Wealth Transfer and Charitable Planning Strategies

Handbook

Wealth Transfer and Charitable Planning Strategies Handbook

This handbook contains 12 core wealth transfer and charitable planning strategies. It also demonstrates how life insurance may enhance the results of the various planning techniques. Each strategy includes a brief description, potential benefits, planning considerations and a diagram of how the strategy works.

CHARITABLE LEAD TRUST

What It Is

A charitable lead trust (CLT) is a taxable split-interest irrevocable trust where a qualified organization (e.g., public charity, private foundation or donor-advised fund) receives income (lead interest) from the CLT for a set time period.* After payment of the lead interest, the CLT remainder interest is distributed to the non-charitable beneficiary or beneficiaries, which may include the donor, donor's estate, children, grandchildren or other trust or trusts for children or grandchildren.

The value of the grantor's gift to the remainder beneficiaries is determined by deducting the present value of the charity's interest (valued using the 7520 rate in effect at the time of the transfer) from the fair market value of the property transferred to the CLT. In addition, the taxable value of the CLT's assets is fixed at the time of the transfer, and any subsequent increase in the value of the assets is outside the donor's estate and thus free of gift and estate tax.

By establishing and funding a CLT, a client can benefit charity, reduce his or her taxable estate and transfer wealth at a reduced transfer tax cost.

Potential Benefits

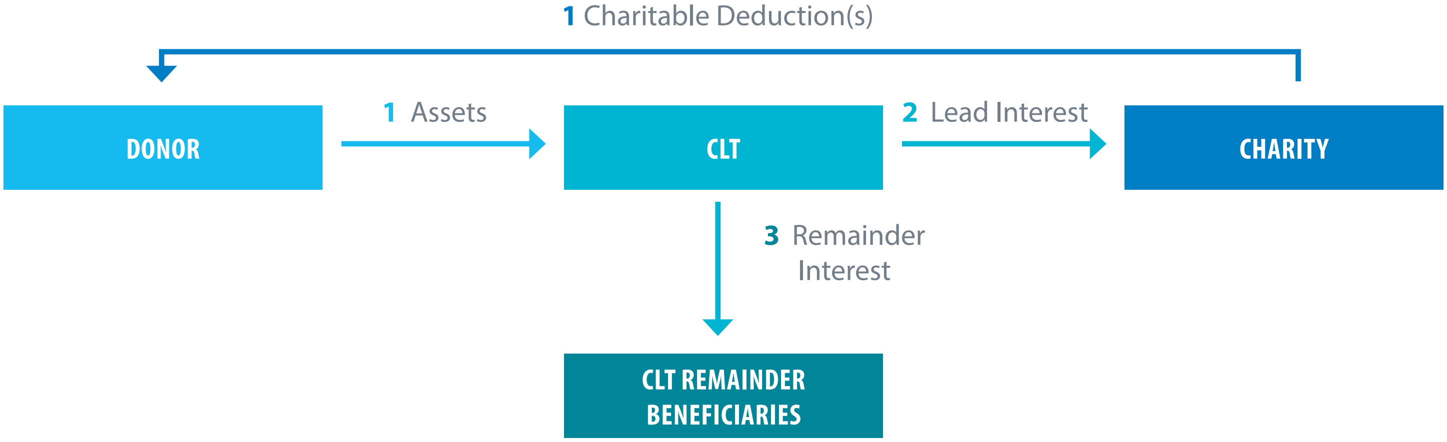
- Leverage gifts to non-charitable beneficiaries.
- Maximize gifts to charitable beneficiaries.
- Reduce taxable estate.

Planning Considerations

- Transfers to the CLT are irrevocable.
- Failure to meet income/growth projections minimizes gifts to non-charitable beneficiaries.
- Deferred benefit to non-charitable beneficiaries.

*The duration and amount of the lead interest is determined by the client. Payments can continue for the life or lives of one or more individuals, all of whom must be living when the trust is created or for a term of years (limited only by the applicable Rule Against Perpetuities). The CLT may be established as an *inter vivos* trust (during life) or as a testamentary trust (at death). Unlike a charitable remainder trust and a private foundation, there is no minimum percentage or amount that must be distributed annually. The CLT instrument may provide for the payment of the annuity or unitrust interest to be made in cash or in kind.

How It Works



1. Donor creates a CLT and irrevocably transfers assets to the trustee of a CLT. In doing so, client receives a charitable gift tax deduction and potential income tax deduction, subject to limitations.*
2. The trustee pays the charity its lead interest as either a fixed percentage of the initial value of the trust (charitable lead annuity trust (CLAT)) or a specified percentage of the trust assets as revalued each year (charitable lead unitrust (CLUT)).**
3. When the CLT terminates, the CLT remainder interest is transferred to the remainder beneficiaries.

*If the CLT is structured as a grantor trust (i.e., grantor taxed on trust income as it is earned), the grantor is entitled to an income tax charitable deduction in the year the CLT is established. In that case, the amount of the deduction is equal to the present value of all future payments that will be made to the charitable beneficiary. While the grantor will be taxed on all CLT income, the grantor will not receive an income tax charitable deduction for the annual charitable payments. The CLT income taxed to the grantor can be thought of as the "recapture" of the previously allowed charitable income tax deduction. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

**GST tax exemption cannot be allocated to the CLAT up front, but must instead be allocated to the value of the CLAT at the end of the CLAT term. As a result, using a CLAT for transfers involving a GST is not prudent. When GST planning is an objective, a CLUT should be used to minimize or avoid GST tax.

CHARITABLE REMAINDER TRUST

What It Is

A charitable remainder trust (CRT) is a tax-exempt split-interest trust to which the donor transfers property and retains an income stream. At the creation of the CRT, the charity's remainder interest must be at least 10 percent of the initial value of the CRT. The income stream retained by the donor may last for a term of years (not to exceed 20 years) or the lifetime of the donor or other specified beneficiaries. The CRT must make income payouts at least annually. At the termination of the CRT, the balance of the CRT assets is distributed to a qualified organization, such as a public charity, private foundation or donor-advised fund, selected by the donor and designated in the CRT.

Because a CRT is a tax-exempt entity, it can sell a highly appreciated asset without incurring a current income tax liability. The donor will receive an immediate income tax deduction based on the estimated present value of the remainder interest that will ultimately be transferred to the charity. As an income beneficiary of the CRT, the donor benefits from the income tax-free liquidation of the highly appreciated assets by receiving income from the sale of those assets. A portion of that income can be used to purchase a life insurance policy to replace the value of the assets transferred to the CRT.

