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The Journal of Wealth Management for Estate-Planning Professionals—Since 1904



This Jean Dubuffet sculpture sold at a private sale for about \$2.2 million, p. 6.

July 2004

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The Frozen T-CLAT

An innovative technique gives clients use of their assets even as they reduce transfer taxes and leave money to charity. Here's how

How would you like to offer your well-to-do clients an estate plan that eliminates or significantly reduces estate taxes and generation skipping taxes (GST) while providing the family with immediate use of the assets and creating a significant charitable legacy? This is not a pie-in-the-sky goal. It can be achieved by meshing disparate planning techniques.

The basic plan utilizes a testamentary charitable lead annuity trust (CLAT), a family limited partnership (FLP), a dynasty trust, a family private foundation (PF) and a post-death installment sale producing a promissory note (a frozen asset) to fund the CLAT. (See, "Sample Structure," p. 34)

Though the technique is not executed until after death, certain steps must be taken during a client's lifetime. For illustration purposes, let's assume a client owns both a limited partnership interest in an FLP and a minority membership interest in the general partner (GP) of the FLP.

(1) Create in the will or revocable trust a formula CLAT. We have no control over the 7520 rate that applies upon death of the taxpayer. If the rates rise significantly from their present levels, this technique may become less attractive—though not necessarily if investment returns increase as well. The dispositive documents could be drafted so that, in the event significantly higher 7520 rates are in effect when the taxpayer

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dies, the T-CLAT plan could be modified or even aborted.

(2) Create and fund an irrevocable dynasty trust for the benefit of future generations. Allocate a sufficient GST exemption to produce a zero inclusion ratio. In many instances, such a trust already may be in place from other planning (for example, a life insurance trust or intentionally defective trust used for lifetime sale transactions).

(3) Have the client and trustee of the dynasty trust enter into an option agreement that grants the dynasty trust the right to acquire the FLP and GP interests owned by the client (either directly from the probate estate or from the revocable trust) at a purchase price equal to the fair market value of such interests as determined for federal estate tax purposes.¹ As an alternative, the FLP could enter into a post-death complete redemption agreement funded with a promissory note, thereby leaving the owners of the other FLP interests as the sole owners.

Payment of the purchase price is evidenced by a promissory note providing for equal annual payments of principal

and interest over the same term as the CLAT. As a sale, the minimum required interest rate on the note is controlled by Internal Revenue Code Section 1274. The interest rate on the note should typically exceed the 7520 rate used in calculating the charitable lead annuity to provide sufficient assets to pay trustee and accounting fees each year. The interest rate on the promissory note should be for whichever is greater, the 7520 rate or the Section 1274 rate. If the duration of the loan is greater than nine years, it is likely that the Section 1274 rate will apply.

(4) Designate a CLAT beneficiary. Usually, this will be a private foundation, but a fund established through a community foundation or other public charity can be used if the client prefers to operate without a private foundation. The plan can be streamlined—by eliminating the CLAT and distributing the note directly to the PF or other charitable entity—and still produce the same transfer tax result. With a PF, however, the required annual distribution will be based upon the fair market value of the PF assets, including the full value of the note, resulting in a

front-loading of distributions and retarding the ability to build up the PF asset base over the term of the CLAT. Although the CLAT is not exempt from income taxation, it is entitled to an unlimited charitable deduction, so there should be no undistributed taxable income in the CLAT in any year of its term.²

SELF-DEALING RULES

A CLAT is considered a private foundation, subject to the rules contained in IRC Section 4941. The relevant document must contain specific prohibitions against the trustee engaging in prohibited activities (or the trustee must be subject to those prohibitions under state law)³ These so-called self-dealing rules prohibit: (1) direct or indirect sales, exchanges or leases of property between the CLAT and a disqualified person; (2) lending money or extending credit between the CLAT and a disqualified person; (3) furnishing goods, services or facilities or payment of compensation or reimbursing expenses by a CLAT to a disqualified person; and (4) transferring to, or using for the benefit of a disqualified

SAMPLE STRUCTURE: HOW THIS STRATEGY WORKS

REVOCABLE TRUST FLP
Liquidation Value \$10 million
Fair Market Value \$6.5 million

99% of FLP → **FUNDED DYNASTY TRUST**

→ \$6.5 million promissory note payable over 15 years with annual payments of \$576,030 to fully amortize debt

↓ Promissory Note \$6.5 million with payments of \$576,030

CHARITABLE LEAD TRUST
15 years of payments of \$576,030 based upon 7520 rate of 4 percent
= 0 value for remainder interest and a \$6.5 million charitable deduction
Total to charity = \$8,640,450

→ - 0 -
Payment to grandchildren at end of CLAT
Each year lead trust receives \$576,030 payment on note and pays charity an equal amount

OPTION AGREEMENT TERMS
A revocable trust sells FLP units to a dynasty trust for a 100 percent note, with annual payments equal to the amount required to pay to charity each year from a charitable lead trust. At the end of 15 years, the result will be a zero remainder value, based on the 7520 rate for month of death.

