



## **Advanced Estate Tax Planning Techniques**

### **Introduction**

A basic estate plan includes a Will or Living Trust, an Advance Health Care Directive (also known as a Durable Power of Attorney for Health Care), and a General Durable Power of Attorney. Wealthy individuals use a variety of additional techniques to minimize the estate and gift taxes payable on their deaths. The main goal of estate planning isn't simply reducing taxes. Rather, even more important goals are the following:

Making sure your children develop a sense of values, ethics, and a desire to be productive members of society.

If you own or control a business, providing for a smooth transition of management into the hands of persons who will effectively manage the business.

Arranging your affairs so that the chance for disputes among your heirs is minimized.

Making sure that your heirs can live with the estate plan. A plan that cannot respond to changes in the economy, or to unanticipated events, can burden the family.

For individuals with charitable wishes, making sure that your vision will be fulfilled. With these overall goals in mind, the following techniques can be used where appropriate.

This memo is intended only to give a general overview of some sophisticated planning techniques. Each technique is subject to technical considerations that may affect its use in a particular situation. You should consult your estate planning advisors to see if a particular technique is appropriate for you.

### **GENERAL GIFT PLANNING**

The best estate tax planning technique is to give away assets while you are living. Naturally, you must reserve enough assets to provide adequately for you (and, if you are married, for your spouse) for your life, regardless of how long you live and regardless of

your medical condition. (Providing for adequate medical, disability and liability insurance is essential!) No parent wants to be placed in the awkward position of having to ask his or her children for financial support!

As discussed below, some gifts can be made with no gift tax at all, but other gifts may require payment of gift tax. You don't get an income tax deduction when you make a gift to an individual, and the recipient doesn't have to report the gift as income for income tax purposes.

In addition to non-taxable gifts which you can make each year (discussed below), each person has an exemption for gift and estate taxes, which is equal to \$11,400,000 in 2019. (Thus, a couple could give away \$22,800,000). This amount is set to change with changes in the cost of living. On the other hand, under current law, the exemption is set to be cut in half in 2026, and if the Democrats gain the presidency and control of both houses of Congress, it might be cut earlier than 2026.

This exemption amount (which arises by way of an estate or gift tax credit) may be given during lifetime or at death without any estate or gift tax. As long as there is an estate tax in effect, it is best to use up this exemption by making gifts as soon as possible, since any growth in the assets you give away, and any income earned on those assets, will accrue to the benefit of the recipient rather than increasing the size of your estate.

When you make gifts in excess of your annual exclusion gifts and after you have exhausted your lifetime exemption, you will have to pay gift taxes on further gifts. While the tax rate schedules for gift tax and estate tax appear to be the same, the ways in which these taxes are computed are different. Gift taxes are computed only on the amount the recipient actually receives. Estate taxes are computed on the total of the assets the recipient receives and the assets which will go to the government in taxes. Based on 2019 rates, assuming that you live for at least three years after you make a gift, the effective maximum gift tax rate is about 28.5%, as compared with the estate tax rate of 40%. In other words, there is a considerable transfer tax discount that can be achieved by making taxable gifts, as opposed to transferring assets at death and paying estate taxes.

Many people assume that it makes sense to avoid making taxable gifts, and leave their assets to their heirs at death, because they assume it makes sense to delay paying taxes as long as possible. Again, as long as there are estate taxes, that "common sense" idea is simply wrong. It makes sense to make gifts even if you have to pay taxes now, for two reasons: As discussed above, effective gift tax rates are lower than estate tax rates, and transferring assets now allows the income and growth on the transferred assets to inure to the benefit of your beneficiaries and avoid all transfer taxes. While there can be offsetting factors (loss of a "stepped up" basis at death and loss of the use of the money used to pay gift taxes), these offsetting factors generally don't outweigh the benefits of making taxable gifts.

If the gift and estate tax rates rise in the future, or if the tax exemptions are reduced in the future, then the value of making gifts now will be even greater. On the other hand, it is possible that gift or estate taxes could be repealed.

As discussed below, the gifts may be "leveraged" by using minority interest and marketability discounts. For example, if one were to give away an undivided 50% interest in real property or in a partnership, then the value of the gift could arguably be discounted for gift tax purposes. The discount varies depending on the type of assets, but it is often as high as 30% to 40%. Thus, if minority interests are given away, considerably more (measured on a proportional basis) can be given without incurring a gift tax.

Correspondingly, if you hold the remaining partial interest in the assets at the time of your death, your estate might enjoy the same type of discount when measuring the value of the remaining interest for estate tax purposes.

