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ESTATE PLANNING

The Best Zero-Tax Planning Tools Help Clients Reach Their Goals

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The Best Zero-Tax Planning Tools Help Clients Reach Their Goals

This article explains how advisors can start with three basic zero-tax planning tools and then choose additional tools to create leveraged, total wealth control, and optimized plans that may result in greater benefits for clients and their heirs.

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American public policy promotes zero-tax planning. The Tax Code has traditionally encouraged the orderly transfer of ownership and control of wealth to the next generation by giving large tax benefits to clients who move their wealth into trusts. Current tax laws allow large deductions against transfer taxes and income taxes when a client redirects tax money to charitable trusts or other types of tax-advantaged investments.

Most taxpayers can benefit from zero-tax planning techniques. Many individuals with a net worth of more than $1 million can lower tax bills significantly by applying ideas discussed in this article. When a client's net worth is greater than $10 million, the benefits of zero-tax planning may exceed the costs by a factor of 100 to 1.

People desiring a zero-tax plan will typically seek out a tax advisor with technical expertise involving tax-exempt trusts, tax-exempt securities, or tax-exempt insurance policies. These tax advisors will often jump at the opportunity to use a tool that will lower taxes. Unfortunately, planners sometimes focus on just one of the various estate, gift, generation-skipping, capital gains, income, or alternative minimum taxes affecting a client's wealth. This preoccupation with just one or a few of the six common taxes can result in planning team members working at cross purposes and making faulty assumptions about the client's goals. Furthermore, as advisors combine different planning tools, they may realize how the tools compete for cash flow or interact in a way that undermines a client's goal of eliminating all unnecessary taxes.

Years of experience working with high net worth clients teach that planning team members should follow a proven process when doing zero-tax planning. First, advisors must show how each recommendation helps fulfill the client's vision. Second, advisors should consider enhancing basic plans to create leveraged or total wealth control plans that redirect tax money to family or favorite causes. Third, advisors should integrate tax planning tools using a wealth optimization process that illustrates simple solutions to complex planning challenges. The following discussion addresses these issues in greater detail.

Advisors must show how each recommendation helps fulfill the client's vision

An advisor must integrate tax planning techniques with other tools that a client may use for asset pro-

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tection, business succession, portfolio management, retirement planning, or other objectives. The process of choosing and integrating tools requires an evaluation of the client's planning goals that takes into account the vision that most inspires the client. Uniting a team of advisors to implement the most effective planning tools is much like bringing together the architect, electricians, plumbers, stone masons, and other builders to construct a dream home. So that all the team members can review the proposed building materials and then work in harmony, an architect should first create a blueprint.

Creating a custom blueprint requires seasoned expertise with choosing, customizing, integrating, and implementing the right components. A 21st-century wealth advisor may consider literally hundreds of different planning instruments when creating a wealth blueprint. Whereas a quarter century ago, advisors typically used just a handful of planning instruments, the modern advisor must now sort through a complex array of trusts, money management instruments, and insurance techniques in order to suggest which legal instruments can form the best building blocks when refining a plan to realize the client's dream.

Experienced advisors realize that no one planner has sufficient knowledge about all the legal tools usually required for a zero-tax plan. For example, advisors with broad expertise involving trusts and legal tools frequently admit that they do not know how to find the optimal combination of investments and insurance to fund or complement the legal strategies. In fact, finding the best combination of legal, financial, and insurance concepts often involves analyzing quintillions of possible outcomes without losing sight of the client's cash flow needs, wealth transfer goals, and envisioned future.

At least one planning team member must have a proven process for uniting the other planning team members around the client's vision while illustrating how planning techniques affect financial statements and realize nonfinancial goals as well. Fortunately, advanced software packages now give advisors the power to analyze the impact of adding legal and financial instruments to a client's plan. As long as one advisor on a planning team has an effective process for choosing the right planning tools before running the software, advanced technology can evaluate and illustrate desired outcomes with clear reports. The rest of this article will explain how advisors can start with just three basic zero-tax tools and then choose additional tools to create leveraged, total wealth control, and optimized plans.

