

JEWISH FEDERATION OF PALM BEACH COUNTY

PAC ROUNDTABLE

CITY PLACE TOWER

OCTOBER 19, 2011

***Why Today's Planners Have to Think Differently –
From An Estate Planning and Philanthropic Perspective***

PRESENTED BY

**Richard B. Comiter, Esquire
Comiter, Singer, Baseman & Braun, LLC
3801 PGA Boulevard, Suite 604
Palm Beach Gardens, Florida 33410
Telephone: (561) 626-2101
Facsimile: (561) 626-4742
E-mail: rcomiter@comitersinger.com**

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I. WHY TODAY'S PLANNERS HAVE TO THINK DIFFERENTLY – FROM AN ESTATE PLANNING PERSPECTIVE

1. Client's First Question Is How Do You Think Future Legislation Will Impact the Estate and Gift Tax 5M Exemption Amount?
 - A. What Congress passed and President signs can actually happen with Obama as it did with Bush. Exemptions could go back to \$1M and 55% in 2013. Don't be surprised, because anything can happen like it did at end of 2010. Why? Congress and President cannot right now agree on anything. After repeal of the estate tax, who anticipated that estates would be able to elect out of an estate tax? To avoid constitutionality challenges arising out of estate tax, Congress passed legislation in December 2010 enacting an estate tax which could be elected out of in order to avoid a retroactive application of estate taxes.
 - B. You need to tell your clients this is the "Golden Age of Estate Planning." If the tax law returns to a \$1M exemption with a 55% estate tax rate and/or discounts become unavailable (in order to pay off the \$14 trillion of debt), your clients will give you a call in 2013 and ask you why you didn't notify them of available opportunities. The point is these opportunities won't remain forever!
 - C. Supercommittee appears to have a remote chance to deal with revisions to the estate tax law. Why? Congress intended to take a year off after two-year estate tax legislation at end of 2010. Changes may occur during the 2012 lame duck session of Congress.
 - D. The bottom line is people in Washington who are in the know, don't know whether planning techniques available today will be available tomorrow.
 - E. Clients need your help in determining what they want and will ask why you didn't tell them to take advantage of the Golden Age of Estate Planning.
 - F. Consider the possibility of a flat tax or a valued added tax. How about a nine percent flat income tax, value added tax and estate tax?
2. Discuss Estate Tax Strategies To Utilize \$5M Exemption. Remember, estate planning is a journey and not a destination.
3. Client Responses To Your Recommending Utilization Of Estate Planning Strategies And Techniques To Take Advantage Of Low Interest Rates, Available Discounts And Depressed Values Of Assets:

- A. Let's take advantage of opportunity now.
- B. Wait until second half of next year.
- C. Want to utilize exemption, but worried about beneficiaries not understanding their values or having too much or not being able to manage money in a fiscally responsible way.
- D. Want to retain control and/or access, but want to be able to utilize \$5M exemption.

4. Want To Utilize Exemption.

- A. Use \$5M exemption to take advantage of fractional interest discount opportunities.
- B. If no current discount opportunities are available, then consider using a portion of \$5M exemption to leverage life insurance inside an ILIT and avoid complexity.

5. Worried About Beneficiaries.

- A. Use GST Dynasty Trusts with asset protection features as a result of grantors' increased emphasis as asset protection for beneficiaries.
- B. Narrow distribution standards with an independent trustee making distributions.
- C. Motivating behavior through Incentive Trusts does not work accordingly to studies over the past 40 years.
- D. Consider a Financial Skills Trust to improve business and entrepreneurial skills of beneficiaries in order for them to learn to be financially and managerially responsible.
 - (i) Use autonomy concepts from the business world to teach beneficiaries under a results oriented trust environment to focus on results rather than on dictating the pathway a beneficiary should follow to get there.
 - (ii) Will respond to an intrinsic method which breeds creativity and responsibility.
 - (iii) Businessmen love the idea of preparing the next generation to handle management responsibility and to avoid family business battles through a Financial Skills Trust. These skills would include living within your means, not abusing credit, management of investments, accounting for assets, procuring a job for what you need, and involvement in charities.
 - (iv) Trustees can focus on the need for education and training before large distributions are made.

