Wealth Transfer Planning for High Net Worth Families

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I. Introduction. The Six Primary Purposes of Estate Planning

Estate planning has **six** primary objectives:

First, to accomplish the transfer of property to surviving members of the property owner's family with minimum death tax;

Second, to **minimize probate costs** and complexity of estate administration;

Third, to accomplish these transfers with a plan that permits the property owner to **retain maximum enjoyment and benefit** from this property during his lifetime;

Fourth, to **minimize income taxes** payable by the senior generation and their heirs on assets received by the junior generations from the senior generations;

Fifth, to **protect assets** of the senior generation from claims of creditors of the senior and junior generations; and

Finally, to accomplish these objectives in accordance with the property owner's **testamentary objectives**.

A well-crafted plan will, therefore, be unique to the client. In addition, while a well-drawn plan is developed with an eye to the future, the planning process is an evolving one, and as a result, the plan will change over time. This paper will cover a number of the techniques often used to accomplish these six goals of estate planning.

II. Estate and Gift Tax – Key Concepts.

The federal estate tax system imposes a transfer tax on the value of assets passing to family members at death. In order to assure taxpayers do not avoid estate taxes by making lifetime transfers, the federal transfer tax system also imposes a gift tax when assets are transferred to family members during the donor's lifetime.

A. Tax Rates. Whenever the transfer of an asset is subject to federal transfer taxes, the effective transfer tax rates range from 37% to 46% (in 2006) on any transfers that are not sheltered by available exemptions from taxation.

B. Applicable Credit Amount. Under the federal transfer tax system, each taxpayer may pass up to $2 million (in 2006) of property away during lifetime, or at death, free of federal estate and gift tax. This number is scheduled to increase over the next several years.

> A credit of the "applicable credit amount" is allowed in computing the estate tax (IRC § 2010(a)) or gift tax (IRC § 2505(a)(1)) of a U.S. citizen or resident. The "applicable credit amount" is the amount of the tentative tax that would be determined under the unified estate and gift tax rate schedule if the amount with respect to which the tentative tax is to be computed were equal to the

"applicable exclusion amount" determined in accordance with the following table (IRC § 2010(c)):

Prior Law:				New Law:			
Prior Law:				New Law:			
Year	Estate Tax Exemption	Maximum Estate Tax Rate	GST Exemption	Year	Estate Tax Exemption	Maximum Estate Tax Rate	GST Exemption
2001	$675,000	55%	$1,060,000	2001	$675,000	55%	$1,060,000
2002	$700,000	55%	$1,060,000*	2002	$1,000,000	50%	$1,060,000*
2003	$700,000	55%	$1,060,000*	2003	$1,000,000	49%	$1,060,000*
2004	$850,000	55%	$1,060,000*	2004	$1,500,000	48%	$1,500,000
2005	$950,000	55%	$1,060,000*	2005	$1,500,000	47%	$1,500,000
2006	$1,000,000	55%	$1,060,000*	2006	$2,000,000	46%	$2,000,000
2007	$1,000,000	55%	$1,060,000*	2007	$2,000,000	45%	$2,000,000
2008	$1,000,000	55%	$1,060,000*	2008	$2,000,000	45%	$2,000,000
2009	$1,000,000	55%	$1,060,000*	2009	$3,500,000	45%	$3,500,000
2010	$1,000,000	55%	$1,060,000*	2010	N/A	N/A	N/A
2011	$1,000,000	55%	$1,060,000*	2011	$1,000,000 ?	55% ?	$1,060,000* ?

C. Unlimited Marital Deduction. Under the federal transfer tax system, an individual may pass an unlimited amount of property to a spouse, completely free of estate or gift taxes.

D. Unlimited Charitable Deduction. Under the federal transfer tax system, an individual may pass an unlimited amount of property to a qualified charity, completely free of estate or gift taxes.

E. Lifetime and Annual Gift Tax Exclusion. Each individual taxpayer may give up to $12,000 ($24,000 for a married couple) of property to an unlimited number of donees each year completely free of gift taxes. This amount is to be adjusted for inflation (in thousand dollar increments). In addition, each taxpayer may make additional aggregate gifts up to $1,000,000 free of federal gift taxes. The Federal gift tax exemption does not increase each year. Also, for North Carolina gift tax purposes, the lifetime gift exemption is only $100,000 per donor.

F. **Gift Splitting.** For federal transfer tax purposes, spouses can elect to treat gifts by one spouse as having been made one-half by each. This means that, regardless of which spouse actually makes the gift, the donor-spouse can use both spouses' annual exclusions and applicable exclusion tax-free amounts to shelter the gift from gift tax. However, the better practice is for the spouses to make separate gifts.

G. **Step-Up in Basis to Fair Market Value.** Under Section 1014 of the Internal Revenue Code, the basis of property inherited by a beneficiary from a decedent is equal to the value of the property as of the date of death of the decedent.

H. **Generation Skipping Transfer Tax System.** The generation skipping transfer tax is imposed at a flat rate of 46% and is in addition to the estate or gift tax. Thus, the GST tax can have a punitive and confiscatory effect. The GST tax is imposed on transfers, distributions and the vesting of present interests, either directly or in trust, to or for the benefit of "skip persons." A "skip person" is (i) a "natural person" assigned to a generation two or more generations below the transferor or (ii) a trust in which all interests are held by skip persons or (iii) a trust in which no person holds an interest in the trust and in which no future transfers may be made to a non-skip person. Section 2613. A grandchild of the transferor is assigned to the generation immediately below the transferor (and thus is not a skip person) if the transferor's child who is the parent of the grandchild is dead. A similar rule applies to descendants below the grandchild, apparently in cases where all lineal descendants between the transferor and the transferee are dead. Section 2612(c)(2).

I. **Estate Taxes Due Within 9 Months of Death.** Federal estate taxes are due and payable nine months after the decedent's death. In some cases, the estate may be able to defer the payment of these death taxes over a period of years.

III. **Overview of Estate Tax Reduction Strategies.** Estate tax reduction strategies usually fall within one of a few broad categories. The "basics" include (1) making sure the unified credits of both spouses are effectively used and (2) using an irrevocable insurance trust to remove life insurance from the taxable estate. Beyond the basics, the planner focuses on lifetime giving to family members, charitable giving, and using life insurance to fund estate taxes.

A. **Summary of Common Estate Tax Reduction Techniques**. The following is a brief summary of common estate tax reduction strategies.

1. Credit Shelter or Bypass Trust. Married couples with estates over $2,000,000 should implement a credit shelter or bypass trust, which will segregate the first $2,000,000 of the first spouse’s assets from the second spouse’s assets at the first spouse’s death.

2. Irrevocable Life Insurance Trust (ILIT). An ILIT is a trust designed to hold one or more life insurance policies on the grantor. By transferring a life insurance policy to an irrevocable trust in which the grantor retains no interest, the death benefit will be excluded from the grantor's taxable estate (subject to a 3-year waiting period).

3. Lifetime Giving to Children and Grandchildren. Making lifetime gifts to family members can be an effective means of reducing a client's taxable estate. A gifting program using $12,000 annual exclusion gifts can reduce (or at least slow the growth of) even the largest of estates. Moreover, taxable gifts will result in lower transfer taxes than taxable bequests. Lifetime gifts must always be weighed against the loss of the step-up in basis.

4. Charitable Giving. For the charitably inclined, making gifts to qualified charities is an obvious choice for reducing estate taxes since a full estate tax deduction is available for transfers to charity. This benefit must be weighed against the fact that assets left to charity will not pass to family members.

5. Life Insurance. For many large estates, particularly those concentrated in closely held business interests and commercial or investment real estate, "liquidity" (the ability to quickly raise cash to pay the estate taxes) is a real issue. Life insurance can be useful in creating a pool of cash at the time estate taxes are due.

B. **The Credit Shelter Trust - Critical Building Block for the High Net Worth Plan.** Basic planning for married couples who expect to have a combined estate over $2,000,000 usually includes a credit shelter bypass trust and marital deduction gift.