Advisors should consider enhancing basic plans to create leveraged or total wealth control plans

A common *basic* zero-tax plan usually involves three planning tools: a revocable living trust ("RLT"), an irrevocable life insurance trust ("ILIT"), and a generation-skipping trust ("dynasty trust"). Even a basic estate plan, if based on the RLT, ILIT, and generation-skipping strategies, can eliminate millions of dollars of unnecessary taxes. The RLT can currently zero out transfer taxes on an estate of $4 million or less by using AB provisions to take advantage of the $2 million exemption given to each of a husband and wife when a married couple establishes a revocable living trust. The ILIT can theoretically avoid all estate taxes on tens of millions of dollars of death benefits while also eliminating income taxes on death benefits or loans made from life insurance cash values. The dynasty trust can offer advantages of the RLT and ILIT trust while also leveraging generation-skipping transfer ("GST") tax exemptions to zero out taxes in multiple future generations.

An advisor can enhance the benefits of the basic plan by adding a family limited partnership ("FLP"), qualified personal residence trust ("QPRT"), and intentionally defective irrevocable trust ("IDIT") to create a *leveraged* plan that directs more wealth to family members. Leveraged plans generate benefits by making the best use of the $1 million gift tax exemption available to all American taxpayers. An astute advisor can leverage these exemptions to transfer millions to heirs with zero transfer taxes. For example, an FLP can be used to discount $3 million of assets down to $2 million or less, and a married couple can use their gift tax exemptions to move all the wealth to their children with no gift taxes. A QPRT can be used to transfer a $4 million home to children tax-free in 20 years or less by leveraging less than $1 million of the gift tax exemption.

Intentionally defective irrevocable trust. Leveraged zero-tax plans frequently include IDITs because they can provide the most efficient use of a client's gift tax exemption. These benefits result from the IRS respecting the IDIT for estate tax purposes but regarding the IDIT as "defective" for income tax purposes. Most IDITs are created primarily to transfer ownership, management, and control to heirs in the right way at the right time.

The IDIT rewards the pursuit of non-tax goals with four significant tax benefits. First, the IDIT helps a client avoid estate taxes by moving assets out of an estate to a trust where the assets can appreciate without any estate tax on the growth. Second, IDITs avoid gift taxes because the proper sale of an asset to the defective trust is not a gift. Third, IDITs avoid capital gains taxes because the IRS disregards sales by a grantor to a defective trust when calculating income taxes. Fourth, when the sale to the IDIT is completed, the client will usually take back an interest-bearing note to provide lifetime income. Given the defective nature of the IDIT, "interest" paid to the grantor on the note need not be subject to the ordinary income taxes normally assessed on interest. Payments on IDIT notes may be paid as capital gains income or even tax-free distributions, depending on the type of income produced by assets in the IDIT.

Total wealth control plan. While the leveraged plan can reduce or eliminate taxes, a more sophisticated client will frequently want to enhance the leveraged plan and maintain control over all his financial and charitable capital using a *total wealth control* plan. Such a plan can eliminate transfer taxes while generating large income tax savings which, when invested prudently, can help beneficiaries receive a larger inheritance than would have been available if the family had simply paid taxes.

Furthermore, a total wealth control plan redirects tax money to a foundation to create a pool of "community capital" that family members can distribute to their favorite charitable causes. Instead of allocating wealth as an involuntary philanthropist who just pays taxes to fund bureaucratic programs, a client with a total wealth control plan can become a voluntary philanthropist and allocate all his assets to the social good through deliberate and loving transfers to family members and favorite charities.

Use of charitable trusts. A total wealth control plan may include a supporting organization ("SO"), charitable remainder trust ("CRT"), testamentary charitable lead annuity trust ("TCLAT"), and an inter vivos grantor charitable lead annuity trust ("Super CLAT"). These tools typically provide both transfer tax and income tax benefits. Illustrations of these tools can show how a client can minimize transfer taxes, reduce income taxes, increase gifts to heirs, and fund charity with money that would have gone to taxes.

