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ESTATE PLANNING

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Planning Need

TAMMI JACKSO

Creative Strategies to Resolve Complex Estate Planning Needs

Low interest rates, coupled with an increased gift tax exemption amount, make this a good year to pursue a strategy of establishing charitable and insurance trusts in tandem.

TAMMI JACKSON

Planning for high net worth individuals can occasionally take advisors into unknown waters, but strategies for these clients can also include traditional planning techniques used in an innovative fashion. A creative approach combining several single-purpose vehicles can help create a comprehensive plan that meets the client's multiple legacy and philanthropic goals.

At first glance, the diverse goals and concerns of high net worth clients may seem difficult to navigate and meld into a comprehensive strategy. These concerns range from estate, gift, and generation-skipping transfer tax planning, to minimizing income taxes and charitable planning. The future of estate taxes is often at the forefront as well. Current relatively low gift and estate tax rates combined with high unified exemptions may have created a comfort zone that inclines some clients to push planning off to another day. The estate tax has moved up and down over the years; however, the tax rules in force at the time of death are what matter. It is imperative that estate planning not take a back seat to trying to guess the future of taxes. There are advantages to acting now as 2013 transfer rates are scheduled to increase, and exemptions become less generous, as the nation debates how to deal with huge federal budget deficits.

A solution for certain clients, while working with an attorney, may be to combine several traditional estate planning strategies, including a nonreversionary grantor charitable lead annuity trust (gCLAT) in conjunction with an irrevocable life insurance trust (ILIT) and private split-dollar (PSD) arrangement. The effect of combining these strategies may help clients not only to better meet their estate planning goals, but also to minimize current gifts into the ILIT, thus preserving some of their gift tax exemption for other planning needs. It also provides for their favorite charitable organization, and allows them to obtain a current income tax deduction.

Closer look at charitable lead trusts

A charitable lead trust (CLT) is one form of a split-interest charitable trust that has become increasingly popular in recent years. In 2001, 4,571 charitable lead trust tax returns were filed compared to 6,626 in 2010.[1] What may be surprising to many is the size of CLTs: IRS figures reveal that in 2009, 63% of CLTs report assets of $1 million or less, with the average size of those trusts at $374,000. When looking at the $1 million to $10 million size range, lead trusts averaged $2.86 million. It appears that CLTs are being created in similar amounts as the most popular form of charitable remainder trusts.[2]

Conceptually, the CLT is the opposite of the charitable remainder trust (CRT) where the charity receives the trust assets at the end of the trust term. In contrast, with the CLT, the charity receives an income payout from the trust annually, and the grantor or his or her beneficiaries receive the remainder. CLTs have become one of the more valuable planning strategies available for individuals who wish to give to charity but also want to provide an inheritance for family members.

An individual may establish a CLT either during life or at death, and the CLT will pay either an annuity or a unitrust amount to charity during its term. The charitable lead annuity trust (CLAT) provides an annuity payment to a charity that is a fixed amount each year, expressed as either a dollar amount or as a percentage of the CLAT's initial value. A charitable lead unitrust (CLUT) pays to the charity a fixed percentage of the fair market value of the CLUT assets as determined annually. If the value of the CLUT increases or decreases, the unitrust amount distributed to charity also increases or decreases.

The payment to the charity may be structured as a "term of years" or "for a life or lives in being" at inception of the CLT. Unlike a CRT, the term of years for a CLT may

TAMMI JACKSON, J.D., is an advanced markets consultant at MetLife in Phoenix, Arizona. The views set forth in this article are the personal views of the author and do not necessarily reflect the views of MetLife and/or any of its affiliates. MetLife and/or any of its affiliates shall not be responsible for any loss sustained by any person who relies on this article. MetLife and/or any of its affiliates do not, by means of this article or otherwise, provide legal or tax advice. This article is not a substitute for such professional advice nor should it be used as a basis for any decision or action that may affect your estate plan.

exceed 20 years. Current regulations limit the measuring lives that can be used for a CLT to the grantor, his or her spouse, descendents of the grantor, and spouses of such descendants.[3] In addition, a CLT may pay any amount to the charity and is not restricted to a minimum 5% payout like the CRT. As family members may be the remaindermen of a CLT, the chosen payout should not invade the principal of the trust in order to maximize the wealth transferred to the remaindermen.