1. <u>Review of Credit Shelter Trust Arrangement</u>.

By way of example, assume that some years ago a married couple executed sweetheart wills. The couple has been financially successful, and now has a combined taxable estate of $4,000,000 (including life insurance death benefits, retirement plans and their personal residence). If one of the spouses died, say the wife, then under her will all of her property would pass to her husband. Any property transferred between spouses is sheltered from estate taxes by what is known as the "unlimited marital deduction," so no estate taxes would be due upon the wife's death.

Upon the husband's subsequent death, however, the amount of the husband's estate in excess of $2,000,000 is taxed at rates beginning at 37%. Therefore, as a result of the sweetheart arrangement, this couple's assets will be subject to approximately <u>$920,000</u> in estate taxes!

The problem in this example is that the couple's estate planning did not take advantage of both spouses' tax-free amounts. Now assume that the couple had estate plans that included "credit shelter" trusts. A credit shelter trust is simply a device by which part of the couple's property is held in trust for the benefit of the surviving spouse. Although the credit shelter property will not pass outright to the surviving spouse, no estate taxes will be due since the trust will be sheltered by the tax-free amount of the spouse who dies first.

Returning to the example above, upon the wife's death, $2,000,000 would be held in the credit shelter trust, and $2,000,000 would pass to the husband outright. The property in the credit shelter trust would be held for the husband's benefit for the rest of his life (the terms of the credit shelter trust can be quite varied, and with careful drafting the trust can approach outright ownership by the surviving spouse and yet still pass tax-free to the children at the surviving spouse's death). Upon the husband's subsequent death, the credit shelter trust property would pass to the children, sheltered by the wife's tax-free amount, and the other $2,000,000 (now held by the husband outright) would pass to the children sheltered by the husband's tax-free amount. Thus, the same couple with proper planning would owe no estate taxes at all, leaving all of their property to their children.

As you can see, proper estate planning will allow couples to pass up to $4,000,000 free of estate taxes (in 2006). The tax savings from proper planning will become even more dramatic as the tax-free amount increases over time.

2. Equalizing Estates to Maximize Benefits of Credit Shelter Trust Arrangement

As you may have noticed, in the above example the wife owned all of the couple's property (at her death one-half of the property passed to the trust and one-half passed to the husband). The credit shelter trust worked perfectly in those circumstances. But what would the tax consequences have been had the husband died first? Since he had no property in his own name, no property would be transferred to a credit shelter trust. Upon the wife's subsequent death, only the first $2,000,000 of the property she owned would be sheltered from taxes. The husband's entire tax-free amount would have been wasted (just as if the couple still had sweetheart wills).

The solution to this problem is known as "asset equalization." Asset equalization involves making sure that each spouse owns a sufficient amount of property in his or her individual name to fund the credit shelter trust, and thus avoid wasting some or all of the spouse's tax-free amount.

Careful consideration and planning are necessary to determine the best way to balance and re-title assets between spouses. Asset equalization is as important to estate tax savings as the use of the credit shelter trust itself, for without sufficient

assets to fund the trust the tax-free amount is wasted as if no trust were ever created. The increases in the tax-free amount over the next several years will present an opportunity to save more in estate taxes; but without proper asset equalization, this benefit may be wasted.

3. Conclusion

All-to-each-other wills, although simpler and less expensive, will waste one spouse's tax-free amount. The wasting of the tax-free amount could result in your children paying up to $920,000 in federal estate taxes (based on this year's tax-free amount) ... that could have been avoided! Moreover, the tax benefit of proper planning will increase dramatically over the next several years. Therefore, a credit shelter trust is critical for couples with taxable estates greater than the current tax-free amount. Finally, even if a couple has proper estate planning documents in place, their planning may not be complete without asset equalization. Each spouse should have a sufficient amount of assets in his or her name to avoid wasting one spouse's tax-free amount.

C. Irrevocable Life Insurance Trust.

1. **Purpose.** The goal in making a gift of life insurance is the removal of the proceeds of the insurance policy from the donor's taxable estate and, if the donor is married, from the estate of the donor's spouse. This should reduce federal and state death taxes by approximately 45% of the value of the death benefits which are received.

2. General Description. While it is possible, for a number of reasons the insured may be reluctant, to make an outright gift of the policy to his or her children. These reasons may include:

- The need to use the proceeds to support the insured's spouse for the spouse's lifetime;
- The need to use the proceeds to pay death taxes at the death of the insured or the insured's spouse;
- The need to use the proceeds to fund a buy-sell agreement with respect to the insured's closely held business;
- Immaturity of the children;
- A desire, as part of the estate plan, to "leverage" the insured's GST exemption by allocating the exemption against cash gifts to the trust which will be used for premium payments; and

- Concerns regarding the distribution of the policy upon the death or divorce of a child of the insured after the insured's death.

Because none of these opportunities is available with an outright gift of insurance, the irrevocable trust is very popular. The trust document is usually designed to accomplish the following estate planning objectives:

- The insurance death benefits can be borrowed by the trust to the grantor's (insured's) estate to provide liquidity for the payment of death taxes, despite the fact the proceeds are not included in the taxable estate of the grantor;

- Transfers to the trust can be structured as "tax-free" gifts using the $12,000 annual gift tax exclusion;

- The proceeds can be held for the benefit of the insured's spouse without being subjected to estate tax upon the spouse's death; and

- The proceeds may be held in a generation skipping trust for the benefit of the insured's children and then ultimately left to the insured's grandchildren without being subject to death taxes upon the deaths of the insured's children.

In most irrevocable life insurance trusts the trustee is authorized to purchase or otherwise acquire life insurance on the grantor's life or on the life of the grantor's spouse. If future gifts are made to the trust the trustee is generally directed to advise all beneficiaries of the trust that they have the right to withdraw a certain part of the gift. Usually the withdrawal right is expressed as a pro rata share of the gift subject to an annual limitation of $5,000 per donee. The beneficiary's power of withdrawal (also known as a "demand right" or "Crummey" power) is usually designed to lapse after the expiration of a certain period of time following notice to the beneficiary that a contribution has been made and that the beneficiary has a withdrawal right. Because the beneficiary, as a result of the withdrawal right, has the right of immediate access to funds contributed to the trust, the insured's gift to the trust will qualify as a "present interest" gift which is eligible for the $12,000 annual gift tax exclusion. If there were no withdrawal right and notice provision, a gift to the trust would be a future interest gift, and would not qualify for the annual exclusion.

In order to curb potentially abusive practices, the Internal Revenue Service has taken the position that gifts to a trust which are subject to "Crummey" powers held by contingent beneficiaries of a trust do not qualify for the annual exclusion. However, the Internal Revenue Service has been losing its battle in this respect, so long as the beneficiary has some genuine interest in the trust. See Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991), Acq., 92-12IRB4.

Thus, during the lifetime of the insured, the trustee receives annual gifts, advises beneficiaries of their rights of withdrawal, and, if no person exercises a right of withdrawal, the trustee pays the insurance premiums.

Upon the death of the insured, the trust will be held for the benefit of the insured's beneficiaries under the terms of the other trust. These terms of the trust are as varied and involved as the various estate plans of our clients.

3. **Income Tax Treatment.** Most irrevocable insurance trusts are drafted so that, during the lifetime of the grantor, any income earned by the trust will be taxable to the grantor. It is possible to vary this result if the trustee is directed to secure permission from someone other than the grantor or the grantor's spouse to use trust income for payment of life insurance premiums.

   After the death of the insured, the trust will be a separate income tax payer and the general rules as to the income taxation of estates and trusts will apply, depending upon who the beneficiaries are and whether the trust requires distribution of all income or permits accumulation of income.

4. **Transfer Tax Treatment.** If a "Crummey" provision is included in an irrevocable life insurance trust, the first $5,000 of each beneficiary's withdrawal right is considered a gift of a present interest that is eligible for the $12,000 annual exclusion. If the beneficiary has the right in excess of $5,000 then the excess will also be eligible for the $12,000 annual exclusion; however, the excess right of withdrawal will be considered as if the beneficiary withdrew the excess amount and then made a gift directly to the trust. This will cause the beneficiary to be treated as a partial grantor to the trust with possible negative tax consequences to the beneficiary. For this reason, most irrevocable trusts are drafted to limit a power of withdrawal to $5,000. Another possibility is to give a larger power of withdrawal but provide that only $5,000 will lapse each year (this special provision is called a "hanging" power).