A total wealth control plan lets the client's heirs receive more financial capital than they would have inherited before planning. The heirs can also control money that would have been spent on taxes. Because beneficiaries can redirect tax money to a charity that gives the heirs influence in the community, beneficiaries can derive much enjoyment from receiving both a financial capital inheritance and a charitable capital inheritance. Because heirs can have great control over both types of capital, a zero-tax plan that directs money away from the government and to heirs and charity is known as a total wealth control plan.

To maximize control over charitable funds, advisors may recommend a supporting organization. The SO is often known as a "public family foundation" because it produces the large income tax deductions of a public charity while still providing much of the flexibility associated with a traditional private foundation. Donors can receive market value deductions for contributions of appreciated assets and use the deductions to offset up to 30% of adjusted gross income. Because SOs can generate tax benefits that are much more attractive than those available from private foundations, SOs are popular recipients of gifts from CRTs, TCLATs, Super CLATs, and other charitable tools.

Practice Notes

An optimized wealth plan, which illustrates an optimal combination of estate planning tools and portfolio planning instruments, can eliminate transfer taxes while generating large income tax savings which, when invested prudently, can help beneficiaries receive a larger inheritance than would have been available if the family had simply paid taxes.

The deductions from gifts to an SO will not zero out all income taxes of the donor, but the assets can grow inside the SO with zero capital gains or income taxes. The tax advantages of an SO remain attractive even after the Pension Protection Act of 2006 imposed new, and sometimes strict, limitations on the control given to SO boards. SO trustees still have great flexibility when funding public charities, but Congress has further limited the ability of SOs to benefit donors and their family members.

Charitable remainder trusts and testamentary charitable lead annuity trusts. Possibly the most popular charitable tool is the CRT. The CRT provides four significant tax benefits. First, a donor can receive a large tax deduction when funding the CRT. Second, low basis assets sold inside a CRT will not be subject to any current income tax. Third, assets can grow tax-free inside a CRT. Fourth, a donor can take tax-favored or tax-free distributions from a CRT.

Although a CRT provides substantial income tax benefits, clients may hesitate to use a CRT because all assets will pass to charity upon death (or at the end of the trust term), thereby reducing the inheritance for the client's heirs. To overcome this problem, advisors often combine the CRT with a TCLAT. The TCLAT and CRT are in many ways opposites of each other and therefore fully complementary. Whereas the CRT provides large income tax benefits, it will not zero out transfer taxes. Alternatively, the TCLAT can eliminate all transfer taxes, but it will not typically affect income taxes.

An advisor combining these tools can show how the client can improve her current plan by reducing income taxes, eliminating estate taxes, and transferring more wealth to heirs. To help assure that heirs will receive a larger inheritance, the client establishing a CRT may use a portion of the tax savings to fund an insurance policy in an ILIT.

The Super CLAT. One of the most intriguing zero-tax planning tools is the inter vivos grantor charitable lead annuity trust. This trust can minimize both transfer taxes and income taxes. Because of this tremendous tax avoidance potential, tax planners have long referred to the inter vivos grantor charitable lead annuity trust as the Super CLAT.

The Super CLAT has one large drawback that has limited its use. Although the trust can generate large income and transfer tax deductions, the tax savings are often offset by the taxes that the grantor must pay on the income generated by the trust. To minimize or avoid this tax on the income, the grantor must fund the Super CLAT with assets that generate tax-free income. Suitable assets include high yield municipal bonds, derivative securities, private placement variable universal life insurance, and leveraged real estate with tax-sheltered rental income. Pools of such assets can be designed to pay income to charity for a period of years while still offering enough appreciation potential that heirs can receive a substantial benefit tax-free at the end of the trust term.

One of the most intriguing zero-tax planning tools is the inter vivos grantor charitable lead annuity trust, which can minimize both transfer taxes and income taxes.

Using a wealth optimization process to integrate tax planning tools

To optimize the basic, leveraged, and total wealth control plans described above, an advisor can use portfolio optimization software and estate optimization software to create a *wealth optimization* plan. As the advisor moves the client through the planning process, the client should see progressively greater cash flow and/or wealth transfer benefits as a result of upgrading from the basic plan to the leveraged plan and then to the total wealth control plan or, ideally, a wealth optimization plan.

