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Charitable Giving and the Wealth Replacement Approach

It is likely that many of your clients are charitably active – volunteering, attending fundraisers, donating money, etc. It is also likely that your clients want to do more to support a favorite charity. A key reason why they may not do as much for charity as they would like is the greater concern for their family's financial well-being. In a worst-case scenario, a too generous charitable gift could leave a family without assets they might need later. The tension between what one would like to give and what one can safely give could push your clients away from pursuing different philanthropic goals. Moreover, these potential donors lose the income or estate tax savings that a charitable gift can create.

Wealth replacement is a technique that addresses a donor's natural concern for family financial security. Wealth replacement involves a three-part approach: (1) a charitable remainder unitrust, (2) a life insurance policy, and (3) an irrevocable life insurance trust. The idea is to enable donors to fulfill their commitments to help favored causes while using the income tax savings created by the charitable deduction plus the income payout from the charitable remainder unitrust to acquire life insurance to replace the assets transferred to charity. Wealth replacement is a strategy that provides assurance as a donor meets philanthropic goals.

WEALTH REPLACEMENT BASICS

The first step of the wealth replacement technique involves the transfer of cash or long-term, appreciated property to a charitable remainder unitrust (CRUT). The trust provides for annual (or more frequent) payouts to the donor, and perhaps also to a surviving spouse, for life or a fixed term not to exceed 20 years. A CRUT usually is preferred over a charitable remainder annuity trust (CRAT) because the CRUT can receive additional contributions after the initial transfer of assets.

The next step is to establish an irrevocable life insurance trust (ILIT). The trustee of the established ILIT purchases a life insurance policy on the donor's life with a death benefit approximate to the value of the assets transferred to the CRUT. In order to pay the premiums on the life insurance policy, the grantor has the option to use the income payouts from the CRUT, along with the tax savings created by the charitable deduction, to make annual gifts to the ILIT in amounts sufficient to enable the trustee of the ILIT to pay those premiums.

NOTE: It is possible that an ILIT may not be necessary if the grantor does not expect to have an estate tax problem – an advantage because of the reduced cost. Instead, the adult children could simply own the life insurance policies.

In Detail: The Charitable Deduction

The present value of the charity's remainder interest is generally deductible as a charitable contribution in the year the property is transferred to the CRUT [IRC Sec. 170(f)(2)]. If a sale of the transferred property on the date of the gift would have resulted in a long-term capital gain, the deduction is subject to the 30-percent-of-AGI limitation [IRC Sec. 170(b)(1)(C)(i); Reg. Sec. 1.170A-8(d)(1)], with a five-year carryover of any excess deduction [IRC Sec.170(b)(1)(C)(ii); Reg. Sec. 1.170A-10(c)]. If cash is used to fund the CRUT, the deduction limitation is 50 percent of AGI [IRC Sec. 170(b)(1)(A)].

There is no capital gain when appreciated property is transferred to the CRUT. And because the trust is income tax-exempt, there is no capital gain when the trust sells the property and reinvests the proceeds. However, capital gains realized inside the trust will be subject to the four-tier system, so the income beneficiary (donor or third party) may have to characterize CRUT distributions as capital gains when trust distributions are made.

In Detail: Funding the Life Insurance Policy

The donor makes annual gifts of cash or appreciated property to the ILIT to enable the trustee to purchase and pay the

premiums on an insurance policy on the donor's life. "Crummey" withdrawal powers are used to qualify these gifts as present interests eligible for the gift tax annual exclusion [IRC Sec. 2503(b); *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321]. Crummey powers give the beneficiaries of the ILIT a right to demand a distribution of these annual gifts for a limited period each year, say for 30 days, after each addition is made to the trust. Provided the beneficiaries decline to exercise these powers, the trustee will have the funds to pay premiums until such time as the policy becomes self-supporting.

In Detail: Distribution from the ILIT and CRUT

At the donor's (or surviving donor's) death, the life insurance death proceeds are paid into the ILIT, where they are administered by the trustee and eventually distributed to the donor's beneficiaries in accordance with the trust terms. Meanwhile, at the expiration of the income interest in the CRUT, usually upon the death of the donor or surviving spouse, the remaining balance of the trust is paid to the designated charitable remainderman.

WEALTH REPLACEMENT IN ACTION

The result: the donor has provided a significant gift to charity while maintaining the size of the original estate for family members. Let's take a look at an example.

Edward and his wife Helen, ages 70 and 68, own appreciated stock held for the long-term and valued at $500,000. The stock has a cost basis of $100,000. In total, Edward and Helen have accumulated $9 million of assets. Note that the survivor will have an estate tax problem even with the phased-in higher exemption (unless he or she is "fortunate" enough to die in 2010, when the federal estate tax is scheduled to be repealed for one year).

