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PRIVATE WEALTH MANAGEMENT

## Topics in Wealth Strategies:

# Potential Portfolio Rebalancing Solution by Creating a Philanthropic Tax-Deferred Synthetic Bond - Pairing CRT(s) & CLT(s)

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Against the backdrop of volatile financial markets and differences in performance across asset classes, there is the potential for the risk profiles of investment portfolios to drift over time if investors do not rebalance their portfolio allocations. Tax implications, as well as psychology, may be contributing factors as it might be difficult to rationalize selling a strongly performing asset and buying a poorly performing asset. Thus, investors may face the conundrum of choosing between their desired risk profile and their preference for relative performance.

If investors are philanthropically inclined, split interest trusts may provide a plausible solution:

- selling an appreciated investment in a split-interest trust
- deferring resulting tax
- receiving a tax deduction up front in some cases
- reinvesting the proceeds into other investments
- rebalancing a holistic portfolio in line with a targeted risk profile
- generating an income stream for the non-charitable beneficiary
- providing a lump sum payment in the future for the non-charitable beneficiary

It is important to understand not only the potential benefits but also the risk considerations of split interest trusts which may include the following:

- Time period – the time period may be one or more lifetimes or a team of years (up to a maximum of 20 years for some trusts); thus, fiscal management may be required over a long period of time.
- Liquidity – the trusts must make annual distributions to an income beneficiary; thus, it is important that the assets generate income and/or can be easily liquidated.

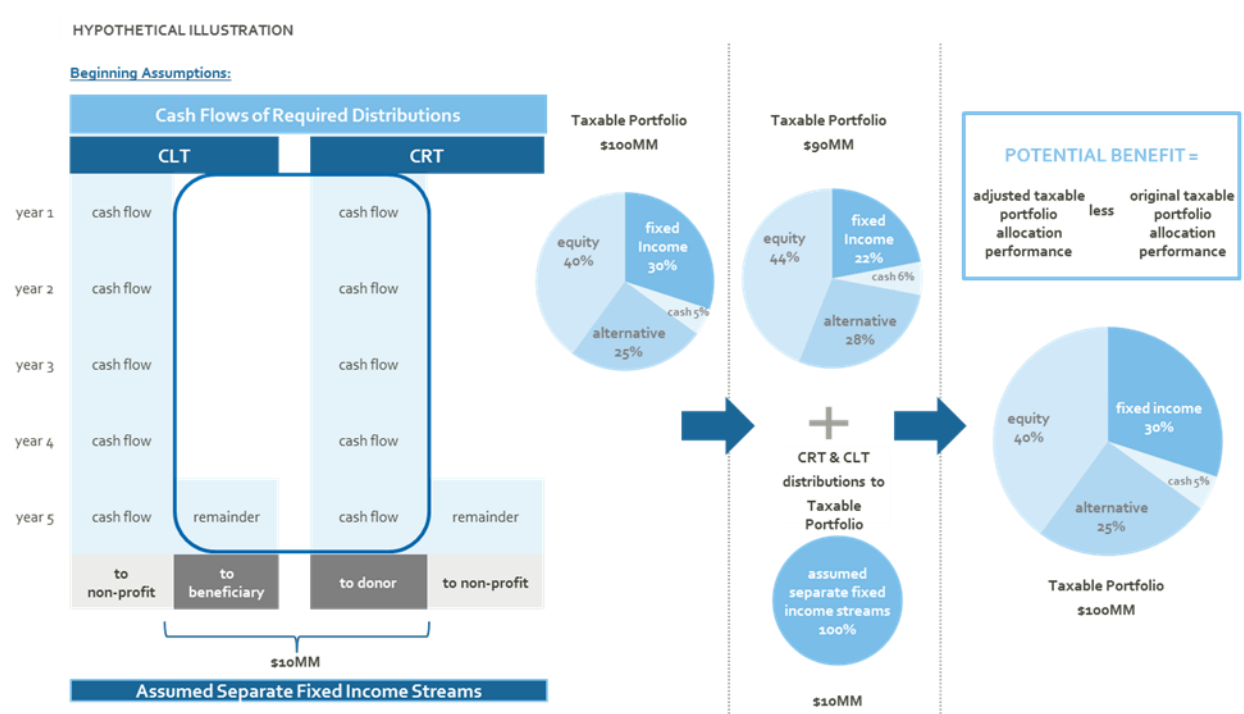
Two examples of split-interest trusts that may be used individually or in combination are Charitable Remainder Trusts (“CRT”) and Charitable Lead Trusts (“CLT”). At a high level, CRTs provide the opportunity for an income tax deduction at the time of establishment as well as an annual income stream to an individual or individuals with any property remaining in the CRT at a specified future date or at the date of death of the individual beneficiary(ies) being distributed to charity. A CLT, as it suggests, is virtually the inverse of the CRT in that a charity receives annual distributions for either a specified period of time or the lifetime(s) of one or more individuals at which time the non-charitable beneficiary(ies) receive(s) the remainder. Depending on how this CLT is structured, an income tax deduction may be available for the donor at the inception of the trust or for the trust annually with each charitable distribution. (Please see illustration for cash flows.)

Both the CRT and the CLT may be compared to a bond in that when established, the time period and applicable Internal Revenue Service (“IRS”) discounting rates determine the annual distribution amounts given the principal or amount the individual commits to the strategy. Exploring the bond analogy further, from the perspective of the individual, if an individual establishes both a CRT and a CLT, the individual effectively is receiving current income from the CRT and a future lump sum from the CLT (albeit for the next and not the current generation) which together mimic the payout of a fixed income investment. (Please see illustration for combination of cash flows.) Further, the individual may customize their own virtual bond investment by specifying the time horizon (specified time or lifetime), selecting the credit quality (by selecting the investments in the entities) and assigning fixed or floating annual distributions (annuitizing or unitizing the legal structures). Finally, given the cap on income tax deductions for annual charitable giving as well as the possibility of additional contributions to certain types of existing split-interest trusts over a number of years necessitating the recalculation of the distributions, one may effectively create a customized laddered bond portfolio by establishing new combinations of split-interest trusts each year (including interest only or principal only derivatives).

If an individual does use some combination of the split-interest strategies, the flexibility available in specifying the structures may alleviate some of the negative effects on investments in changing rate environments. Specifically, an individual may set the time horizon of the structures (lifetime or a term of years) or the duration of the bond-like security. So, in a rising rate environment, the individual would set a shorter duration. Also, the individual may determine the allocation and risk profile of the investments in the structures or the credit quality of the bond-like security. So, in a rising rate environment, the individual would create a high quality and well-diversified portfolio. Additionally, the individual may choose a unitrust or annuity distribution or the coupon of the bond-like security. So, in a rising rate environment, the individual would choose an annuity for the CLT (so the payment to charity would not increase with an increase in investment performance) and a unitrust for the CRT (so the payment to the individual would increase with an increase in investment performance).

If an individual questions the efficacy of split-interest structures given their dependence on the treasury yield curve to determine the applicable rates for the legal structures established, it is prudent to remember that while rates do set the baseline and hurdles for the structures, the efficacy of the structures depend on the performance of their investments, which may be quite diverse and may provide more opportunity, relative to the treasury yield curve. Additionally, when considering the entirety of an individual's assets, an individual who utilizes the split-interest structures may benefit from an even higher allocation to equities and illiquid investments given the presumed fixed income like the nature of the combination of structures in place. (Please see illustration for asset allocation and location.)

CHARITABLE REMAINDER AND CHARITABLE LEAD TRUSTS (CRT & CLT)



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