By establishing and funding a CRT with low-basis, highly appreciated assets, such as stocks, bonds or real estate, the donor may be able to achieve charitable objectives, receive a charitable income tax deduction, reduce the size of his or her estate and maximize wealth transferred to beneficiaries.

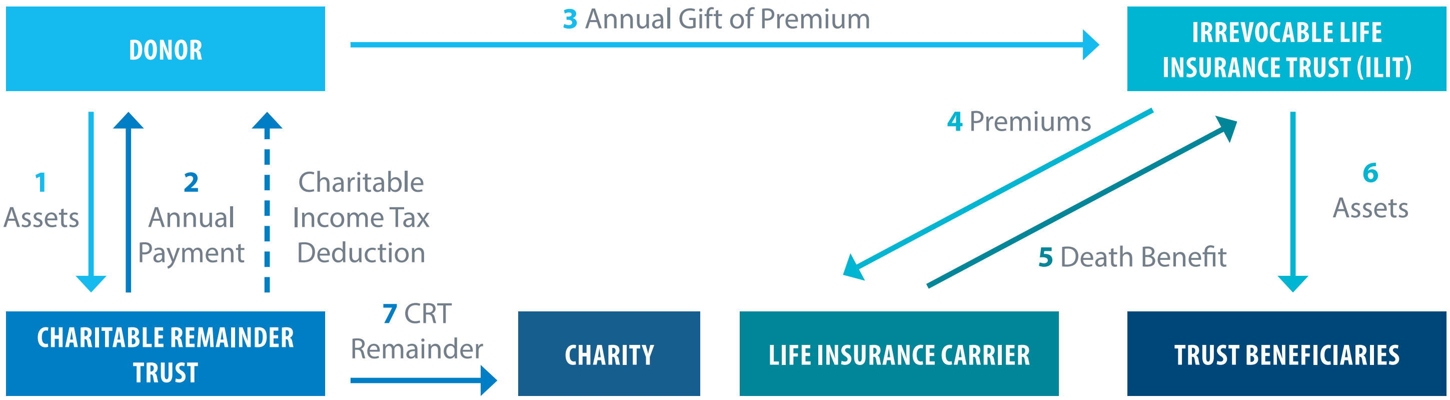
Potential Benefits

- May increase current income, reduce taxable estate and provide current charitable income tax deduction.
- Benefits donor's favorite charity.
- May provide tax-efficient asset repositioning.
- Life insurance death benefit can help to replace value of assets transferred to the CRT and maximize wealth transfer to beneficiaries.
- Charitable beneficiary of the CRT may be a private foundation.

Planning Considerations

- Transfers to the CRT are irrevocable.
- When the CRT terminates, the CRT assets pass to charity, not to family members.
- Income tax deductions not used currently may be carried forward for five years.
- The current income tax deduction depends on the type of asset donated, the type of charity and benefits paid out to the income beneficiaries.
- Cost of creation and maintenance of the CRT.

How It Works



1. Donor irrevocably transfers property to the trustee of a CRT and receives a federal income tax deduction for the present value of the charity's remainder interest, subject to limitations.*
2. The trustee pays the donor either a fixed percentage of the initial value of the trust (annuity trust) or a specified percentage of the trust assets as revalued each year (unitrust). If the donor chooses to have the income assigned to a beneficiary other than a spouse, the donor is still responsible for income taxes. Payments to the beneficiary are subject to the federal gift tax but may qualify for the gift tax annual exclusion.
3. Donor creates an irrevocable life insurance trust (ILIT), the beneficiaries of which are typically the donor's family members.
4. Donor makes annual, scheduled or lump sum gifts of cash or other assets to the ILIT. Often, the amount of the gift made to the ILIT coincides with the life insurance premium.
5. ILIT purchases a life insurance policy on the donor's life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
6. Upon the donor's death, the ILIT assets, including life insurance, pass to the ILIT beneficiaries free of income and transfer taxes.
7. When the CRT terminates, the CRT remainder is transferred to the charity.

*Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

CREDIT SHELTER TRUST WITH LIFE INSURANCE

What It Is

A credit shelter trust (CST), also known as a family trust or bypass trust, often plays an integral role in married couples' estate plans. At the death of the first spouse, an amount equal to the applicable exclusion amount (formerly the unified credit amount) is typically transferred to the CST, free of estate and GST taxes. Often, the CST is drafted to provide income and/or principal to a surviving spouse subject to certain limitations.* Properly drafted, the CST assets remain outside the surviving spouse's taxable estate. At the death of the surviving spouse, the CST assets are transferred to the CST remainder beneficiaries pursuant to the terms of the CST.

Using CST assets to fund a life insurance policy on the surviving spouse's life can greatly enhance the amount of wealth transferred to the CST beneficiaries. Because the assets of the CST reside outside the taxable estate of the surviving spouse, utilizing the CST assets to purchase life insurance may be a transfer tax-free approach to funding a needed life insurance death benefit. Specifically, there are no gift taxes or estate taxes associated with the premium payments. In addition, since a life insurance policy's cash values grow tax-deferred, it may reduce the surviving spouse's income tax liability.

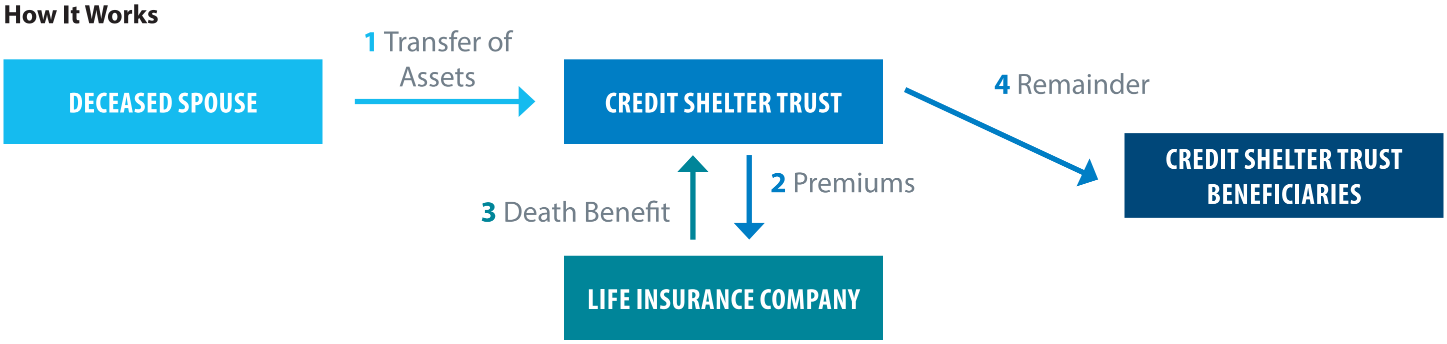
Potential Benefits

- Maximizes wealth transfer to CST beneficiaries.
- Life insurance policy cash values grow tax-deferred.
- May reduce overall income tax liability of CST and surviving spouse during lifetime.
- Provides an income-tax-free death benefit for CST beneficiaries.
- Diversifies and lowers investment risk of CST assets.
- Enables the surviving spouse to acquire life insurance outside of his/her taxable estate without using annual exclusion gifts.
- Policy cash values can be accessed for the benefit of the surviving spouse and children as provided by the terms of the CST.