Although a taxpayer could significantly reduce taxes using just one of the tax planning tools discussed in this article, great synergy develops as the advisor combines planning instruments. For example, high cash flow from some planning tools may offset low cash flow on other tools, or large tax write-offs from some growth-oriented investments may offset taxable income on liquidating assets. As the advisor combines complementary legal and financial tools and analyzes how the combined tools affect financial statements, the client typically sees much more capital accumulating for family and favorite causes. Clients see that they should pursue fully-integrated wealth optimization planning because the whole is greater than the sum of the parts.

Estate optimization. The performance of the ten legal tools discussed above depends greatly on how each is designed. A planner cannot know how to establish the duration, payout, and other variables for a particular tool without taking into account design terms for all tools in a client's plan. This process of developing interrelated design specifications is known as estate optimization.

Estate optimization requires an understanding of how each planning tool is expected to perform over time. This is done by projecting out asset values to show when assets will transfer to heirs and what transfer taxes might affect the transfer. In addition, the cash flows generated by each tool should be illustrated across time to spot unnecessary income tax, capital gains, or AMT tax exposure created by the tool. The estate planning architect must know how to adjust each tool to minimize taxes. For example, a TCLAT can have very good results or very bad results depending on the eight interrelated assumptions about rate of return, payout rates, growth rates, trust term, discounting percentages, contribution amounts, timing of distributions, and desired deductions.

Even if an advisor knows how to design the TCLAT and all other recommended tools with great precision, the focus on precise detail may cause the advisor to ignore problems that often develop when tools are combined. For example, an instrument that results in a zero transfer tax can easily produce additional income, capital gains, or AMT taxes. Alternatively, tools like annuities that have low income taxes can easily produce very negative transfer tax consequences.

An estate planning architect should have a process that helps monitor how cash flows from each planning tool are affected by all types of transfer taxes and income taxes. An advisor can easily underestimate the complexity inherent in solving a tax minimization puzzle that involves optimizing cash flow after payment of six types of taxes listed above. Too many advisors optimize cash flow to a client or the client's beneficiaries after minimizing just a few of the taxes. This shortsighted approach is tantamount to claiming that a Rubik's Cube® puzzle has been solved when only two or three of the six sides have uniformly-colored squares. Anyone who thinks carefully about the mathematics behind optimizing returns after taxes will realize that the tax puzzle, like Rubik's® puzzle, has literally quintillions of possible solutions that should receive fair consideration while looking for the optimal outcome.

Optimizing an estate plan can create much more complexity than one faces when optimizing Rubik's Cube®. Whereas the cube has a finite number of possible solutions with predictable movements for each square on the cube, an estate plan is composed of legal tools that can have very different performance outcomes depending on which financial instruments fund each legal tool. Because investment returns can have a significant impact on the well-being of beneficiaries, prudent investor guidelines normally require that estate planning tools have investment policy statements that describe the optimal mix of portfolio assets for each tool. An astute advisor will therefore combine the estate optimization process with a portfolio optimization process in order to create true wealth optimization.

Portfolio optimization. The portfolio optimization process helps an advisor "stress test" each legal tool under different rate of return assumptions. When projecting cash flows generated by different types of portfolios, it is possible to produce millions of projections and choose only the scenarios that optimize the after-tax cash flow and wealth transfer benefits for the client. As clients and advisors consider the incremental benefits of combining portfolio optimization with estate optimization, they see that both these techniques can help reduce taxes.

It is reasonable to conclude that the wealth optimization process is the best zero-tax planning tool.

Portfolio optimization, in addition to producing many non-tax benefits, can help reduce taxes in at least ten ways. Portfolio optimization professionals can:

1. Review account statements to confirm that the correct trusts own each account in order to keep assets outside the taxable estate,
2. Apply trust accounting principles to accumulate and distribute trust assets tax-efficiently,
3. Confirm the accuracy of tax basis and market value numbers shown on the balance sheet,
4. Determine that cash withdrawn from accounts for lifestyle needs will be taxed at the most favorable rates,
5. Evaluate whether assets not kept liquid for lifestyle needs are invested tax-efficiently in longer-return assets,
6. Estimate which rates of return to assume when designing tax minimization tools,
7. Clarify whether asset management fees are tax deductible,
8. Identify unnecessary taxes on portfolio rebalancing transactions,
9. Integrate tax-efficient investments into portfolios, and
10. Gather data to graph projected after-tax inheritance for heirs under different return/risk assumptions.

