Wealth Transfer and Charitable Planning Strategies

Handbook

BAY FINANCIAL ASSOCIATES
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Wealth Transfer and Charitable Planning Strategies Handbook

This handbook contains 12 core wealth transfer and charitable planning strategies. It also demonstrates how life insurance may enhance the results of the various planning techniques. Each strategy includes a brief description, potential benefits, planning considerations and a diagram of how the strategy works.

Bay Financial Associates, LLC does not engage in the practice of law or accounting. Anything contained herein dealing with legal, tax or accounting matters should be discussed with your lawyer, CPA or tax advisor.

Charitable Lead Trust

What Is a Charitable Lead Trust?

A charitable lead trust (CLT) is a taxable split-interest irrevocable trust where a qualified organization (e.g., public charity, private foundation or donor-advised fund) receives income (lead interest) from the CLT for a set time period.[1] After payment of the lead interest, the CLT remainder interest is distributed to the non-charitable beneficiary or beneficiaries, which may include the donor, donor's estate, children, grandchildren or other trust or trusts for children or grandchildren.

The value of the grantor's gift to the remainder beneficiaries is determined by deducting the present value of the charity's interest (valued using the 7520 rate in effect at the time of the transfer) from the fair market value of the property transferred to the CLT. In addition, the taxable value of the CLT's assets is fixed at the time of the transfer, and any subsequent increase in the value of the assets is outside the donor's estate and thus free of gift and estate tax.

Potential Benefits

- Leverage gifts to non-charitable beneficiaries.
- Maximize gifts to charitable beneficiaries.
- Reduce taxable estate.

Planning Considerations

- Transfers to the CLT are irrevocable.
- Failure to meet income/growth projections minimizes gifts to non-charitable beneficiaries.
- Deferred benefit to non-charitable beneficiaries.
- When life insurance is being considered, only a portion of trust assets should be used to purchase life insurance to ensure that other trust assets are available to make the required income payments to charity and to pay the trust's administrative expenses.

By establishing and funding a CLT, you can benefit charity, reduce your taxable estate and transfer wealth at a reduced transfer tax cost.

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[1] – *You determine the duration and amount of the lead interest. Payments can continue for the life or lives of one or more individuals, all of whom must be living when the trust is created or for a term of years (limited only by the applicable rule against perpetuities). The charitable lead trust (CLT) may be established as an inter vivos trust (during life) or as a testamentary trust (at death). Unlike a charitable remainder trust and a private foundation, there is no minimum percentage or amount that must be distributed annually. The CLT instrument may provide for the payment of the annuity or unitrust interest to be made in cash or in kind*.

Charitable Remainder Trust

What Is a Charitable Remainder Trust?

A charitable remainder trust (CRT) is a tax-exempt split-interest trust to which you transfer property and retain an income stream from the CRT. At the creation of the CRT, the charity's remainder interest must be at least 10 percent of the value of the CRT. The income stream that you retain may last for a term of years (not to exceed 20 years) or for your lifetime or the lifetime of other specified beneficiaries. The CRT must make income payouts at least annually. At the termination of the CRT, the balance of the CRT assets are distributed to a qualified organization, such as a public charity, private foundation or donor-advised fund, that you select and designate in the CRT.

Because a CRT is a tax-exempt entity, it can sell a highly appreciated asset without incurring a current income tax liability. Donors will receive an immediate income tax deduction based on the estimated present value of the remainder interest that will ultimately be transferred to the charity. As an income beneficiary of the CRT, your benefit from the income tax-free liquidation of the highly appreciated assets by receiving income from the sale of those assets. A portion of that income can be used to purchase a life insurance death benefit to replace the value of the assets transferred to the CRT.

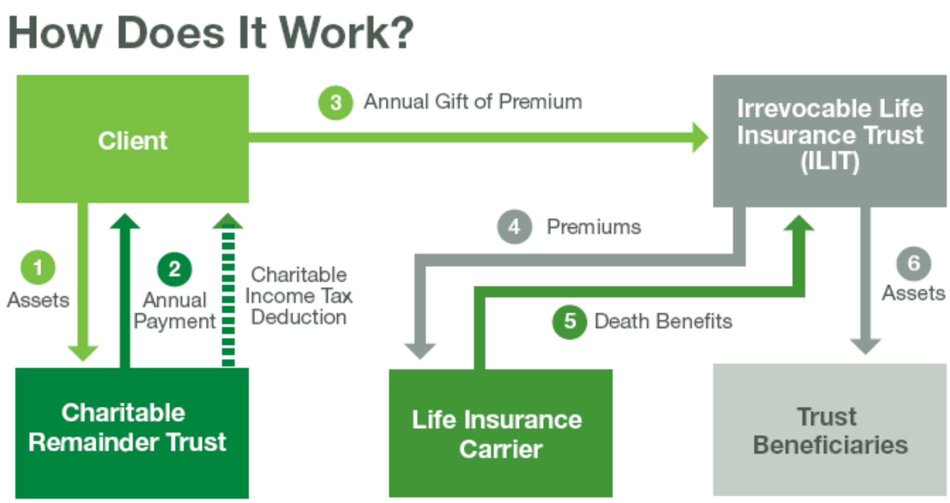
By establishing and funding a CRT with low-basis, highly appreciated assets, such as stocks, bonds or real estate, you may be able to achieve charitable objectives, receive a charitable income tax deduction, reduce the size of your estate and maximize the wealth transferred to your beneficiaries.

Potential Benefits

- May increase your current income, reduce your taxable estate and provide you with a current charitable income tax deduction.
- Benefits your favorite charity.
- May provide tax-efficient asset repositioning.
- Life insurance death benefit can help to replace value of assets transferred to the CRT and maximize wealth transfer to your beneficiaries.
- Charitable beneficiary of the CRT may be a private foundation.

Planning Considerations

- Transfers to the CRT are irrevocable.
- When the CRT terminates, the CRT assets pass to charity, not to the family members.
- Income tax deductions not used currently may be carried forward for five years.
- The current income tax deduction depends on the type of asset donated, the type of charity, and benefits paid out to the income beneficiaries.
- Cost of creation and maintenance of the CRT.