6. Grantor Can Retain Control and Access, and Utilize a Portion of \$5M Gift Tax Exemption Through the Transfer of Assets to Non-Reciprocal Spousal Trusts.

- A. This is a strategy under which your clients can have their cake and eat it too. If your client is reluctant to make a gift at this time, but does not want to lose the opportunity to use the \$5M exemption, each spouse can create a spousal trust for the benefit of the other spouse. The creation of a lifetime

credit shelter trust permits the grantor to retain access and control as a result of his or her spouse being the primary beneficiary and children being secondary beneficiaries. If funds are needed, the spouse can receive a distribution from the trust. The spouse can even be a trustee with a HEMS standard.

- B. Key point is you do not have to gift solely to your children to use the \$5M exemption.
 - C. Flexibility in design. The trust document would not require distributions only to spouses or direct distributions of all net income to spouses.
 - D. Funds could accumulate inside the trust and not be subject to any future transfer taxes. Moreover, if the trusts are grantor trusts, the income tax is removed from the grantor's estate tax-free.
 - E. Risk of spouse's premature death can be reduced by procuring life insurance.
 - F. Risk of divorce mitigated by the creation of a Non-Reciprocal Spousal Trust. However, the IRS may argue reciprocal trust doctrine requires the transferred funds to be brought back into the grantor's estate. Can make the spousal trusts non-reciprocal by using different trustees, lifetime beneficiaries, powers of appointment, distribution standards, and years.
 - G. Be aware, however, of limitations on gift splitting because of right of spouse to distributions.
7. Use A GRAT For Elder Parent Who Does Not Have Sufficient Net Worth To Utilize \$5M Exemption.

II. WHY TODAY'S PLANNERS HAVE TO THINK DIFFERENTLY- FROM A PHILANTHROPIC PERSPECTIVE

1. Virtual Endowment With a Twist.
- A. Alternative to an endowment bequest at death to the Charity through an approximately 4% discretionary or restricted gift annually.
 - B. Charity would treat the transfer as if already been made. Donor would contribute 4% of his virtual endowment each year to provide the Charity with current funds. Thus, the Charity is able to distribute the same amount annually toward the purpose of the endowment that would have been otherwise available if the entire endowment had been funded from inception.
 - C. Donor makes provision in his will to create endowment with no binding legal obligation.
 - D. Donor is recognized currently by Charity. Statistically, 90% to 95% of pledged endowments are funded.
 - E. Donor becomes vested in endowment as a result of annual contributions and becomes a participant in the Charity's annual planned giving campaign.

- F. Works well for high income clients who do not have currently available capital to create the endowment, but want to further the purpose of the endowment annually.
 - G. See Article on “Virtual Endowments” attached to this Outline.
2. Charitable Gift Annuity Alternative. Explain Philanthropic Landscape – Charitable giving is 49% down due to donors’ psychological fear of parting with assets; which, in turn, has accentuated the cash needs of Charities.
- A. Key is this is a win-win gifting design. This alternative is not a financial planning design involving a gift today or a bequest at death; however, charitable intent is necessary.
 - B. Assume donor has an investment of \$100K generating a 4% return.
 - C. Charity receives an upfront cash donation from the donor equal to the present value of the amount the charity would otherwise receive at the back end of a charitable gift annuity.
 - E. Charity invests the remaining proceeds in a single premium annuity, and utilizes the annuity proceeds to provide the donor with annual income of \$4,000 under a Guaranteed Income Contract and to pay an insurance premium for life insurance policy providing a guaranteed death benefit to the donor equal to his \$100K investment.
 - F. Ultimate Results:
 - (i) Donor receives the same 4% income from Guaranteed Income Contract, a 100% return of his or her contribution, and an immediate charitable deduction.
 - (ii) The Charity receives a cash gift up front and is relieved of the administrative and financial obligations and responsibilities of a charitable gift annuity.
 - (iii) Alternatively, the gifting design can replace the payment of insurance premiums for a guaranteed death benefit with an annual gift to charity. Alternatively, the donor could use the annual income from the Guaranteed Income Contract to make an annual charitable gift.
 - (iv) The bottom line is a win-win planned giving alternative with options for a donor to give a cash gift at inception and annual gift during their lifetime, his and receive an annual payment of income and a guaranteed death benefit equal to his or her investment.
 - (v) See “Charitable Gift Annuity Alternative” attachment to this Outline.

