

Planning Ideas - The Wealth Replacement Trust

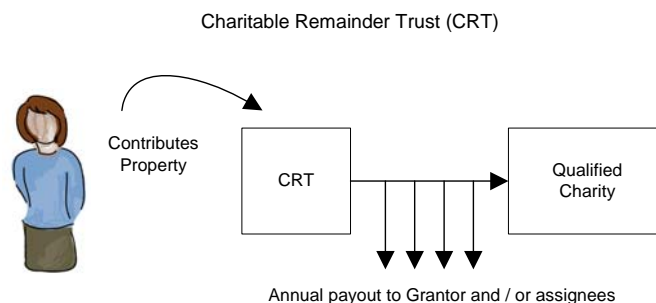
As the year end approaches, clients may be encouraged to flex their philanthropical muscles. But even the most philanthropically inclined clients often balk at outright gifts that cause them to lose the income, enjoyment, and/or control associated with a valuable asset. Also, given the fresh memory of the recent market downturn and credit crisis, many clients may be reluctant to make charitable gifts that could reduce the inheritance their children and grandchildren will eventually receive.

On the other hand, with the Obama administration proposing additional limits on charitable giving, beginning in 2011, it may make sense to make those charitable gifts sooner rather than later.

By combining a couple of tried and true planning techniques, you may be able to address your clients' concerns while saving them taxes, fulfilling their charitable inclinations, and even increasing the amount of wealth transferred to heirs.

The Charitable Remainder Trust

With the CRT, the client contributes assets to a trust. The client or other non-charitable beneficiary enjoys a payment stream from the trust for life or a term of years, thus addressing the client's first concern relative to losing income. The charity receives the remainder interest following expiration of the payment stream. Figure 1 illustrates the operation of a CRT.



- Grantor and / or assignees receive annual payout from trust, generally for life
- At trust termination, charity receives corpus
 - Charitable beneficiaries can typically be added, changed or deleted

CRTs come in two “flavors,” the Charitable Remainder Annuity Trust (CRAT) and the Charitable Remainder Unitrust (CRUT).

A CRAT pays a defined annuity, either a fixed dollar amount or a fixed percentage of the initial fair market value of the trust assets, to the non-charitable beneficiary, at least annually, regardless of the value of the trust assets or the income generated by the trust.

A CRUT pays a defined percentage of the net fair market value of the assets of the trust, valued as of a certain day each year, to the non-charitable beneficiary, at least annually. This amount is called the “unitrust amount.”

Clients wishing to retain an income from the contributed property that potentially keeps pace with inflation are advised to use a CRUT, as the payment stream to the non-charitable beneficiary increases as the value of the underlying assets increases in value.

A CRT works especially well if the client contributes a highly-appreciated, but non-income producing asset to the trust (for example, art work or real estate). Not only does the client receive a current income tax deduction based on the fair market value of the remainder interest passing

to charity, he or she also avoids taxation on the realized gain, if and when the property is sold. Furthermore, since the CRT is tax exempt, the gain escapes tax at the trust level, making the entire sales proceeds available for reinvestment for the benefit of both the client and the trustee.

The WRT is an irrevocable trust. At first blush, this suggests a rigidity and loss of control, but careful drafting can provide the trustee and beneficiaries with discretionary powers that create tremendous flexibility over the long term.

The Wealth Replacement Trust

The Wealth Replacement Trust (WRT) is a version of the Irrevocable Life Insurance Trust (ILIT), and in combination with the CRT addresses the client concern that a charitable gift will reduce wealth transfer to heirs.

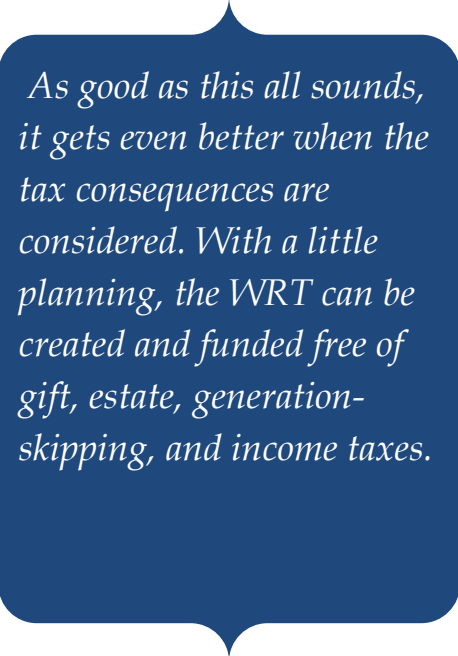
The WRT is an irrevocable trust. At first blush, this suggests a rigidity and loss of control, but careful drafting can provide the trustee and beneficiaries with discretionary powers that create tremendous flexibility over the long

