



# GOING LONG

Detterbeck Wealth Management, Inc.



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## CHARITABLE LEAD TRUSTS - A POWERFUL PLANNING TOOL

By Les Detterbeck So, if you really believe the estate tax is going away permanently, please stop reading and grab yourself a mint julep. If, on the other hand, you believe that looming budget deficits and politics as usual indicate that the estate tax may or may not be in effect at the time of your death, then read on.

We, along with most top wealth strategies professionals, believe that good planning recognizes that the estate tax may be in or out on the eventual date of death. Such plans provide flexibility to produce desired results whether or not the estate tax is in effect. Adopting this perspective, one technique that can potentially benefit the family is the use of testamentary charitable lead trusts ("CLTs").

CLTs can eliminate or reduce estate taxes, benefit your favorite charities (maybe even your own family foundation), and ultimately pass the funds to your children and grandchildren with little or no estate tax.

### Here's how they work:

A CLT can be created during the life of the grantor or at his or her death. A CLT is a split-interest trust that provides an annuity or unitrust interest to a charity or charities for a defined period. Upon expiration of the defined period, the remainder interest passes to the named beneficiaries, usually descendants of the grantor or a trust created for their benefit. With a testamen-

tary (done at time of death) CLT, the value of the interest passing to charity is fully deductible against the value of the decedent's gross estate.

The CLT pays a "guaranteed annuity" to the charity. It is either a specific dollar amount (a charitable lead annuity trust or CLAT) or a percentage of the fair value of the trust's assets (a charitable lead unitrust or CLUT).

The value of the annuity interest is determined by payment amount, the number of years of payment and the applicable federal rate. By combining these parameters in an appropriate manner, it is possible to reduce the present value of the remainder to zero. In this situation, all money put into the trust is fully deductible as a charitable contribution for estate tax purposes.

For each designated year of the trust, payments are made to the charity or charities. The charity could be a family foundation that could be directed by family members. In fact, under certain circumstances, family members can be employed by the family foundation and the family foundation can pay expenses, including travel incurred in connection with the foundation's charitable activities. At the termination of the designated payout period, the remaining funds go to the beneficiaries, usually the children and grandchildren.

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## 1031 = TREMENDOUS ADVANTAGES FOR THE PROPERTY-OWNING TAXPAYER

By Brett Detterbeck In 1990, the IRS established Section 1031 of the Internal Revenue Code putting in detail the procedure for turning a taxable sale/purchase type transaction into a tax-free exchange. Also called tax deferred, Starker, and like-kind exchanges, Section 1031 generally reads that if a taxpayer relinquishes investment property and acquires property of a like-kind, then no tax would have to be paid.

This tremendous advantage for the taxpayer lies in the fact that the like-kind provision for real property is quite broad and includes land, rental, and business property - any of which can be exchanged for the other. Raw land, condominiums, single-family residences, shopping centers, apartment buildings are all potential fair game.

For example, let's say that you have had some raw land in Nebraska for a while. You pay real estate taxes on it and have to pay a colleague to fly out there and clean it up every year. It has accumulated in value, however you no longer intend on building on it since the population outflow craze from Omaha has not panned out as you had previously predicted.

At the same time, there's an income producing property that just opened up to investors on LaSalle Street in Chicago. The building features office space in the top 5 floors and a strong retail presence on the bottom. In fact, several big name outfits (i.e. Walgreen's,



Starbuck's, McDonald's, etc) have signed leases to rent from the property for several years. A management team takes care of all operations.

Instead of shelling out cash on your place in Nebraska or selling it and paying capital gains taxes, you can enter into a 1031 exchange, sell the Nebraska property, and buy a piece of the LaSalle Street Building. Not only do you not pay taxes on the gains from the Nebraska sale, you pick up a 7% rental income dividend from your income-producing rental property here in Chicago. A *qualified* 1031 exchange can make this possible.