In selecting assets for the gift program, you should consider the income tax basis of the gift asset. Generally, upon death, the assets in the decedent's estate receive a step-up (or step down) in basis to their value at the date of death. If the asset is sold shortly after death, there should be no capital gains tax. However, when an appreciated asset is given away during lifetime, the donor's tax basis carries over to the donee and the donee will not receive a step-up in basis on the death of the donor. It is therefore generally more tax efficient to give away assets with a relatively high tax basis, or to give away assets that the donee is unlikely to sell.

Gifts can be made to your beneficiaries, or to irrevocable trusts established for their benefit. These Trusts may either be kept as a nest egg for the beneficiaries for their lives (so the funds can eventually pass on their children) or they may be distributed to the beneficiary at a particular age.

### **Tax Free Gifts**

Each donor may give \$15,000 each year to each beneficiary, without any gift tax consequences. (Prior to 2002, this "annual exclusion" was \$10,000, and from 2002 to 2005 it was \$11,000, from 2006 to 2008 it was \$12,000, from 2009 to 2012 it was \$13,000, and from 2013 to 2017 it was \$14,000.) In addition, without gift tax, you can pay the school tuition of any other person, and the medical expenses of any other person, as long as these payments are made directly to the school or medical service provider. These gifts don't use up any part of your lifetime exemption. If these are the only gifts made during a year, they needn't be reported to the IRS.

Assume that a husband and wife have two children, each of whom is married, and each of whom has two unmarried children. This couple could give away a total of \$240,000 each year without using up any part of their lifetime exemption. (Each parent could give \$15,000 to each child, each child-in-law, and each grandchild, for a total of eight individual recipients, or \$120,000 of gifts for the husband and \$120,000 of gifts for the wife.)

A gift will qualify for the \$15,000 annual exclusion only if it is a gift of a "present interest." Generally, this means that these gift must be made outright to the recipient, or (in the case of a person under age 21) to a Custodianship under the Uniform Transfers to Minors Act, or to certain kinds of trusts (typically, a "Crummey Trust"). It may require that the asset given away be income-producing or currently salable by the recipient.

### **College Savings Plans**

A gift to a Section 529 "college savings" plan should be considered. In the initial year, a gift of up to five times the annual exclusion amount (thus, currently \$75,000) can be made without a current gift tax. (For a couple, they could set up a \$150,000 account.) This uses up an equal amount of the annual gift tax exemption for the year of the gift plus the following four years. While this means that no more tax-free gifts could be given to the beneficiary in the following four years, there is a larger amount of money earning for the benefit of the beneficiary from the beginning. Also, funds withdrawn from a Section 529 plan and used for certain college or graduate school expenses (generally, at U.S. institutions) may be exempt from income tax, and (effective from 2017) up to \$10,000 per year to pay for private primary and secondary education tuition. You can always take the money in the Section 529 plan back for yourself (which would trigger taxes on the previously deferred income, plus some penalties), or designate certain other relatives as the beneficiary in place of the initially named beneficiary.

### **Crummey Trusts and Intentionally Defective Trusts**

A Crummey Trust is one where the beneficiary has the right to withdraw a certain amount out of contributions made to the trust that year (typically, the smaller of \$15,000 or the amount of the gifts made by the donor that year). If the beneficiary doesn't withdraw the permitted amount within a certain period of time (typically, 30 days after the gift is made and the beneficiary is given notice of the right to withdraw), then the beneficiary loses the right to demand withdrawal at a later date, and the assets remain in the trust and will be distributed at the times called for under the trust.

It is also possible to create a Trust that is a "grantor trust" for income tax purposes. (This kind of trust is called "Intentionally Defective," but that simply means that it was designed to have the income taxed to the person who gave the assets to the trust.) By creating a Trust of this nature, during your lifetime, you will bear the burden of paying income taxes on the income earned by the Trust. (If it becomes too burdensome at a future date, you can relinquish the powers that cause you to be taxed on the income.) This has the effect of further depleting your estate (which will be subject to estate tax on your death), and at the same time, increasing the assets in the Trust (which will not be subject to estate tax on your death). Paying these income taxes is, in essence, a gift that is free of gift taxes. Such a trust can be used as part of a "sale to a defective trust" strategy, discussed below.

## **Generation Skipping Trusts ("Dynasty Trusts")**

A trust can be set up to be fully distributed to the recipient during the recipient's lifetime. For example, it can be set up so that the assets are distributed in thirds, when the recipient reaches ages 30, 35 and 40. Alternatively, a trust can be set up so that the assets will continue in trust for the beneficiary's entire lifetime, and then pass on to the beneficiary's descendants. Such a "generation skipping trust" or "Dynasty Trust" can give the beneficiary the right to benefit from the assets, but provide two important benefits which an outright gift can't provide:

The funds in the trust should be exempt from the claims of most of the beneficiary's creditors.