   For federal and state inheritance tax purposes, transfers of life insurance made more than three years before the insured's death will be excluded from the taxable estate of the insured. Generally, policies which are purchased by the trustee are excluded from the insured's taxable estate, even if death occurs within three years, as long as certain formalities are observed. Thus, it would be possible to establish a trust less than three years before an insured's death, have the trustee purchase a life insurance policy shortly thereafter, and exclude the life insurance coverage from the insured's taxable estate.

5. **Special Considerations.** Due to the extraordinary transfer tax savings which are possible with an irrevocable life insurance trust, strict adherence to all formalities is very important. The grantor should not (i) be a trustee (ii) have a power of removal or replacement over the trustee, or (iii) have any other rights over the

trust. The trust should be carefully drafted to insure that no part of the trust will ever revert to the grantor regardless of the order of deaths of the beneficiaries and, accordingly, it is advisable to have a contingent beneficiary named to take the trust in the event the grantor and all beneficiaries die.

The Internal Revenue Service is generally hostile to this device; however, there have been almost no tax law changes regarding irrevocable trusts since the late 1960's. This is a tribute to the strength of the insurance lobby. Various proposals have been made that would radically limit the use of the "Crummey" provision or that would cause inclusion in the taxable estate of an insured all insurance proceeds which are received by a relative of the insured. This is an area to watch closely.

D. Lifetime Giving to Children and Grandchildren.

1. Generally. Lifetime gifts are a more tax effective way of transferring property to succeeding generations than are transfers at death. Thus, the advisability of a gift-giving program should always be considered in the context of an estate plan for a wealthy client.

(a) Appreciating Assets. One of the primary benefits of a lifetime gift is that appreciation in the gifted property that occurs following the gift is effectively removed from the donor's taxable estate. The younger a client is at the time the client makes a gift, the more appreciation there is that is likely to occur. However, younger clients may be less inclined to part with their assets, because of the uncertainty of the future, than are older clients, who are in a better position to predict the sufficiency of their assets for future needs. Although post-gift appreciation of the gift property will be less significant for an older donor than for a younger donor, the benefits of lifetime gifts for an elderly client nevertheless can be significant.

Keeping this in mind, in selecting assets to give away, the client should choose those assets the client anticipates will appreciate most significantly in value following the date of the gift. Thus, cash is one of the less attractive assets to give away during life. Securities, and particularly stock in a closely held business, may be one of the more attractive assets to give away. Real estate also is an attractive asset to give away, both because of its potential for appreciation and because of its illiquid nature.

(b) Tax Advantages of Taxable Gifts. Another important benefit of lifetime gifts is that the effective transfer tax for lifetime gifts is lower than the effective transfer tax for testamentary gifts. Although the gift and estate transfer taxes are now unified, and the rate structure appears to be identical, the gift tax is tax exclusive, while the estate tax is tax inclusive.

In other words, the gift tax is computed on the value of the property received by the donee. The estate tax, on the other hand, is computed on the gross amount of the transfer, rather than on the net amount in the hands of the recipient.

Example: Assume Client has used his full unified credit with previous lifetime gifts, and any additional gifts made by Client will be taxed at a fifty percent (50%) marginal rate. If Client makes a $10,000 taxable to Child, the tax on the gift will be $5,000. Thus, in order to make the $10,000 gift, Client must expend $15,000 of his assets. On the other hand, if at Client's death, Child receives $10,000, Client's estate must expend $20,000 in assets. The estate tax on the $20,000 is $10,000, for a net transfer to Child of $10,000. An additional benefit of the lifetime gift is that, if Client lives for three years after making the $10,000 taxable gift to Child, the $5,000 in gift tax paid is also removed from Client's taxable estate.

(c) Step-Up in Basis. Finally, in choosing assets to give away as part of a lifetime gift giving program, the client must consider the loss of the step-up in basis that would have been available for the assets if the client had died owning the assets that are to be given away. Under Section 1015 of the Internal Revenue Code (hereinafter section references made will be to the Internal Revenue Code unless otherwise indicated), the basis of gift property in the hands of a donee is equal to the donor's basis increased by the gift tax paid as a result of the gift. On the other hand, under Section 1014, the basis of property inherited by a beneficiary from a decedent is equal to the value of the property as of the date of death of the decedent. As a result of the so-called "step-up" in basis for property inherited from a decedent, a client who is planning to make lifetime gifts should consider making gifts of high basis property. Nevertheless, because of the difference in the capital gains and estate tax rates, the estate tax savings achieved by a lifetime gift almost always outweigh the capital gains tax savings achieved by a step-up in basis.

2. Qualified Minors Trust (2503(c) Trust). Section 2503(c) provides a mechanism for making an annual exclusion gift in trust for the benefit of a minor beneficiary. In order to meet the requirements of a so-called "qualified minor's trust," a trust must provide that the principal and income from the trust may be expended for the benefit of a donee who is under the age of twenty-one, and that the principal and income not so expended will pass to the trust beneficiary once the beneficiary attains age twenty-one. If the beneficiary dies before reaching age twenty-one, the trust property must be payable to the estate of the donee or be subject to a general power of appointment (a general power of appointment is the power to direct that the trust's assets will be paid to the beneficiary, the beneficiary's creditors, the beneficiary's estate or the creditors of the beneficiary's estate).

Often it is not desirable for a beneficiary of a qualified minor's trust to receive the trust assets at age twenty-one. In this case, the qualified minor's trust may provide that at age twenty-one, the trust beneficiary will have the opportunity to withdraw the assets from the trust. If the beneficiary does not exercise this withdrawal right within a period of time of perhaps thirty or sixty days following the twenty-first birthday of the beneficiary, then the trust will continue until the beneficiary reaches an age at which it is more appropriate for the beneficiary to receive the assets. If the beneficiary indicates that he or she wishes to exercise the withdrawal option at age twenty-one, counseling the beneficiary about the importance of leaving the assets in the trust will usually dissuade the beneficiary from proceeding to withdraw trust assets.

3. Family Partnerships and Limited Liability Companies.

(a) Overview. Real estate is often an ideal subject of annual exclusion gifts. A client may feel more comfortable in making gifts of illiquid real estate, particularly if the client is not dependent on the income generated by the real estate. An outright gift of interest in the real estate, however, may present problems. Whenever there are multiple owners of real estate, one owner can force a division of the real estate among the owners. This sort of division is known as a partition proceeding, and aside from the expense associated with such a proceeding, it may yield undesired results. Alternatively, one of several owners of real estate can force a sale of the property. Thus, when a client wishes to make annual exclusion gifts of interest in real estate, the resulting lack of control often makes outright gifts undesirable.

A family limited partnership or a family limited liability company offers a viable solution to the control problem associated with outright gifts of real estate. In addition, a family limited partnership resolves the practical problem of issuing multiple deeds to real estate. The client simply executes a deed transferring title to the real estate into the partnership. The client then makes gifts of interests in the partnership by issuing certificates for percentage interests of the client’s limited partnership interest.

(b) Structuring the Discount Family Limited Partnership. In the typical situation involving a discount family limited partnership, one or more senior family member will transfer one or more types of property to a family limited partnership in exchange for limited partnership interests in the partnership. If the donors wish to play an active role in the management of the partnership, then the donors will also acquire general partnership interests in the partnership. In some cases, other general partners will also be brought into the partnership. These additional general partners will often include other members of the donors' family who likely will be involved in the management and operation of the limited partnership.

The limited partnership agreement typically will vest in the general partners all decision-making authority with respect to the management and investment of partnership property during the term of the partnership. Likewise, the partnership agreement typically also will provide that the nature and timing of partnership distributions will be determined by the vote of the general partners. Thus, the general partners also will control the amount and frequency of cash and non-cash distributions from the partnership.

