

“The Frozen T-CLAT”

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Breakout Session C (8:20 AM)



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Typical Planning Strategies

- Life Insurance (leveraged funding of estate tax payment) – Insufficient to cover estate tax liability
- GRAT – Life expectancy & control are issues
- FLP & Sale to Intentionally (Delightful) Grantor Trust – Degree of effectiveness depends in part on longevity & willingness to implement
- Zeroed-Out T-CLAT – Solves estate tax problem but assets are unavailable to beneficiaries during term of the CLAT & limits dynasty planning

CLAT/CLUT BASICS

- CLAT can result in a “zero” remainder interest to non-charitable beneficiary thereby eliminating gift & estate taxes
- GSTT exemption cannot be allocated until the end of the CLAT term
 - So CLAT is typically not used in dynasty planning

CLAT/CLUT BASICS

- CLUT cannot be “zeroed out” for estate & gift tax purposes, but GSTT exemption may be allocated at the time of transfer
 - Therefore, CLUTS are typically used in dynasty planning
- CLAT/CLUT are considered “private foundations” and are subject to IRC § 4941 self-dealing rules (See IRC § 4941(a) & -(b) for initial & additional tax imposed)

CLAT/CLUT Strategies

- Accordingly, our typical “clean-up strategy” for zeroing out estate taxes is to create a formula clause which results in a T-CLAT & T-CLUT being funded at the time of a decedent’s death:
 - T-CLUT is funded with assets equal to the GSTT exemption
 - “Zeroed-out” T-CLAT is funded with the remaining assets

CLAT/CLUT Strategies

- RESULT: NO ESTATE TAX, and balance of assets in T-CLUT at end of term funds dynasty trust
- BUT: Family will have to wait until end of term of T-CLAT & T-CLUT to receive any assets
 - Example: Based on February 2008 AFR of 4.2%, a 20 year T-CLAT is “zeroed out” with annual payments of approximately 7.5%

CLAT/CLUT Strategies

- As a result, “zeroed-out” T-CLAT/T-CLUT strategy works best when other planning techniques leave assets to family without adversely impacting estate & GST tax liability
 - Examples: ILITs, “zeroed-out” GRATs, and/or FLPs/FLLCs and sale to IDITs
- Another alternative is to compromise estate & GST tax planning by leaving up to “applicable credit amount” (formerly unified credit) directly to next generation and leave balance to T-CLAT/T-CLUT

CLAT/CLUT Strategies

- Our experience: clients considering T-CLTs typically balance desire to minimize estate taxes with desire to leave as much as they can to beneficiaries as soon as possible after death.
 - Because beneficiaries do not have access to assets immediately, clients compromise estate tax and GSTT savings