1. You (the donor) irrevocably transfer property to the trustee of a CRT and receive a federal income tax deduction for the present value of the charity's remainder interest, subject to limitations.
2. The trustee pays the donor either a fixed percentage of the initial value of the trust (annuity trust) or a specified percentage of the trust assets as revalued each year (unitrust). If the donor chooses to have the income assigned to a beneficiary other than a spouse, the donor is still responsible for income taxes. Payments to the beneficiary are subject to the federal gift tax but may qualify for the gift tax annual exclusion.
3. You create an irrevocable life insurance trust (ILIT), the beneficiaries of which are typically your family members.
4. You make annual, scheduled or lump sum gifts of cash or other assets to the ILIT. Often, the amount of the gift made to the ILIT coincides with the life insurance premium.
5. ILIT purchases a life insurance policy on your life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
6. Upon your death, the ILIT assets, including life insurance, pass to the ILIT beneficiaries free of income tax and transfer tax.

When the CRT terminates, the CRT remainder is transferred to the charity.

Credit Shelter Trust with Life Insurance

What Is a Credit Shelter Trust with Life Insurance?

A credit shelter trust (CST), also known as a family trust or bypass trust, often plays an integral role in most married couples' estate plans. At the death of the first spouse, an amount equal to the applicable exclusion is typically transferred to the CST, free of estate taxes. Often, the CST is drafted to provide income and/or principal to a surviving spouse subject to certain limitations.[2] Properly drafted, the CST assets remain outside the surviving spouse's taxable estate. At the death of the surviving spouse, the CST assets are transferred to the CST remainder beneficiaries pursuant to the terms of the CST.

Using CST assets to fund a life insurance policy on the surviving spouse's life can greatly enhance the amount of wealth transferred to the CST beneficiaries. Because the assets of the CST reside outside the taxable estate of the surviving spouse, utilizing the CST assets to purchase life insurance may be a transfer tax-free approach to funding a needed life insurance death benefit. Specifically, there are no gift taxes or estate taxes associated with the premium payments. In addition, since a life insurance policy's cash values grow tax-deferred, it may reduce the surviving spouse's income tax liability.

Potential Benefits

- Maximizes wealth transfer to your beneficiaries.
- Life insurance policy cash values grow tax-deferred.
- May reduce overall income tax liability of CST and surviving spouse during lifetime.
- Provides an income tax free-death benefit for CST beneficiaries.
- Diversifies and lowers investment risk of CST assets.
- Enables the surviving spouse to acquire life insurance outside of his/her taxable estate without using annual exclusion gifts.
- Policy cash values can be accessed for the benefit of the surviving spouse and children as provided by the terms of the CST.

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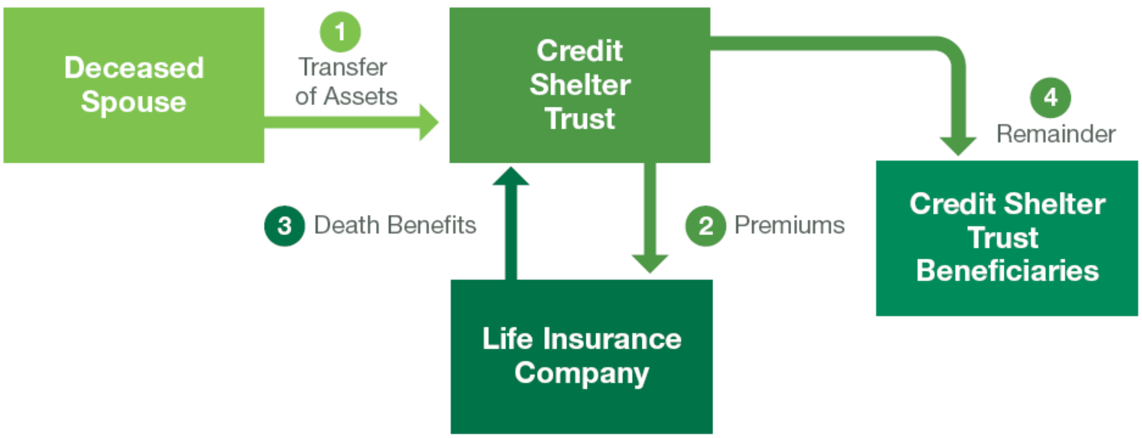
[2] - *Often, during the surviving spouse's lifetime, the principal and/or income of the credit shelter trust may be used as necessary for the health, education, maintenance and support of the surviving spouse.*

Planning Considerations

- The surviving spouse should not serve as sole trustee of the CST.
- The surviving spouse cannot hold a general power of appointment over the CST assets.
- Any use of "5 and 5 powers" or limited powers of appointment in a trust must exclude the life policy or all or part of the death proceeds could be subject to estate tax at the death of the surviving spouse.
- The CST trustee must have the authority to purchase life insurance under the terms of the CST or applicable state law.
- If the spouse is uninsurable or in poor health, life insurance may be unavailable or very expensive.
- Limits CST income and assets available to surviving spouse.

How Does It Work?



1. Typically, upon the death of the first spouse, a CST is funded with a specified amount of assets.
2. The CST trustee purchases a life insurance policy on the surviving spouse's life, retains ownership rights and designates the CST as the beneficiary of the policy.
3. Death benefit paid to CST.
4. Upon the surviving spouse's death, the CST assets, including life insurance, will pass to the CST beneficiaries free of income tax and transfer tax.

Dynasty Trust

What Is a Dynasty Trust?

A dynasty trust is an irrevocable trust designed to benefit multiple generations of beneficiaries, thus protecting transferred assets, creating a legacy and providing for professional management if desired. By establishing a dynasty trust and funding it with life insurance, you can leverage the amount of wealth transferred to your heirs.

Typically, life insurance premiums are relatively small compared to the amount of death benefit proceeds. Therefore, allocating the generation-skipping transfer (GST) tax exemption to assets transferred into the dynasty trust for payment of life insurance premiums can be an efficient use of your GST tax exemption. This exemption is allocated up-front to each premium gift made to the trust, not to the policy's future cash value accumulation or death benefit proceeds, thus leveraging a smaller gift into a significantly larger legacy.

As long as the life insurance remains in force, policy cash values grow on a tax-deferred basis. Life insurance death benefits will be paid to the dynasty trust — free of income tax, estate tax and GST tax. Not all of these benefits are available when the dynasty trust invests in traditional investments, such as publicly traded stock.