YEAR	0	4%	6%	8%	10%	12%
0	\$10,000,000	\$10,000,000	\$10,000,000	\$10,000,000	\$10,000,000	\$10,000,000
1	9,823,966	10,023,966	10,223,966	10,423,966	10,623,966	10,823,966
2	9,640,891	10,049,371	10,465,850	10,890,329	11,322,809	11,781,649
3	9,450,494	10,076,299	10,727,085	11,403,329	11,806,512	12,262,466
4	9,252,480	10,104,844	11,009,218	11,967,628	12,322,140	12,784,223
5	9,046,545	10,135,101	11,313,922	12,588,357	12,883,963	13,347,980
6	8,832,374	10,167,173	11,643,002	13,271,159	13,487,736	13,953,747
7	8,609,635	10,201,170	11,998,408	14,022,242	14,132,504	14,601,515
8	8,377,987	10,237,207	12,382,247	14,848,432	14,917,272	15,292,283
9	8,137,073	10,275,406	12,796,793	15,757,242	15,752,042	16,027,051
10	7,886,522	10,315,896	13,244,503	16,756,933	16,756,933	16,806,820
11	7,625,949	10,358,817	13,728,030	17,856,592	17,856,592	17,631,589
12	7,354,954	10,404,312	14,250,239	19,066,218	19,066,218	18,502,358
13	7,073,118	10,452,537	14,814,224	20,396,806	20,396,806	19,418,127
14	6,780,009	10,503,656	15,423,329	21,860,453	21,860,453	20,378,896
15*	6,475,384	10,577,804	16,080,712	23,469,366	23,469,366	21,483,665

Ending balances based upon annual rates of return as indicated

	4%	6%	8%	10%	12%
LESS DEFERRED CAPITAL GAINS TAX	\$282,552	\$885,943	\$1,857,377	\$3,276,284	\$5,236,858
NET AMOUNT TO 3RD GENERATION W/LEAD TRUST OPTION	6,192,832	9,671,862	14,223,335	20,193,082	28,011,189
BASELINE - NET OF DEFERRED CAPITAL GAINS TAX**	8,539,408	11,076,715	14,376,073	18,646,713	24,149,986
ADVANTAGE/DISADVANTAGE OF CLAT***	(2,346,576)	(1,404,853)	(152,738)	1,546,369	3,861,203

BASELINE ASSUMPTIONS
FLP interest valued at \$6.5 million net of a 35 percent discount is transferred at death directly to the grandchildren and subject to estate and GST taxes at death. The after-tax proceeds are assumed to be reinvested for 15 years.

BASELINE TO GRANDCHILDREN NET OF DEFERRED GAINS

	4%	6%	8%	10%	12%
4%	\$8,539,408				
6%	11,076,715				
8%	14,376,073				
10%	18,646,713				
12%	24,149,986				

*Total assets remaining in the dynasty trust using option sale to lead trust.
**Baseline if no lead trust and all to grandchildren with net proceeds invested for 15 years.
***Net benefit or (detriment) based upon projected rates of return over 15 years as compared to baseline.

NOTE: Actual payments should exceed the zeroed-out rate to take into account administrative expenses so there will be less left in FLP than indicated above.

person, the income or assets of the CLAT.⁴

For purposes of the self-dealing rules, a disqualified person is: (1) a substantial contributor, (2) a foundation manager, (3) an owner of more than 20 percent of the voting power of a corporation or the profits interest of a partnership or the owner of the beneficial interest of such a trust; or (4) a corporation or partnership in which the ownership interests of such people are more than 35 percent of the combined voting power, profits interest or beneficial interest.⁵ A foundation manager is an officer, director, trustee or responsible employee.⁶ An individual's family includes a spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of such descendants.⁷ In our transaction, the dynasty trust is therefore a disqualified person.

An exception to the direct self-dealing rules applies to sales of assets out of an estate or trust of a decedent during a reasonable period of initial administration and before the CLAT is funded.⁸ If the sale occurs during this initial time frame, there is no prohibited transaction. But the indirect self-dealing prohibitions could apply to the sale or the extension of credit—unless certain conditions spelled out in the regulations are satisfied. Regulation 53.4941(d)-1(b)(3) creates an exception to the indirect self-dealing rules if these criteria are met:

- The trustee of a revocable trust (including a trust that has become irrevocable due to the grantor's death) has the power to sell the property, reallocate the property to another beneficiary, or is required to sell the property under the terms of any option;
- Such transaction is approved by a court having jurisdiction over the trust;
- Such transaction occurs before the trust is considered to be subject to IRC Section 4947,⁹ and
- The trust receives an amount that equals or exceeds the fair market value of the trust's interest in the property sold and results in the trust receiving an asset as liquid as the one sold, the CLAT receiving an asset related to the execution of its exempt purposes, or is required under the terms of any option that is binding on the trust.