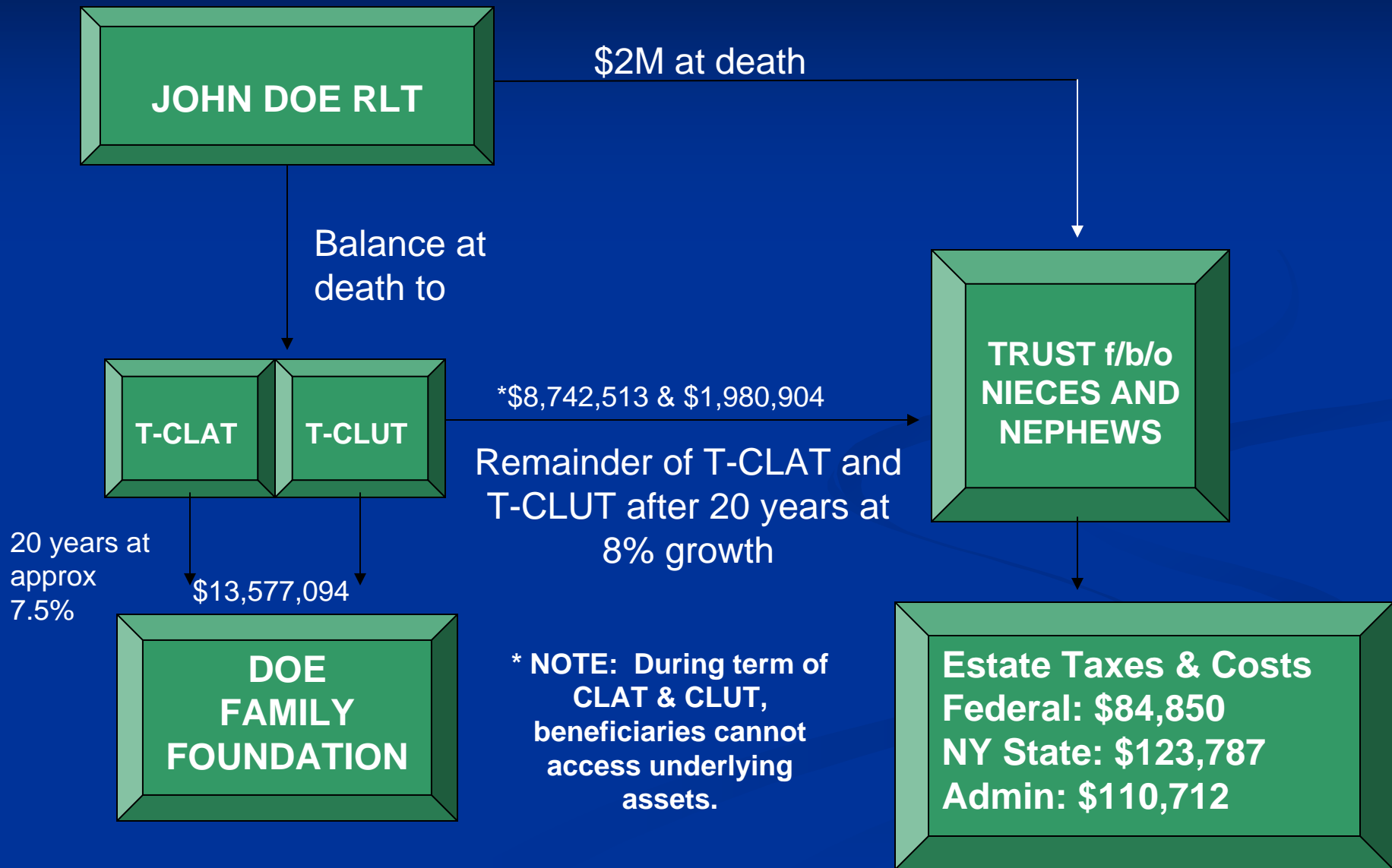
CLAT/CLUT Strategies

- See Case Study #1: Sale of FLP/LLC interests to IDIT frustrated by sudden illness & age of client
- See Case Study #2: GRAT not attractive since client wants to retain control & use of his assets. Using IDIT based in Alaska and naming grantor as beneficiary has some risk; clients sometimes view as overly complicated and does not eliminate estate taxes since note included in estate (or assets used to pay off note before death are included in estate)
(NOTE: Could use T-CLTs as clean-up strategy)

CLAT/CLUT Strategies

- Review of Potential T-CLAT/T-CLUT strategy in Case Study #2: Use T-CLAT & T-CLUT but leave applicable credit amount to beneficiaries

John Doe Estate Plan CLAT & CLUT



Frozen T-CLAT Strategy

- See Donald R. Teschler & Barry A. Nelson, *The Frozen T-CLAT*, 143 Tr. & Est. 33 (July 2004)
- Designed to:
 - eliminate estate taxes,
 - maximize opportunity for dynasty planning,
 - allow grantor use & control of assets during life,
 - provide significant gifts to charity(ies), and
 - allow beneficiaries access to assets during term of “zeroed-out” T-CLAT following grantor’s death

Frozen T-CLAT Strategy

- Our feedback from clients:
 - This strategy is SIMPLE -- without a lot of moving parts
 - Also, not much for clients to implement during life

Frozen T-CLAT: Creation

- Step 1: Create formula zeroed-out T-CLAT in will or RLT
- Step 2: Create irrevocable dynasty trust (does not have to be IDIT)
- Step 3: Fund dynasty trust & allocate GST exemption
- Step 4: Assist client (individually or as trustee of RLT) in entering into “option agreement”:
 - Option grants dynasty trust the right to acquire assets from estate or RLT at “fair market value”
 - Use discounted assets such as LP or LLC membership interests

Frozen T-CLAT: Creation (Cont'd)

- Step 5: Define terms of transaction so that consideration given to exercise option is secured promissory note amortized over term of CLAT at applicable federal rate or Section 7520 rate (whichever is greater)
- Step 6: Designate charitable beneficiary of T-CLAT, *e.g.*, private foundation, community foundation, or public charity