Potential Benefits

- Create a legacy for future generations.
- Pass assets to your heirs free of estate taxes and GST taxes.
- Leverage the GST tax exemption using life insurance to create a larger legacy.
- Provide for the professional management of trust assets.
- Control the timing and circumstances when transfers are made.

Planning Considerations

- The duration of a dynasty trust may be limited in some states by the "rule against perpetuities."*
- The desired life insurance policy premium may be higher than your available annual gift tax exclusion, lifetime gift tax exemption and generation-skipping transfer tax exemption.
- Transfers to a dynasty trust are irrevocable and you may not possess any incidents of ownership in the life insurance policy owned by the dynasty trust.
- Life insurance qualification generally requires medical and financial underwriting.
- Cost of creation and maintenance of dynasty trust.

How Does It Work?

1. A dynasty trust is created, the beneficiaries of which are typically your family members.
2. You make annual, scheduled or lump sum gifts of cash or other assets to the dynasty trust. Often, the amount of the gift made to the dynasty trust coincides with the life insurance premium. Your GST tax exemption is allocated to each gift made to the dynasty trust.
3. Dynasty trust purchases a life insurance policy on the your life, retains ownership rights, and designates the dynasty trust as the beneficiary of the policy.
4. At death, the life insurance proceeds are paid to the dynasty trust. The dynasty trust continues until the end of the trust term, if any.

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***Depending on state law, a trust may terminate in the future according to the state's rule against perpetuities, which limits the duration of a trust. In jurisdictions that follow the common law Rule Against Perpetuities, a transfer of property in trust will be invalid unless it vests within a life or lives in being at the creation of the trust, plus 21 years (approximately 90 years or so). A number of states have revised the common law Rule Against Perpetuities by statute, passing legislation permitting one to opt-out of the rule, or abolished it entirely.*

Grantor Retained Annuity Trust

What Is a Grantor Retained Annuity Trust?

A grantor retained annuity trust (GRAT) is an estate freeze technique that may help transfer significant wealth to future generations with minimal transfer tax impact.[1] A GRAT is an irrevocable trust to which the grantor transfers property and retains an annuity interest from the transferred property for a fixed term.

For transfer tax valuation purposes, the amount of the taxable gift is the fair market value of the property transferred minus the value of the grantor's retained annuity interest. If the value of the annuity interest equals the total value of assets transferred to the GRAT, the transfer will be valued at zero for transfer tax purposes (e.g., Walton GRAT or zeroed out GRAT). The transfer "freezes" the value of the appreciating assets by converting the appreciating assets into a fixed annuity interest that is payable to you. As a result, all post transfer appreciation and income is removed from your estate. Because the GRAT is a grantor trust, you pay the GRAT income tax liability at your individual income tax rate, which means GRAT assets effectively grow income tax-free.[2]

At the end of the GRAT term, the remaining trust assets are distributed to the remainder beneficiary without the imposition of additional gift tax and are excluded from the grantor's taxable estate. In the event the grantor dies during the GRAT term, a portion of the GRAT assets are included in the grantor's taxable estate.[3] Life insurance is often used to protect against the grantor's death during the trust term.

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1. *Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws. Failure to do so could result in adverse tax treatment of trust proceeds.*
2. *The grantor trust is drafted in such a manner as to subject itself to the grantor trust provisions of IRC. §§671-679. Revenue Ruling 85-13, 1985-1 CB 194.*
3. *See Proposed Regulation 119097-05, Rev. Ruls. 76-273 and 82-105 (portion of GRAT corpus included), but see PLRs 9345035, 9403002 and 9451056 (full value of GRAT corpus included).*

Potential Benefits

- The grantor can make a current gift of assets with little or no gift tax cost while allowing the grantor the right to receive a fixed annuity interest during the term of the GRAT.
- To the extent the return on the assets transferred to the GRAT exceed the Section 7520 rate, the excess value is transferred to the GRAT beneficiaries without gift or estate taxes.
- Unlike an installment sale to a grantor trust, a GRAT does not require the grantor to gift money to the trust prior to the transaction.
- A GRAT can provide the funds necessary to terminate premium leveraging arrangements with minimal gifting implications, while at the same time maintaining your desired level of insurance protection.
- By paying the income tax liability generated by GRAT assets, the grantor has effectively made a gift-tax free transfer to the beneficiaries equal to the amount of the annual income tax liability of the GRAT.
- A GRAT is a statutorily created wealth transfer vehicle with a long history of use.

Planning Considerations

- If the grantor dies during the term of the trust, a substantial portion, if not all, of the trust assets will be included in the grantor's estate.
- The assets transferred to the GRAT may not generate income and/or appreciate as planned.
- A GRAT is an ineffective vehicle for multigenerational wealth transfers. Your generation-skipping transfer tax exemption cannot be allocated to the GRAT upfront, but must instead be allocated to the value of the GRAT at the end of the estate tax inclusion period.

How Does It Work?

1. Grantor transfers assets to the GRAT and retains an income stream from the transferred property for a fixed term. The trust term and the amount of the income stream are determined by the grantor.
2. GRAT makes annual annuity payments to the grantor for the length of the trust term.
3. At the end of the GRAT term, the remaining trust assets are distributed to the remainder beneficiary without the imposition of additional gift tax and are excluded from the grantor's taxable estate.

Irrevocable Life Insurance Trust

What Is an Irrevocable Life Insurance Trust?

An irrevocable life insurance trust (ILIT) is an irrevocable trust used to remove the ownership and control of a life insurance policy from an estate. Like other irrevocable trusts, transfers to an ILIT are completed gifts in which you relinquish control and ownership of the assets transferred to the ILIT.

Moreover, in creating an ILIT, you do not retain the right to modify, revoke or terminate the ILIT. However, assets owned by an ILIT are removed from your taxable estate. The ILIT is a wealth transfer vehicle that may assist you in removing assets from your estate, provide survivor income or liquidity for your estate.