The regulations also extend the exception to the self-dealing rules to a note received in a sale transaction that satisfies the binding option exception.

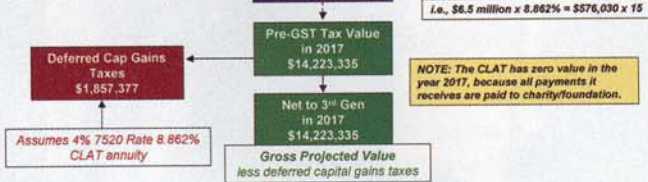
HOW FROZEN T-CLAT FUNDS CAN INCREASE

ASSUMING 8 PERCENT GROWTH AND INCOME

John Doe 2 percent Income – 6 percent growth compare to direct skip to GC

Testamentary GST-CLAT – Transfer to Third Generation

On the basis of current assumptions, using a frozen T-CLAT structure is projected to produce a net **after-tax disadvantage of \$152,738** in the year 2017. The baseline is \$14,376,073 (net of deferred gains), not including the annual distributions to charity.

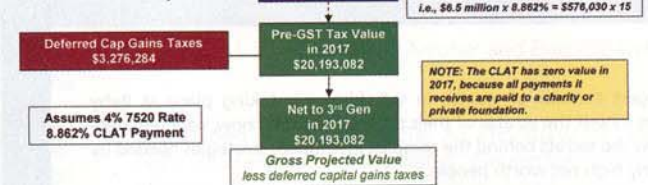


ASSUMING 10 PERCENT GROWTH AND INCOME

John Doe 2 percent Income – 8 percent growth compare to direct skip to GC

Testamentary GST-CLAT – Transfer to Third Generation

On the basis of current assumptions, using a frozen T-CLAT is projected to produce a net **after-tax advantage of \$1,546,369** in the year 2017. The baseline is \$18,646,713 (net of deferred gains), not including the annual distributions to charity.



ASSUMING 12 PERCENT GROWTH AND INCOME

John Doe 2 percent income – 10 percent growth compare to direct skip to GC

Testamentary GST-CLAT – Transfer to Third Generation

On the basis of current assumptions, using the frozen T-CLAT structure is projected to produce a net **after-tax advantage of \$3,861,203** in the year 2017. The baseline is \$24,149,986 (net deferred gains), not including the annual distributions to charity.



NOTE: Software used to compute the information in the flowcharts is published by Wealthtec, www.wealthtec.com



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CHARITABLE GIVING

RISKS AND BENEFITS

The T-CLAT can be a dynamic planning device under appropriate circumstances. Certainly, the client needs to have a sufficient level of charitable interest. While the opportunity to leverage the transaction with a discounted asset makes the economics more attractive, the discount is not absolutely critical, and the transaction may work without it.

Before adopting this plan, a client should be aware of its potential benefits and risks. Depending upon economic performance during the term of the T-CLAT, it is possible that providing an outright GST gift to family members could result in greater assets passing to grandchildren than they would receive under the T-CLAT. But if the economic performance of the assets significantly exceeds the applicable 7520 rate, there is a potential for grandchildren to receive greater distributions using the T-CLAT and for the family to benefit from significant funds in their charitable foundation.

There is no substitute for performing a numerical analysis and comparing the results with either alternative planning or no planning. It also helps to be an economic optimist. |

Endnotes

1. Carlyn S. McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 U. Miami Philip E. Heckerling Inst. On Est. Plan., 400(1999); See also, Tech. Adv. Memo. 200245053 (July 31, 2002), which concludes that a formula adjustment clause used in connection with a sale of a limited partnership interest is ineffective for gift tax purposes.
2. See Matthew J. Madsen, "Funding a CLAT With a Note Can Accelerate The Transfer of Wealth To Heirs," 30 *Est. Plan.* 495 (October 2003) for a discussion on funding a CLAT with a note.
3. IRC Section 4947 (a)(2) generally provides that Section 4941 applies to CLATs as if such trusts were private foundations.
4. IRC Section 4941(d).
5. IRC Section 4946(a)(1).
6. IRC Section 4946(b).
7. IRC Section 4946(d).
8. Treasury Reg. Section 53.4941 (d)-1. See Private Letter Rulings 200232033, 200124029, 200024052.
9. A revocable trust is subject to Section 4947 after a reasonable period of administration. See Reg. 53.4947-1(c)(6)(iii).