The limited partners, on the other hand, will have virtually no voice in the management or operation of the partnership. Thus, the limited partners will not be able to influence the amount or timing of partnership distributions and, likewise, will have no rights or voice in management decisions and investment philosophies of the general partners. In addition, the partnership agreement will often provide that partnership interests (general and limited) may be transferred only with the consent of the other partners.

Finally, the partnership agreement will typically provide that the partnership may be dissolved and liquidated only upon the unanimous consent of all partners, both general and limited. Thus, the limited partners will not have the unilateral right to force the dissolution of the partnership and the liquidation of the partnership property.

(c) Funding the Family Limited Partnership. The family limited partnership can be structured to hold virtually any type of asset. Thus, real estate, marketable securities, closely held business interests (but not S corporation stock), life insurance policies, and even cash can be assets of a discount family limited partnership.

To fund the limited partnership, the donor will simply execute a deed, stock assignment or other transfer document which transfers ownership over the transferred property to the partnership. Then, the donor will make gifts of limited partnership interests by executing assignments of limited partnership interests.

(d) Gifting of Limited Partnership Interests. Once the partnership is established, the donor-client will then begin making gifts of limited partnership interests to one or more members of the donor's family. By transferring limited partnership interests, the donor effectively removes all future appreciation and earnings attributable to partnership property the donor's taxable estate.

In making gifts of limited partnership interests, the donor may elect to limit gifts to the $10,000 gift tax annual exclusion amounts. However, because of the substantial valuation discounts which may be attributable to transfers of limited partnership interests, many donors choose to leverage their gift-making ability and will elect to use part or even all of their $675,000 federal estate tax and $1 Million GST exemption amounts with gifts of limited partnership interests.

(e) Valuation Discounts On Gifts of Limited Partnership Interests. For transfer tax purposes, the value of transferred property typically is equal to the value that a willing buyer and a willing seller would place on the transferred property. For gift tax purposes, the value of the gifted property is determined based upon the value of the property passing from the donor to the donee. Reg. 20.2031-1(b); Reg. 25.2512-1. Likewise, for estate tax purposes, the value of property in the decedent's estate is determined based upon the value of property at the estate level and not in the hands of the estate beneficiaries.

For transfer tax purposes, gifts of limited partnership interests may be subject to discounts for lack of marketability, as well as for minority interest, even though these types of valuation discounts typically are not available for outright transfers of assets (such as cash and marketable securities) that are held in the family limited partnership.

Because limited partners are restricted under state law and the terms of the partnership agreement from forcing liquidation of the partnership, and even from participating in management decisions, the value of the limited partners' interests in the partnership should be discounted to reflect their lack of control over the partnership and its activities. Similarly, because the limited partnership agreement will contain restrictions on the transfer of limited partnership interests, lack of marketability discounts often will also be available in valuing gifts of limited partnership interests.

(f) Non-Tax Advantages of Using the Family Limited Partnership Arrangement.

(1) Donor May Direct Control Over Transferred Property.

Even after the partnership is established and the senior family members have transferred property to the partnership, the senior family members will have the right to determine who will have continuing control over the future operation of the partnership via their rights as general partners. Thus, the donor-client often will be able to control the future operational and investment decisions of the partnership. Thus, the senior family members often will have sole authority to determine how the partnership assets are utilized throughout the partnership term. Likewise, the general partners also will determine and control the timing and nature of partnership distributions to limited partners. And finally, by virtue of their veto powers over transfers of partnership interests, the senior family members will often be able to assure family ownership of the partnership interests.

(2) Simplification of Gifting.

Because gifts of partnership interests are made by executing assignments of partnership interests, it is often much easier to make gifts of limited partnership interests than it is to make gifts of undivided interests in the property held in the partnership. In addition, the limited partnership vehicle facilitates the transfer of fractional interests in partnership property. For instance, in the case of real estate limited partnerships, gifting is simplified since the recording of multiple deeds is unnecessary.

(3) Protection from Claims of Creditors.

In addition, the nature of the limited partnership interests will insulate partnership assets from the creditors of the limited partners, since these creditors generally may only obtain a charging order against the limited partnership interests. Under the laws of most states, such a charging order will confer no rights to liquidate the partnership, force partnership distributions or control management of the partnership. Thus, although creditors of limited partners can attach limited partnership interests, they cannot threaten the ownership of title to the underlying property.

(4) Facilitates Gifting to Certain Groups of Donee Candidates.

Since the partnership agreement typically will grant limited partners with only limited management and distribution rights, the donor may be willing to make gifts of limited partnership interests to those individuals who would not otherwise be candidates for outright gifts. Thus, potential candidates for outright gifts of limited partnership interests may include in-laws, inexperienced family members, as well as those family members who may have marital problems or who have demonstrated an inability to manage their financial affairs.

Moreover, because of the nature of limited partnership interests, the limited partnership essentially will serve as a trust equivalent during the partnership term. Thus, spendthrift individuals may be protected from their own proclivities. In addition, for even younger or more inexperienced members of the donor's family, gifts in trust or gifts under the Uniform Transfers to Minors Act may be appropriate.

(5) Protection From Claims of In-Laws.

Under the laws of most states, gifts of limited partnership interests will be deemed to be separate property for equitable distribution purposes. Therefore, a donor-client who wishes to make gifts that are beyond the reach of his children’s spouses can make separate property gifts of limited partnership interests. Since the partnership agreement will restrict future

transfers of limited partnership interests, the donor-client will be assured that the children will not be able to convert separate property to marital property by making subsequent gifts to in-laws.

4. Qualified Personal Residence Trusts (QPRT).

(a) Overview. For families that need to consider making larger lifetime gifts (larger than annual exclusion gifts), a Qualified Personal Residence Trust (or QPRT, pronounced "cue-pert") may be an excellent choice.

A QPRT is a trust designed to hold a personal residence (the primary residence or a vacation home). A donor transfers the personal residence to the trust, and retains the right to live in the house rent-free during the existence of the trust. After a specified period of time (e.g., ten years), the trust ends and the ownership is transferred to the children (or the house continues to be held in trust for the children).

The secret to the effectiveness of this technique is that the value of the gift is reduced by the value of the right to live in the house retained by the donor. For example, assume that Jane, a 55-year-old single woman, puts her $300,000 home into a QPRT that will last for a term of 15 years. During the 15-year term, Jane continues to live in the house and pays the taxes and other expense of upkeep. When the trust ends, the ownership of the house passes to her children (see discussion below of what happens after the term).

Under actuarial tables published by the IRS, Jane has made a gift for gift tax purposes in the amount of $71,058 (even though the house is worth $300,000!). This amount is well within the $1,000,000 gift tax-free amount, so she is not required to pay gift tax on creation of the trust. If Jane had kept the house in her name, the full value would have been subject to estate taxes in the future. If she had given the house outright to her children, she would have used up $300,000 of her $1,000,000 gift tax-free amount. By creating the trust, Jane has removed the house from her estate and has made a gift of only about $71,000. Assuming a 50% estate tax bracket, and an annual appreciation rate for the house of 5%, the amount of tax saved is approximately $275,000!

Of course, there is always a catch. If Jane does not survive the term established by the trust (15 years in this case), then the effect will be approximately the same as if she had never created the trust. The house will be included in her estate at its date of death value, and the gift she made by creating the trust will not be taxed. The potential inclusion in the donor's estate also reduces the value of the gift.

Thus, the decision on the length of the term is critical. The longer the term, the greater the tax savings. When the term is longer, the gift is smaller, since the donor's right to live in the house is longer, and since the chance that the donor will not survive the term is greater. On the other hand, if the term is too long, and the donor does not survive the term, then the effort has been wasted. Therefore, a donor should choose a term that he or she is confident of surviving, but that will produce substantial tax savings.