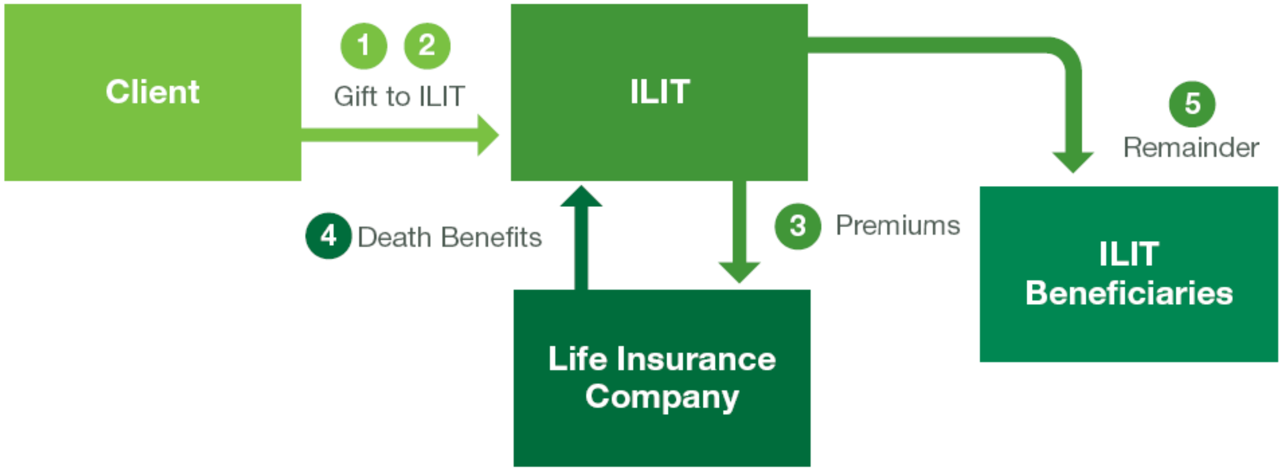
Potential Benefits

- May enable you to leverage your annual gift tax exclusion, lifetime gift tax exemption and generation-skipping tax exemption with the purchase of life insurance.
- Provides estate liquidity for you heirs on an income and transfer tax-free basis.
- May replace assets used to pay estate taxes or used to provide a charitable bequest.
- Gives the grantor the opportunity to control the distribution of the death proceeds through the terms of the ILIT provisions in a manner consistent with his/her overall estate objectives.
- May protect ILIT assets from the creditors of the ILIT beneficiaries.
- May reduce the size of your taxable estate and corresponding estate taxes.
- May increase the amount of wealth transferred to your heirs.

Planning Considerations

- Cost of creation and maintenance of the ILIT.
- Life insurance qualification generally requires medical and financial underwriting.
- The desired life insurance policy premium may be higher than your available annual gift tax exclusion and/or lifetime gift tax exemption.
- Transfers to an ILIT are irrevocable and you may not possess any incidents of ownership in the life insurance policy owned by the ILIT.

How Does It Work?



1. You create an ILIT, the beneficiaries of which are typically your family members.
2. You make annual, scheduled or lump sum gifts of cash or other assets to the ILIT. Often, the amount of the gift made to the ILIT coincides with the life insurance premium.
3. ILIT purchases a life insurance policy on your life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
4. At death, the death benefit is paid to the ILIT.
5. At the end of the trust term, the ILIT assets, including life insurance, will pass to the ILIT beneficiaries free of income tax and transfer tax.

Life Insurance as an Asset

What Is Life Insurance as an Asset?

As you are well aware, the value of an investment portfolio is subject to market fluctuations. The amount of wealth transferred to your beneficiaries is based on the value of your investment portfolio at an indeterminate point in the future. Depending on the performance of the investment portfolio, your beneficiaries may receive more or less than expected. By allocating a small portion of your portfolio to purchase a life insurance death benefit, you may hedge market losses. In doing so, you may increase the amount of wealth transferred to your beneficiaries.

Life insurance is a unique asset in that the death benefit risk is borne by the life insurance carrier, which will pay the death benefit in full at the event of death no matter what the "timing." As a result, life insurance provides a death benefit that is uncorrelated with other sectors of the investment marketplace such as equities or bonds. In other words, the death benefit is based on the event of death — not a market event that can cause a downturn in value.

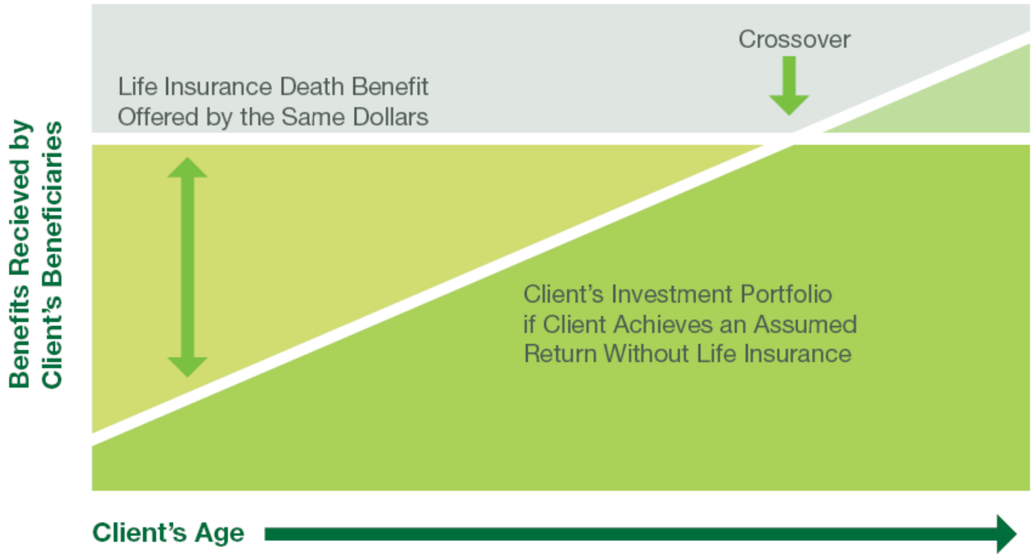
Potential Benefits

- Life insurance death benefit may offer significant leverage, especially in the early years, and may increase the amount of wealth transferred to heirs.
- By directing a portion of portfolio to life insurance premiums, you may hedge against market losses.
- Life insurance death benefit is uncorrelated with other sectors of the investment marketplace, such as equities or bonds.
- May increase tax-adjusted internal rate of return of your portfolio.
- If properly owned, death benefit can be received free of estate tax and income tax.

