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The Practitioner Estate Planning

# Mortal Thoughts

Designing a Plan to Gain Maximum Benefit From Philanthropic Giving

By Robert E. Burton

**T**he recent Sotheby's auction of personal belongings from the estate of Jacqueline Kennedy Onassis focuses attention on a number of important lessons in estate planning. Of all areas of personal planning, estate planning is probably the most neglected, even by people with significant wealth. Most likely, this is because estate planning forces an individual to face and accept the unpleasant reality of one's own mortality.

Estate taxes are one of the major considerations in estate planning. Under current law, the tax on the first \$600,000 of an estate, calculated at the lowest brackets, is eliminated by application of the unified credit of \$192,800. The starting tax rate on an estate over \$600,000 is 37 percent, and the rate climbs rapidly to 55 percent on all values over \$3 million. On values between \$10 million and \$21.04 million, there is an additional tax of 5 percent, which serves to phase out both the unified credit and all rates below 55 percent. This results in a flat 55 percent rate starting at the first dollar on truly large estates.

Planned philanthropy — arranging for property to pass, generally at death, to qualified charitable organizations — is deductible from the estate in calculating the estate tax. This is the only "pure" estate-tax deduction, because it is for property put to positive use rather than for assets lost to debts and expenses or where the deduction serves only to defer taxes until the surviving spouse's death.

It is likely that Ms. Onassis' heirs held the Sotheby's auction to help raise cash to pay estate taxes. If, as rumored, her estate was in the neighborhood of \$100 million, her estate tax would normally have been about \$55 million. Certainly, the items sold at the Sotheby's auction were never expected to raise that kind of money. Even the unexpectedly large sum raised — some \$34 million or so — would not come close to covering that large a tax, particu-

larly after paying the large capital-gains tax due on the difference between the estate-tax value of the items sold and the astronomical sums for which they were actually sold at auction.

According to some reports, the actual estate tax on Ms. Onassis' estate was somewhere around \$15 million, not insignificant but a far cry from \$55 million. Thus, Ms. Onassis must have done some sophisticated estate planning if she reduced her estate tax bill by \$40 million. In fact, she did.

Pursuant to her will, Ms. Onassis used a form of planned philanthropy known as a charitable lead trust. Under this arrangement, income from property for a specified term of years, or during specified individuals' lifetimes, is payable exclusively to one or more charitable organizations; then, at the end of the applicable time period, the property itself (the trust principal) passes to or for the benefit of the desired family members, usually children or grandchildren.

For estate tax purposes, the value of the income interest payable for philanthropic purposes is deducted from the value of the property placed in the charitable lead trust. The deduction is determined from government tables and can depend on the property's fair market value; the specified rate of income payable to the charitable organization; the applicable federal rate during the month the trust is created; and the specified term of years or life expectancies over which the trust will last.

A charitable lead trust can enable an estate owner to pass large amounts of property to family members with a relatively small estate-tax bite — assuming family members are able to do without the income from the property during the term of the trust (a condition that surely applied to the surviving members of Ms. Onassis' family).

Like all available planning tools, a charitable

lead trust can produce excellent results under the right circumstances. And it should not be overlooked that one of the benefits of this tool is its substantial philanthropic element. A charitable lead trust can also be used effectively during one's lifetime to save gift taxes.

Another, perhaps more common, form of planned philanthropy is the charitable remainder trust. This can be viewed as the opposite of the charitable lead trust, in that the income interest is reserved for family members, with the principal ultimately passing to one or more charitable organizations at the end of

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the trust term. While charitable remainder trusts can be created at death, their primary use is during one's lifetime. A charitable remainder trust can accomplish these results:

■ During the estate owner's lifetime, a charitable remainder trust will create an immediate income tax deduction, which can be spread over as many as six years; avoid capital gains tax on the sale of appreciated assets; and significantly increase the estate owner's spendable income.

■ At the estate owner's death, a charitable remainder trust will save estate taxes, benefit the desired philanthropic organizations, create a lasting legacy to benefit the community and achieve a measure of immortality.

Perhaps the largest perceived drawback of the charitable remainder trust is that the property placed in the trust ceases to benefit

the family at the end of the trust term, because it is used exclusively for philanthropic purposes from that point forward. For this reason, many individuals who consider using a charitable remainder trust as part of their estate plan, and who would benefit significantly from its use, choose not to do so.

This drawback can be overcome in most situations by the use of life insurance on the estate owner's lives (typically owned by adult children) or, better still, by a wealth replacement trust. This is an irrevocable trust that owns life insurance on the estate owner's life and is created for the benefit of the family so as to make the life insurance estate tax free as well as income-tax free.

Dramatic benefits can be achieved by using a charitable remainder trust in combination with a wealth replacement trust. Suppose a married couple in their early 60s owns stock in a Silicon Valley company with a cost basis of \$100,000, a current market value of \$1 million, and a current annual dividend at 2 percent (\$20,000).

If the couple sold the stock, they would have a \$900,000 long-term capital gain, with a combined federal and state capital-gains tax of more than \$300,000, leaving less than \$700,000 to reinvest to produce income. In addition, the \$700,000 would ultimately be subject to estate tax, leaving only about \$350,000 for their family.

If, however, this stock were donated to a charitable remainder trust, the typical deduction would be about \$250,000, saving the couple as much as \$100,000 of income tax. Then, if the stock were sold within the charitable remainder trust, the total proceeds could be reinvested to produce income, and if the specified income payout rate was 7 percent, the estate owners' annual income would now be \$70,000, instead of the \$20,000 they were previously receiving or the \$48,000 or so they would have been receiving had they sold the stock themselves. Additionally, when both the husband and the wife die, there will be no estate tax on the property in the charitable remainder trust.

At the couple's death, the property would pass exclusively for philanthropic purposes (which is why there will be no estate tax), and the family would receive nothing — except, perhaps, satisfaction along with an elevated standing in their community.

Now suppose the couple had a wealth replacement trust. The premium cost of sufficient life insurance to replace what the family would have received if nothing had been done (here, perhaps \$500,000) probably can be totally financed using nothing more than the income-tax savings achieved from the gift to the charitable remainder trust. If necessary, a little of the significant additional income created as a result of the arrangement can also be tapped for this purpose. When properly structured, the wealth replacement trust can be completely free of gift, estate, income and generation-skipping taxes.

Everyone benefits from this arrangement. But why is it permitted — even encouraged — under current tax law? Because the government is interested in promoting private philanthropy, but also because it actually produces more, rather than less, tax revenue over the long term. Why don't more people use it? Mostly due to lack of knowledge, but also because it is both complicated and irrevocable. And perhaps because it almost sounds too good to be true.

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