term. The trustee applies for a life insurance policy insuring the client or the client and the client’s spouse jointly. Survivor joint life policies, which pay a death benefit at the death of the survivor of the client and his or her spouse, have a significantly lower premium per \$1,000 of

death benefit than single life policies. The trustee names itself as owner and beneficiary of the policy.

In the most straightforward version of this technique, the client uses income from the CRT to make annual gifts to the WRT. These annual gifts are then used by the trustee to pay the insurance premium. More complex approaches to premium payment involve gifts of interests in family limited partnerships to the WRT or the use of “family split-dollar” plans.

Following the insured's death, the trustee collects and invests the life insurance proceeds for the benefit of heirs, replacing the wealth that passes to charity through the CRT. Dispositive provisions in the trust determine how income and principal are distributed. If the client has a special needs child, make special provision for him or her in the trust document. If the client wishes the trust assets to be available for specific uses such as college education, the purchase of a first home, or the acquisition of a business, just write it into the trust. If the client wants to be sure that a beneficiary doesn't squander his or her share, build in a spendthrift clause that limits distributions to a big spender and protects trust assets from claims of the beneficiary's creditors.



As good as this all sounds, it gets even better when the tax consequences are considered. With a little planning, the WRT can be created and funded free of gift, estate, generation-skipping, and income taxes.

The trust may be designed to continue on through the children's generation or continue for the benefit of younger-generation beneficiaries, consistent with the state law relating to the Rule Against Perpetuities. Long-term, generation-skipping trusts, are sometimes referred to as “Dynasty Trusts.”

Tax Considerations

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Gift Taxes—The client's annual contributions to the WRT for the payment of premiums are considered gifts for gift tax purposes. But, if the trust is properly drafted, the premium payments should qualify for the gift tax annual exclusion. This means that a client can contribute up to \$13,000 annually per beneficiary (\$26,000, if the spouse joins in the gift) without making a taxable gift. To qualify gifts for the annual exclusion, beneficiaries are typically granted the power to withdraw gifts for a limited period of time. Most beneficiaries don't have to be told twice that they'll be better off in the long run, if they don't touch the gifts.

Estate Taxes—Although the federal estate tax is due to be repealed in 2010, many expect Congress to extend 2009 rates and exemptions into 2010. Furthermore, most people expect the estate tax to return in 2011, although it remains unclear what the rates and exemption amounts might be. In any event, it makes sense to "bullet proof" the WRT against the federal estate tax. As a general rule, so long as the trustee is owner and beneficiary of the life insurance policy from the outset, the death proceeds are excluded from the insured's estate.

Generation-Skipping Taxes—Like the estate tax, the generation-skipping tax is repealed in 2010 (unless Congress acts), but is set to return in 2011. This particularly onerous tax applies to transfers and distributions to beneficiaries more than one generation removed from the client (i.e., grandchildren and great-grandchildren). The tax is in addition to estate and gift taxes and the flat rate is whatever the highest estate tax rate happens to be - 45 percent in 2009. The good news is that by properly allocating the current \$1 million GST tax exemption to gifts used to purchase life insurance by the WRT, the trust assets can escape generation-skipping taxes for as long as the WRT lasts, regardless of how much the invested life insurance proceeds appreciate in value.

Income Taxes—Finally, the death proceeds of the life insurance policy should be income tax free when received by the WRT. That's one of the things that makes life insurance superior to other assets that could be used to fund the CRT. The appreciation on other assets given away during life is subject to income or capital gains taxes when the trust sells those assets.

Bottom Line

By combining a CRT with a WRT, clients' two major concerns associated with charitable giving (loss of income and/or control and "impoverishment of heirs) are addressed. The bottom line is that the CRT creates current cash flow for the client and wealth for a favorite charity. The WRT is not only a way to assure fair treatment to heirs, it's a way to do so free of income and transfer taxes.

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