Planning Considerations

- Directing funds to life insurance premiums may reduce the return on your portfolio.
- Potential advantage offered by life insurance needs to be viewed in light of your overall financial situation.
- Your ability to see this plan to fruition is based on continuing premium payments, as required, as well as the claims-paying ability of the underlying insurer.
- Your total insurance capacity may be limited by financial underwriting.
- Life insurance qualification generally requires medical and financial underwriting.

How Does It Work?



A life insurance death benefit offers substantial leverage during the early years of the policy. The value of the death benefit is substantially more than the value of the premiums had they been placed in an investment account (non-life insurance assets). The advantage may decrease over time if the non-life insurance assets increase in value. At some point, the value of non-life insurance assets may exceed the death benefit. The point at which this occurs is often called the "crossover" point. Life insurance offers an advantage when the crossover point occurs after your life expectancy.

Lifetime Gifting

What Is the Power of Lifetime Gifting?

You can make tax-free gifts to an irrevocable trust annually and reduce the size of your taxable estate in the process.* By making gifts of appreciating assets, you also remove future growth and income from your estate. In addition, certain assets may be valued at a discount for gift tax purposes allowing you to transfer more wealth to your family in a shorter period of time. In some cases, you may also be able to give away an interest in an asset without giving up control of it.

Although making lifetime gifts alone can be an efficient way to transfer assets and minimize gift and estate tax, the gifts may be leveraged significantly with the purchase of life insurance. Life insurance proceeds are generally not subject to income taxes. If properly structured, life insurance proceeds may also be excluded from estate tax.

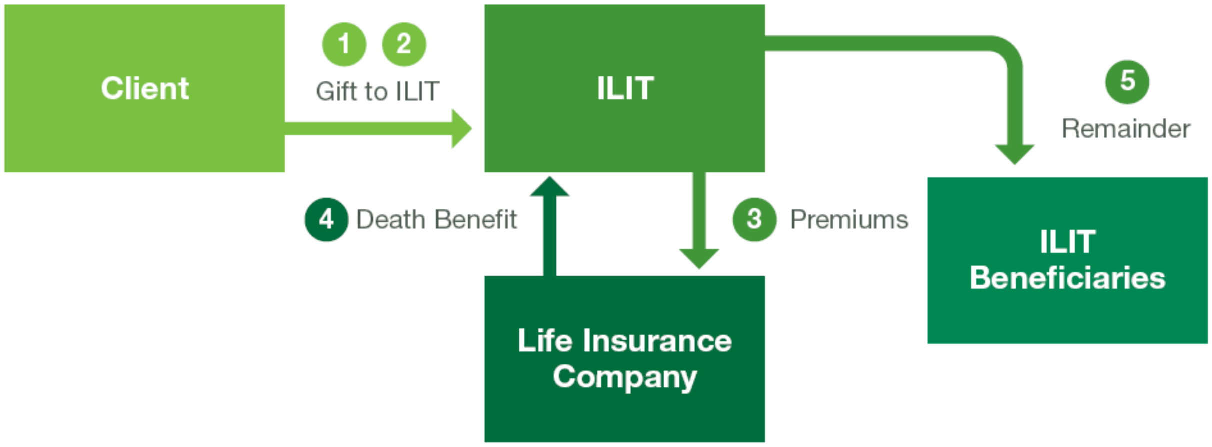
Potential Benefits

- Reduces the size of the taxable estate and corresponding estate taxes.
- Removes future appreciation and income attributable to gifted assets from estate.
- Provides greater privacy and probate avoidance.
- May provide creditor protection for gifted assets.
- May increase the net amount of wealth transferred to your heirs.

Planning Considerations

- Generally, gifts are irrevocable.
- Life insurance qualification generally requires medical and financial underwriting.
- The desired life insurance policy premium may be higher than your available annual exclusion gifts and/or lifetime gift tax exemption amount.
- There is no guarantee to absolute creditor protection.

How Does It Work?



1. You create an irrevocable life insurance trust (ILIT), the beneficiaries of which are typically your family members.
2. You makes annual, scheduled or lump sum gifts of cash or other assets to the ILIT.
3. ILIT purchases a life insurance policy on the your life, retains ownership rights, and designates the ILIT as the beneficiary of the policy.
4. At death, the death benefit is paid to ILIT
5. At the end of the trust term, the ILIT assets, including life insurance, will pass to the ILIT beneficiaries free of income tax and transfer tax.

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**Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws. Failure to do so could result in adverse tax treatment of trust proceeds.*

Premium Financing

What Is Premium Financing?

Premium financing is a strategy intended to help you obtain life insurance for which you have an established need. Typically, premium financing is a fair market loan arrangement between a commercial lender and an irrevocable life insurance trust (ILIT) where the lender loans the premiums for a life insurance policy on your life to the ILIT.* In that case, the gift to the ILIT is equal to the amount of loan interest charged — not the entire policy premiums. As a result, you are able to acquire the death benefit needed with little or no gift tax impact.