The funds in the trust may escape estate taxes when the beneficiary dies. It is possible to set up a Dynasty Trust to give the beneficiary a great deal of power and control, or to limit the rights and power of the beneficiary. Where a beneficiary is a trustworthy person and a good financial manager, the beneficiary could have rights as broad as the following:

The right to all interest and dividends of the trust.

The right to withdraw principal for the health, support, maintenance and education of the beneficiary.

The right to decide who will inherit the assets of the trust when the beneficiary dies. This power can be virtually unlimited (so that the beneficiary can direct the funds in favor of anyone other than the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate). Or, the power can be limited so that the funds can be distributed only to your descendants, or possibly the spouse of a descendant.

A Dynasty Trust also makes sense when you are trying to protect a child from himself or herself. For example, a Dynasty Trust should be used if the child has problems with creditors, or problems with drugs, or is susceptible to cults, or is developmentally disabled, or is a "spendthrift" or bad money manager.

There is a Generation-Skipping Transfer Tax that can be imposed when gifts are made to a grandchild (or a trust for a grandchild's benefit), or to a trust for a child for life with benefits passing to grandchildren when the child dies. (Persons in the same generation as a grandchild are generally treated the same as a grandchild.) For 2019, each individual has a \$11,400,000 exemption from that tax (so a husband and wife have a total of \$11,400,000 of exemptions). Thus, in 2019, the most money that can be placed in a Dynasty Trust and protected from tax when the child dies, is generally \$11,400,000 per contributor. However, as noted above, there may be non-tax reasons for setting up a Dynasty Trust, in which case you may want to place even more into such a trust. Note

that, if the money placed in the Dynasty Trust grows (through successful investing), an \$11,400,000 contribution could grow to a much larger sum over time.

The Generation-Skipping Transfer Tax rate is the same as the estate tax rate (i.e., 40%).

## **Business Opportunities**

One of the best ways to pass wealth to children is to make sure that the children, rather than you, make successful investments in the first place. If you become aware of a great investment opportunity, consider giving or loaning money to your children and have them make the investment.

## **Spousal Planning**

Generally, there is no income, gift or estate tax on funds passing between spouses, even if assets are sold between them. However, the gift and estate tax marital exemptions only apply if the assets are given or left to a spouse who is a citizen of the United States. This is the only area of the tax law where citizenship matters; generally, anyone with a "green card" or who has lived in the United States for a certain period of time (generally, 183 days in any year, or an average of 122 days over 3 years) is treated the same as a U.S. person for income tax purposes; and a person who is "domiciled" in the United States is otherwise subject to the full range of U.S. gift and estate taxes.

If the recipient spouse is a non-citizen, then the maximum amount which can be given to the spouse annually without payment of gift tax is \$155,000 for 2019 (it changes annually with the cost of living). When a spouse dies, a marital deduction is available only if the non-citizen spouse receives the assets through a Qualified Domestic Trust, or transfers any assets received to a Qualified Domestic Trust. A Qualified Domestic Trust is a trust meeting a variety of rules, including a requirement that there be a United States individual or United States bank serving as a trustee or co-trustee; and in certain cases that a bond be furnished to guarantee payment of estate taxes when the surviving spouse dies.

When one spouse wants to make gifts to third parties, if the spouses are U.S. citizens, the spouses can agree to "split gifts," or treat all gifts made by them that year as if each had given half of the gifts. This type of planning makes sense when one spouse has separate property which he or she wants to give to children from a prior marriage.

## **FREEZE AND DISCOUNTING TECHNIQUES**

### **Grantor Retained Trusts**

There are four types of Grantor Retained Trusts (GRITs, QPRTs, GRATs, GRUTs). A GRIT is used when the remainder beneficiaries are not related to you; the other techniques are used when the remainder beneficiaries are related to you. All of these techniques "freeze" (or at least limit) the value of the assets transferred to the trust for gift

and estate tax purposes (although a GRUT does so only to a limited extent), with the future appreciation inuring to the benefit of the remainder beneficiaries; and also discount the value of the gift for gift tax purposes.

All of these techniques are based on the same concept. With a Grantor Retained Trust, you retain the right to benefit from an irrevocable trust for a fixed number of years, after which a portion of the trust assets either is distributed to other beneficiaries, or remains in trust solely for other beneficiaries. A taxable gift (for gift tax purposes) is made when you transfer assets to the trust; but because of your retained right to benefit from the trust, the value of the gift (for gift tax purposes) received by the remainder beneficiaries is a fraction of the value of the assets you transfer to the trust. Most GRATs are designed so that there is no gift tax payable on the creation and funding of the GRAT. The percentage of the value of the assets transferred which constitutes the taxable gift will be based on the type of Grantor Retained Trust, the amount you will receive from the trust, interest rates prevailing when you transfer assets to the trust, and the length of time you will benefit from the trust.

