► **Greycourt White Paper**

White Paper No. 6 – *Investment Considerations Associated with Complex Estate Planning Strategies*

All poor families are alike,
But all wealthy families are wealthy in their own way.
- Tolstoy, 1st Draft

The following estate planning vehicles are frequently encountered in the course of Greycourt's advisory work with wealthy families. The purpose of this white paper is to highlight the investment implications associated with the use of each strategy.[1]

Asset protection trusts – These offshore vehicles are often used by clients in litigious professions or who fear large legal judgments. They are similar to spendthrift trusts except that the trust is established in a foreign jurisdiction with laws that make it difficult for creditors to enforce their rights (often via very short statutes of limitation). A key provision is the presence of a "protector" who will not be subject to US court orders. Unlike spendthrift trusts, with an APT the presence of the donor as a discretionary beneficiary does not render the gift to the trust incomplete; hence, APTs can effectively be used to remove assets from the estate of the donor. APTs must be created before a judgment is entered against the donor, and preferably before any claim has been asserted. Investment implications: All US taxes must be paid on income and gains as they occur, exactly as though the trust were a domestic trust. Consequently, the investment considerations will be similar to those posed by a domestic portfolio. Assets placed in APTs may remain in trust longer, and hence have a longer investment time horizon associated with them, than the same assets may have had when held directly and domestically.

CLAT – Charitable lead annuity trust. A CLAT is the opposite of a CRAT, i.e., the trust pays a fixed amount to charity for a period of years, then passes (outright or in trust) to the children or other beneficiary tax-free. A charitable deduction is available for the value of the charitable payments. A significant amount of property can be removed from the donor's estate at no tax cost using properly structured CLATs. Investment implications: Depends on the charitable intent of the donor. He may wish to benefit charity, in which case high-income assets will be placed in the trust. If he wishes to benefit the children, low-income, high-growth assets will be placed in the trust. Note that the investment

[1] Of course, every family is different and hence every strategy will be different. This paper simply identifies investment issues which should be considered by families who are utilizing complex estate planning strategies.

advisor may be representing the donor or the ultimate family beneficiaries, or, in some cases, both.

CLUT – Charitable lead uni-trust. A CLUT is simply a CLAT that pays to charity a percentage of the fluctuating value of the trust assets, rather than a fixed amount. Investment implications: Generally, same as a CLAT. However, the fluctuating value of the payments to charity must be taken into account – the use of very low-yielding assets in CLUTs is usually unwise.

CRAT – Charitable remainder annuity trust. Assets in a CRAT pay a fixed amount of income to the donor for life or a period of years, then pass outright to charity – which can be a family foundation. Appreciated property is usually placed in a CRAT. The donor receives a charitable deduction for the value of the gift less the value of the income payments. CRAT payments must equal at least 5% of the value of the property. Investment implications: Most donors will want to insure the annuity payout to themselves, and will have little interest in how much ultimately passes to charity. However, this is not always the case. Remember that taxes paid by the beneficiary are determined by the nature of the income at the trust level. Highest taxable income must be distributed first.

CRUT – Charitable remainder uni-trust. A CRUT is a CRAT that pays the donor a percentage (not less than 5%) of the fluctuating value of the trust. The donor can make additional contributions to a CRUT, unlike a CRAT. Surprisingly, a CRUT can pay out the lesser of 5% or the "net income" of the trust, making it ideal for appreciating assets that pay little or no income. Investment implications: Generally used when there is a serious charitable motive. Remember that taxes paid by the beneficiary are determined by the nature of the income at the trust level. Highest taxable income must be distributed first.

Dynasty trust – A term typically applied to any trust that is designed to last for several generations. Dynasty trusts created in states that have abolished the rule against perpetuities (Alaska, Delaware, Idaho, South Dakota and Wisconsin) can theoretically last forever. Investment implications: These vehicles have very long investment time horizons and few income demands. Invest aggressively, consistent with fiduciary principles.

Generation skipping trusts – Gifts that skip a generation are subject to a flat tax of 55%, plus the usual estate tax. There is a $1 million exemption available to each spouse, but those gifts are subject to the gift tax, net of the $600,000 lifetime exemption. The parents create a trust and allocate their GST exemptions to it (or, often, only $1.2 million, rather than the full $2 million, to avoid any gift tax). GST trusts are limited in most states by the rule against perpetuities, but by creating the trust in a state that has repealed the rule (Alaska, Delaware, Idaho, South Dakota and Wisconsin) the trust can last theoretically forever. A GST dynasty trust can be leveraged considerably by combining it with a CLUT. Investment implications: These vehicles have very long investment time horizons and few income demands. Invest aggressively, consistent with fiduciary principles.