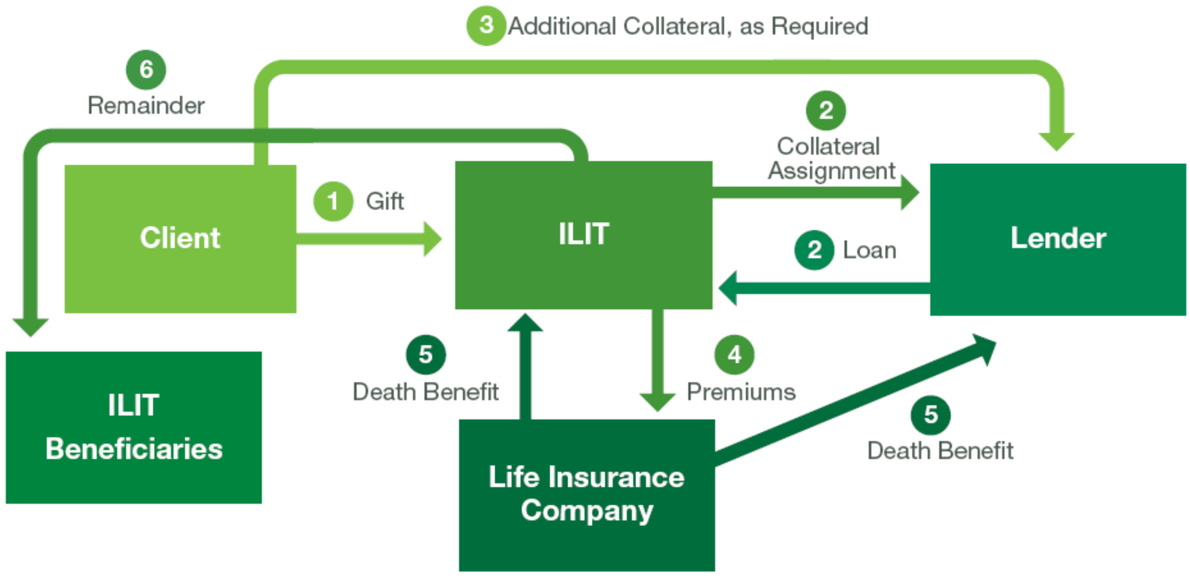
Potential Benefits

- Death benefit payable to the ILIT should pass to the trust beneficiaries estate and income tax-free.
- Substantially reduce or eliminate gift tax cost associated with your desired level of life insurance protection.
- Reduced net out-of-pocket cost for the life insurance.
- Minimal or no impact on the current investment portfolio; you maintain control and use over assets that otherwise would have been liquidated to pay life premiums.
- Potential to leverage your investment portfolio when the portfolio returns are higher than the cost of the loan.

Planning Considerations

- Premium financing is complex and involves many risks, such as the possibility of policy lapse, loss of collateral, interest rate and market uncertainty, and failure to re-qualify with the lender to keep the financing in place and maintain the desired level of insurance protection.
- Subject to the lender's collateral and financial underwriting requirements.
- Loan interest paid by the ILIT is not deductible.
- ILIT assets may be insufficient to pay the premiums, loan interest and/or repay the lender.
- Pledged collateral and, in certain situations, additional out-of-pocket contributions to the ILIT, may be required to retire the debt and/or maintain the desired level of insurance protection.
- A well-planned exit strategy should be in place from the beginning.

How Does It Work?



1. You create an ILIT, the beneficiaries of which are typically your family members.
2. ILIT borrows funds to pay the premiums due and collaterally assigns the policy to the lender. Loan interest may be paid annually or deferred for a period of time, depending on the terms of the loan.
3. You pledge additional assets as collateral.
4. ILIT uses the loan proceeds to purchase a life insurance policy on your life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
5. At death, the loan is repaid from the death proceeds. Alternatively, the loan may be repaid during your lifetime, in a lump sum or installments, from sources outside of your estate. Funds to repay the loan may include an ILIT side fund into which you have contributed annual gifts that have been invested, or an existing trust or partnership that may have significant assets available.
6. At the end of the trust term, the ILIT assets, including death proceeds in excess of the amount required to repay the loan, are distributed to the ILIT beneficiaries free of estate tax and income tax.

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Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

Private Financing

What Is Private Financing?

Private financing is a fair market loan arrangement between you and an irrevocable life insurance trust (ILIT) where you loan the premiums for a life insurance policy on your life to the ILIT.[1] In that case, the gift to the ILIT, if any, is equal to the amount of loan interest charged — not the entire policy premiums. As a result, you are able to acquire a needed life insurance death benefit outside your estate with minimal cash flow and/or transfer tax impact.

The ILIT repays you the loan principal and accrued interest, from the life insurance proceeds or from other sources during your lifetime. Potentially, a return of premium rider can be used to repay the premium loan without diminishing the death benefit needed.

In summary, private financing premiums can make great economic sense when there is a positive arbitrage between the policy's internal rate of return or the trust's investment return and the loan interest rate.

Potential Benefits

- Death benefit payable to the ILIT should pass to the trust beneficiaries transfer tax and income tax-free.
- Minimize transfer tax cost associated with acquiring your desired level of life insurance protection.
- Flexible, attractive loan terms (e.g., loan can be demand or term and made annually or in an upfront lump sum, loan interest paid current or accrued, payable on death and interest rate based on AFR).
- Loan interest paid to you is not subject to income tax if the ILIT is a grantor trust (i.e., you are treated as the owner of all ILIT assets for federal income tax purposes).[2]
- Not subject to the third-party lender's approval or stringent collateral requirements.
- No risk of loan being called by third-party lender.

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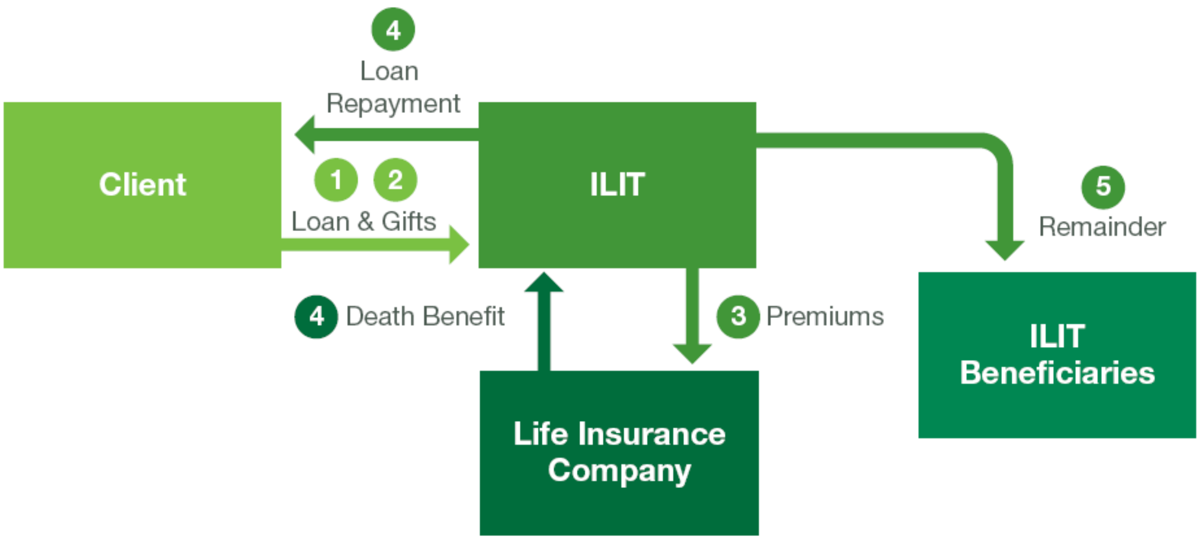
[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping tax). Failure to do so could result in adverse tax treatment of trust proceeds.