Many clients are concerned that they will lose control of their home by using a QPRT. A properly drafted QPRT can function to provide a discounted gift as well as ensure that the donor will not be evicted from his or her home. The IRS has approved the donor's leasing the home from the trust after the term. That is, the house can remain in trust after the term, and the donor can enter into a lease with the trust. Renting from the children's trust may seem like a negative, but for individuals trying to reduce the size of their taxable estates, paying fair market rent to the trust (in effect, a tax-free "gift") is a real bonus.

(b) Advantages and Disadvantages. Using a QPRT has **one significant advantage:** the potentially dramatic reduction in the grantor's transfer taxes. From a transfer tax point of view, there is no potential downside to a QPRT – either the grantor wins by surviving the term of his retained interest, or he dies during the term, in which case his estate is in the same position it would have been in if he had not created a QPRT. But a QPRT does have the following disadvantages:

(1) **Loss of ownership during the grantor's life.** If the trust works the way it's supposed to, the grantor will survive the term of his retained interest, and the residence will then pass to the remaindermen of the trust (usually the grantor's children). With proper planning, this disadvantage can be minimized.

(2) **No step-up in basis.** When the residence passes to the remaindermen at the end of the trust term, they do not get a stepped-up basis. Instead, the grantor's basis carries over to them (Code Sec. 1015(a)), so if the children sell the residence they will have to pay income tax on any appreciation in value over what the grantor originally paid for it (plus or minus adjustments to basis). This problem can't be avoided by having the grantor buy back the residence from the trust before the trust term ends, because the governing instrument of a QPRT must include a provision prohibiting the sale of the residence to the

grantor, the grantor's spouse, or an entity controlled by either of them. Reg. § 25.2702-5(c)(9).

(3) **Possible loss of property tax exemption.** Depending on the law of the state in which the residence is located, the transfer of the residence to a QPRT may result in the loss of a property tax exemption.

(4) **Inability to mortgage the residence after the QPRT is created.** If the grantor needs to raise cash for any reason after creating a QPRT, he can't do so by mortgaging the residence – because he no longer owns the residence (as discussed below, the fact that the residence may already be mortgaged when it is transferred to the trust is no bar to creating a QPRT).

5. **Grantor Retained Annuity Trust (GRAT).** A GRAT is a technique specifically authorized by statute that can be a dramatic tax-saver in the right circumstances. The grantor of a GRAT transfers property to the trust and retains an annuity usually payable for a term of years. At the end of the term, the trust property will remain in trust for, or pass directly to, the remainder beneficiaries provided in the trust instrument. Upon the initial transfer of the stock to the GRAT, the grantor makes a taxable gift of the value of the remainder interest after the term (i.e., the property left in the trust at the end of the term).

The gift will ordinarily be valued pursuant to actuarial tables prepared by the IRS. The power of the GRAT is the opportunity to make a tax-free gift of an amount greater than the amount of the gift according to the actuarial tables. That is, the GRAT offers a chance to transfer all of the appreciation in the transferred property in excess of a fixed amount at no or minimal gift tax. Benefits can be spectacular with rapidly appreciating property.

The use of the GRAT does trigger a current taxable gift, although the size of the gift can be manipulated by the size of the annuity payment and the length of the term. However, in order to get substantial benefit from a GRAT, the grantor must survive the term, and therefore a term shorter than the grantor's life expectancy should be chosen. Also, significant benefit can be obtained by creating two or three GRATs with varying terms. As with the sale to the defective grantor trust, all of the Sub S income allocated for stock in the GRAT will be taxable to the Grantor, even if the annuity payments do not equal the tax due. This is not necessarily bad from an estate planning perspective, as it may be a way to further reduce the grantor's estate (although the IRS takes the position that the payment of these taxes constitutes an additional gift).

One significant disadvantage with the GRAT is that the grantor cannot allocate generation skipping transfer (GST) tax exemption at the time that the trust is

created. The effective use of GST exemption can be very valuable to a high net worth family, and should be used where possible. Therefore, this technique should be considered as a companion to other techniques that can use GST exemption at inception.

6. **Private Annuity.** In this technique, the grantor sells his or her assets to children (or a trust for their benefit), in exchange for the transferees' promise to make periodic payments in fixed amounts for a period of time which is equal to the anticipated remainder of the grantor's lifetime. Under this approach, the value of the assets is removed from the grantor's estate in exchange for lifetime annuity payments (and, obviously, the value of the right to payments is not included in the estate because it expires at death). Part of each payment is tax-free return of capital, while the balance is ordinary income. Also, no gift occurs if the private annuity is properly structured.

   Since the payments under a private annuity are for the grantor's entire lifetime, more will be brought back into the grantor's estate so long as he or she lives. Accordingly, the private annuity works best with a grantor who does not expect to live his or her full life expectancy.

7. **Self-Cancelling Installment Note (SCIN).** With a self-canceling installment note, the grantor sells his or her assets in exchange for a note that cancels at the death of the grantor. In other words, the purchaser makes note payments until the purchase price has been paid in full, or until the death of the grantor, whichever occurs first.

   At the death of the grantor, the unpaid principal balance of the note is canceled, and the note is not included in the grantor's taxable estate. However, the purchase price of the assets must be increased by an appropriate risk premium for the cancellation at death clause. In the alternative, the interest rate could be increased to take into account the risk that the grantor would die before the full payment of the note. As with the private annuity, the longer the grantor lives, the more value is brought back into the grantor's estate. Again, therefore, the SCIN works best with individuals with shortened life expectancies.

8. **Sale to Intentionally Defective Grantor Trust.** Instead of a GRAT or outright gift, a grantor might consider an installment sale by the grantor to an intentionally defective grantor trust. This is especially effective if the grantor owns appreciated property, wants liquidity, and does not want to pay capital gains tax. A defective grantor trust is one that is treated as owned by the grantor for income tax purposes, but not for gift or estate tax purposes.

   An installment sale to a grantor trust that is not includable in the grantor's estate is another way for the grantor to receive liquidity before his death without recognizing gain. Additionally, the appreciation on the assets from date of sale is removed from the grantor's estate.

Here's how it works. The Grantor sells appreciated property to grantor trust which has other property. The significance of the other property is twofold – first, so that the other property can be used to pay the Grantor back and, second, so that the note will not be recharacterized as a retained interest in the trust. If the note is characterized as a retained interest, then the rules of Section 2702 will apply. Those rules will treat the entire loan as a gift, unless the note is structured as a qualified annuity, in which case the GRAT rules will apply. Additionally, if the Grantor dies within the term of the note, the assets transferred in exchange for the note may be included in his estate under Section 2036. Hence, care needs to be taken that the note constitutes real debt, and not a retained interest.

Supposing that the note is truly debt, the Grantor realizes no gain on the sale or income from the interest payments. The Grantor does continue to pay income tax directly on the income of the trust. If the Grantor dies within the term of the note, the note is included in his estate, unless it is a SCIN. The trust ceases to be a grantor trust, so the IRS may take the position that the Grantor or the Grantor's estate recognizes gain on the remaining payments. Since the gain on the installment note is IRD, the note receives no step-up in basis on the Grantor's death.

E. Charitable Giving.

1. <u>Introduction</u>. Planned giving advisors are often called upon to devise ingenious strategies for reducing their donors' income and estate and gift tax liabilities through planned charitable giving. However, in many cases, advisors overlook the potential valuable tax planning opportunities that are available to those persons who are charitably inclined.

Of course, the U.S. tax laws allow donors to take an immediate income tax deduction for qualifying lifetime charitable transfers. In addition, the tax laws also provide for estate and gift tax deductions for charitable contributions as well. Thus, charitable giving may produce very favorable estate and gift tax benefits as well as income tax benefits.

In fact, when gift, estate tax and income tax benefits of charitable giving are aggregated, many potential donors realize that they can accomplish their charitable goals at a very low after-tax cost.

Oftentimes, however, donors are not aware that the tax laws offer them many tax planning opportunities even if they are not yet ready to part with ownership of their property. For these donors, the use of charitable trusts may provide donors with immediate, and valuable, tax benefits, while also allowing donors to retain beneficial ownership of the gifted property.

This portion of the paper will review how individual taxpayers can reduce the economic costs of making charitable gifts by utilizing the income and estate and gift tax deductions available under federal and state tax laws.