Planning Considerations

- The surviving spouse cannot serve as sole trustee of the CST.
- The surviving spouse cannot hold a general power of appointment over the CST assets.
- Any use of "5 and 5 powers" or limited powers of appointment in a trust must exclude the life policy or all or part of the death proceeds may be subject to estate tax at the death of the surviving spouse.
- The CST trustee must have the authority to purchase life insurance under the terms of the CST or applicable state law.
- If the spouse is uninsurable or in poor health, life insurance may be unavailable or very expensive.
- Limits CST income and assets available to surviving spouse.

How It Works



1. Typically, upon the death of the first spouse, a CST is funded with a specified amount of assets.
2. The CST trustee purchases a life insurance policy on the surviving spouse's life, retains ownership rights and designates the CST as the beneficiary of the policy.
3. The death benefit is paid to CST.
4. Upon the surviving spouse's death, the CST assets, including life insurance, will pass to the CST beneficiaries free of income and transfer taxes.

*Often, during the surviving spouse's lifetime, the principal and/or income of the credit shelter trust may be used as necessary for the health, education, maintenance and support of the surviving spouse.

DYNASTY TRUST

What It Is

A dynasty trust is an irrevocable trust designed to benefit multiple generations of beneficiaries, thus protecting transferred assets, creating a legacy for a donor and providing for professional management, if desired. By establishing a dynasty trust and funding it with life insurance, a donor can leverage the amount of wealth transferred to heirs.

Typically, life insurance premiums are relatively small compared to the amount of death benefit proceeds. Therefore, allocating the generation-skipping transfer (GST) tax exemption to assets transferred into the dynasty trust for payment of life insurance premiums can be an efficient use of a donor's GST tax exemption. This exemption is allocated up front to each premium gift made to the trust, not to the policy's future cash value accumulation or death benefit proceeds, thus leveraging a smaller gift into a significantly larger GST tax-exempt legacy.

As long as the life insurance remains in force, policy cash values grow on a tax-deferred basis. Life insurance death benefit will be paid to the dynasty trust free of income tax, estate tax and GST tax. Not all of these benefits are available when the dynasty trust invests in traditional investments, such as publicly traded stock.

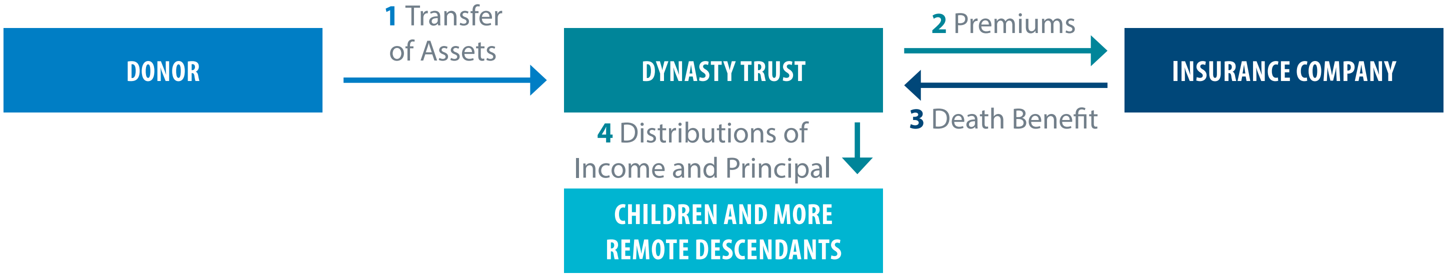
Potential Benefits

- Create a legacy for future generations.
- Pass assets to heirs free of estate tax and GST tax.
- Leverage the GST tax exemption using life insurance to create a larger legacy.
- Provide for the professional management of trust assets.
- Control the timing and circumstances when transfers are made.

Planning Considerations

- The duration of a dynasty trust may be limited in some states by the Rule Against Perpetuities.*
- The desired life insurance policy premium may be higher than the donor's available annual gift tax exclusion, lifetime gift tax exemption and GST tax exemption.
- Transfers to a dynasty trust are irrevocable and the donor may not possess any incidents of ownership in the life insurance policy owned by the dynasty trust.
- Life insurance qualification generally requires medical and financial underwriting.
- Cost of creation and maintenance of dynasty trust.

How It Works



1. Donor creates a dynasty trust, the beneficiaries of which are typically the donor's family members.
2. Donor makes annual, scheduled or lump sum gifts of cash or other assets to the dynasty trust. Often, the amount of the gift made to the dynasty trust coincides with the life insurance premium. Donor's GST tax exemption is allocated to each gift made to the dynasty trust.
3. Dynasty trust purchases a life insurance policy on the donor's life, retains ownership rights and designates the dynasty trust as the beneficiary of the policy.
4. At the donor's death, the life insurance proceeds are paid to the dynasty trust. The dynasty trust continues until the end of the trust term, if any.

*Depending on state law, a trust may terminate in the future according to the state's Rule Against Perpetuities, which limits the duration of a trust. In jurisdictions that follow the common law Rule Against Perpetuities, a transfer of property in trust will be invalid unless it vests within a life or lives in being at the creation of the trust plus 21 years (approximately 90 years or so). A number of states have revised the common law Rule Against Perpetuities by statute, passing legislation permitting one to opt out of the rule, or abolished it entirely. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

GRANTOR RETAINED ANNUITY TRUST

What It Is

A grantor retained annuity trust (GRAT) is an estate freeze technique that may help a donor transfer significant wealth to future generations with minimal transfer tax impact.[1] A GRAT is an irrevocable trust to which a donor transfers property and retains an annuity interest from the transferred property for a fixed term.

