,000,000 in 2008, or over \$3,500,000 in 2009.

There is great uncertainty about the estate tax after that date, but experts believe there will be some form of tax, around the \$3,000,000 and higher asset level. His advisor suggest he consider a 20 year, 8% Charitable Remainder Annuity Trust (“CLAT”) funded with \$3,000,000 in securities that recently took a hit in the market. This still leaves him with his home to live in, a pension, social security and a portfolio of \$2,000,000.

By creating this CLAT, the school will receive \$240,000 for 20 years, or a total of \$4.8M to endow the chair in memory and honor of Phil’s wife. Because of the CMFR, the 8% payable to the school and the 20 year term of the trust, no gift tax

is due on the establishment of the trust. This allows Phil to gift \$1M during lifetime, if he wishes, amongst his three children, leaving just \$2,000,000 in his estate, which will render it below current – and likely foreseeable - taxable levels. The school gets a fabulous gift, the kids get \$3,000,000 in assets and nothing gets paid to Uncle Sam in the form of transfer tax.

The premier web authority on Planned Giving, the Planned Giving Design Center, in a super article on the various types of trusts used in charitable gift planning, *The Coming Boom in Charitable Trusts*, July 26, 2007 by Barlow T. Mann and Robert F. Sharpe, Jr. at www.pgdc.com/usa/item/?itemID=421595, reprinted by permission from the publishers of *Trusts & Estates* ® also has some great illustrations involving CLT's and other vehicles. I suggest you take a look.

In summary, the news isn't all bad these days: especially if you can look up, and see the stars aligning for Charitable Lead Trust opportunities.

Planning for Good – *because sustainability is a gift*, supports the engineering of sustainability for non-profits, in collaboration with professional advisors and foundations that support capacity building, one gift at a time. Visit us at www.planningforgood.net.

The foregoing is not intended as tax or legal advice and should not be relied upon for that purpose. Individuals must seek the advice of their own professional advisor regarding their own circumstances, needs and financial goals. While licensed to practice in the state and federal courts of Maine and New Hampshire, Ms. Ruef-Lindquist is not currently in active practice. She has 20 years experience combined in law, philanthropy, trust administration, endowment and wealth management.

“CTFA” signifies the designation “Certified Trust and Financial Advisor” from the Institute of Certified Bankers of the American Bankers Association.