Frozen T-CLAT: Details

- Note payment should be equal to T-CLAT payment plus any costs associated with administration of T-CLAT
- At end of T-CLAT term, note paid off & T-CLAT no assets to pass to non-charitable beneficiary
 - Accordingly no GSTT liability arising from frozen T-CLAT strategy
- Option to purchase should be for discounted FLP or LLC membership interests owned by estate or RLT at time of death

Frozen T-CLAT: Details (Cont'd)

- T-CLAT is deemed private foundation and subject to self-dealing rules
 - Frozen T-CLAT strategy must satisfy self-dealing rules – see below for procedures that must be implemented so that “frozen T-CLAT” strategy does not trigger excise tax under IRC § 4941(a) & -(b))
- Assets in dynasty trust must be managed and administered to satisfy promissory note payments
- During T-CLAT term, trustee of dynasty trust may allow beneficiaries access to its funds through distributions and/or loans
- Sale (option) must be approved by appropriate state court

Frozen T-CLAT: Self-Dealing Rules

- Section 4941 (d) provides that “self dealing” means any direct or indirect
 - (A) sale or exchange or leasing of property between CLAT and disqualified person;
 - (B) lending of money or other extension of credit between CLAT and disqualified person;
 - (C) furnishing of goods, services, or facilities between CLAT and disqualified person;
 - (D) payment of compensation or reimbursement of expenses by CLAT to disqualified person;
 - (E) transfer to or use by or for the benefit of a disqualified person of income or assets of CLAT.
- Clearly frozen CLAT strategy violates self-dealing rules unless it falls under one of exceptions

Frozen T-CLAT: Self Dealing Rules: Estate Administration Exception

- Treas. Reg. s. 53.4941(d)-1(b)(3) provides exception to self-dealing rules for transactions during administration of estate or RLT (that becomes irrevocable on grantor's death) if trustee:
 - (1) either possesses power of sale with respect to property, has power to reallocate property to another beneficiary, or is required to sell property under terms of any option;
 - (2) Transaction is approved by court having jurisdiction over estate or RLT or CLAT;

Frozen T-CLAT: Self Dealing Rules: Estate Administration Exception (Cont'd)

(3) Transaction occurs during settlement of estate/RLT (See Treas. Reg. s. 53.4941-1(b)(2)(iv) (“reasonable period for settlement”))

(4) Estate/RLT receives amount equal to or in excess of FMV of CLAT’s property; and

(5) Transaction either (a) results in CLAT receiving interest or expectancy at least as liquid as one given up; (b) CLAT receives assets related to active carrying out of its exempt purpose; or (c) is required under terms of any option which is binding on estate/RLT

Frozen T-CLAT: Self Dealing Rules: Estate Administration Exception (Cont'd)

■ Summary for implementation:

- Create option before death and set its terms calling for FMV payable by secured promissory note with interest rate of greater of Section 1274 or 7520 rates;
- Will or RLT and dynasty trust documents must trustee to enter into and execute option agreement
- Transaction must be approved by appropriate state court
- Transaction must be completed before T-CLAT is funded and post-death estate/RLT administration terminates

Frozen T-CLAT Applications

- See Case Study #1:
 - “Death-bed” planning results in zero estate tax (savings of up to \$2.7M on \$8M estate)
 - Beneficiaries have access to assets during term of T-CLAT

Case Study I

- Jane Smith (Single - Widowed)
- Age 90
- Assets Total: \$8M
- Under Guardianship
- Uninsurable
- One child & two grandchildren
- GOAL: Estate tax minimization
- Physical health good but then stroke resulted in Jane being placed on life support

Frozen T-CLAT Applications (Cont'd)

- See case study #2:
 - Grantor retains control of assets during life
 - Planning results in zero estate tax
 - Economic benefit to beneficiaries depends on rate of return on assets & spread between discounted value of FLP/LLC and FMV of underlying assets
 - Beneficiaries have access to assets during T-CLAT's term