The super lead trust

CLTs are also used for income tax and transfer tax planning. These trusts can be structured as grantor lead trusts, nongrantor lead trusts, or super lead trusts. The structure discussed in this article is a super lead trust, which is referred to as a "gCLAT." The trust is drafted to take advantage of aspects from both the grantor and nongrantor lead trusts by allowing the donor to qualify for an immediate charitable income tax deduction equal to the actuarial value of the stream of annuity payments to be made to charity over the term of the CLT and also remove the trust assets from the donor's estate. The super lead trust is structured similar to a nongrantor lead trust with the donor's heirs as the CLT remainder beneficiaries. If the super lead trust is established during the donor's lifetime, the donor is considered to have made a taxable gift to the CLT equal to the initial value of the assets contributed, less the present value of the charity's interest in the trust.

The value of the charity's interest in the trust is computed by using the Section 7520 rate published each month by the IRS. CLTs work best in a low-interest-rate environment because if the assets in the trust appreciate at a rate greater than the Section 7520 rate, the beneficiaries of the trust will receive assets in excess of that which was reported as a taxable gift without any additional gift tax consequence. In addition, the current gift tax exemption of $5.12 million for 2012 should help cover any taxable gifts made through 2012.

Establishing the plan

For this strategy, the client establishes a CLT during his or her lifetime and structures it to pay an annuity amount so it is a charitable lead annuity trust (CLAT). Furthermore, the CLAT is structured as a gCLAT, which means the donor retains a power over the trust sufficient to cause the donor to be taxed on the income of the trust under the grantor trust rules.[4] This is important because in order to qualify for the income tax charitable deduction, the grantor must be treated as the owner of the trust for income tax purposes.[5] Care should be taken that the power does not cause inclusion of the CLT assets for purposes of the federal estate tax.

In the year that the gCLAT is established, it will provide the donor with an immediate income tax deduction for the present value of the annuity amounts to be paid to charity.[6] It is important to note that this income tax deduction is produced only in the year the CLAT is established; the donor receives no income tax deduction in succeeding years. However, the donor can carry forward any part of the deduction not used in the first year for an additional five years. Furthermore, in exchange for receiving an upfront income tax deduction, during the term of the trust, the donor will be taxed on the income of the trust, even though he or she will not receive any of that income and even though that income is distributed to charity.

The donor may benefit from establishing a gCLAT in a year when his or her income tax rate is higher than normal. For example, high net worth individuals may experience an increase in their income tax rate when receiving a large bonus, or on the sale of an asset or exercise of a stock option that produces ordinary income. The donor may fund the gCLAT with the lump-sum proceeds of the sale, the stock option, or the bonus to create a charitable income tax deduction to offset the income they receive that year.

At the same time the donor establishes and funds the gCLAT, an irrevocable life insurance trust (ILIT) will be set up. This same donor will then enter into a nonequity collateral assignment private split-dollar arrangement (PSD) with the ILIT. The ILIT will pay a portion of the insurance premiums due by virtue of loans from the donor, and it will pay the economic benefit portion of the premium with trust assets that have been gifted to the ILIT by the donor. Contributions made by the ILIT for the economic benefit are taxable to the donor unless the ILIT is structured as an intentionally defective grantor trust (which means tax consequences between the trust and the donor/insured are ignored for federal income tax purposes). The economic benefit that the ILIT contributes is measured by Table 2001. The ILIT legally owns the policy and assigns back to the donor an interest in the policy equal to the greater of the policy cash values or the total premiums paid.