Let's walk through the mechanics of a 1031 exchange:

1. The owner of the Original Property to be traded (taxpayer) finds a buyer (the 2nd Party) to purchase his property;
2. The taxpayer and the 2nd Party enter into an Exchange Agreement with a **qualified intermediary ("QI")** which provides that:
  - a. The taxpayer assigns the sale contract on the Original Property to the QI
  - b. The taxpayer deeds the Original Property to the 2nd Party
  - c. The proceeds of the "sale" of the Original Property are held by the QI
  - d. The taxpayer identifies the property he wishes to acquire (the "Replacement Property")
  - e. The QI, using the funds from the transfer of the Original Property, acquires the replacement property and it is deeded directly to the taxpayer.

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(CLT Continued from page 1)

**Here's an example:**

Let's say that John and Mary Smith have an estate of \$10.0 million. If they were both to die this year, their estate tax bill would be \$4.0 million and their two children would receive \$6.0 million (\$3 million each) Let's further assume that they and their children have charitable goals and would like to establish the Smith Family Foundation. Furthermore, they do not believe their children need more than \$2.5 million each at their deaths.

John and Mary could create testamentary CLTs. Assuming that both die this year and they designate \$1.0 million for a CLAT (for the benefit of their children) plus \$1.0 million for a CLUT (for the benefit of their grandchildren), their taxable estate will be reduced by roughly \$1,900,000 (the charitable interest deduction) and their estate tax will be reduced from \$4,000,000 to roughly \$3,070,000. Their two children will receive \$4.9 million (\$2.45 million each) upon their death.

The CLAT, in our example, would run for 13 years. It would pay \$100,000 per year (\$1,300,000 total) to the Smith Family Foundation. At the end of 13 years, the two children would split the remaining balance of \$570,094.

The CLUT, in our example, would run for 20 years. It would pay a percentage of the trust's value each year. In our example, this would average \$83,000 per year over the 20 years (\$1,660,000 total). At the end of 20 years, the grandchildren (or their trusts) would receive the remaining balance of \$667,608.

In summary, roughly \$930,000 of estate taxes were saved. The Smith Family Foundation received almost \$3.0 million and the kids and grandchildren received over \$1.0 million. Not bad.

Some wealthy individuals use this technique to eliminate all estate taxes. What they have done as part of their planning is to have provided sufficient assets for their heirs that are not part of their estate. This can be done through family limited partnerships, irrevocable life insurance trusts and other techniques.

The beauty of the CLTs is that they can be created using formulas. These formulas are then used at the date of death. The amount of the CLT, if any, is determined based upon the actual assets and the estate tax in effect at the time. Hence the value can automatically adjust without having to change your estate planning documents each year.

We hope we have provided a quick overview of the potential power of CLTs. If you have any questions, please give us a call.



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**(1031's Continued from page 1)**

It is important to structure these exchanges correctly or one could be subject to substantial capital gains. For example, if you had directly taken hold of the proceeds of the Nebraska property instead of going through the QI, the transaction would not be considered as a tax-deferred exchange and you would have to pay taxes on the gains. Why? Because you had taken **"constructive receipt"** of the funds, which is a no-no. A QI must be used.

Other guidelines include that any property located outside of the United States will not be considered a valid exchange. Also, you must identify up to 3 properties to be acquired within 45 days after closing on the original property. Then, you must close on the replacement property within 180 days after the close of the original property.

Many transactions involve **"boot"**. Boot is a non-kind property, like cash, received by the taxpayer in part or full consideration for the original property and *is* taxable to the taxpayer. Many transactions include boot as it is rare to see a property of exact same fair market value exchanged for another. The IRS considers any boot or any net proceeds not reinvested to be subject to capital gains taxes to the full extent of the gain.

In conclusion, 1031 exchanges can be very advantageous for owners of real property other than their primary residence. Taxable gains are often substantial, sometimes even greater than the amount of cash realized from the sale. In a like-kind exchange, up to the full net proceeds may be used to acquire other property, not otherwise possible if the seller depletes his cash by paying profits out in taxes. At the same time, the taxes you would have paid are deferred until the taxpayer finally sells the property in a taxable fashion, if ever. At that point, the taxpayer may be in a much lower tax bracket.

If you are interested in engaging in a 1031 like-kind exchange or just would like some more information, contact us at DWM.



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