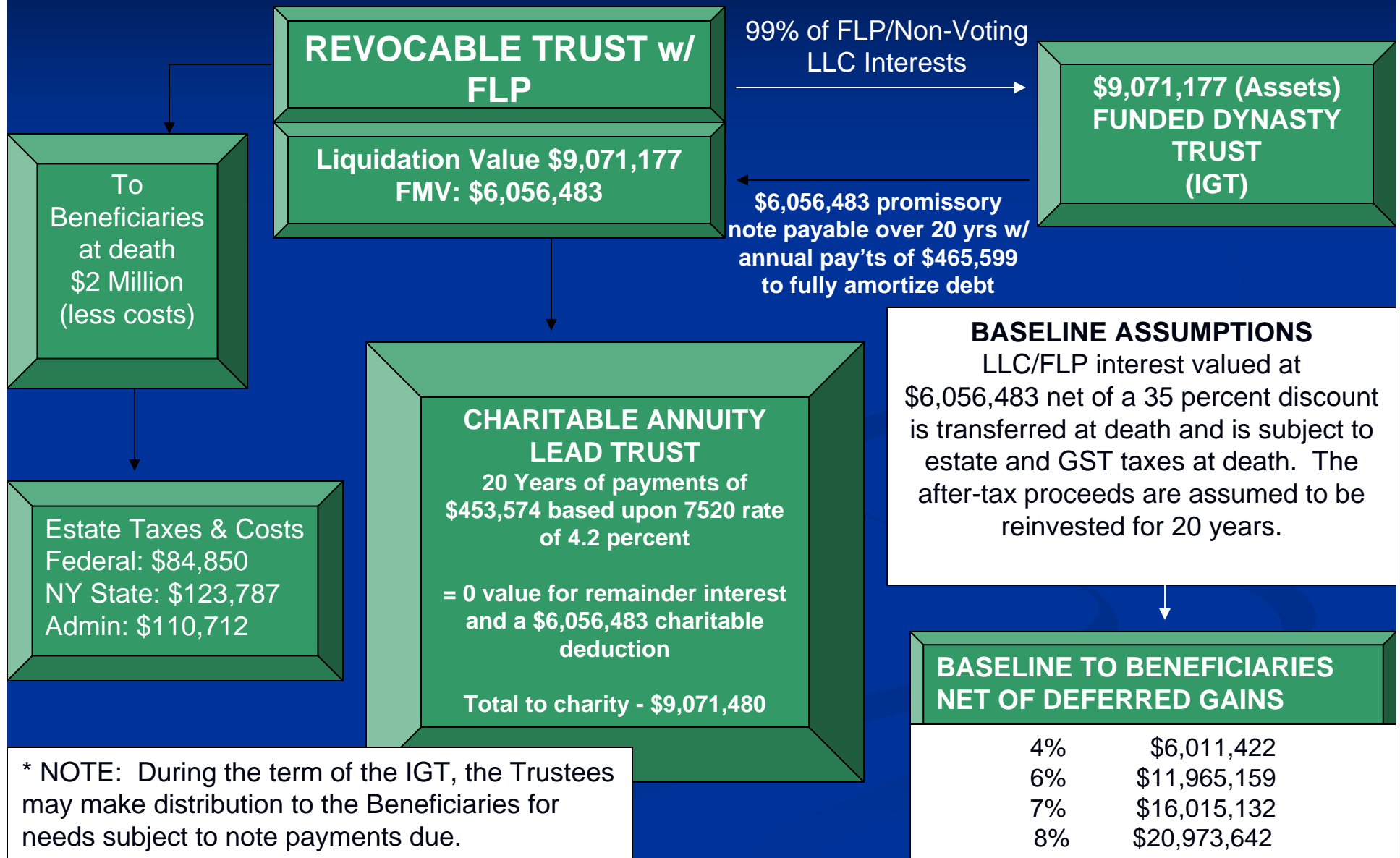
Frozen T-CLAT Applications (Cont'd)

- Case Study #2 assumptions:
 - 7520 rate: 4.2%
 - AFR: 4.5%
 - 7.5% annual CLAT payments for 20 years
 - 8% growth of assets in dynasty trust

Case Study II

- John Doe (Single)
- Age 68
- Assets Total: \$11,071,177
- ILIT Owns \$2.5M Policy
- Control during life mandatory
- GOAL: Estate tax minimization
- Receptive to charitable giving

SAMPLE STRUCTURE: HOW THE FROZEN T-CLAT WORKS



Frozen T-CLAT Research

- See Donald R. Tescher & Barry A. Nelson, *The Frozen T-CLAT*, 143 Trust & Estates 33 (July 2004)
- See Matthew J. Madsen, *Funding a CLAT With a Note Can Accelerate the Transfer of Wealth to Heirs*, 30 Estate Planning 485 (Oct. 2003)
- IRC §§ 4941(d), 4946 & 4947(a)(2)
- Treas. Regs. §§ 53.4941(d)-1(b)(3) & 53.4947-1(b)(2)(iv)
- Priv. Ltr. Ruls. 200232033, 200124029 & 20024052