One benefit of combining the gCLAT and PSD strategies is that the ILIT rather than an individual family member is the beneficiary of the gCLAT. This provides an exit strategy for the PSD arrangement. At the end of the gCLAT term, any funds remaining will be distributed to the ILIT, which will be used to help repay the donor for the advancement of the premiums for the life insurance policy.

Hypothetical case study

Brian is a successful executive of Sawyer Inc., a large company, and has a personal net worth of around $30 million. This year Brian is going to receive a $5 million bonus from Sawyer Inc. He is concerned about reducing his income tax liability for the current year, and wants to devise a strategy that will maximize wealth transfer to his beneficiaries and incorporate charitable planning to benefit his favorite charity.

Brian's tax and legal advisors recommend implementing a gCLAT in conjunction with a purchase of a survivorship policy in an ILIT. Brian makes a gift of the $5 million to a 12-year term gCLAT, which produces an immediate charitable income tax deduction of $4,527,517, assuming a 1.4% Section 7520 rate at the time the trust is established. The gCLAT will provide his favorite charity with an 8.25% annuity income stream ($412,500) for 12 years.[7]

Brian concurrently establishes an ILIT, which will be the remainder beneficiary of the gCLAT. Because the remainder beneficiary of the gCLAT is a third party, Brian has to pay gift tax or allocate his lifetime gift tax exemption for an amount equivalent to the value of the gCLAT's remainder interest. He enters into a private split-dollar arrangement (PSD) with the ILIT to purchase a survivorship policy on himself and his spouse. Brian and his wife are both age 63 and rated standard non-smokers. Brian advances premiums of $599,251 to purchase a $10 million survivorship policy, spreading the premiums out over four years.

At the end of 12-year term the remainder in the gCLAT is $2,413,466 (assuming the assets in the trust grow at 5%) which is paid into the ILIT and is sufficient to pay off and terminate the private split-dollar arrangement. This results in the ILIT receiving a $10 million death benefit from the policy at the later of Brian and his spouse's death. The policy death benefit, as well as any remaining proceeds from the gCLAT, are distributed to the ILIT beneficiaries free from estate tax pursuant to the trust's terms.

Using these strategies, Brian has met his goals of reducing his income tax liability, maximizing the wealth transfer to his beneficiaries, and providing a gift to his favorite charity. Brian is able to create a nearly $5 million gift to charity as well as $10 million guaranteed death benefit for the trust beneficiaries.

Conclusion

CLTs offer many different planning opportunities for donors looking for charitable, income, and estate tax planning options. Using a gCLAT in conjunction with an ILIT and PSD provides the donor with a current income tax deduction in addition to supplying an income stream to a favorite charity. The ILIT eventually furnishes income and estate tax-free life insurance proceeds for the beneficiaries. Additionally, the PSD minimizes current gifts to the ILIT. Finally, the gCLAT remainder interest can help the ILIT terminate the private split-dollar arrangement. This allows the full death benefit to be used on behalf of the trust beneficiaries rather than being diminished by virtue of being required to pay back the assigned interest to the donors.

Legal and tax advisors who are charting a course through implementation of these strategies may help the donor realize his or her charitable goals, help to reduce the overall estate, and maximize the wealth transferred to the beneficiaries. ■

1 IRS Statistics of Income Division, 2001 and 2010.

2 Rosenmerkel, "Split-Interest Trusts, Filing Year 2009," 30 SOI Bulletin 103 (Winter 2011).

3 Regs. 1.170A-6(c)(2), 1.170A-6(e), 20.2055-2(e)(2), and 25.2522(c)-3(c)(2).

4 Sections 671-678. The preferred retained power is usually the power held by a non-adverse party, in a nonfiduciary capacity. The non-adverse party has the ability to reacquire the corpus by substituting assets of equivalent value.

5 Leimberg, Allen, Hays, MacNab, Shumaker, Yang, and Zipse, *Tools and Techniques of Charitable Planning* (Nat'l Underwriter), page 124.

6 Section 170(f)(2)(B); Reg. 1.170A-6(c)(1).

7 Numbers calculated using Leimberg and LeClair's Numbercruncher.