If you die while you are entitled to receive benefits from the trust, then the entire value of the assets in the trust will be taxed as part of your estate for estate tax purposes. In other words, the benefits of having made a gift will be lost. Thus, it is not wise to pick too long a term for the trust, taking into account age or health considerations.

In every Grantor Retained Trust, you are subject to income tax on some or all of the trust income, even if you don't receive it, at least while you benefit from the trust (and sometimes thereafter). In other words, a Grantor Retained Trust is a grantor trust for income tax purposes.

### **Grantor Retained Income Trust ("GRIT")**

A GRIT can only be used where the remainder beneficiary is not related to you. Thus, a GRIT could be used to benefit a friend or a non-spouse partner. You would reserve the right to receive whatever ordinary income (generally, interest and dividends) is earned by the trust. If the GRIT holds a home, you could reserve the right to live in the home for a period of years, including the right to buy back the home from the trust before the trust ends.

### **Qualified Personal Residence Trust ("QPRT").**

You can create a QPRT using a principal residence or one other residence (e.g., a vacation home), where the remainder beneficiaries are related to you. During the period of the QPRT, you will continue to enjoy the benefit of the residence in the QPRT. The gift you make (for gift tax purposes) is based on the value of the residence when you put it into the QPRT, even if you expect that the home may significantly appreciate in value before your right of residence ends.

At the end of the term, when the residence passes to the remainder beneficiaries, it appears that you can lease the home back from the remainder beneficiaries for its fair rental value. However, there is a risk that if you pick a rental value less than fair value, the home may be included in your estate for estate tax purposes.

A residence donated to the QPRT cannot be reacquired by the donor by buying it back from the QPRT during the term. A purchase after the term would be a taxable transaction, resulting in (most likely) capital gains.

### **Grantor Retained Annuity Trust ("GRAT") and Grantor Retained Unitrust ("GRUT").**

These trusts pay money to you for a fixed period of time. In the GRAT, this is a fixed percentage of the initial contribution, and in the GRUT, this is a fixed percentage of the assets in the trust each year.

This technique will work well for an asset that has a good chance of appreciating in value, or for a partial interest in an asset where the value of the initial contribution is lowered using the partial interest discounts discussed above. It can be used where you want to leverage your lifetime exemption gift or get a large amount out of your estate using only a small portion of your exemption.

Most GRATs are designed to last for two years, and are designed so that no gift tax is payable with respect to the GRAT. Thus, if the assets appreciate in excess of the fixed percentage, all that appreciation goes to the remainder beneficiaries without gift tax. On the other hand, if the assets don't appreciate more than the fixed percentage, or decline in value, then you'll get back whatever is in the GRAT. As long as you would have made the same investments with the assets in the GRAT that you would have made if you had not set up the GRAT, then you would have had the same result in either case; but if the assets in the GRAT appreciate more than the fixed percentage, then the excess passes to the remainder beneficiaries without gift taxes.

### **Installment Sales.**

Another way of freezing the value of an asset for estate tax purposes is to sell the asset to a family member, or to a trust for family members, on the installment basis of income tax reporting. Generally, an income tax is payable on interest received on the note, as well as on any capital gains as principal payments are received. This could be combined with the discounting technique referred to above.

### **Sale to an Intentionally Defective Irrevocable Trust**

You could sell an appreciated asset to a trust which is treated as a grantor trust for income tax purposes, but which is treated as an irrevocable trust for gift and estate tax purposes (an Intentionally Defective Irrevocable Trust, or "IDIT"). Again, this freezes (at current



value) the value of the asset being sold. Unlike a regular installment sale, you don't report gain for income tax purposes on the sale to the trust. Such a sale defers gain on the sale until the asset is sold by the Trust to a third party, or until your death (whichever occurs first). If the asset is sold during your lifetime, then you would pay (from personal assets) any capital gains tax generated by the sale. As discussed above, the payment of income taxes is not treated as a gift for gift tax purposes. As a variant of this technique, you could have the trust borrow money from a third party (such as a bank), and pay the cash to you (eliminating the need for an installment note); but again you wouldn't report taxable income on the sale until the asset is sold to a third party or until your death.

### **Self Canceling Installment Notes (SCINs)**

You could lend money to someone (such as a child), or sell an asset to someone, in exchange for a promissory note that provides for the payment of interest and principal over a specified term, but which also provides that if you die before the note is repaid in full, the balance will be cancelled and forgiven. Because your child may benefit (by not having to repay the balance if you die while the note is outstanding), either your child must pay you a higher rate of interest than would normally be required, or a bonus must be added to the principal amount of the note. The amount of the interest or principal bonus must be calculated by an actuary. The term of the note must be set so that it will be repaid during your actuarial life expectancy. The interest you receive is taxable as ordinary income. If you lend money to the other person, the principal repayments generally are tax free; but if you sell an asset to the other person, the principal repayments will be partially a return of your investment (basis) and partially capital gain.

