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CHARITABLE LEAD TRUSTS CAN PROVIDE GREAT BENEFITS

Kenneth Edelman

A Charitable Lead Trust ("CLT") is an often overlooked estate planning technique that, given the right circumstances, can be very beneficial. A CLT is a trust that provides income for a set term (or for a term of the grantor's life) to one or more charities, with the remaining principal at the end of the term passing to one or more individuals, usually the grantor's children. The grantor will be making a taxable gift to his children, but, for gift tax purposes, the value of the gift will be reduced by the value of the charitable interest. The value of the charitable interest will be determined based on the length of the term and the IRS interest rate in effect at the time of the transfer.

Low IRS Interest Rates and Appreciating Assets Create CLT Opportunities

This technique can be very beneficial when two

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IRA PLANNING ALTERNATIVES

Carl S. Rosen

The tax laws relating to the IRA distribution rules are considered by some to be the most complex provisions in the Internal Revenue Code. Understandably, many people do not understand the different alternatives and elections available to them with respect to their IRA. This is an unfortunate situation because IRA's can cause a significant tax burden as they are subject to both federal income tax and federal estate tax. The purpose of this article is to answer some of the most frequently asked questions relating to IRA's.

When must I begin taking distributions from my IRA?

You must generally begin taking distributions from your IRA no later than April 1 of the calendar year following the year in which you become 70½. This date is referred to as the "required beginning date".

How much must I withdraw annually after I reach my required beginning date?

After you reach your required beginning date, each year you are required to receive "minimum required distributions." The minimum required distributions usually take the form of distributions over your life expectancy or over the joint life expectancies of you and your Designated Beneficiary.

How is my life expectancy determined?

Your life expectancy (and the life expectancy of your Designated Beneficiary) is generally determined at your required beginning date. Each year after your required beginning date your life expectancy will decrease by one full year. However, you (and your spouse, if your spouse is your Designated Beneficiary) may recalculate your life expectancies annually. No other life expectancies may be recalculated.

If you elect to recalculate your life expectancy, your life expectancy will change each year based on the IRS actuarial tables. Based on such tables, your life expectancy will not automatically be reduced by one full year each year. Instead, it will be reduced by less than one full year.

The advantage of recalculating your life expectancy is that it will provide you with a longer payout period during your lifetime, thereby allowing you to defer your

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income tax by receiving lower minimum required distributions each year. The disadvantage is that your life expectancy will be zero for the calendar year after your death, thereby requiring the Designated Beneficiary to withdraw the assets over his or her lifetime only (and not your combined joint lifetimes). The election to recalculate must be irrevocably made by the required beginning date.

What is a Designated Beneficiary?

A Designated Beneficiary is an individual or a group of individuals. The tax laws also now allow certain trusts to be Designated Beneficiaries so long as various rules are complied with. Your estate or a charity is not a Designated Beneficiary.

Why is it important that I designate a Designated Beneficiary?

It is important that you name a Designated Beneficiary as the beneficiary of your IRA. Otherwise, (i) after your required beginning date you will be required to withdraw your IRA over your own life expectancy (and not the joint life expectancy of you and your Designated Beneficiary); (ii) if you die before your required beginning date all IRA assets must be distributed within five years (and not based on the beneficiary's life expectancy); (iii) if you die after your required beginning date, all IRA assets must be distributed over your remaining life expectancy (or immediately if you elected to recalculate).

What happens if I die before my required beginning date?

The general rule states that if you die before your required beginning date all benefits must be distributed within five years from your date of death. However, if you have named a Designated Beneficiary, the proceeds may be distributed over the Designated Beneficiary's life expectancy as of your year of death. Also, if you name your spouse as your Designated Beneficiary, your spouse may roll over your benefits into his or her own IRA in order to postpone distributions and defer income taxes until the spouse's required

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factors exist: low IRS interest rates and appreciating assets. For example, suppose a grantor ("G") transfers $1 million to a CLT, providing for a seven percent ($70,000 per year) annual payout for 20 years to a charity. At the end of the 20-year period, the trust assets will pass to G's children. For gift tax purposes, because you reduce the amount of the gift based on the charity's interest, G will have made a gift to his children valued at $170,000. This will normally not cause a gift tax, but will use up a portion of G's $650,000 unified credit exemption. The charity will receive $70,000 per year for 20 years, totaling $1.4 million. Assuming the trust grows at seven percent per year, $1 million will pass to the children and will be excluded from G's estate for estate tax purposes. However, assuming the growth is ten percent (10%) per year, the amount passing to the children will equal approximately $1.8 million. Therefore, G will have transferred $1.8 million of assets to his children at a gift tax value of only $170,000. Therefore, with the right type of assets and a low IRS interest environment, a CLT can be very advantageous.