For transfer tax valuation purposes, the amount of the taxable gift is the fair market value of the property transferred minus the value of the donor's retained annuity interest. If the value of the annuity interest equals the total value of assets transferred to the GRAT, the transfer will be valued at zero for transfer tax purposes (e.g., Walton GRAT or zeroed-out GRAT). The transfer "freezes" the value of the appreciating assets by converting the appreciating assets into a fixed annuity interest payable to the donor. As a result, all post-transfer appreciation and income are removed from the donor's estate. Because the GRAT is a grantor trust, the donor pays the GRAT income tax liability at the donor's individual income tax rate, which means GRAT assets effectively grow income tax-free.[2]

At the end of the GRAT term, the remaining trust assets are distributed to the remainder beneficiary without the imposition of additional gift tax and are excluded from the donor's taxable estate. In the event the donor dies during the GRAT term, a portion or all of the GRAT assets will be included in the donor's taxable estate.[3] Life insurance is often used to protect against the donor's death during the trust term.

Potential Benefits

- The donor can make a current gift of assets with little or no gift tax cost while allowing the donor the right to receive a fixed annuity interest during the term of the GRAT.
- To the extent the return on the assets transferred to the GRAT exceeds the Section 7520 rate, the excess value is transferred to the GRAT beneficiaries without gift or estate taxes.
- Unlike an installment sale to a grantor trust, a GRAT does not require the donor to gift money to the trust prior to the transaction.
- A GRAT can provide the funds necessary to terminate premium leveraging arrangements with minimal gifting implications, while at the same time maintaining the donor's desired level of insurance protection.
- By paying the income tax liability generated by GRAT assets, the donor has effectively made a gift-tax-free transfer to the beneficiaries equal to the amount of the annual income tax liability of the GRAT.
- A GRAT is a statutorily created wealth transfer vehicle with a long history of use.

Planning Considerations

- If the donor dies during the term of the trust, a substantial portion, if not all, of the trust assets will be included in the donor's estate.
- The assets transferred to the GRAT may not generate income and/or appreciate as planned.
- A GRAT is an ineffective vehicle for multigenerational wealth transfers. A donor's generation-skipping transfer (GST) tax exemption cannot be allocated to the GRAT up front, but must instead be allocated to the value of the GRAT at the end of the estate tax inclusion period.

How It Works

1. Donor transfers assets to the GRAT and retains an income stream from the transferred property for a fixed term. The trust term and the amount of the income stream are determined by the donor.
2. GRAT makes annual annuity payments to the donor for the length of the trust term.
3. At the end of the GRAT term, the remaining trust assets are distributed to the remainder beneficiary without the imposition of additional gift tax and are excluded from the donor's taxable estate.

[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

[2] The grantor trust is drafted in such a manner as to be subject to the grantor trust provisions of IRC §§671-679. See Rev. Rul. 85-13, 1985-1 CB 194.

[3] See Treas. Reg. §20.2036-1(a) and (c).

IRREVOCABLE LIFE INSURANCE TRUST

What It Is

An irrevocable life insurance trust (ILIT) is an irrevocable trust used to remove the ownership and control of the life insurance policy from an estate. Like other irrevocable trusts, transfers to an ILIT are completed gifts in which the donor relinquishes control and ownership of the assets transferred to the ILIT.

Moreover, in creating an ILIT, the donor does not retain the right to modify, revoke or terminate the ILIT. However, assets owned by an ILIT are removed from the donor's taxable estate. The ILIT is a wealth transfer vehicle that may help a donor remove assets from his/her estate and provide survivor income or liquidity for their estate.

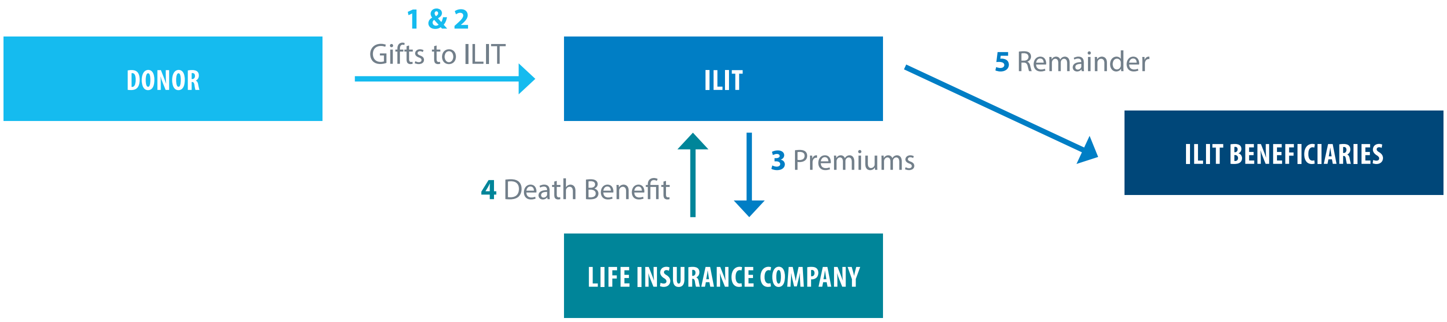
Potential Benefits

- May enable the donor to leverage his/her annual gift tax exclusions, lifetime gift tax exemption and generation-skipping transfer (GST) tax exemption with the purchase of life insurance.
- Provides estate liquidity for the donor's heirs on an income and transfer tax-free basis.
- May replace assets used to pay estate taxes or used to provide a charitable bequest.
- Gives the donor the opportunity to control the distribution of the death proceeds through the terms of the ILIT provisions in a manner consistent with his/her overall estate objectives.
- May protect ILIT assets from the creditors of the ILIT beneficiaries.
- May reduce the size of the donor's taxable estate and corresponding estate taxes.
- May increase the amount of wealth transferred to the donor's heirs.

Planning Considerations

- Cost of creation and maintenance of ILIT.
- Life insurance qualification generally requires medical and financial underwriting.
- The desired life insurance policy premium may be higher than the donor's available annual gift tax exclusions and/or lifetime gift tax exemption.
- Transfers to an ILIT are irrevocable and the donor may not possess any incidents of ownership in the life insurance policy owned by the ILIT.

How It Works



1. Donor creates an ILIT,* the beneficiaries of which are typically the donor's family members.
2. Donor makes annual, scheduled or lump sum gifts of cash or other assets to the ILIT. Often, the amount of the gift made to the ILIT coincides with the life insurance premium.
3. ILIT purchases a life insurance policy on the donor's life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
4. At the donor's death, the death benefit is paid to the ILIT.
5. At the end of the trust term, the ILIT assets, including life insurance, pass to the ILIT beneficiaries free of income tax and transfer tax.

*Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

LIFE INSURANCE AS AN ASSET

What It Is

Clients are well aware that the value of an investment portfolio is subject to market fluctuations. The amount of wealth transferred to their beneficiaries is based on the value of their investment portfolio at an indeterminate point in the future. Depending on the performance of the investment portfolio, their beneficiaries may receive more or less than expected. By allocating a small portion of their portfolio to purchase a life insurance death benefit, clients may hedge market losses. In doing so, they may increase the amount of wealth transferred to their beneficiaries.

Life insurance is a unique asset in that the death benefit risk is borne by the life insurance carrier, which will pay the death benefit in full upon death no matter the "timing." As a result, life insurance provides clients with a death benefit that is uncorrelated with other sectors of the investment marketplace, such as equities or bonds. In other words, the death benefit is based on the event of death — not a market event that can cause a downturn in value.

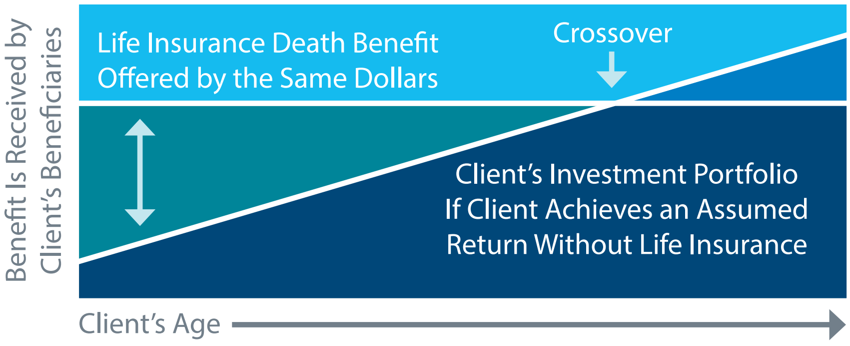
Potential Benefits

- Life insurance death benefit may offer significant leverage, especially in the early years, and may increase the amount of wealth transferred to heirs.
- By directing a portion of a portfolio to life insurance premiums, client may hedge against market losses.
- Life insurance death benefit is uncorrelated with other sectors of the investment marketplace, such as equities or bonds.
- May increase tax-adjusted internal rate of return of a client's portfolio.
- If properly owned, death benefit can be received free of income and transfer taxes.

Planning Considerations

- Directing funds to life insurance premiums may reduce the return on the portfolio.
- Potential advantage offered by life insurance needs to be viewed in light of a client's overall financial situation.
- Client's ability to see this plan to fruition is based on continuing premium payments, as required, as well as the claims-paying ability of the underlying insurer.
- Client's total insurance capacity may be limited by financial underwriting.
- Life insurance qualification generally requires medical and financial underwriting.

How It Works



A life insurance death benefit offers substantial leverage during the early years of the policy. The value of the death benefit is substantially more than the value of the premiums would be if they had been placed in an investment account (non-life insurance assets). The advantage may decrease over time if the non-life insurance assets increase in value. At some point, the value of non-life insurance assets may exceed the death benefit. The point at which this occurs is often called the "crossover" point. Life insurance offers an advantage when the crossover point occurs beyond a client's life expectancy.

LIFETIME GIFTING

What It Is

A donor can make tax-free gifts to an irrevocable trust annually and reduce the size of his/her taxable estate in the process.* By making gifts of appreciating assets, a donor also removes future growth and income from his/her estate. In addition, certain assets may be valued at a discount for gift tax purposes, allowing a donor to transfer more wealth to his/her family members in a shorter period of time. In some cases, a donor may also be able to give away an interest in an asset without giving up control of it.

Although making lifetime gifts alone can be an efficient way to transfer assets and minimize gift and estate tax, the gifts may be leveraged significantly with the purchase of life insurance. Life insurance proceeds are generally not subject to income taxes. If properly structured, life insurance proceeds may also be excluded from the estate tax and federal generation-skipping transfer (GST) tax.

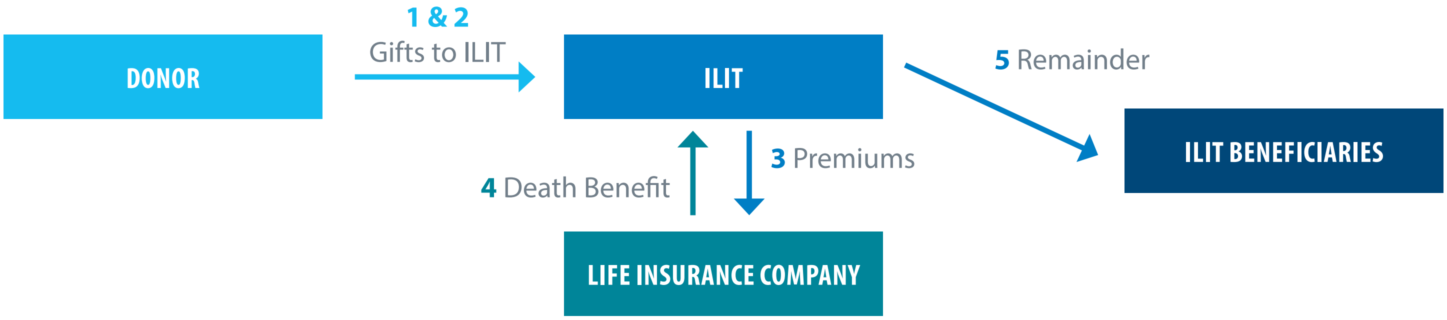
Potential Benefits

- Reduces the size of the taxable estate and corresponding estate taxes.
- Removes future appreciation and income attributable to gifted assets from estate.
- Provides greater privacy and probate avoidance.
- May provide creditor protection for gifted assets.
- May increase the net amount of wealth transferred to heirs.

Planning Considerations

- Generally, gifts are irrevocable.
- Life insurance qualification generally requires medical and financial underwriting.
- The desired life insurance policy premium may be higher than the donor's available annual exclusion gifts and/or lifetime gift tax exemption amount.
- There is no guarantee to absolute creditor protection.