[2] A grantor trust is drafted in such a manner as to subject itself to the grantor trust provisions of IRC§§671-679. Revenue Ruling 85-13, 1985-1 CB 194. When a grantor enters into a transaction with a trust under which he or she is deemed the owner for income tax purposes, and therefore all items of income and deduction related to the transaction are attributed to the grantor, the result is a non-taxable event. Revenue Ruling 85-13; 1985-1 CB 194.

Planning Considerations

- Proceeds of loan repayment may be subject to estate tax.
- Loan interest payments may be subject to income tax.
- The loan interest paid by the ILIT is not deductible.
- ILIT assets may be insufficient to pay the premiums, loan interest, and/or repay the lender.
- May require you to make additional loans or gifts to the ILIT to maintain the desired level of insurance protection.

How Does It Work?



1. You create and fund an ILIT, the beneficiaries of which are typically your family members.
2. You loan the premiums for a life insurance policy on your life to the ILIT at the applicable federal rate (AFR). The loan can be made in a lump sum or in a series of annual scheduled loans.
3. With the loan proceeds, the trustee of the ILIT purchases a life insurance policy on your life, retains ownership rights, and designates the ILIT as the beneficiary of the policy. The policy usually serves as the collateral for the loan. Loan interest can be paid current or accrued.
4. At death, the death benefit is paid to the ILIT and the loan is repaid from the death proceeds. Alternatively, the loan may be repaid during your lifetime in a lump sum or installments, from sources outside of your estate. Funds to repay the loan may include an ILIT side fund to which you have contributed annual gifts that have been invested, or an existing trust or partnership that may have significant assets available.
5. At the end of the trust term, the ILIT assets, including death proceeds in excess of the amount required to repay the loan, are distributed to the ILIT beneficiaries free of estate tax and income tax.

Private Split Dollar

What Is Private Split Dollar?

Private split dollar is a premium sharing arrangement between you and an irrevocable life insurance trust (ILIT).* You enter into a non-equity collateral assignment agreement with ILIT wherein you agree to pay the full annual premium in exchange for a restrictive collateral assignment in the policy which entitles you to be repaid the greater of the premiums paid or the total cash value of the policy at some point in the future. As a result, you are able to acquire the death benefit needed with little or no gift tax impact.

The collateral assignment may be satisfied with life insurance proceeds or from other sources during your lifetime. Potentially, a return of premium rider can be used to satisfy the collateral assignment without diminishing the death benefit needed. In summary, private split dollar can provide a tax-efficient and cost-effective strategy to pay for life insurance.

Potential Benefits

- Death benefit payable to the ILIT should pass to the trust beneficiaries estate and income tax-free.
- Minimize gift tax cost associated with your desired level of life insurance protection.
- Annual exclusion gifts can be leveraged significantly.
- Lock in insurability now at a low gift tax cost, while maintaining flexibility to terminate or continue the plan.
- Potential ability to be repaid the greater of the premiums paid or the total cash value.

Planning Considerations

- Collateral assignment may be subject to estate tax.
- Annual term cost increases as you grow older.
- Cash is required to fund the premiums.
- A well-planned exit strategy should be in place from the beginning.
- Must comply with 2003 Final Split Dollar Regulations.

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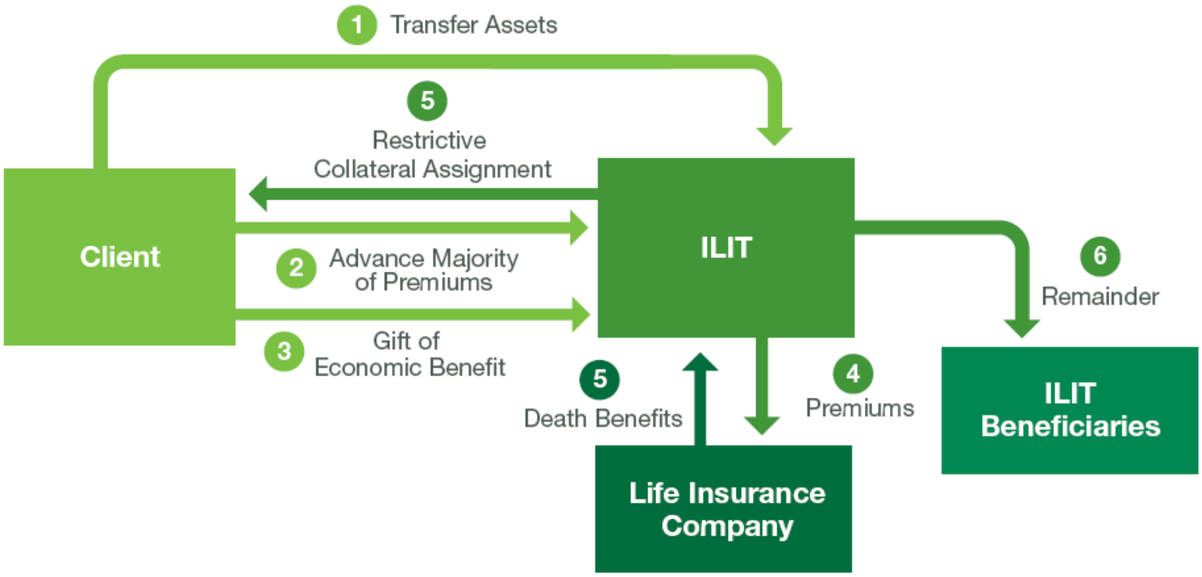
**Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including generation-skipping tax). Failure to do so could result in adverse tax treatment of trust.*

How Does It Work?



1. You create an ILIT, the beneficiaries of which are typically your family members.
2. You enter into a non-equity collateral assignment agreement with the ILIT wherein you agree to pay the full annual premium in exchange for a restrictive collateral assignment in the policy which entitles you to be repaid the greater of the premiums paid or the total cash value of the policy at some point in the future.
3. You make annual gifts of the economic value of the death benefit or "term cost" of the premiums to the ILIT.
4. ILIT purchases a life insurance policy on your life, retains ownership rights and designates the ILIT as the beneficiary of the policy.
5. At death, the collateral assignment may be satisfied from the life insurance death proceeds. Alternatively, the collateral assignment may be satisfied during your lifetime, from sources outside of your estate.
6. At the end of the trust term, the ILIT assets, including death proceeds in excess of the amount required to satisfy the collateral assignment, are distributed to the ILIT beneficiaries estate and income tax free.