2. How Do Charitable Gifts Reduce Taxes?

(a) Income Tax Deductions. By making a charitable gift, the taxpayer-donor will be entitled to an immediate income tax deduction. This may reduce the taxpayer's income tax liability by a portion of the value of the gifted property up to the maximum income tax rate. Of course, the tax benefit of the contribution will vary depending upon the taxpayer's marginal income tax bracket. In addition, the taxpayer may avoid the potential capital gains tax on gifts of appreciated property.

(b) Estate and Gift Tax Deductions. For estate tax purposes, bequests of property to a charitable organization will reduce the amount of property in the decedent's estate that is subject to estate taxation. Therefore, in order to reduce estate taxes, many donors include charitable bequests to charitable organizations in their wills.

Likewise, in some cases, donors are inclined to make charitable gifts during their lifetimes in order to reduce their potential taxable estate. Furthermore, once property is given away during lifetime, any future appreciation in the value of the property will escape estate taxation in the donor's estate.

For estate tax purposes, deathtime or lifetime transfers may reduce estate taxes by as much as 46% of the value of the gifted property.

(c) Summary. Therefore, once you aggregate the favorable income tax deduction with the capital gains tax and estate tax avoided by the gift, it becomes apparent that gifts of highly appreciated property may only insignificantly reduce the taxpayer's economic position. Thus, the taxpayer may accomplish his or her charitable goals at a low after-tax cost.

(d) Other Miscellaneous Types of Charitable Contributions.

1. **Value of Services are Not Deductible.** Taxpayers may not deduct the value of their services provided to charities, even though the services may be valuable to the charity. Reg. § 1.170A-1(g).

2. **Out-of-Pocket Expenses.** However, taxpayers may claim a deduction for out-of-pocket unreimbursed expenses such as for uniforms, telephone expenses, etc. Reg. § 1.170A-1(g).

3. **Transportation Expenses.** In general, taxpayers can deduct the cost of transportation and travel (including meals and lodging) incurred in the performance of services away from home on behalf of the charity (but see Reg. § 170(j), preventing deductions for what are essentially vacations). Taxpayers can deduct actual automobile expenses or they can claim 14 cents per mile, plus parking fees and tolls. Rev. Proc. 98-63; Res. Proc. 99-38. Reg. § 1.170A-1(g).

4. **Deductions for Purchase of Tickets to a Charity Event.** If the taxpayer purchases a ticket to a charity event, such as a sale, bazaar or show, the taxpayer gets no deduction unless they can establish that the amount paid exceeds the value of the admission to the event.

5. **Raffle Tickets.** The purchase price of a raffle ticket is never deductible.

3. Summary of Selected Charitable Giving Strategies.

(a) Outright Gifts. Outright gifts to charity, such as giving a check to the United Way or transferring title to real estate to a church, are usually the simplest transactions. Such gifts qualify for an income deduction, and those assets given away will not be subject to estate or gift taxes. The primary disadvantages of outright gifts are that the donor does not retain any interest or benefit from the asset given away, and those assets will not be available to transfer down to the donor's heirs.

(b) Will Bequests. Will bequests would include leaving a provision in the donor's will for a distribution of cash or a particular asset to a charity. The advantages of such gifts include a full estate tax deduction, relative simplicity and the donor's retained use of the asset. The primary disadvantage of this technique is that no income tax deduction.

(c) Charitable Trusts. Charitable trusts, discussed in detail below, can take many forms, but typically entail splitting the rights to an asset between the donor, the donor's family and charity. The primary charitable trusts are charitable remainder trusts and charitable lead trusts. A charitable remainder trust retains an interest in an asset for the donor (and/or other

members of the family), with the remainder being distributed to charity. A charitable lead trust gives a charity an interest in an asset for a certain period, followed by the return of the asset to the donor or the donor's family.

(d) Gifts of Retirement Plans. Retirement plans are heavily taxed to say the least. Distributions are taxed as ordinary income, and account balances are fully includable for estate tax purposes. For wealthy families, as little as 25% to 30% may be left for heirs after income and estate taxes. Therefore, retirement plan assets make excellent candidates for charitable gifts. Instead of passing 25% to 30% to one's heirs, the donor can leave 100% of the asset to charity. Similar to a will bequest, the advantages of such gifts include a full estate tax deduction, relative simplicity and the donor's retained use of the asset. The donor would simply change the beneficiary designation to the charity and the remaining account balance would be distributed to the charity (please note that particular caution should be taken when a donor would like to divide a retirement plan between charitable and non-charitable beneficiaries).

(e) Gifts of Life Insurance. Gifts of life insurance can be an effective means of transferring assets to charity. By making a charity the owner and beneficiary of a life insurance policy, a donor has the potential of making a substantial future gift for the cost of the premiums on the policy. In addition, an income tax deduction would be available for the premiums paid (not the death benefit).

(4) Use of Charitable Trusts in Charitable Giving. In many cases, a client will be reluctant to part with property. Perhaps the client is concerned that, although he wants to make a charitable gift, he is concerned that he will later suffer financial hardship. In other cases, the taxpayer will have charitable inclinations, but will not want to deprive his children or heirs of the benefit of the property. And still in other cases, the potential donor will wish to make a donation from certain assets which have appreciated in value, but will not want to incur income taxes on the sale of the appreciated property prior to making the gift.

For example, Donor is at retirement age and owns a highly appreciated asset (such as a business or real estate) that produces income each year. The Donor wants to make a charitable donation of the appreciated asset, but at the same time, the Donor wants to use income from the appreciated asset to fund his retirement years or to provide income source for his wife and children.

To alleviate these concerns, the donor should consider the possibility of making a gift to a charitable remainder trust or to a charitable lead trust.

(a) Charitable Remainder Trusts.

1. Purpose. A charitable remainder trust is a trust which provides for payment of certain amounts to a non-charitable beneficiary (or to several non-charitable beneficiaries) for a term of years or for the lifetime of the donor or other beneficiaries. Upon the termination of the non-charitable trust term, whatever remains in the trust will pass to a charity or charities. Thus, the grantor can put property in trust and retain a stream of payments from the trust either for his or her own benefit or for the benefit of a relative or further desired beneficiary.

Because the trust is exempt from federal and state income taxation, it may afford a significant income tax benefit to the donor who wishes to fund it with highly appreciated property that may be sold. Because the trust does not pay federal or state income taxes, the entire sales price will then be available for reinvestment with the result being that the cash flow enjoyed by the donor beneficiaries will be greater than the cash flow that would be realized if the gain on the sale were subject to federal and state income taxation. Moreover, if a grantor wishes to provide a beneficiary only a lifetime benefit and wishes to provide a future interest for school, church or other worthy cause, the charitable remainder trust is ideally suited.

2. When are Charitable Remainder Trusts Advantageous? Because of the many uses of charitable remainder Trusts, charitable remainder trusts can be created during lifetime or at death. In most circumstances, a charitable remainder trust will be advantageous in the following situations:

a. Retain and Perhaps Increase Cash Flow. Donor wants to enjoy the post-donation cash flow generated by the donated property. In many cases, an under-performing asset can be sold and a larger annual payout can be obtained.

b. Defer Capital Gains Taxes. If the donor has a highly-appreciated asset that he would like to sell, but does not want to incur the capital gains taxes, a charitable remainder trust may be an excellent choice. Since a charitable trust is a tax-exempt entity, the asset can be sold by the trust tax-free.

c. **Investment Diversification.** A substantial portion of Donor's net worth is invested in a highly appreciated asset, and Donor wants to "diversify" her investment portfolio.

d. **Reduce Estate Taxes.** Donor receives a full estate tax deduction for balance of trust property at donor's death.

e. **Benefit Charity.** At the termination of the trust, one or more designated charities receive the remaining trust property.

f. **Income Tax Deduction Needed.** The Donor receives an income tax deduction as of the date of funding the trust, the value of which is actuarially calculated to the date the charity will receive the property.