How It Works



1. Donor creates an irrevocable life insurance trust (ILIT), the beneficiaries of which are typically the donor's family members.
2. Donor makes annual, scheduled or lump sum gifts of cash or other assets to the ILIT.
3. ILIT purchases a life insurance policy on the donor's life, retains ownership rights, and designates the ILIT as the beneficiary of the policy.
4. At the donor's death, the death benefit is paid to ILIT.
5. At the end of the trust term, the ILIT assets, including life insurance, will pass to the ILIT beneficiaries free of income tax and transfer tax.

*Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping tansfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

PREMIUM FINANCING

What It Is

Premium financing is a strategy intended to help donors obtain life insurance for which they have an established need. Typically, premium financing is a fair market loan arrangement between a commercial lender and an irrevocable life insurance trust (ILIT) where the lender loans the premiums for a life insurance policy on the donor's life to the ILIT.* In that case, the gift to the ILIT is equal to the amount of loan interest charged — not the entire policy premiums. As a result, the donor is able to acquire the death benefit needed with little or no gift tax impact.

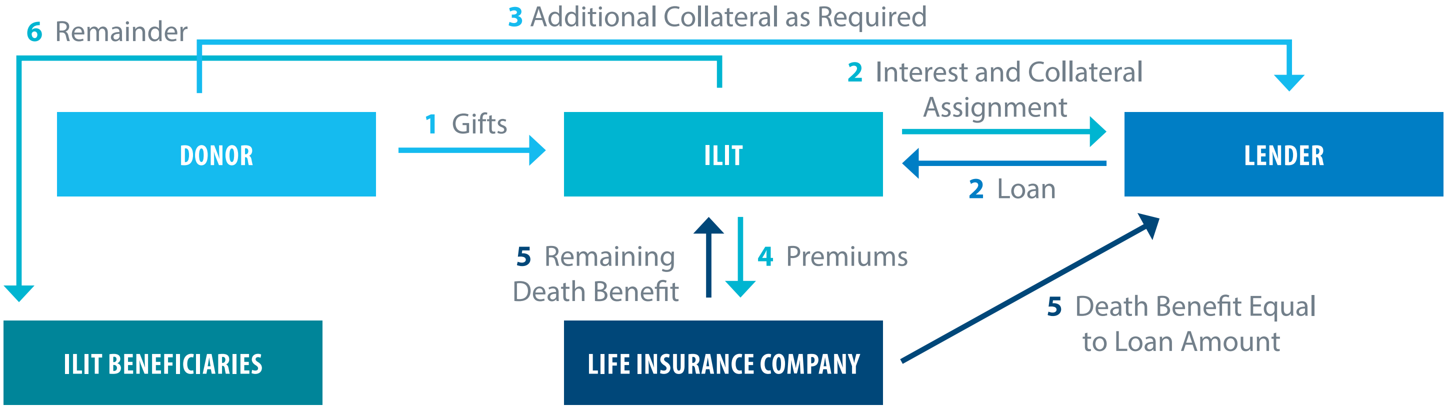
Potential Benefits

- Death benefit payable to the ILIT should pass to the trust beneficiaries free of income and transfer taxes.
- Substantially reduce or eliminate gift tax cost associated with the donor's desired level of life insurance protection.
- Reduced net out-of-pocket cost for the life insurance.
- Minimal or no impact on the current investment portfolio; the donor maintains control and use over assets that otherwise would have been liquidated to pay life insurance premiums.
- Potential to leverage the donor's investment portfolio when the portfolio returns are higher than the cost of the loan.

Planning Considerations

- Premium financing is complex and involves many risks, such as the possibility of policy lapse, loss of collateral, interest rate and market uncertainty, and failure to requalify with the lender to keep the financing in place and maintain the desired level of insurance protection.
- Subject to the lender's collateral and financial underwriting requirements.
- Loan interest paid by the ILIT is not deductible.
- ILIT assets may be insufficient to pay the premiums or loan interest and/or repay the lender.
- Pledged collateral and, in certain situations, additional out-of-pocket contributions to the ILIT, may be required to retire the debt and/or maintain the desired level of insurance protection.
- A well-planned exit strategy should be in place from the beginning.

How It Works



1. Donor creates an ILIT, the beneficiaries of which are typically the donor's family members.
2. ILIT borrows funds to pay the premiums due and collaterally assigns the policy to the lender. Loan interest may be paid annually or deferred for a period of time, depending on the terms of the loan.
3. Donor pledges additional assets as collateral.
4. ILIT uses the loan proceeds to purchase a life insurance policy on the donor's life, retains ownership rights and designates the ILIT as the policy beneficiary.
5. At the donor's death, the loan is repaid from the death proceeds. Alternatively, the loan may be repaid during the donor's lifetime, in a lump sum or installments, from sources outside of the donor's estate. Funds to repay the loan may include an ILIT side fund to which the donor has contributed annual gifts that have been invested, or an existing trust or partnership that may have significant assets available.
6. At the end of the trust term, the ILIT assets, including death proceeds in excess of the amount required to repay the loan, are distributed to the ILIT beneficiaries free of income and transfer taxes.

*Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

PRIVATE FINANCING

What It Is

Private financing is a fair market loan arrangement between a donor and an irrevocable life insurance trust (ILIT) where the donor loans the premiums for a life insurance policy on the donor's life to the ILIT.[1] The gift to the ILIT, if any, is equal to the amount of loan interest charged — not the entire policy premiums. As a result, the donor is able to acquire a needed life insurance death benefit outside his/her estate with minimal cash flow and/or transfer tax impact. The ILIT repays the donor the loan principal and accrued interest from the life insurance proceeds at the donor's death or from other sources during the donor's lifetime. Potentially, a return of premium rider can be used to repay the premium loan without diminishing the death benefit needed.

Private financing premiums can make great economic sense when there is a positive arbitrage between the policy's internal rate of return or the trust's investment return and the loan interest rate.

