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THE Good Advisor

The Story of Philanthropy

The *StoryCorps* Mission:
"To remind one another of our shared humanity, to strengthen and build the connections between people, to teach the value of listening, and to weave into the fabric of our culture the understanding that everyone's story matters."

For more than a decade, *StoryCorps* has recorded ordinary people sharing compelling stories about their lives.[1] Over 100,000 of these recordings are archived in the American Folklife Center of the Library of Congress. All are available to anyone who wants to listen to them—and many people do. We like hearing other people's stories, even when they're tinged with sadness, because it reminds us of our shared humanity. That's why we find *StoryCorps* touching.

StoryCorps' mission might also resonate with professionals dedicated to furthering the charitable interests of clients, since client stories provide a context for the technical solutions we propose. Life stories connect us to clients and to the charities that can fulfill our clients' most heartfelt wishes to leave a legacy and make a difference.

In this issue of ***The Good Advisor*** we present the fictional story of Dr. Keller—a dedicated professional who, though inspired to give, is hesitant to decrease his children's inheritances. For two more case studies, access an in-depth version of The ***Good Advisor*** at www.catholicfoundation.com.

The Case of Dr. Keller: Wealth Replacement

Often, donors want to make a substantial gift to charity but feel constrained by concerns about their family's financial security. A technique called wealth replacement (also known as capital replacement) provides a solution. In a nutshell, here's how it works.

A donor:

- Funds a charitable remainder unitrust (CRUT) with appreciated property
- Establishes an irrevocable life insurance trust (ILIT) with a life insurance policy
- Uses annual CRUT income to make gifts to the ILIT for premium payments
- Names the charity that will receive the CRUT remainder at the donor's death
- Designates heirs to receive the life insurance proceeds from the ILIT

Let's see how Dr. Fritz Keller uses this technique.

Competing Goals

Dr. Fritz Keller, 67, is a prosperous oral surgeon and decorated Vietnam veteran. His wife, Jen, is a retired accountant. Their sons, Ronald and Phillip, followed in their father's footsteps by joining the military, where Phil continues a successful career. Unfortunately, Ron was not so lucky—he was severely injured during his last tour of duty in Afghanistan and has since retired. Both are married with children. They will undoubtedly earn far less in their lifetimes than their father did in his. The Kellers want to leave their sons with as much of their $14 million estate as possible to help them support their growing families.

Still, Dr. Keller continues to have a compelling interest in the lives and concerns of his military comrades, and the Kellers have a strong desire to give back by contributing substantially to select veteran-focused charities. A completed gift during the current year would not only be personally satisfying, it would reduce the amount of income tax the Kellers owe. However, they remain concerned about gifting assets, as their sons may need

the money for support, emergencies, or their children's college tuition. The Kellers are particularly concerned about the ongoing medical expenses Ron faces as a result of his military injuries.

Putting Together a Plan

The Kellers meet with their financial advisor, Thomas Sloane, who introduces them to the concept of wealth replacement. They are thrilled to find a way to reduce income and/or estate taxes, make significant charitable contributions, and still provide their sons with an identical inheritance amount. With Thomas' help, the Kellers take the following steps to implement this plan.

Establish a CRUT. They transfer $1 million in long-term appreciated securities (with a cost basis of $300,000) into a charitable remainder unitrust (CRUT). They briefly considered a charitable remainder annuity trust (CRAT), but the CRAT didn't allow additional contributions. They select to receive 5% of the trust assets annually for both of their lives, and choose three charities to share equally in the remaining assets at the end of the trust term.

The Kellers appreciate the benefits of this arrangement:

- **They receive a charitable deduction of $387,320—** the present value of the charity's remainder interest, based on the 2% applicable federal rate (AFR) at the time of the transfer. This deduction is subject to the 30% limitation.[2] If they can't use it all in one year, they have five years to use the rest. In their 39.6% marginal tax bracket, this deduction will save them $153,378 in federal income taxes.
- **They avoid paying $140,000 in capital gains tax** by transferring their $1 million appreciated stock to the CRUT instead of selling it ($700,000 appreciation taxed at a 20% rate). The savings are even greater when they factor in the 3.8% Medicare surtax.
- **They pay tax on gains inside the trust only as funds are distributed.** Because the trust is income tax exempt,[3] the trust does not owe capital gains tax when the trustee sells the stock and reinvests the proceeds. The Kellers pay tax on capital gains inside the trust only as those gains are paid out. (Gains are taxed under the four-tier system, which mandates that the trust pays out the highest taxed income or gain first.)[4]

Create an ILIT and purchase a life insurance policy. The central idea of wealth replacement is to "replace" the assets transferred to the CRUT with life insurance proceeds, so the Kellers, who are in good health, purchase a second-to-die life insurance policy. But since their estate will likely be subject to federal estate tax, they wisely choose not to purchase the policy personally. Instead, they establish an irrevocable life insurance trust (ILIT) which will purchase and own the $1 million policy. Ron and Phil are the beneficiaries of the ILIT and will receive the proceeds under the trust terms. The ILIT keeps the life insurance policy out of the Kellers' gross estates for federal estate tax purposes,[5] and also provides protection from creditors, in case that becomes an issue in the future.[6] The income tax deduction from the CRUT helps the Kellers balance out the life insurance purchase, and they can use the CRUT distributions each year to pay the premiums (the initial year's $50,000 distribution will not remain constant since future distributions will vary from year to year as trust assets are revalued to account for gains and losses).

