

Wealth replacement trusts: Satisfying philanthropic and family goals

One of the most popular tools for charitable giving, the *charitable remainder trust*, offers families a way to reap rewards for their generosity while achieving significant income and estate tax benefits.

In addition to satisfying philanthropic goals, a charitable trust in tandem with a *wealth replacement trust* allows you to reduce taxes as well as preserve the inheritances of your loved ones.

To give you an idea of how this two-trust plan works, let's take a look at the fictitious Morrison family.

Goal: preserving income for a lifetime

Mr. and Mrs. Morrison plan to make a substantial gift to a local hospital. However, they wish to retain as much of their assets as possible, in order to have a solid capital base from which they can draw income during their retirement years. In other words, they would like to defer their gift until after they are gone.

Therefore, the Morrises will transfer assets to a charitable remainder trust (CRT) that will pay them a stated income annually for the rest of their lives—either a fixed dollar amount or a fixed percentage of the trust's assets, depending upon the kind of trust that they choose. After their deaths the assets remaining in the trust will pass to the hospital's building fund.

A look at the tax benefits

The Morrises have held stock in Company for many years. The stock is currently worth \$1 million, but yielding a dividend of 3%. Their basis in the stock is only \$100,000. They want to sell Company's stock and invest it elsewhere for a higher return, but recognize that they will incur federal tax on their long-term capital gain (\$135,000), plus any state capital gain tax that they might owe).

To avoid the impact of the tax on their earning power, the Morrises choose to make a gift of the stock directly to the hospital, via the charitable remainder trust. The trustee will

sell the stock without incurring any capital gain on the sale, allowing the full \$1 million proceeds from the sale of the stock to earn income for the Morrisons.

In addition to the capital gain tax saving, the Morrisons are entitled to an income tax deduction for their charitable gift. The size of the deduction, which is equal to the *current* value of the hospital's *future* interest in the trust, is dependent on a number of factors. Deductions are computed using IRS tables, taking the Morrisons' age, prevailing interest rates and the terms of the trust into account.

Finally, because the stock has been transferred to the trust, the Morrisons have removed the asset from their estate. Result: The value of the stock escapes the federal estate tax. (Although the estate tax is set to expire for 2010, it will be revived in 2011, when the maximum rate will be 55%.)

But what about the children?

Although the combination of their generosity and tax savings is hard to ignore, the Morrisons have two grown children, and sometime soon (so they hope) grandchildren. The thought of a \$1 million "disinheritance" is troublesome.

Fortunately, there is a way to make their gift and keep their children "whole."

When the Morrisons set up their charitable remainder trust, they also will set up what's commonly called a wealth replacement trust. This trust is funded with \$1 million in insurance, purchased by the trustee, on Mr. or Mrs. Morrison's life (or both of their lives), with their children named as the beneficiaries of the policy. The annual premiums are to be paid with funds that the Morrisons transfer to the trust each year. (Although the premiums are out-of-pocket payments, the amounts saved by way of the income tax deduction and avoidance of the capital gain tax will reduce, if not eliminate, the financial impact of the premium payments.) Some of the proceeds may come from the CRT as well.

Because the premium payments to the trust are gifts, they potentially are subject to federal gift tax. However, the annual gift tax exclusion is available to help shelter the premiums from taxation (\$12,000 in 2008). Here, the Morrisons each make gifts to both of their children, providing a \$48,000 a year gift tax exemption.

What's more, at the Morrisons' death the proceeds from the insurance policy will not be subject to tax in their estates. Neither will the proceeds be reduced by the expense and delays of probate.

Summing up

The Morrisons have put themselves in a “win-win” situation. By setting up a charitable remainder trust, they satisfy their philanthropic goal, while retaining a steady flow of income for as long as they live from the assets transferred to the CRT. At the same time they achieve significant tax savings. Finally, by setting up a wealth replacement trust and paying annual premiums to the trust, the Morrisons are able to make their charitable gift and keep their children’s inheritance intact.

A little more about wealth replacement trusts

The wealth replacement trust is also an excellent planning tool in many other circumstances.

For instance, a wealth replacement trust may be used in conjunction with other charitable giving plans, such as the establishment of a *private (family) foundation*. In addition, a wealth replacement trust is especially appropriate in cases where estate liquidity is an issue. For example, for an estate with a valuable asset such as a family business or commercial real estate, a wealth replacement trust offers a ready source of funds to pay a substantial estate tax bill, without forcing a sale of the asset. Even if liquidity is not an issue, a wealth replacement trust can replace those funds used to pay estate taxes, thus preserving family wealth for the next generation.

Explore your opportunities

Charitable-giving strategies come in many forms and variations. We will be glad to explore the charitable arrangement that works best for you and your family. Please contact us for more details.

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Any developments occurring after January 1, 2008, are not reflected in this article.