They decide to donate this stock to a charitable remainder unitrust (CRUT), which will pay them five percent of the annually revalued principal in quarterly installments for their joint lifetimes, with the remainder to a designated charitable organization. Based on the initial valuation, they will receive a quarterly trust payout of $6,250 or a total of $25,000 during the first year.

Edward and Helen will receive an income tax charitable deduction in the year the CRUT is established, based on the applicable federal interest rate (AFR) at the time of the transfer, and subject to the 30 percent limitation and the five-year carryover. If we assume an AFR of 5.0 percent, their deduction will be $203,910, which is the present value of the charity's remainder interest in the CRUT. A $203,910 deduction will save them $71,369 in federal income taxes in their 35 percent marginal bracket. Moreover, they will not pay the capital gains tax that would be levied on a current sale of the appreciated stock, and will pay tax on the gains realized inside the CRUT only as it is deemed to flow out to them under the tier system.

With the tax savings from the charitable deduction and the income payout from the CRUT, Edward and Helen expect to have more than enough left to pay the annual premiums on a $500,000 second-to-die life insurance policy on their lives, depending on the issuer and specific product, with income left over to augment their retirement income. (Note: In a second marriage situation, it will often be desirable to use a single-life policy.) The $500,000 second-to-die policy will be applied for and owned by an irrevocable life insurance trust (ILIT) which they have established for the benefit of their three children. Since they have never held any incidents of ownership in the policy, it will be excluded from their gross estates for federal estate tax purposes. More wealth will be available for the benefit of their children than would have been the case if the stock had been held and passed under their wills and taxed in the survivor's estate.

Edward and Helen will donate cash or stock annually to the ILIT for the premiums on the second-to-die policy held in trust. The children, as ILIT beneficiaries, hold Crummey withdrawal powers, which qualify the annual gifts to the trust for the gift tax annual exclusion, currently set at $12,000 per donee for 2008 (indexed for later years), or $24,000 with gift-splitting. Thus, Edward and Helen can avoid making a string of taxable gifts as each transfer is made to the ILIT.

Upon the death of the survivor of Edward and Helen, the income interest in the CRUT will terminate and the trust principal will be paid to the charitable remainderman. At the same time, the life insurance proceeds will be paid into the ILIT and will be disposed of for the benefit of the children as provided in the trust instrument.

SUMMARY OF THE ADVANTAGES OF WEALTH REPLACEMENT

Let's review what Edward and Helen have accomplished with the wealth replacement technique. They were able to:

- Fulfill their dream of making a major gift to charity without reducing the inheritance of their children.

- Use the untaxed appreciation in their stock to generate a current economic benefit in the form of a charitable deduction.
- Replace a property that produces little or no income with a life income gift that produces an income payout that is substantially greater.
- Reduce investment risk by selling one asset within the trust and replacing it with a diversified portfolio.
- Receive an immediate federal income tax deduction of $203,910 in the year the stock is transferred to the CRUT. Subject to the 30 percent limitation, this deduction will save $71,369 in their 35 percent tax bracket. This federal income tax deduction can be carried over for up to five additional years if the entire deduction cannot be used in the year the CRUT is established.
- Use the income tax savings and the annual payouts from the CRUT to pay the annual premiums on the life insurance policy, with income left over to supplement their retirement income.
- Avoid the federal gift tax on the annual transfers to the ILIT through the strategic use of Crummey withdrawal powers.
- Remove both the property transferred to the charity and the life insurance proceeds from their gross estates for federal estate tax purposes.
- Provide creditor protection for their three children by having the life insurance proceeds paid into an ILIT and paid out for the children's benefit as described in the trust instrument.

One last and very important point: The life insurance death proceeds usually will be received federal income tax-free by the ILIT.

SOME PITFALLS TO AVOID

1. The donor could purchase the life insurance policy, then transfer it to the ILIT. But, under this scenario, the death proceeds would be includible in the donor's gross estate if he or she died within three years of the transfer [IRC Sec. 2035(a)(2)] or if the donor retained some string on the policy that was an incident of ownership [IRC Sec. 2042(2)]. The safer course is to have the ILIT apply for, own, and pay the premiums on the policy.

2. There are various ways in which the validity of Crummey powers can be jeopardized. For example, if the trust beneficiaries are given only a very brief time in which to exercise their withdrawal powers, the IRS may view such powers as illusory. Some authorities recommend a minimum 30-day period before the powers lapse. Also, some authorities believe the ILIT trustee should give formal, written notice of withdrawal rights to the beneficiaries each year.