2. **General Description.** There are two major types of charitable remainder trusts: the charitable remainder annuity trust ("CRAT") and the charitable remainder unitrust ("CRUT"). The key provisions of a charitable remainder annuity trust are that a sum certain (which must be at least five percent of the initial fair market value of the property placed in the trust) is to be paid, at least annually, to one or more persons living on the date the trust is created for the life or lives of the beneficiary or beneficiaries or for a term of not more than twenty years. Upon expiration of the trust (either because of the death the beneficiary or beneficiaries or at the end of the term of years) whatever remains must be paid to a charity described in Section 170(c) of the Internal Revenue Code or must be retained in the trust for a use that will qualify under Section 170(c) of the Internal Revenue Code.

A charitable remainder unitrust is similar to a charitable remainder annuity trust except payment must be made of a fixed percentage (which must be at least five percent) of the net fair market value of the assets, valued annually.

Pursuant to The Taxpayer Relief Act of 1997 (P.L. 105-34), for transfers to a CRT (annuity trust or unitrust) after July 28, 1997, the present value of the remainder interest ultimately passing to the charitable remainderman must equal at least 10% of the net fair market value of the property transferred to the CRT on the date of the contribution to the CRT. IRC §§664(d)(1)(D) & 664(d)(2)(D).

a. **Income Tax Treatment.** Upon creation of the trust, the donor receives a charitable income tax

deduction equal to the present value of the future interest to be received by the charitable beneficiary (subject to applicable limitations discussed above). Payments from the trust to the grantor will be treated according to the so-called "four-tier distribution rules." Accordingly, amounts distributed by a charitable remainder annuity trust (CRAT) or by a charitable remainder unitrust (CRUT) are **generally** treated as having the following characteristics in the hands of a beneficiary to whom the annuity amount or the unitrust amount is paid:

(1) First, as ordinary income to the extent of the trust's ordinary income for its tax year and its undistributed ordinary income for earlier years.
(2) Second, as capital gain to the extent of the trust's undistributed capital gain.
(3) Third, as other income to the extent of the sum of the trust's other income for the tax year and its undistributed other income for earlier years.
(4) Finally, as a distribution of trust corpus.

b. Gift Tax Treatment. In the case of a charitable remainder trust established during the grantor's lifetime, a partial gift tax charitable contribution deduction will be allowed in calculating the amount of any taxable gift by determining the actuarial value of the charitable remainder interest (taking into account the applicable federal rate in effect in the month prior to and the month of the establishment of the trust). If the beneficiary is a person other than the grantor, the value of the non-charitable beneficial interest is treated as a taxable gift (subject to the annual exclusion and against which the unified credit may be applied).

c. Estate Tax Treatment. Upon the subsequent death of the grantor, the entire value of the trust will be included in the grantor's gross estate. If the trust passes to charity upon the death of the grantor, then the entire value of the trust will be subject to a charitable deduction under Section 2055 of the Internal Revenue Code. If there is an intervening non-charitable beneficial interest, the value of the non-charitable beneficial interest will be subject to federal estate tax liability (to the extent the unified credit does not cover the liability). The value of the charitable remainder will be eligible for the charitable deduction under Section 2055.

d. What is a "Wealth Replacement" Charitable Remainder Trust? A Wealth Replacement trust is a trust established for the donor's heirs at the same time the Charitable Remainder Trust is also created. In simple terms, the Wealth Replacement Trust is designed to replace the economic wealth given away by the donor upon creation of the Charitable Remainder Trust. In most cases, the wealth is "replaced" by having the Wealth Replacement Trust purchase life insurance on the life of the donor.

During the donor's lifetime, the annual distributions from the Charitable Remainder Trust are used to pay the life insurance premiums on the life insurance policy held in the Wealth Replacement Trust. Upon the donor's death, the life insurance proceeds will be distributed to the donor's heirs, thus "replacing" the economic value of the assets which were originally donated to the charity. Also, because the trust, rather than the donor, owns the life insurance policy on the donor's life, the proceeds of the policy will pass to the donor's heirs completely tax-free upon the donor's death.

e. Special Considerations. This is a very technical area and due to the number of Revenue Rulings issued by the Internal Revenue Service it is an area that should be approached very carefully. However, in the case of a grantor who is considering the possible future sale of highly appreciated property (and who has charitable motivations), it may be a very effective technique to enhance cash flow or to give a family member or friend a lifetime benefit with the certainty that whatever remains will ultimately pass to a qualified charity.

E. **Use of Life Insurance to Fund Estate Taxes.** As mentioned above, estate taxes are due and payable (in cash) 9 months from the date of death. This requirement can put a great deal of strain and pressure on the executor and heirs of a decedent, particularly when the amount of taxes due are significant and the amount of cash in the estate is not. This predicament is often referred to as a "liquidity problem." That is, there are not enough liquid assets to pay the taxes due. The result is that assets would have to be liquidated quickly in order to raise cash to pay the taxes. This can have disastrous results for a family, since a family business or

family real estate may have to be sold at a substantial discount, destroying a continued source of family wealth. Moreover, it may not be advisable or timely (from an investment standpoint) to sell more liquid assets at a time when cash is needed.

Oftentimes, life insurance can be a good choice or even the only choice to effectively fund the payment of estate taxes (of course, policies purchased for the purpose of funding the payment of estate taxes should be owned by an irrevocable life insurance trust (discussed above), in order to avoid having 50% of the death benefit also being lost to estate taxes). The payment of death benefits at a time when estate taxes are due can ease the stress and burden of liquidating assets at an inopportune moment. Of course, life insurance is simply one tool available to the planner, and its advantages must be compared to the opportunity cost of investing premium dollars elsewhere and the benefits of alternative estate planning techniques.

F. Generation Skipping Estate Planning. Wealthy clients often have wealthy children, either as a result of the children's enterprise or as a result of the client's generosity. These wealthy children will, in turn, have their own estate tax problems at their subsequent deaths. Thus, any inheritance the children receive from their parents will add to the estate tax problems the children face. For example, if a child has assets of $2,000,000 ($4,000,000 if married and he has implemented tax planning in his estate plan), then approximately fifty cents of each dollar the child inherits from the child's parents will be spent in federal estate taxes at the child's death. Likewise, half of each dollar of appreciation in the inherited assets will be forfeited to the federal government.

Wealthy families have long implemented estate plans that cause a child's inheritance to be held in a trust that permits the child to enjoy the benefit of the trust during life, but that prevents the trust assets from being taxed at the child's death. By avoiding a generation of taxation, these trusts double and triple the value of assets that ultimately pass to successive generations.

a. Chapter 13. In 1986, to bring to a halt the tax avoidance achieved through the use of generation skipping trusts, Congress enacted Chapter 13, which seeks to ensure that a death tax is imposed at each generation.

i. Outright Gifts. Chapter 13 accomplishes its objective by providing that a transfer directly to a person who is two or more generations beneath the transferor will be subject to a generation skipping transfer tax (a "GST" tax) in addition to the gift tax on the transfer. Thus, if a grandmother makes a taxable gift to her grandson (this sort of transfer is

referred to as a "direct skip"), she has made a gift that will be subject to the GST tax.

ii. **Gifts in Trust.** Similarly, Chapter 13 attacks gifts in trust for the benefit of trust beneficiaries two or more generations below the donor. For example, if a grandmother establishes a trust to accumulate income and to pay out the balance to her grandson at age twenty-five, she again has run afoul of Chapter 13.

iii. **Generation Assignment.** Section 2651 provides rules for determining the generation to which a donee or trust beneficiary will be assigned. In the case of lineal descendants of the donor's grandparents, generation assignment is straightforward. Thus a child of a donor is one generation beneath the donor, and a gift to the child will not be a generation skipping transfer. A grandchild is two generations beneath the donor, and thus a transfer to the grandchild is a generation skipping transfer. There is one exception to this rule. If the grandchild's parent (the donor's child) is deceased at the time of the transfer, then the grandchild will move up to the generation of the parent and a transfer to the grandchild will not be a generation skipping transfer. These same rules apply to lineal descendants of the grandparents of the donor's spouse. Effective for transfers during or after 1998, these "deceased parent" rules also apply to certain "collateral heirs" of the donor. Thus, if the parent of a donee is a lineal descendant of the parent of the donor (i.e., if the parent of the donee is a niece or nephew of the donor) and if the parent of the donee is deceased, the niece or nephew will move up a generation.