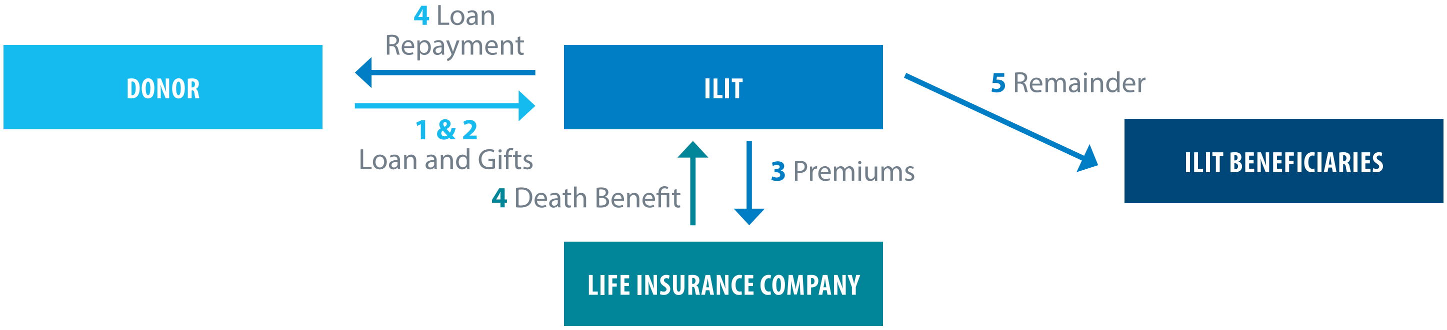
Potential Benefits

- Death benefit payable to the ILIT should pass to the trust beneficiaries free of income and transfer taxes.
- Minimize transfer tax cost associated with acquiring the donor's desired level of life insurance protection.
- Flexible, attractive loan terms (e.g., loan can be demand or term and made annually or in an upfront lump sum, loan interest can be paid currently or accrued, payable on death, and interest rate can be based on applicable federal rates (AFR)).
- Loan interest paid to the donor is not subject to income tax if the ILIT is a grantor trust (i.e., the donor is treated as the owner of all ILIT assets for federal income tax purposes).[2]
- Not subject to the third-party lender's approval or stringent collateral requirements.
- No risk of loan being called by third-party lender.

Planning Considerations

- Proceeds of loan repayment may be subject to estate tax.
- Loan interest payments may be subject to income tax.
- The loan interest paid by the ILIT is not deductible.
- ILIT assets (including the life insurance death benefit) may be insufficient to pay the premiums or loan interest, and/or to repay the donor or his/her estate.
- May require the donor to make additional loans or gifts to the ILIT to maintain the desired level of insurance protection.

How It Works



1. Donor creates and funds an ILIT, the beneficiaries of which are typically the donor's family members.
2. Donor lends the premiums for a life insurance policy on the donor's life to the ILIT at the applicable federal rate (AFR). The loan can be made in a lump sum or in a series of annual, scheduled loans.
3. With the loan proceeds, the trustee of the ILIT purchases a life insurance policy on the donor's life, retains ownership rights and designates the ILIT as the beneficiary of the policy. The policy usually serves as the collateral for the loan. Loan interest can be paid currently or accrued.
4. At the donor's death, the death benefit is paid to the ILIT and the loan is repaid from the death proceeds. Alternatively, the loan may be repaid during the donor's lifetime in a lump sum or installments, from sources outside of the donor's estate. Funds to repay the loan may include an ILIT side fund to which the donor has contributed annual gifts that have been invested, or an existing trust or partnership that may have significant assets available.
5. At the end of the trust term, the ILIT assets, including death proceeds in excess of the amount required to repay the loan, are distributed to the ILIT beneficiaries free of income and transfer taxes.

[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

[2] A grantor trust is drafted in such a manner as to subject itself to the grantor trust provisions of IRC§§671-679. When a grantor enters into a transaction with a trust of which he or she is deemed the owner for income tax purposes, and therefore all items of income and deduction related to the transaction are attributed to the grantor, the result is a non-taxable event. Rev. Rul. 85-13; 1985-1 CB 194.

PRIVATE SPLIT DOLLAR

What It Is

Private split dollar is a premium sharing arrangement between a donor and an irrevocable life insurance trust (ILIT).* The donor enters into a non-equity collateral assignment agreement with the ILIT wherein the donor agrees to pay the full annual premium in exchange for a restrictive collateral assignment in the policy which entitles the donor to be repaid the greater of his/her premiums paid or the total cash value of the policy at some point in the future. As a result, the donor is able to acquire the death benefit needed with little or no gift tax impact.

The collateral assignment may be satisfied with the life insurance death proceeds or from other sources during the client's lifetime. Potentially, a return of premium rider can be used to satisfy the collateral assignment without diminishing the death benefit needed.

Private split dollar can provide a tax-efficient and cost-effective strategy to pay for life insurance.

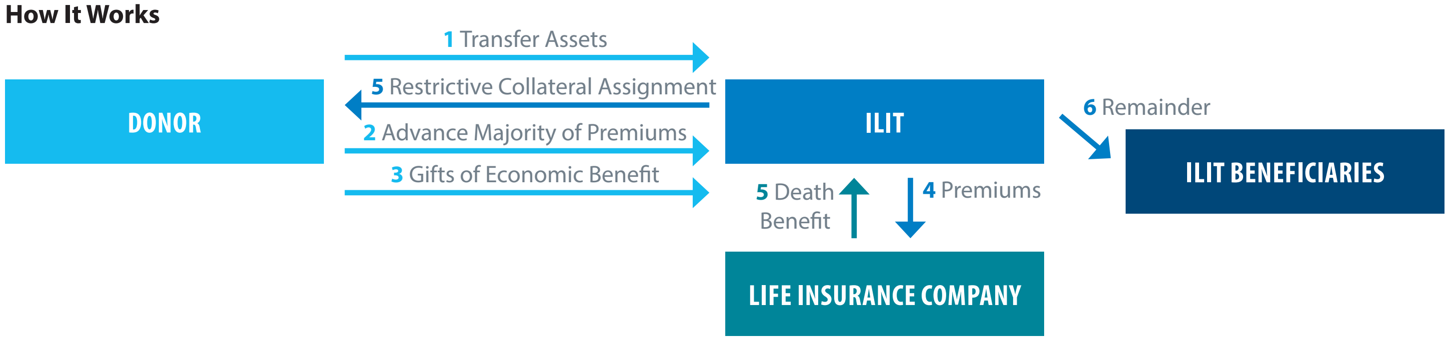
Potential Benefits

- Death benefit payable to the ILIT should pass to the trust beneficiaries free of income and transfer taxes.
- Minimize gift tax cost associated with the donor's desired level of life insurance protection.
- Annual exclusion gifts can be leveraged significantly.
- Lock in insurability now at a low gift tax cost, while maintaining flexibility to terminate or continue the plan.
- Potential ability to be repaid the greater of the premiums paid or the total cash value.

Planning Considerations

- Collateral assignment may be subject to estate tax.
- Annual term cost increases as the donor ages.
- Cash is required to fund the premiums.
- A well-planned exit strategy should be in place from the beginning.
- Must comply with 2003 Final Split Dollar Regulations.