"Annuity" CLT vs. "Unitrust" CLT

Note that there are two types of CLT's, an "annuity" trust, whereby the charity (or charities) will receive a fixed payment each year (such as the $70,000 payment described above), or a "unitrust" whereby the charity (or charities) will receive a fixed percentage of the value of the trust, as revalued each year. Assuming the assets appreciate in value, in order to transfer the most assets to the children, an annuity trust will be the best choice. These trusts can be created during lifetime, in an irrevocable trust, or at death, in a will or revocable trust. They can be a great method of passing assets to children and also providing a great benefit to your favorite charities. BC

The Benefits of an Employee Stock Ownership Plan (ESOP)

Michael Dribin

An Employee Stock Ownership Plan ("ESOP") is a defined contribution employee benefit plan that invests primarily in the stock of the employer company. To set up an ESOP, a company creates a trust fund for employees and funds it by one or a combination of the following methods:

1. Contributing company shares;
2. Contributing cash to buy company shares; or
3. Having the plan borrow money to buy shares and then making pay ments to the ESOP trust to repay the loan.

From the perspective of the principal owners of closely held businesses, ESOP's can be used effectively to accomplish important estate planning objectives. They can provide a source of liquidity with which to pay estate taxes, while deferring or completely avoiding the recognition of a gain and converting ordinary income into capital gain. An ESOP can facilitate private business ownership succession and reduce the after-tax cost of borrowing and effectively reduce the rate of transfer taxes (estate and gift taxes).

Contributions to an ESOP are deductible by the employer, within certain limits. Income earned by the sub-trust is exempt from tax and participants in the ESOP do not recognize income until their benefits are withdrawn.

Under certain circumstances, the tax laws provide special benefits for owners of stock which is sold to an ESOP. The special benefits are generally available only with respect to sales of common stock of private "C" corporations. The stock must have been owned by the seller for at least 3 years and immediately after the sale of the company stock to the ESOP, the ESOP must own at least 30% of the employer's stock. The sale proceeds received by the seller of the stock must be invested in "qualified replacement property", which includes marketable securities and bonds of domestic operating corporations. In this way, the owner of stock in a closely held business has the opportunity to diversify his or her portfolio through the creation of the ESOP. Furthermore, the seller can elect to defer income tax on the sale of the closely-held stock until the disposition of the "qualified securities". If the qualified securities are not disposed of until after the death of the owner, there is a step-up in basis and the gain may be largely or entirely eliminated.

One of the obvious questions in such an arrangement becomes, how does the ESOP get the cash to buy the stock from the company's principal shareholder? Ordinarily, fiduciary rules applicable to tax-qualified deferred compensation plans prohibit sponsoring employers from lending money to a qualified plan, guaranteeing the loan to a plan or providing collateral for a loan. However, special exemptions provide for loans to ESOP's where the loan proceeds are used to acquire common stock of the sponsoring employer. For example, an ESOP may use loan proceeds from a commercial institution to purchase shares of the sponsoring corporation, either from the corporation or from shareholders. The corporation makes annual cash contributions to the ESOP in amounts sufficient to amortize the loan and the corporation is allowed to deduct the amount so contributed (with both the amount used to pay principal as well as the amount used to pay interest). Furthermore, a tax deduction is allowable to a C corporation for cash dividends paid on employer stock held by an ESOP if either the dividends are used to make payment on an ESOP loan, the proceeds of which were used to acquire the employer's securities with respect to which the dividends are paid, or the dividends are paid in cash to the plan participants or paid to the plan and then distributed to the participants within 90 days after the close of the plan year in which the dividends are paid.

> ***ESOP's can....***
>
> *- provide estate liquidity while deferring or avoiding gain.*
> *- facilitate portfolio diversification.*
> *- promote business succession planning.*

Obviously, ESOP's are a very technical device and will not suit every situation. However, where appropriate, they can present an attractive alternative to the sale of a closely held business, if younger executives have been adequately trained to manage the business. Furthermore, an ESOP sale provides a source of liquid assets which can be used to pay estate taxes and to diversify the holdings of a family business. Also, control over the business can be retained by the family, since only a minority interest in the business need be sold to the ESOP. Finally, the receipt of "qualified replacement properties" (i. e., marketable securities) as a result of the ESOP sale, can be used by the family members in conjunction with other estate planning techniques, such as charitable remainder trusts, family limited partnerships, generation-skipping trusts, etc. BC

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beginning date. The spouse could then name a new Designated Beneficiary to receive the IRA proceeds at the spouse's death and take distributions over the spouse's and the spouse's Designated Beneficiary's combined life expectancy.

What happens if I die after my required beginning date?