CRATs and CRUTs—A Refresher

A gift of a partial interest does not typically qualify for the income tax, gift tax or estate tax charitable deduction. CRTs offer an exception to this "partial-interest rule." A CRT is an irrevocable trust wherein the donor receives trust income for life (or for a period of up to 20 years) and after this term, the trust corpus is distributed to charity. The payout period may last for more than one life, but the present value of the charitable remainder must be 10% or more of the initial value of the property placed in trust.

Charitable remainder trusts come in two forms—charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). The major difference is in the payments to the donor. CRATs pay a specified percentage of the initial value of the trust assets, meaning each payment is the same amount. CRUTs pay a specified percentage of the annually revalued trust assets, allowing the payment to vary each year with any increase or decrease in the trust principal. In either case, the percentage must be at least 5% and not more than 50%, and the payments must be made at least annually.

Grant Crummey powers. When the Kellers make annual gifts to the ILIT to enable the trustee to pay the insurance premiums, those gifts are subject to the federal

gift tax—unless they qualify as gifts of a present interest. To make sure they qualify, Dr. Keller grants "Crummey powers" to Ron and Phil,[7] giving each son the right to take a distribution of these annual gifts for a limited time after each addition to the trust (say, 30 days). Provided Ron and Phil choose not to exercise these powers, the trustee will use the funds to pay the life insurance premiums. Thanks to the Crummey powers, the annual gifts qualify for the gift tax exclusion ($14,000/child in 2015, or $28,000/child with gift splitting).

Analyzing Results

After the Kellers pass away, the life insurance proceeds will flow into the ILIT for distribution to Ron and Phil, and the CRUT will pay out its remaining balance to the charities. Ron and Phil may even inherit more wealth than if they had inherited the appreciated stock under their parents' wills, where it would have been subject to estate tax when the second parent died.

The Kellers were able to:

- Fulfill their dream of making major gifts to three meaningful charities without reducing their children's inheritance
- Turn the untaxed appreciation in their stock into a current economic benefit in the form of a charitable deduction of $387,320
- Use the income tax savings and the CRUT payouts to fund premiums on a life insurance policy, with income left over to supplement their retirement income
- Avoid federal gift tax on the annual transfers to the ILIT through the strategic use of Crummey powers
- Remove both the assets transferred to the charity and the life insurance proceeds from their gross estates for federal estate tax purposes
- Provide protection from creditors by using an ILIT

Listening Can Be Crucial

The *StoryCorps* archive catalogues recordings on subjects ranging from family and growing up, to Hurricane Katrina and September 11, to legacies, the military—even the loss of memory itself. Each story is unique, just as each donor is unique, with his or her own history, motivation and combination of assets. Listening to and learning from individual stories can be the crucial step in helping clients realize financial security and life-long dreams.

Endnotes

1 *StoryCorps* is regularly broadcast on many public radio stations. See storycorps.org.

2 If the Kellers had used cash to fund the CRUT, the deduction limitation would have been 50% of AGI. The 30% and 50% limits apply to gifts to public charities—different limits apply to gifts to private foundations. See IRC §170(b) and the regulations thereunder.

3 The trust is income tax exempt unless it has unrelated business taxable income (UBTI).

4 As long-term capital gains realized inside the trust are distributed under the four-tier system, the income beneficiaries report capital gains at the rate determined by their tax bracket—20% for the Kellers, but donors with lower income may be eligible for a rate of 15%, or even 0%. See IRC §664(b) and regulations thereunder.

5 If a donor purchases a life insurance policy and transfers it to an ILIT, the death proceeds are still includible in the donor's gross estate if the donor dies within three years of the transfer or retained any incidents of ownership [IRC §2035(a)(2) and IRC §2042(2)]. If the ILIT applies for, owns, and pays the premiums on the policy, the donor should not serve as trustee.

6 An ILIT is unnecessary if the donor does not expect to be subject to the estate tax and/or sees no need for protection from creditors.

7 IRC §2503(b); *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968); Rev. Rul. 73-405, 1973-2 C.B. 321.
Caution – trustees must give beneficiaries written notice of withdrawal rights each year and offer a minimum of 30 days in which to exercise their withdrawal powers.

Access more information now!

An electronic copy of our in-depth campanion booklet with two additional case studies on gifts of retirement assets and charitable gift annuities may be accessed in the Professional Advisor section of our webite at: www.catholicfoundation.com.

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