BUILDING BLOCKS

Among the elements needed to construct a frozen T-CLAT plan are a CLAT and a FLP

CLATS

Charitable lead trusts are a well known planning technique¹ that gained wide notice after the death of Jacqueline Kennedy Onassis. Her will made alternate provisions for such a trust, though her charitable lead annuity trust (CLAT) was never implemented.² CLATs gained even greater use in recent years as the applicable federal rate (AFR) dropped to historic lows.³ For assets to be left for a family, the CLAT needs to outperform the applicable AFR at the date of death. The lower the AFR, the greater likelihood of outperforming it.

Charitable lead trusts take two basic forms: the CLAT and the charitable lead unitrust (CLUT).⁴ The CLAT provides for the payment of an annuity amount that must be determinable at the trust's inception, for a term measured either by years, individual lives or a life or a combination thereof. The annuity amount must be paid to a qualified charity (or charities) either designated in the instrument or selected by the trustee.⁵ At the end of the lead term, any remaining assets typically pass to the next generation. The CLUT differs from the CLAT in its calculation of the annuity amount, which is stated as a percentage of the net fair market value of the CLUT assets, recalculated annually.

With a CLAT, any future appreciation (or depreciation) in the trust assets inures solely to the benefit (or detriment) of the remainder beneficiaries. In a CLUT, both the charitable lead interest and the remainder beneficiary share in the appreciation or depreciation of trust assets.

A CLAT can be structured through a formula in the trust document to produce a zero remainder value and a 100 percent estate-tax charitable deduction. (See, "Sample Structure" p. 34). In contrast, a CLUT can never be structured to produce a zeroed-out remainder value.

Finally, for the purposes of the generation skipping tax (GST), it can be difficult to plan an allocation of a GST exemption to a CLAT, because the Internal Revenue Code requires a look-back at the end of the charitable lead term. On the other hand, you can make an allocation of a GST exemption to a CLUT at the inception of the trust, based upon the then actuarially-determined value of the remainder interest.⁶

There are three primary variables used to calculate the values of the charitable lead and remainder: The applicable 7520 rate, which is derived from the AFR, the annuity amount and the lead term. The 7520 rate is the lower of the rates for the month in which death occurred or the two preceding months. To create a zeroed-out formula, begin with the applicable 7520 rate, then either (1) specify a trust term

or (2) specify an annual annuity payment. If a specific trust term is chosen, calculate the required annuity payment necessary to zero out the remainder value. If choosing an annuity payment, solve for the required minimum lead term necessary to produce a zero remainder value.⁷

There are two major drawbacks to using a CLAT or CLUT. The first is that the assets are typically tied up in the trust, and the family cannot access them until the end of the charitable lead term. Another problem is that, depending upon the applicable 7520 rate, it may be difficult to earn a rate of return on the trust assets and produce sufficient income for the annual annuity payments and growth to build up the remaining trust principal for the family at the end of the term.

FLPS

Much is being written about family limited partnerships as cases questioning their parameters wind through the courts. Yet they remain a popular transfer tax planning tool, and many clients who now own interests in these entities are hopeful of ultimately obtaining valuation discounts for transfer tax purposes. The discounts available for FLPs improve the overall economics by reducing the required charitable annuity payment and thereby enhancing the remainder interest for the family.

—Donald R. Tescher and Barry A. Nelson

Endnotes

1. See Robert P. Connor, "CLTs: An Important Tool in the Right Situation," *Trusts & Estates*, (September 1997) and Edward J. Beckwith, "Charitable Lead Trusts Re-Examined: The Dawning of a Golden Age," *37th Annual University of Miami Phillip E. Heckerling Institute on Estate Planning*, Chapter 5 (2003).
2. Conrad Teitell, "Jackie O's Charitable Lead Annuity Trust: The C&J Foundation," *Trust & Estates* (September 1994).
3. Michael D. Whitty, "Effects of Low Interest Rates on Investment-Driven Estate Planning Techniques," *30 Est. Plan.* 587 (December 2003); Joel H. Yudenfreund, "Monitoring and Exiting Estate Planning Strategies for Best Results," *30 Est. Plan.* 552 (November 2003).
4. To obtain the charitable income, gift or estate tax deductions under IRC Section 170(f)(2)(B), 2055(e)(2)(B), or 2522(c)(2)(B), the CLAT and CLUT must be properly structured.
5. To be a qualified charity, it must be one to which contributions are deductible under IRC Sections 170, 2055 and 2522.
6. IRC Section 2642(e).
7. Jonathan E. Gopman, "The Formula CLAT and the Super Formula CLAT: Estate Planning with Charitable Lead Annuity Trusts Established at Death," *23 Tax Mgmt. Est., Gifts and Trusts Journal*, pp.186, 203 (1998).