Seasoned advisors appreciate the opportunities that result from optimizing portfolios and then updating an estate plan in response to changing tax laws, cash flow needs, and asset values. This wealth optimization process may seem daunting as an advisor considers the use of hundreds of different legal tools and an even broader assortment of financial instruments that might fund each legal tool. Fortunately, the same advanced 21st-century economic system that produces the complexity also gives advisors solutions to the complexity in the form of sophisticated software programs that can evaluate myriad options while finding an optimal solution.

An estate planner, such as a CPA or tax lawyer, can team up with a portfolio planner, such as a registered investment advisor, to run the optimization software. Although one advisor could in theory manage all the interrelated tax and portfolio planning issues, a collaboration of two or more professionals can often serve the client most effectively.

Modern wealth optimization software routinely helps clients minimize transfer taxes and reduce income taxes dramatically. The software can illustrate year-by-year cash flows and action steps to help a client navigate through the confusing array of recommendations provided by tax lawyers, financial planners, accountants, money managers, insurance agents, and other advisors who need to evaluate all six sides of the tax planning puzzle. The software considers many different combinations of legal tools under different legal and financial design assumptions to determine how a client can maximize after-tax lifetime income and/or testamentary transfers to heirs and favorite charities.

To help the client appreciate the advantages of using advanced planning techniques, it is useful to illustrate for the client the benefits of the techniques with graphics supported by pages of appendices for the advisors. For example, a client's advisor can depict an RLT, ILIT, and dynasty trust on a simple flow chart with a few boxes and then upgrade the flow chart until it eventually illustrates results from all 12 planning tools discussed in this article. The optimized flow chart might look like the one in Exhibit 1.

EXHIBIT 1
Plan Distribution

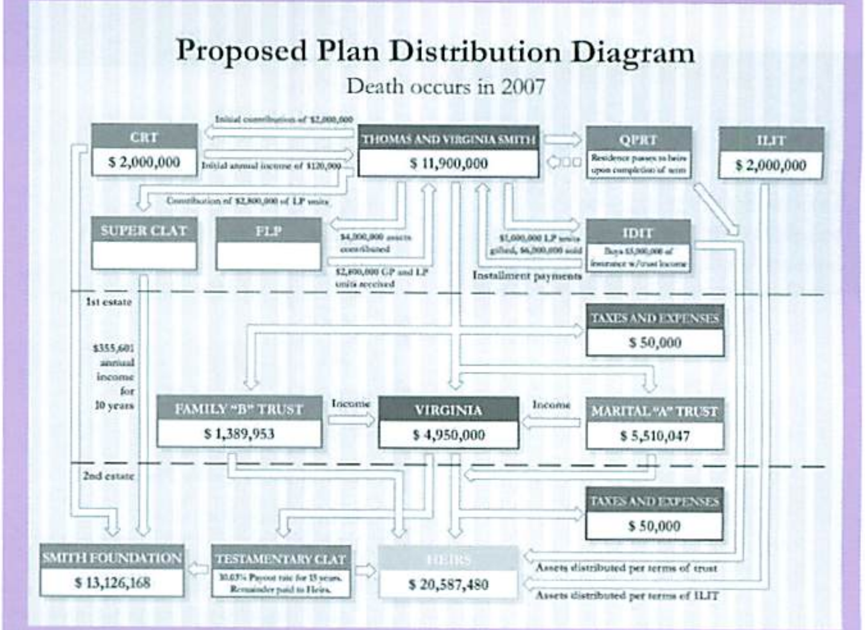
Proposed Plan Distribution Diagram
Death occurs in 2007
CRT
$ 2,000,000
Initial contribution of $2,000,000
Initial annual income of $120,000
THOMAS AND VIRGINIA SMITH
$ 11,900,000
QPRT
Residence passes to heirs upon completion of term
ILIT
$ 2,000,000
Contribution of $2,800,000 of LP units
SUPER CLAT
FLP
$4,000,000 assets contributed
$2,800,000 GP and LP units received
$1,000,000 LP units gifted, $6,000,000 sold
Installment payments
IDIT
Buys $5,000,000 of insurance w/trust income
1st estate
$355,601 annual income for 10 years
TAXES AND EXPENSES
$ 50,000
FAMILY "B" TRUST
$ 1,389,953
Income
VIRGINIA
$ 4,950,000
Income
MARITAL "A" TRUST
$ 5,510,047
2nd estate
TAXES AND EXPENSES
$ 50,000
SMITH FOUNDATION
$ 13,126,168
TESTAMENTARY CLAT
10.03% Payout rate for 15 years. Remainder paid to Heirs.
HEIRS
$ 20,587,480
Assets distributed per terms of trust
Assets distributed per terms of ILIT