### **Private Annuities**

A private annuity is a promise by someone (such as a child) to pay a fixed amount of money to you every year for the rest of your life. You buy this annuity by paying money, or selling an asset, to the person who has promised to make the payments to you. (This kind of annuity should be compared to a commercial annuity, which is payable by an insurance company, or be a charitable gift annuity, which is payable by a charity.) The amount of the payment is based on IRS tables, which take into account IRS life expectancy tables and an IRS determined interest rate, as well as the amount you pay for the annuity promise. The promise must be unsecured, so you are relying on the creditworthiness of the person making the promise. The payments you receive are partially ordinary income, with the balance either a tax-free return of your investment (basis), or capital gain. The person making the payments will invest the money you transferred to him or her (paying income tax on the income), but doesn't get a deduction for the payments made to you. Thus, effectively, the income earned on the money you transferred is taxed twice (once to the person making the payments and again to you). Generally, a private annuity makes financial sense only if you die within a few years after buying the annuity; on the other hand, if you are suffering from an illness and expect to die within a year (or in some cases, two years), the IRS tables can't be used, but rather,

your actual life expectancy must be used to set the amount of the payments. Generally, it doesn't make sense to fund a private annuity with appreciated assets.

### **Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs)**

A family limited partnership or a limited liability company can provide important tax and non-tax benefits. From a non-tax standpoint, these entities are important in that they can provide a vehicle for managing family assets, and can protect you from liabilities arising in connection with the assets held in the FLP or LLC. They can also provide asset protection, in that a creditor who seizes the partnership interest from you will succeed only to your rights, and may not be able to force a liquidation of the partnership (making it a much less attractive asset to seize). Thus, a FLP or LLC is an excellent way to own buildings or an unincorporated business. From an income tax standpoint, a FLP or LLC can be superior to a corporation because there are no federal income taxes, and minimal or no state income taxes, on the income. From a gift and estate tax planning standpoint, a FLP or LLC can give rise to significant valuation discounts.

If a person owns a percentage interest in a FLP or LLC, the value of that interest will be less than the same percentage of the value of the net assets of the FLP or LLC. For example, assume that a FLP owns assets worth \$100,000, and you own 10% of the partnership. Generally, your interest would be worth less than the \$10,000 you'd receive if the partnership terminated and distributed the assets to the partners. That's because you probably can't force the partnership to terminate and distribute the assets. Rather, you're entitled only to whatever distributions the general partner of the FLP or manager of the LLC elects to make. Typically, discounts will range from 15% to 40%, depending on the facts of the case.

If you make gifts of interests in a FLP or LLC, the value of the gift is based on the rights that the recipient has in the interest. Thus, the more power you retain in the partnership (and the less power the recipient has over the partnership), the smaller the value will be for the gift. On the other hand, on your death, the value of the asset in your estate will be based on the rights you've retained. Thus, the more power you retain in the partnership (and the less power the recipients of gifts you've made have received), the greater the value will be in your estate.

For California real property, there are important differences between the property tax treatment of real estate transferred by a parent to a child, as opposed to an interest in a FLP or LLC owning real estate which is transferred to a child. In some cases, where the property tax assessed value for a property is much lower than the current value of the property, it may make sense not to use a FLP or LLC to own that property.

### **Transfers of Stock Options**

Many executives of public companies receive non-qualified stock options as part of their compensation package. These options can generally be transferred to a family member or

a trust for a family member. The amount of the gift will be based on gift tax principles, which generally will mean using an approach such as the Black Scholes formula. When the options are exercised by the recipient, the executive must pay income tax on the difference between the value of the stock and exercise price. This income tax amounts to a gift-tax-free gift to the person or trust that owns the options. There can be tremendous leverage in using an option to make a gift, since a relatively small percentage increase in the value of the underlying stock can result in a huge increase in the value of the stock options.

The IRS takes the position that a completed gift of stock options can only be made with vested options. It also takes the position that no valuation discount can be applied even if there are certain restrictions on the options. It is unclear whether the IRS position will be upheld if challenged in court.

## **LIFE INSURANCE PLANNING**

Life insurance plays a major role in estate planning for many individuals. It can provide an "instant estate" for someone who has financial obligations that must be covered (for example, for a young person who has not yet had time to acquire sufficient assets to provide for his or her family, to replace the income that would be lost on the person's death). It can also provide cash ("liquidity") to a person's heirs to cover the estate taxes that will be payable on the person's death, or to allow a "buy-sell" agreement to be funded so that the person's interest in a business can be repurchased by a partner. Where a person wants to leave a major asset (say, a business) to one child, it can provide the resources to allow another child to receive assets of equal value. There are many other reasons why a person might want to buy life insurance.