3. When the premium payment is substantial, there may not be enough beneficiaries to shelter the annual transfers to the trust under the gift tax annual exclusion. Grantors have tried to get around this by "manufacturing beneficiaries" who have no rights in the trust except the Crummey powers. The IRS has attacked this practice in letter rulings.

However, the IRS received something of a setback in *Estate of Maria Cristofani v. Comm'r* [97 T.C. 74 (1991)]. The Tax Court ruled that the unexercised rights of withdrawal by several beneficiaries allowed additions to the trust to qualify for the gift tax annual exclusion. The IRS later acquiesced in the result in *Cristofani* [Action on Decision 1992-09, 1992-1 C.B. 1 and Action on Decision 1996-10, 1996-2 C.B. 1], but has indicated that it will continue to press the issue. Specifically, the IRS will seek to deny exclusions when (1) the Crummey power holders have no other interests in the trust, (2) there is a prearranged understanding that the powers will not be exercised, or (3) the withdrawal rights are not in substance what they purport to be in form [TAM 9628004, Action on Decision 1996-10]. To be safe, beneficiaries should have some other interest in the trust besides their Crummey withdrawal powers.

4. It can be fatal to the arrangement for the donor to serve as trustee of the ILIT. The control the donor could exercise over the beneficial enjoyment of the trust, even though exercisable only in a fiduciary capacity, will jeopardize a key part of the ILIT strategy: to keep the life insurance proceeds out of the gross estate of a donor who expects to be subject to the estate tax.

5. The wealth replacement technique is not a panacea for all client situations. For example, if the donor is a substandard insurance risk, premium rates on the life policy may be higher than the CRUT payout. The efficacy of the arrangement hinges on supporting the policy from the income paid out by the CRUT as well as the donor not needing the CRUT distribution to live on.

New Tax Developments

Early Termination of CRT Not Self Dealing

A married couple established a Charitable Remainder Unitrust with a Net Income Makeup provision (NIMCRUT). However, after more than a year, the couple wanted to terminate the trust. They wanted the trustee to divide the assets between the non-charitable beneficiaries and the charity based on the actuarial value of the non-charitable beneficiaries' income interest. The grantors would assign their interest to the charity; the charity would then make a lump sum payment to the couple. The problem centered on consequences of the early termination of the NIMCRUT as a sale of an income interest by the grantors. Namely, would the sale be considered an act of self-dealing subject to an excise tax under IRC Sec. 4947? What would be considered the gain from the sale? And, how should that gain be treated for tax purposes?

The IRS answered as follows:

- The sale would not be considered an act of self-dealing because the distribution to the couple is equal to the value of the income interest and the charity is a qualified public charity, not a private foundation [T. Reg. 53.4947-1(c)(2)(i)].
- To determine the gain, the disposition of a term interest in property has no basis. IRS Sec. 1015]. No basis means the entire amount is taxable gain.
- Because the trust held the property for more than one year, the amount is treated as long term capital gain.

The IRS did note several important factors: state law permitted early termination of the NIMCRUT; the couple passed a physical with good health; and the charity would take both the income and remainder interest in the trust so there would no longer be a split interest.

Source: PLR 200733014

A Split Interest Trust Fails to Qualify for a Charitable Deduction

Decedent Anthony J. Tamulis, a Catholic priest, left an estate of $3.4 million. Upon his death, the revocable trust (the primary dispositive document) established a trust to last for either ten years or the joint lives of the decedent's brother and sister-in-law (whichever time period was longer). During that period, income would be paid to various family members. At the completion of the trust, the remainder would go to charity. The executors claimed a $1.5 million charitable deduction on the estate tax return. The return described the charitable deduction as "the residue following ten year term certain charitable remainder unitrust at 5% quarterly payments…"

Unfortunately, the form of this split interest trust was neither a fixed annuity nor a unitrust interest. And, doubly unfortunate, the executor did not reform the split interest trust in a timely manner as allowed under IRC Sec. 2055(e)(3)(C)(iii).

The Seventh Circuit affirmed the Tax Court in denying a charitable deduction. The Court rejected the argument that the trust had substantially complied with the requirements for a split interest trust under IRC Sec. 664. Instead, the Court noted that the executor had not taken the simple steps required for reforming the trust within the statutory deadlines.

Even though the executor had tried to file a petition to reform the trust and was thwarted by the refusal of a trust beneficiary to sign onto the petition as required under state law, the Court refused to accede to the use of the doctrine of substantial compliance.

Source: Estate of Tamulis v. Commissioner, No. 06-4141 (7/29/07), aff'g T.C. Memo. 2006-183

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