Virtual Endowments

Once the business owner's cash flow and financial security issues are resolved, the business owner frequently becomes much more amenable to discussing transfers of ownership and control to the next generation. By reducing their dependence on the family business for cash flow, business owners no longer need to rely on the business to maintain their lifestyle and can focus their attention on effective succession planning.

Endnotes

1. http://familybusinesssurvey.com/2007/pdfs/LNT_FamilyBusinessSurvey_2007.pdf.
2. Michael D. Allen, "Representing the Patriarch in Family Business Succession," ABA Course of Study Materials, *Estate Planning for the Family Business Owner* (July 2006).

PHILANTHROPY

Making a Gift and Keeping it Too ...

By Robert F. Sharpe, Jr., president of The Sharpe Group, Memphis, Tenn.

The dust is slowly settling after the enactment of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the 2010 Tax Act). Estate planners are beginning to carefully consider a number of opportunities that allow clients to take maximum advantage of current conditions. Postponed income tax rate increases and deduction limits, a moratorium on phase-outs of exemptions, lower estate and gift tax rates coupled with higher exemption levels and other changes are acting as catalysts for prudent planning between now and the end of 2012.

The philanthropic area, for example, has seen strong interest in the use of lead trusts and other plans that leverage new lifetime exemption increases during the rather limited time period when they're a certainty (see the article I wrote for the March 2011 issue of *Trusts & Estates*, "Increased Exemption Amounts Create New Opportunities," p. 14.) Since the beginning of the year, increasing numbers of charitably minded individuals have reportedly begun funding relatively low payout lead trusts for shorter periods than in the past, making significant charitable gifts

before passing underlying assets to their heirs on a tax-favored basis.

In addition, some charitably inclined individuals are looking for other charitable giving strategies that allow them to preserve some measure of control over their assets, while also maximizing available tax benefits.

Accelerating Bequests

In times of lower returns on traditional retirement portfolios, for example, many of those with charitable interests are looking for ways to increase their spendable income. Some have discovered that when they "accelerate" charitable bequests by funding split-interest gifts during their lifetimes, they can enjoy immediate tax savings, increase their income and be secure in the knowledge that the funds may also be free from creditors' claims.

Take, for example, the case of a 75-year-old woman with an estate of \$5 million who was planning to leave \$500,000 to one or more charitable interests and the remainder to her nieces and nephews. Under 2009 law, estate tax would have been due on amounts over \$3.5 million, but there would have also been estate tax savings realized as a result of the charitable bequests. Under today's law, on the other hand, no federal estate tax would be due on the estate of \$5 million, whether left to charity or other heirs, and thus there would be no tax savings associated with the \$500,000 donated to charity.

Suppose this woman owns securities worth \$500,000 that pay dividends of 1 percent and cost \$150,000, 15 years ago. If she used these securities to fund a 5 percent charitable remainder unitrust, this would result in an immediate charitable income tax deduction of just over \$300,000 that she could use to reduce income taxes for the current year and carry forward any excess for up to five more years. Depending on her tax bracket and other factors, this could yield income tax savings in the range of \$50,000 to \$100,000. She would also bypass capital gains tax at the time the trust sold the securities. And, by making that sale, the trust will have diversified the assets used to fund the trust. If the trust earns more than 5 percent over time, the corpus will grow on a tax-free basis, resulting in increased income and ultimately transferring more to the charitable recipients of the trust remainder.

In addition, for the rest of the donor's lifetime, she can choose who will be trustee of the trust and enjoy income

Briefing

from what amounts to "fenced off" assets. The bad news is, she can't access the trust corpus—the good news is that no one else can either! If the donor had instead continued to hold the assets, she would have received a low return before making an eventual gift to charity through her estate, and under current law her estate would have enjoyed no federal estate tax benefits.

If desired, the income tax savings from this gift could be used to offset taxes should she decide to convert a traditional individual retirement account to a Roth IRA. This would allow her to take future distributions from the IRA on a tax-free basis. Also, her eventual heirs would benefit significantly by receiving part of their inheritance in the form of a Roth IRA instead of a traditional IRA because distributions taken from a traditional IRA left to them would be considered income in respect of a decedent.