The subject of life insurance is complex. There are many different types of policies available. You should speak with your insurance agent, as well as your estate planning lawyer, before buying or changing the beneficiary on any life insurance policy.

### **Irrevocable Insurance Trusts**

If the insured person holds certain powers over a policy of insurance on his or her life, either directly or (in some cases, indirectly), then the entire face value of the policy will be subject to estate taxes on his or her death. The powers which can cause this to occur include the right to name the beneficiary, the right to borrow against the cash value, and the right to cash in the policy.

In order to keep life insurance proceeds from being taxed as part of the insured person's estate, people often set up an irrevocable trust to own the insurance policy. Typically, a family friend is named as the trustee of the trust. Annual gifts can be made to the trust, in order to provide the trustee with the money to pay the premiums. An irrevocable insurance trust is generally structured as a "Crummey" trust, in order to allow the annual gifts to qualify for the \$15,000 annual exclusion from taxable gifts. Generally, new insurance

policies should be applied for by the trustee of the trust. If the insured applies for, or owns, the policy, and the insured dies within three years after the policy is transferred to the trust, then some or all of the policy proceeds will be taxed as part of the insured person's estate.

There can be income tax consequences if an existing policy is transferred to an irrevocable trust, and the insured has borrowed against the cash value.

### **Split Dollar (and Family Split Dollar) Insurance Plans**

Split dollar insurance involves dividing ("splitting") the ownership or benefits of a cash value insurance policy between two people. One person (typically the insured person's employer) pays part or all of the premium each year, and upon the insured person's death, this person is entitled to receive back all of the premiums (or possibly all of the cash value of the policy). The rest of the policy proceeds are paid to the insured person's beneficiaries.

A split dollar arrangement allows a cash value insurance policy to be purchased with very little or no outlay by the insured person. It is sometimes provided as an employee benefit to executives of companies. It is also possible to use the same concept to fund an irrevocable insurance trust without gift taxes, by having the insured pay the portion of premium which represents the addition to the policy's cash value (a "Family Split Dollar" arrangement).

## **CHARITABLE GIFT PLANNING**

Many wealthy individuals use charitable gift planning to accomplish their charitable wishes and reduce income, gift and estate taxes. Often, these techniques can provide important benefits for family members as well.

### **Charitable Remainder Trusts (CRATs and CRUTs)**

A charitable remainder trust provides distributions to you (or you and your spouse or other beneficiary) for a period of years (up to 20 years) or for the life or lives of the beneficiaries. When the initial term ends, the assets remaining in the trust pass to a charity (which can be a family controlled charity). A Charitable Remainder Unitrust gives the current beneficiary a fixed percentage of the value of the assets in the trust, as determined each year. Thus, if the value of the assets increases, the payout increases; but if the value of the assets declines, the payout declines. A Charitable Remainder Annuity Trust gives the current beneficiary a fixed dollar amount each year.

A charitable remainder trust is often used when a person wants to sell appreciated assets, because the trust pays no current capital gain or other income tax on a sale. Money that otherwise would be paid to the government in taxes on a sale will, instead, be held in the trust and can be invested. Distributions from the trust will be taxed to the beneficiary as

ordinary income, capital gain income or tax-free income, depending on the type of income earned by the trust.

You can be the Trustee of the trust, and you can retain the right to change the charitable beneficiaries. A Charitable Remainder Unitrust can be designed so that distributions don't exceed the current income of the trust. It is also possible to design a Charitable Remainder Unitrust so that distributions are limited to the current income of the trust pending a sale of an asset (such as raw land), but after the sale this limit can be removed.

If a charitable remainder trust is set up during your lifetime, you will be entitled to an income tax deduction for some part of the value of the assets transferred to the Trust. The amount of the deduction will depend on what kind of trust (unitrust or annuity trust) is used, the payout rate, interest rate when the trust is funded, the number of years the non-charitable beneficiaries will benefit, the type of asset (stocks, artwork, real estate, etc.) given to the trust, and the type of charity (public or private) which will benefit at the end.

It can make sense to set up a charitable remainder trust under your Will or Living Trust when you want to benefit someone (for example, a parent) for a period of time or for life, and get an immediate estate tax charitable deduction. It can also make sense to leave retirement plan assets to a charitable remainder trust (for example, if you want your unmarried partner to benefit from your pension funds).

### **Charitable Lead Trusts**

A Charitable Lead Trust (CLT) gives a charity the right to receive payments for a fixed number of years, after which the remaining funds pass to family members. The charity can be a private family foundation. The amount payable to charity can be either a fixed dollar amount each year, or a percentage of the value of the assets as determined each year. Usually, a CLT is used to pass assets to family members at a reduced gift tax cost, while benefitting a charity.

