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Doing Well by Doing Good with Year-End Tax Planning

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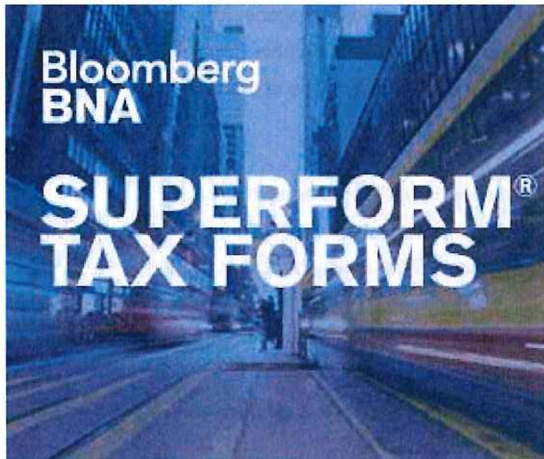
Now that the October 15 extended filing deadline for personal income tax returns has passed, we have only 10 weeks to help our clients plan for the tax returns that will be due April 15.

Is there good-quality income tax planning that we can help clients to do at this late date? Of course there is. Unfortunately, most income tax planning opportunities are only available to business owners. Happily, one is available whether the client has their own business, is an employee of a company, or is retired. The bonus is that this income tax deduction will also make the client feel good.

Taxes are, after all, a type of forced charitable contribution. A client may feel better if he or she can direct the way in which the forced charitable contribution is spent. If there are certain programs in the federal and state governments of which the client disapproves, the client may prefer to have the funds spent on their favorite house of worship. alma mater or a charity that combats a disease afflicting one of the client's family members.



Now, imagine that the client—let's call him Joe—could contribute $100,000 to a trust, get a $100,000 income tax deduction for the charitable contribution, and at the end of 15 years have the $100,000 comes back to him (or be distributed to his children or other heirs)? During the 15 years, $100,000 will have been distributed to Joe's favorite charity (or to Joe's own private foundation).

The Internal Revenue Code encourages precisely this type of structure. It works well if Joe is able to grow money faster than the interest rate required by the IRS —currently 2 percent—and through capital gains instead of ordinary income. Why capital gains? Because Joe will be taxed on the trust's income each year, so we want to minimize ordinary income.

Take this example: Joe contributes $100,000 to the trust in year one and gets a $100,000 income tax deduction. Each year for 14 years the trust's assets appreciate in value by 6 percent. Each year for 14 years the trust distributes 2 percent ($2,000) to Joe's favorite charity. In year 15, the trust will be worth $195,104. To make the total payments to the charity over the 15-year period worth $100,000, the year 15 distribution to charity must be $88,938. As a result, $106,166 (that is, $195,104 minus $88,938) will be returned to Joe, or distributed to Joe's children or other heirs.

What was that worth? Assume Joe is in the 50 percent state and federal income tax rate for

Robert Pagliarini ordinary income and a 35 percent combined rate for capital gains. Joe saved $50,000 up front and paid capital gains tax of $40,928.30 ($2,000 X 14 = $28,000 + $88,938 = $116,938 X 35%).

From an income tax point of view, Joe is only $9,071.70 better off. However, if Joe gets $106,166 back (or it goes to his children) and the other $100,000 went to Joe's favorite charity, that may be a more thoroughly satisfying result compared to paying $50,000 of tax in year one and being left with $50,000. (At the end of 15 years, $50,000 at 6 percent would be worth $119,828.)

What is this structure called? The technical term is a grantor charitable lead annuity trust. This is not mysterious: the IRS issued a sample form grantor charitable lead annuity trust in Revenue Procedure 2007-45. Is it for everyone in every situation? Of course not. There are complex rules that require each taxpayer to sit down with their CPA to discuss that taxpayer's unique facts.

However, this is a drastically underused structure given the significant tax advantages provided by Congress, highly charitable nature of our citizens and historically low interest rates required by the IRS.

Some people use this structure as a way to accomplish three goals: current income tax deduction; support important causes; and pass assets tax free to their heirs. Instead of having the $106,166, in our example, come back to Joe, those funds can go to Joe's children or other heirs. Joe need not file a gift tax return because the entire $100,000 initial transfer to the trust was accounted for by the initial $100,000 charitable gift.

Others use this structure also as a way to fund their own private foundations. In other words, the $2,000 per year for 14 years and the $88,938 final distribution can go to Joe's own family controlled charitable foundation. Therefore, at the end of the 15th year Joe can have three good results: a $100,000 income tax deduction, $100,000 to a charity he controls and $100,000 returned to Joe or transferred to his heirs.

One use for this structure is to endow a chair at the client's alma mater. Suppose Joe wishes to give $2,500,000 (a not unusual figure for universities) to establish an endowed chair to support a full professor. The university might accept payments of $250,000 per year for 10 years. A charitable lead annuity trust can be structured to accomplish that by Joe contributing $5,000,000 to distribute $250,000 per year for 10 years. Joe would earn a charitable deduction of $2,245,650 and, if the assets grow by 6 percent, there would be $5,600,000 returned to Joe at the end of the 10-year term.

Of course the economic results are determined by how much is distributed to charity each year (some advisors do not like this small amount distributed in the first 14 years, a so-called "shark fin CLAT"); how much the assets appreciate in excess of the interest rate required by the IRS; and the nature of the income. That is why the client needs a thoughtful approach to money management.

If your clients are interested in an attractive income tax deduction that will offer them the opportunity to use what would otherwise go in income taxes to support their favorite causes, get them to your office now. Time is running out on calendar 2013.

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