Another tax planning consideration that makes such a gift more attractive in 2011 or 2012 is the fact that the 2010 Tax Act postponed the return of the "Pease Amendment," which requires higher income taxpayers to reduce the amount of their charitable and other deductions by 3 percent of the amount by which their adjusted gross income exceeds threshold amounts. Those considering funding larger charitable remainder trusts and other gifts that generate tax deductions should keep this in mind when considering the timing of their gifts.

Virtually Possible?

A previously little-known planning strategy gaining in popularity for some is the use of what has been described as a "virtual" or "flexible" endowment. This strategy requires the donor to make a commitment to give what's usually a relatively substantial amount at some point in the future. The donor then gives the charity each year a sum equal to the amount that the charity would have spent based on the "endowment" if the transfer of the gift amount had been completed. The underlying agreement may provide that the donor can suspend the payments for a period of time if necessary due to health costs or other personal needs.

One major university reported that over 200 donors took advantage of this method of giving in a recent year.¹

This idea is particularly attractive to donors whose capital is illiquid or invested in ways they believe will yield greater returns over time than the charitable recipient's expected endowment return.

A virtual endowment allows older donors to maintain access to their capital in later years should they need it for living expenses, healthcare or other uses. Their endowment is then fully funded through a gift included in their estate plans.

Consider the case of an 80-year-old widower who has decided he can't make a \$1 million gift to an endowment campaign because he may need all or part of the funds at some point before he passes away. He instead funds a \$1 million "virtual endowment" that's backed by a pledge to make a bequest in that amount from his estate. In the meantime, the charity notifies him each year of the amount that was spent from its endowment. If, for example, the charity spent 4 percent of its endowment in a given year, the donor would direct his asset managers to make a transfer of \$40,000. If the charity's endowment grew 2 percent beyond its spending, the payoff amount could be indexed upward by that amount, if desired.

While there are no current tax benefits other than the deduction of the gift amount each year, the donor rests assured that the \$1 million is still available should he need it and he retains the option to suspend the annual payments if necessary. At a future point in time, the donor may decide to fully fund the gift on an inter vivos basis.

As an intermediate step, the donor may choose to convert the gift to a charitable remainder trust, enjoy all of the benefits described earlier and use the trust payments to fund the virtual endowment payment each year. If the donor's economic outlook improves in the future, he has the option of disclaiming any future income interest, allowing the trust to terminate and fully funding the endowment right away.

These are just a few examples of the many ways clients may make significant charitable transfers while meeting other personal needs and maximizing available tax incentives. The 2010 Tax Act may have shut the door on tax savings for certain charitable gifts, but many estate planning strategies still remain available that enable clients to make charitable gifts while cost-effectively achieving their goals. ■

Endnote

1. See Kathryn Maslerson, "Private Giving to Colleges Dropped Sharply in 2009," *The Chronicle of Higher Education* (Feb. 3, 2010), www.chronicle.com/article/Private-Giving-to-Colleges/63879/; David Cay Johnson, "Charities Wrestle With Tax Uncertainty," *The New York Times* (Nov. 10, 2010).

WHY TODAY'S PLANNERS HAVE TO THINK DIFFERENTLY

An Estate, Income, Insurance and Philanthropic Planning Perspective

INCOME

- Roth conversion
- Taking advantage of elimination of phase-out for itemized deductions

INSURANCE

- Why smart wealth holders aren't pulling the trigger on planning (and an observation on why they **will**)
- Taking advantage of today's extraordinarily low interest rate environment
- Amplifying charitable gifts with life insurance
- Obtaining the best results with proper underwriting

ESTATE

- How important is what the client wants?
- Using Incentive Trusts to control actions of beneficiaries
- Increased emphasis on asset protection planning for grantor and beneficiaries
- Non-Reciprocal Spousal Trusts as a creative transfer tax strategy to take advantage of the increased exemption while retaining access and control
- Historically low interest rates create planning opportunities
- Impact of future legislation

PHILANTHROPIC

- Supercharging Charitable Gift Annuities through Charity Annuity Arbitrage
- CRTs funded with artwork
- Endowments with a twist