How It Works



1. Donor creates an ILIT, the beneficiaries of which are typically the donor's family members.
2. Donor enters into a non-equity collateral assignment agreement with the ILIT wherein the donor agrees to pay the full annual premium in exchange for a restrictive collateral assignment in the policy which entitles the donor to be repaid the greater of the premiums paid or the total cash value of the policy at some point in the future.
3. Donor annually gifts the economic value of the death benefit, or "term cost," of the premiums to the ILIT.
4. ILIT purchases a life insurance policy on the donor's life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
5. At the donor's death, the collateral assignment may be satisfied from the life insurance death proceeds. Alternatively, the collateral assignment may be satisfied during the donor's lifetime from sources outside of the donor's estate.
6. At the end of the trust term, the ILIT assets, including the insurance death proceeds in excess of the amount required to satisfy the collateral assignment, are distributed to the ILIT beneficiaries free of income and transfer taxes.

*Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

SALE TO A GRANTOR TRUST

What It Is

An installment sale to a grantor trust (sale to a grantor trust, or SAGT) is an estate freeze technique that may help a donor transfer significant wealth to future generations with minimal transfer tax impact.[1] To reduce the size of his/her estate and minimize estate taxes, a donor may consider gifting highly appreciating/income-producing property (appreciating assets) to future generations.

While gifting is a simple approach and will reduce the size of the taxable estate, there is one major drawback: the gift may exceed the donor's gifting capacity and result in a taxable gift. Rather than gifting appreciating assets, a donor can sell appreciating assets to a grantor trust in exchange for an interest-bearing promissory note at the applicable federal rate (AFR). The sale "freezes" the value of the appreciating assets by converting the appreciating assets into a fixed-yield, non-appreciating asset (the promissory note).

As a result, all post-transfer appreciation and income are removed from the donor's estate. Because the trust is a grantor trust, the donor pays the grantor trust income tax liability at the donor's individual income tax rate, which means grantor trust assets effectively grow income tax-free.[2]

If the donor dies before the note is repaid, only the balance of the note is included in the donor's estate.

A portion of the income earned on the appreciating assets may be leveraged by the grantor trust to acquire a needed life insurance death benefit outside the donor's estate.

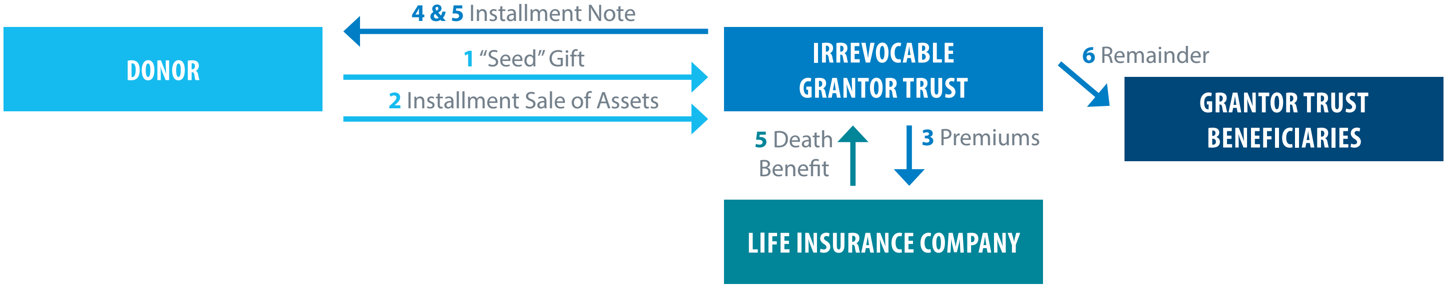
Potential Benefits

- Grantor trust assets grow income tax-free.
- Removes post-sale asset appreciation and income from the donor's gross estate.
- No income or gain is recognized on the sale of property between the donor and the grantor trust.
- Death benefit payable to the grantor trust should pass to the trust beneficiaries free of income and transfer taxes.
- Minimizes gift tax cost associated with acquiring the donor's desired level of life insurance protection.
- Flexible, attractive terms of repayment (e.g., installment loan payment can be interest only with a balloon payment, interest rate based on AFR, not the potentially higher IRC §7520 rate).
- Loan interest paid to the donor is not subject to income tax (because the donor is treated as the owner of all ILIT assets for federal income tax purposes).[3]

Planning Considerations

- Donor's annual exclusions, applicable lifetime gift tax exemption and generation-skipping transfer (GST) tax exemption may be needed to shelter the initial "seed" gift to the trust.
- The balance of the installment note at donor's death will be included in the donor's gross estate for estate tax purposes.
- Income tax uncertainty at the donor's death if promissory note remains unpaid. In that case, a number of issues arise, including whether death causes an income tax recognition event, the character of gain if recognized, and the grantor trust's basis in the asset(s) purchased from the donor.
- Grantor trust assets may not produce sufficient income or appreciation to service the note payments.
- May require the donor to make additional loans or gifts to the grantor trust in order to maintain the desired level of insurance protection.
- Loan interest paid by the grantor trust is not deductible.
- No statutory roadmap.

How It Works



1. Donor creates and funds an irrevocable grantor trust with cash or appreciating assets to "seed" the trust.
2. After the initial gift, the donor sells additional appreciating assets to the grantor trust in exchange for an interest-bearing promissory note. Grantor trust assets appreciate and/or earn income each year. The donor pays income tax annually on the income earned on grantor trust assets. Grantor trust assets effectively grow income tax-free.
3. The trustee of the grantor trust purchases a life insurance policy that may be used to pay the balance of the note and provide estate liquidity at the donor's death.
4. The trustee uses the income earned by the grantor trust assets to service the note and pay life insurance premiums.
5. At the donor's death, the loan is repaid from the death proceeds. Alternatively, the loan may be repaid during the donor's lifetime in a lump sum or installments from sources outside of the donor's estate. Funds to repay the loan may include a side fund to which the donor has contributed annual gifts that have been invested, or an existing trust or partnership that may have significant assets available.
6. At the end of the grantor trust term, death proceeds in excess of the amount required to repay the loan are distributed to the grantor trust beneficiaries free of income and transfer taxes.

[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws (including the generation-skipping transfer (GST) tax). Failure to do so could result in adverse tax treatment of trust proceeds.

[2] When a grantor enters into a transaction with a trust under which he or she is deemed the owner for income tax purposes, and therefore all items of income and deduction related to the transaction are attributed to the grantor, the result is a non-taxable event. Rev. Rul. 85-13; 1985-1 CB 194.

[3] See note above.