Sale to a Grantor Trust

What Is a Sale to a Grantor Trust?

An installment sale to a grantor trust (sale to a grantor trust or SAGT) is an estate freeze technique that may help you transfer significant wealth to future generations with minimal transfer tax impact.[1] To reduce the size of your estate and minimize estate tax, you may consider gifting highly appreciating and/or income-producing property (appreciating assets) to future generations.

While gifting is a simple approach and will reduce the size of the taxable estate, there is one major drawback: The gift may exceed your gifting capacity and result in a taxable gift. Rather than gifting appreciating assets, you can sell appreciating assets to a grantor trust in exchange for an interest-bearing promissory note at the applicable federal rate (AFR). The sale "freezes" the value of the appreciating assets by converting the appreciating assets into a fixed-yield, non-appreciating asset (promissory note).

As a result, all post transfer appreciation and income is removed from your estate. Because the trust is a grantor trust, you pay the grantor trust income tax liability at your individual income tax rate, which means grantor trust assets effectively grow income tax-free.[2] If you die before the note is repaid, only the balance of the note is included in your estate. A portion of the income earned on the appreciating assets may be leveraged by the grantor trust to acquire a needed life insurance death benefit outside of your estate.

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[1] Trusts should be drafted by an attorney familiar with such matters in order to take into account income and transfer tax laws. Failure to do so could result in adverse tax treatment of trust proceeds.

[2] The grantor trust is drafted in such a manner as to subject itself to the grantor trust provisions of IRC §§671-679. Revenue Ruling 85-13, 1985-1 CB 194.

Potential Benefits

- Grantor trust assets grow income tax-free.
- Removes post-sale asset appreciation and income from your gross estate.
- No income or gain is recognized on the sale of property between you and the grantor trust
- Death benefit payable to the grantor trust should pass to the trust beneficiaries transfer tax and income tax-free.
- Minimize transfer gift tax cost associated with acquiring your desired level of life insurance protection.
- Flexible, attractive terms of repayment (e.g., installment loan payment can be interest only with a balloon payment, interest rate based on AFR not the potentially higher IRC §7520 rate).
- Loan interest paid to you is not subject to income tax if the ILIT is a grantor trust (i.e., you are treated as the owner of all ILIT assets for federal income tax purposes).*

Planning Considerations

- Your annual exclusions, applicable lifetime gift tax exemption and generation-skipping transfer tax exemption may be required in the initial gift to "seed" the trust.
- The balance of the installment note at death will be included in your gross estate.
- Income tax uncertainty at your death if promissory note remains unpaid. In that case, a number of issues arise including whether death causes a recognition event, the character of gain if recognized and the grantor trust's basis in the asset(s) purchased in the SAGT.
- Grantor trust assets may not produce sufficient income or appreciation to service the note payments.
- May require you to make additional loans or gifts to the grantor trust in order to maintain the desired level of insurance protection.
- Loan interest paid by the grantor trust is not deductible.
- No statutory roadmap.

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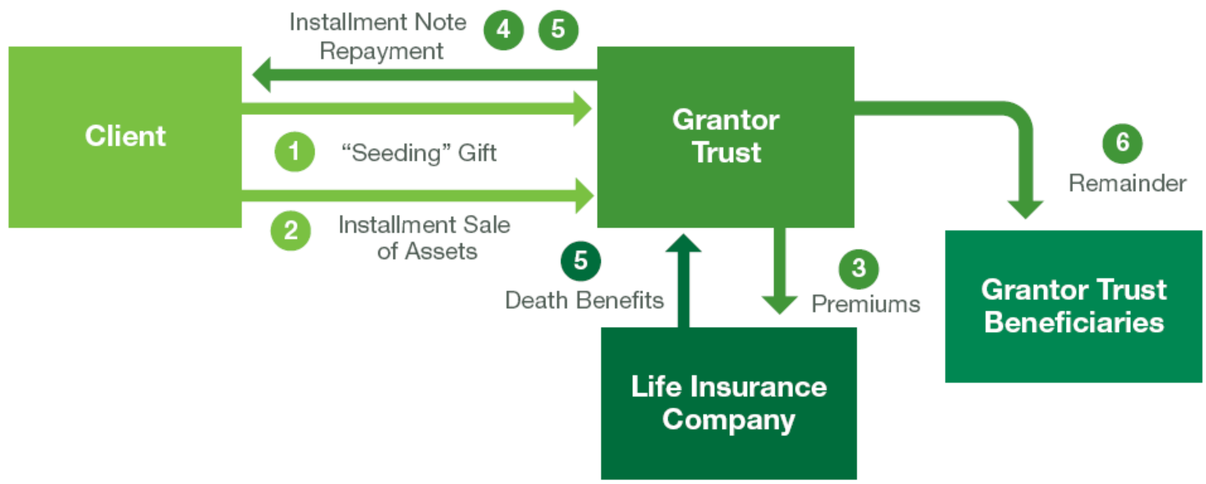
**When a grantor enters into a transaction with a trust under which he or she is deemed the owner for income tax purposes, and therefore all items of income and deduction related to the transaction are attributed to the grantor, the result is a non-taxable event. Revenue Ruling 85-13; 1985-1 CB 194.*

How Does It Work?



1. You create and fund a grantor trust with cash or appreciating assets to "seed" the trust.
2. After the initial gift, you sell additional appreciating assets to the grantor trust, in exchange for an interest-bearing promissory note. Grantor trust assets appreciate and/or earn income each year. You pay income tax annually on the income earned on grantor trust assets. Grantor trust assets effectively grow income tax-free.
3. The trustee of the grantor trust (trustee) purchases a life insurance policy which may be used to pay the balance of the note and provide estate liquidity at your death.
4. The trustee uses the income earned by the grantor trust assets to service the note and pay life insurance premiums
5. At death, the loan is repaid from the death proceeds. Alternatively, the loan may be repaid during your lifetime in a lump sum or installments, from sources outside of your estate. Funds to repay the loan may include a side fund to which you have contributed annual gifts that have been invested, or an existing trust or partnership that may have significant assets available.
6. At the end of the grantor trust term, death proceeds in excess of the amount required to repay the loan are distributed to the grantor trust beneficiaries free of estate tax and income tax.

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