EXHIBIT 2
Benefits of the Four Plans

	Basic Blueprint	Leveraged Blueprint	Total Wealth Control Blueprint	Optimized Blueprint
Heirs Receive	$ 11,631,000	$ 18,873,000	$ 19,651,000	$ 20,587,000
Charity Receives	-	-	$ 13,126,000	$ 13,126,000
Estate Tax Savings	-	$ 3,243,000	$ 10,267,000	$ 10,267,000
Income Tax Deductions	-	-	$ 3,241,000	$ 3,241,000

When creating the flow chart, it is important to anticipate which assets will fund each legal tool depicted on the diagram. This level of analysis helps planners avoid funding legal tools with inappropriate assets. Moreover, when analyzing particular assets, the planner can collect information about the basis, yield, tax character of cash flow, beneficiaries, and other details that affect calculations regarding future lifetime income and transfers to heirs.

Understanding the attributes of each asset helps the planner illustrate numbers for each tool in a way that clearly shows how tools work together to improve transfers to heirs, increase capital available for charity, avoid estate taxes, minimize income taxes, or achieve other benefits. The client can study these numbers for any particular year and can see the relative benefits of moving from the basic plan to the leveraged plan and then to the total wealth control or optimized plan. The chart in Exhibit 2 depicts the relative benefits of these four plans.

Exhibit 2 shows that a client can receive significant tax benefits as he upgrades his plan until he ultimately has an optimized blueprint. More important than the tax benefits may be the peace of mind that results from having all estate and portfolio strategies summarized on one flow chart. The client and his advisors can then all look at a one-page blueprint for minimizing taxes and maximizing capital available to fulfill the client's vision. A summary of the 12 planning tools discussed here appears in Exhibit 3.

Greater synergy develops as an advisor combines estate planning strategies.

EXHIBIT 3
Summary of the Tools Discussed

	Basic Plan[1]	Leveraged Plan[2]	Wealth Control Plan[3]	Optimized Plan[4]
1. AB Trust	*			
2. ILIT	*			
3. GST Trust (Family Bank)	*			
4. QPRT		*		
5.FLP		*		
6. IDIT		*		
7. CRT			*	
8. SO			*	
9. TCLAT			*	
10. Super CLAT			*	
11. Optimized Estate Plan				*
12. Optimized Portfolios				*

[1] Makes efficient use of gift, estate tax , and GST exemptions
[2] Uses discounts to leverage wealth to beneficiaries
[3] Allows for control of all financial and philanthropic capital
[4] Illustrates the optimal combination of assets to fund the optimal combination of legal tools

Conclusion

The quest to find the best zero-tax planning tools leads to several interesting conclusions. First, as different planning techniques are analyzed, we see that the choice of tools depends greatly on the vision and goals of each client. Second, as we study how leveraged and total wealth control plans improve benefits for clients, we see that planning teams should include legal and financial professionals who understand the more advanced planning techniques.

Perhaps most important, we see that integrating planning instruments, like solving a Rubik's Cube®, can create a very challenging puzzle unless we have a proven way to analyze all the six main taxes affecting wealth planning. Fortunately, the modern wealth planning process gives us the power to optimize after-tax wealth by combining legal and financial instruments to achieve a client's vision. Therefore, it is reasonable to conclude that the wealth optimization process is the best zero-tax planning tool. ■

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