A CLT can be set up during your lifetime, or on your death. If the CLT is set up during your life as a grantor trust for income tax purposes (so you are taxed on the income earned by the trust each year), then you can claim an income tax deduction when the trust is funded, but you will not get an income tax deduction as distributions are made to charity. If the trust is not set up as a grantor trust for income tax purposes, then you get no income tax deduction when the trust is funded, but distributions to charity from the trust will be deductible against the trust's income.

More frequently, a CLT is set up under a Living Trust or Will. Your estate gets an estate tax deduction for a portion of the assets going into the trust. The amount of the deduction will depend on what kind of CLT (Unitrust or Annuity Trust) is used, the payout rate, interest rate when the trust is funded, and the number of years of the charitable term. A

CLT works well if you have assets which are likely to increase in value far faster than the IRS assumed rate of interest, or if valuation discounts can be claimed to reduce the value of the assets going into the CLT.

### **Charitable Gift Annuities**

Some charities sell Charitable Gift Annuities. These are arrangements where you give an asset or cash to the charity, and the charity agrees to pay you a fixed amount each year for life. You receive an income tax deduction for a portion of the value of the asset you transfer to the charity. The amount paid is generally set by a table published by a national organization, based on your age. The charity receives the asset or cash and can immediately put it to use in its activities. You receive only the unsecured promise of the charity to pay the annuity amount.

### **Pooled Income Funds**

A pooled income fund is like a mutual fund operated by a charity. You contribute assets or cash to the fund, and receive units based on the value of the fund. You are entitled to receive a payout based on the investment performance of the fund. On your death, your units go to the charity, which can then withdraw a part of the funds which the units represent. You receive an income tax deduction for a portion of the value of the assets you transfer to the fund, based on the fund's past investment performance and your age.

### **Private Charitable Foundations**

Many wealthy individuals set up a private charitable foundation to accomplish their charitable goals. These foundations accomplish many different goals: obtaining income, gift and estate tax deductions; teaching your children philanthropy and money management if they become part of the foundation's board; assuring that your charitable vision will be realized; and perpetuating your name in connection with charitable works. Following your death, family members can use a family foundation to support their particular charitable interests, which may bring them social prominence.

A Private Operating Foundation is a private foundation which carries on an active program, instead of merely making grants to other charities. An example of a private operating foundation is a research facility or museum, such as the Getty Foundation.

A private foundation must give away at least 5% the sum of its assets and income each year. If the foundation earns more than 5% on its investments, then the foundation's assets can grow over time.

There are significant limits on income tax deductions when gifts are made to a private foundation. Generally, cash gifts are deductible up to 30% of the donor's adjusted gross income. Non-cash gifts may be deductible up to 20% of the donor's adjusted gross income; but in some cases the donor's deduction is based on the **smaller** of the donor's

income tax basis or the value of the asset given away. In comparison, cash gifts to public charities are generally deductible up to 50% of the donor's adjusted gross income, while non-cash gifts are generally deductible up to 30% of the donor's adjusted gross income. In most (but not all) cases, a donor's deduction on a gift to a public charity is based on the value of the asset and isn't limited to the donor's income tax basis.

### **Community Foundations; Donor Advised & Donor Directed Charitable Funds; Supporting Organizations**

There are costs (both legal and accounting) involved in setting up a private foundation. A private charitable foundation requires ongoing administration, including the preparation of filing of annual tax returns. A private foundation generally pays a tax of 2% of its earnings. A California charity with over \$2,000,000 of receipts in a year must have a certified audit, and if formed as a corporation must have a separate independent audit committee. In order to avoid these administrative burdens, some people turn to existing public charities to sponsor their charitable activities.

### **Community Foundations sponsor Donor Advised and Donor Directed Funds.**

A Community Foundation is a public charity whose sole function is to facilitate charitable activities of individuals, companies and other charities. Many Community Foundations provide an important service by giving donors access to philanthropy professionals, who have experience evaluating grant proposals, and determining how effectively donations are used by other charities. In recent years, many investment companies have established their own organizations to function like a Community Foundation. In fact, the Fidelity Gift Fund (operated in conjunction with Fidelity Investments) has in recent years raised more money than any other U.S. charity.