If you die after your required beginning date, your benefits must be distributed at least as rapidly as the method of distribution on the date of your death. Accordingly, if you elected to receive payments over a joint life expectancy, payments can continue to the Designated Beneficiary in the same manner as they were being distributed before your death. Again, if you name your spouse as your Designated Beneficiary, your spouse may roll over your benefits into his or her own IRA in order to postpone distributions and defer income taxes until the spouse's required beginning date.

Are there any special concerns if I name my child or children as my Designated Beneficiary?

Yes. First, if you name more than one Designated Beneficiary, the payout period is computed using the life expectancy of the oldest beneficiary, unless each beneficiary is a beneficiary of a separate account or separate share. Second, if a child or other person who is not your spouse is named as your Designated Beneficiary, the age of the Designated Beneficiary is limited to ten years

less than your age for purposes of determining the minimum required distributions during your lifetime. This is called the minimum incidental benefit rule.

Can I change my Designated Beneficiary?

Yes, you can always change your Designated Beneficiary. However, the required beginning date is the last date for making choices that will determine the longest payout period of benefits. For example, after your required beginning date you cannot lengthen the maximum payout period by changing to a younger Designated Beneficiary. Alternatively, you will shorten your payout period if you change to an older Designated Beneficiary after your required beginning date.

Can I name a charity or charitable remainder trust as the beneficiary of my IRA?

Yes. If upon your death you are planning to leave money to a charity or charitable remainder trust, it is usually advantageous to leave your IRA (or a portion of your IRA) to the charity or charitable remainder trust rather than other types of assets. This is because the IRA would pass to the charity or charitable remainder trust free of income tax, thereby allowing you to leave other assets (which would not be subject to income tax upon your death) to family members. Unfortunately, a charity is not a Designated Beneficiary and has no life expectancy when determining the minimum required distributions during your lifetime. Accordingly, during your lifetime you will be required to withdraw your IRA over your life expectancy rather than a joint life expectancy.

What are the consequences if I name a charity as the beneficiary of my IRA?

Assume that Mrs. Smith is charitably inclined and owns $1 million worth of marketable securities and a $1 million IRA. She has several children to whom she would like to leave $1 million, and would like to leave $1 million to her favorite charity. Mrs. Smith should leave the IRA to the charity and the remaining assets to her children. This is beneficial because the charity will pay no income tax on the receipt of the IRA because it is tax-exempt. Mrs. Smith's estate will be entitled to an estate tax charitable deduction for the full amount of the IRA. Mrs. Smith's remaining assets would receive a step-up in basis and pass to her children free of income tax. The children could then sell the assets and recognize little or no capital gain. If the children were to receive the IRA, the children would pay income tax as they received distributions, thereby reducing their overall inheritance.

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What are the consequences of naming a charitable remainder trust as the beneficiary of my IRA?

If you designate a charitable remainder trust as the beneficiary of your IRA (or a portion of your IRA), such trust would not recognize income when it received the IRA because it is a tax-exempt entity. You would specify that a child or children (or any other individual) would receive an income interest in the trust assets for his or her life, at the end of which the property would pass to charity.

You would receive an estate tax charitable deduction based upon the value of the remainder interest passing to charity (the deduction is based on various factors, including the age of the individual receiving the income interest, the interest rate in effect, and the percentage payout to the beneficiary). The end result is that the entire IRA has basically escaped income tax and the remainder interest of the IRA is no longer included in your estate for estate tax purposes. In addition, you have made a large charitable contribution.

Can I gift my IRA to charity during my lifetime?

No. IRA's are not assignable during your lifetime. The only method by which you can transfer IRA assets to charity during your lifetime would be to withdraw the assets, pay the income tax with respect to such distributions, and then give the balance to charity.

How can I leave my IRA to my spouse but also require that upon her death the IRA go to my children?

You should consider naming a "QTIP Trust" as the beneficiary of your IRA. Under newly issued Treasury Regulations, a QTIP Trust can qualify as a Designated Beneficiary so long as various rules are complied with. In addition, the IRA can qualify for the Federal estate tax marital deduction so long as the trust contains certain provisions. Your spouse, however, would not be allowed to roll-over the IRA in order to postpone distributions and defer income.

How can I utilize my IRA to fund my Credit Shelter Trust?

So long as various rules are complied with, you can designate your credit shelter trust as the beneficiary of your IRA. However, a more flexible solution would be to designate your spouse as the designated beneficiary of your IRA, and your credit shelter trust as the contingent beneficiary. Your spouse (with the help of an attorney) could then analyze his or her needs and the current income and estate tax laws at the time of your death to determine whether it would be more appropriate to roll-over your IRA and defer income, or "disclaim" the IRA to fund the credit shelter trust and save estate tax.

The above discussion is an attempt to explain some of the most frequently encountered IRA planning alternatives, however, it is not an exhaustive list. Each situation may require different planning strategies and should be examined carefully with a professional who has expertise in this area of the law. BC

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