GRAT – Grantor retained annuity trust. Under a GRAT, the grantor retains the right to receive a fixed dollar amount for a specified number of years. Assuming that the grantor survives the annuity period and that the assets in the trust appreciate rapidly, a considerable amount will pass to the children free of estate and gift taxes. A gift is made upon the creation of the GRAT equal to the initial value of the assets reduced by the value of the annuity payments. You can also create zero-gift GRATs by setting the annuity amount so high that no gift is made. Gifts of closely held stock and limited partnerships are especially useful because they are already discounted for lack of marketability. The grantor is taxed on gains in the trust, and these tax payments represent additional tax-free gifts. So-called "cascading GRATs" are often used in situations where it is possible that an investment will appreciate extremely rapidly. If so, a substantial sum is passed tax-free to the children. If not, the GRAT simply expires. Investment implications: Invest as aggressively as is consistent with the need to make the annuity payments (or more aggressively in the case of cascading GRATs).

Insurance wraps – Not technically trusts. Placing a tax-inefficient asset inside an insurance product (usually a modified endowment contract or a variable annuity contract) causes the tax consequences to pass to the insurance company while the gains remain in the policy as increasing cash value. The insured can access the cash value through low-cost policy loans or simple cash withdrawals. Many insurance wraps are structured through offshore insurance companies to avoid strict state rules on investment options. The ongoing costs of these programs is an important issue. Investment implications: These vehicles are useful to shelter the income from growth assets that generate substantial ordinary income or short-term capital gains; e.g., non-directional hedge funds. Keep in mind that the insured cannot select the investments inside the policy.

Intentionally defective trusts – An intentionally defective trust is one which will not be includable in the grantor's estate but on which the grantor pays all taxes incurred on the trust assets even though the income or appreciation is going to the children. These taxes represent an additional untaxed gift. A trust can be "defective" by giving the grantor the right to "sprinkle" income or principal among a group of beneficiaries, by retaining the power to reacquire the trust assets by substituting property of equal value, or if the trust income can be distributed to the grantor's spouse. Investment implications: Since the donor pays all taxes, his tax picture must be kept in mind. It is usually preferable to invest in assets that generate long-term capital gains.

NIMCRUT – A version of a CRUT containing an income make-up provision that allows more income to be paid out in later years, to the extent that income paid out in earlier years was less than the required percentage amount. Thus, rapidly appreciating property can be placed in a NIMCRUT while the donor is young; later, during retirement, the investments can be switched to high-yield assets paying the donor a very high income. Investment implications: Invest in high-growth, low-income assets during the accumulation phase, and high-income assets (e.g., junk bonds) during the payout phase.

Offshore trusts – No tax benefit if the donor or beneficiary is a US citizen, but many wealthy clients will have non-US citizens somewhere in their families. This presents the opportunity to site trusts in offshore jurisdictions and avoid all US (and often foreign) taxes. Investment implications: Depends on the needs of the beneficiary.

Private foundation – Foundations can be established as trusts or corporations. Corporations are much simpler to administer and they avoid bizarre state limits on investments. Trusts, however, are better equipped to preserve family control over the generations. A private foundation is a grantmaking organization which must make grants equal to 5% or more of its assets each year; pays a 1% or 2% excise tax, depending on the scale of the grantmaking; must file a Form 990-PF with the IRS every year; and must make available to the public either its 990-PF or an annual report. Note that most foundations will likely find themselves the target of unsolicited funding proposals, and failure to respond to these funding requests can harm the family's reputation. Gifts to private foundations are limited to 20% of AGI. Investment implications: Many foundations invest far too conservatively. During extended bear markets (as in the 1970s), the 5% payout requirement, plus the excise tax, can actually amount to a much higher percentage of the current asset base.

Revocable trust – Also called a revocable inter vivos trust. A property management vehicle, often abused by unscrupulous lawyers, accountants and financial planners. Revocable trusts have no tax benefits. Assets placed in a revocable trust must be re-titled in the name of the trust, and of the trustee is anyone other than the grantor, separate tax returns must be filed. Can be useful for complex asset management situations where a durable power of attorney might be too simple, and to preserve privacy. In a few states a revocable trust can be used to prevent a spouse from receiving his or her statutory share of the grantor's property at death. Investment implications: The only investment issue is the important point that well-drafted revocable inter vivos trusts can be effective asset and property management vehicles with less unwieldiness than a general power of attorney.

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(This paper was written by Gregory Curtis, Greycourt's Chairman.)