Money or assets transferred to a Donor Advised or Donor Directed Fund are separately accounted for under each donor's name. The Community Foundation is responsible for investing the funds, and filing all governmental reports. A Donor Advised Fund gives an individual the right to recommend to the Community Foundation which charities should receive gifts from the donor's particular fund. A Donor Directed Fund gives the donor the right to direct which charities will receive gifts from the donor's particular fund. There are no required minimum gifts which must be made in any year, so income can be accumulated in a fund for a number of years. There is no tax (such as the 2% tax on private foundations) applicable to a Donor Advised or Donor Directed Fund. Typically, a fund is established by filling out a one or two page form, and gifts can be made out of the fund by signing a simple authorization request and sending it to the Community Foundation. A Community Foundation will charge the fund for the cost of its investment manager, and may either charge a further administrative fee or require that a portion of the fund's income be set aside for grant making by the Community Foundation's board.

A Sponsoring Organization is a separate charity which generally is controlled by a public charity. These organizations are often set up where a donor wants the "feel" of a private

foundation (e.g., a separate board of directors, a particular investment manager and a particular investment program), and the tax benefits of donating to a public charity. It is generally sufficient that the public charity name a majority of members of the board of directors. A sponsoring organization can be used to support the work of a Community Foundation, thereby opening up the chance to benefit a broad variety of other charitable organizations. Alternatively, with a majority of the board consisting of "outsiders," it is possible to limit recipients to a small number of public charities which are named in the original trust establishing the Sponsoring Organization.

## **OTHER PLANNING TECHNIQUES**

### **Expatriation**

The United States estate, gift and generation skipping transfer taxes only apply to persons who are U.S. citizens or "domiciliaries," and to U.S. assets owned by non-residents who are not U.S. citizens or domiciliaries (referred to as Non-Resident Aliens, or NRAs). It is possible for a United States taxpayer to surrender his or her United States citizenship, become an NRA, and move his assets outside the U.S. in order to avoid U.S. taxes. It is even possible for NRAs to avoid estate taxes on their U.S. assets by placing them in foreign corporations.

For estate tax purposes, domicile is a difficult concept to define. Generally, it means the place where you intend to reside permanently.

In order to deter taxpayers from renouncing their U.S. citizenship and moving abroad, the law provides that a taxpayer is generally treated as if he or she had sold all of his or assets upon expatriation, triggering an immediate tax. (There is an exemption for certain persons with low income and a small amount of assets, and a certain amount of gain is exempt.) You don't get to use some tax breaks otherwise available to U.S. persons, such as the \$250,000 or \$500,000 exclusion from gain on a home sale. You're even taxed on your qualified retirement plan benefits! In certain cases, the tax can be deferred, but this generally requires the posting of a bond to cover the eventual tax. Special gift and estate tax rules apply if you give or leave assets to a U.S. person (other than a spouse or charity) that generally subject the transfer to gift or estate tax to the extent that the transfer exceeds the annual gift tax exclusion amount. Similar provisions apply to long term U.S. residents (or "Green Card" holders) who give up their U.S. residency.

### **Planning with Retirement Plan Assets**

Generally, qualified retirement plan assets (including IRAs, Roth IRAs, pension and profit sharing plans and 401(k) plans) must begin to be withdrawn from the plan by April 1 of the year following the year when the participant attains age 70-1/2. Before 2001, the beneficiary you named by the April 1 date (and in some cases, after that date) determined how fast **you** had to withdraw funds from your plan during **your** lifetime; but since 2001, your beneficiary designation generally won't affect the amount you have to withdraw from your retirement plans during your lifetime. However, the choice of beneficiary creates major tax and estate planning issues upon your death, and can affect how quickly you



withdraw funds from your retirement plan if your spouse is more than 10 years younger than you. You should speak to qualified advisors before making or changing any designation.

Retirement plan assets (including IRAs (other than Roth IRAs), pension and profit sharing plans, 401(k) plans, and non-qualified deferred compensation arrangements), are assets which have never been subjected to income tax. These assets will be subject to estate tax on the participant's death (unless left to a spouse or charity), and will be subject to income tax when the assets are withdrawn from the plan by the beneficiary. The combined estate and income tax burden can be 75% of the plan assets.

Typically, these taxes are postponed by a married person by leaving the retirement assets to the person's spouse. However, on the spouse's death, or on the participant's death if the participant is not survived by a spouse, the only way to avoid estate taxes is to leave the plan assets to charity. Many people decide to leave their retirement plan assets to a family foundation or to another charity, so that there will be no estate or income tax payable on these assets.

Where the plan assets are left to individuals other than a spouse, it is important to try to arrange for cash to be available to the beneficiaries from other sources so they can pay the estate taxes, and defer the time for withdrawing the funds from the retirement plan. (For example, an irrevocable life insurance trust may loan funds to the beneficiary.) With appropriate planning, the funds can be withdrawn from the plan over the life expectancy of the beneficiary, which may be a period of 40 to 60 years. In the interim, the funds that remain in the plan can grow on a tax deferred basis, so that even with withdrawals each year the total fund balance may increase for many years.