Generation assignment for individuals who are not lineal descendants of the donor's grandparents or the grandparents of the donor's spouse will be assigned to generations depending on the difference between their age and the age of the donor. An individual who is less than twelve and one-half years younger than the donor will be assigned to the donor's generation. An individual born between twelve and one-half years and thirty-seven and one-half years after the donor will be assigned to the generation beneath the donor. Each successive generation is deemed to be twenty-five years apart. Thus, a transfer to an individual who is between thirty-seven and one-half and sixty-two and one-half years younger than the donor will be

assigned to the generation that is two generations beneath the donor. A transfer to an individual in this age group would be a generation skipping transfer. Inadvertent generation skipping transfers may be made when gifts are made to friends and employees of a donor. Care should be given to such transfers, and it may be appropriate to allocate a portion of the donor's $1,000,000 GST exemption to such transfers.

Example: Client, aged 80, makes a gift to his housekeeper, aged 50. Because housekeeper is more than 12½ years but less that 37½ years younger than Client, she will be assigned to one generation below Client. The gift to the housekeeper is not a generation skipping transfer.

Example: Client, aged 80, makes a gift to Child, aged 40. Grandchild's age relative to Client's age is immaterial. For lineal descendants, the familial relationship controls. Thus, even though Child is more than 37½ years younger than Client, Child is assigned to one generation beneath Client, and the gift is not a GST.

Example: Client, aged 80, makes a gift to Grandchild. Grandchild is two generations beneath Client, and thus the gift is a GST. If, however, Grandchild's parent who is Client's child is deceased at the time Client makes the gift to Grandchild, then Grandchild steps up into her parent's generation, and is thus one generation beneath Client. In this latter case, the gift would not be a GST.

Example: Client, aged 80 makes a gift to his girlfriend. If Girlfriend is under age 42 (that is, more than 37 1/2 years younger than Client), then the gift is a GST. Moral: always get the date of birth for a donee.

iv. **Exceptions.** There are two important exceptions to the general rules described above.

1. **GST Exemption.** Every individual may make up to $1,000,000 of generation skipping transfers without incurring the GST "penalty" tax. This amount will now be indexed for inflation in increments of $10,000. Thus, for calendar year 1999, the exemption is $1,010,000.

2. **Nontaxable Gifts.** Annual exclusion gifts are free of GST tax. Thus, in the above examples, if the grandmother makes an outright gift of $12,000 to her grandson, there are no GST consequences for

the gift. Likewise, if she makes a $12,000 gift to a qualifying minor's trust (§2503(c) trust) for the benefit of her grandson, this gift also is not subject to GST tax. Caution: gifts that are not subject to a gift tax solely because of a withdrawal power (a so-called "5-by-5 power" or "Crummey power") are subject to GST tax.

Example: Grandmother establishes a trust for the benefit of her adult Grandson with income payable annually to the Grandson and the balance payable to the Grandson at age thirty-five (note: this is not a Section 2503(c) trust). Grandmother contributes $100,000 to the trust. In an effort to reduce the gift tax consequences of the transfer, grandmother gives grandson the ability to withdraw the greater of $5,000 or 5% of contributions made to the trust. Even though $5,000 of the gift is not a taxable gift, the full $100,000 is a gift subject to GST tax.

If Grandmother establishes a Section 2503(c) trust for her minor Grandchild, and contributes $100,000 to the trust, then $12,000 of the gift will qualify for the annual gift tax exclusion and will thus also be exempt for GST purposes. Thus, only $88,000 of the gift would be subject to GST tax.

b. Using the GST Rules to the Client's Advantage. If Client and his spouse have a combined net worth of $4,000,000, and their daughter, an only child, and her spouse are also worth $4,000,000, then approximately fifty percent of Daughter's inheritance from her parents will be paid in federal estate tax at Daughter's death. That is, through effective tax planning designed to take full advantage of their applicable credit amounts, Daughter and her spouse can shield their own wealth from federal estate tax. Anything that Daughter inherits from her parents, however, will push her estate above her applicable credit amount, and thus will be subject to federal estate tax at Daughter's death at approximately a fifty percent rate. Thus Daughter's child will ultimately inherit **$6,000,000** (Child will receive $2,000,000 from his parents' assets, which pass tax free because of the parents' applicable unified credits, and fifty percent of Client's assets after payment of fifty percent in taxes at Daughter's death).

If, instead of leaving their estate to Daughter outright, Client and Spouse leave their $4,000,000 in a generation skipping trust to Daughter (free of GST tax because Client and Spouse each may leave $2,000,000, free of GST tax), Daughter's child will ultimately inherit **$8,000,000** (that is, Child receives both Daughter's and Client's assets tax-free).

If we assume a rate of appreciation of four percent in the assets Daughter inherits, and if we assume Daughter lives for thirty-six years after her parents' deaths (at four percent, assets double in value every eighteen years) the impact on Child's inheritance is substantial:

Outright Inheritance		
Daughter's assets		$4,000,000
Daughter's inheritance	16,000,000	
Less: tax on inher.	(6,440,000)	9,560,000
Total inheritance to Child		**$13,560,000**

Generation Skipping Trust		
Daughter's assets		$ 4,000,000
Daughter's inheritance	$16,000,000	
Less: tax on inher.	(0)	16,000,000
Total inheritance to Child		**$20,000,000**

c. Flexibility of GST Trust. Generally the value of assets transferred to a generation skipping trust should be limited to the donor's available GST exemption. In other words, it is desirable to create a trust that is completely sheltered by the donor's $2,000,000 GST exemption. If a trust is not completely sheltered by the client's GST exemption, then each transfer from the trust will be partially subject to generation skipping transfer tax. For a client with children whose estates will be taxable, the use of a generation skipping trust that is fully sheltered by GST exemption should be considered. Because the tax savings achieved through the use of a generation skipping trust do not benefit the client or the children, but rather benefit the children's heirs, it may be appropriate to solicit the input of the client's children in deciding whether to incorporate a generation skipping trust in the client's estate plan.

Because the purpose for establishing the trust is not to protect the assets from the child, but rather to protect the assets from taxation, the terms of the trust will typically be drafted in a manner that will give the children the greatest flexibility and control over the trust that is possible without subjecting the trust to taxation in the children's estates. The child may be given the right to receive the entire annual net income earned by the trust. In addition, the child may have the right to withdraw the greater of $5,000 or five percent of trust assets each year for any reason the child deems appropriate. The trustee may also be given the discretion to distribute assets to the trust for the child's needs. Often the child will serve as trustee of the child's trust upon reaching an appropriate age. Thus, the child, as trustee, can control the investment and management of

the trust. The child may be given the power to direct the trustee to distribute assets to charity, or among a group of individuals named in the trust (often the group of individuals will consist of the client's lineal descendants). Finally, the child may be given the power to direct that, following the child's death, the trust assets will continue to be held in trust for the benefit of the child's surviving spouse for the lifetime of such spouse.

As a result of the broad scope of powers available to the beneficiary of a generation skipping trust, the child has virtually all of the rights with respect to the trust property that the child would have if the child had inherited the trust assets outright. However, the child will not have the privilege of withdrawing trust assets beyond the five-by-five limitation and will not have the privilege of paying estate taxes on the trust at the child's death.

d. Not Just for Wealthy Client. Tax savings can be achieved through the use of a generation skipping trust only if the client has a child whose own estate, together with assets the child inherits from the child's parents, will be taxable for federal estate tax purposes. Thus, even though a client may be of modest means, generation skipping planning may be appropriate if the client's children are of sufficient means to have taxable estates. For this reason, in planning a client's estate, it is important to gather information on the financial position of the client's children. If the children are doing well financially, it may be appropriate to approach them about the viability of receiving their inheritance in a generation skipping trust. Note that all of the client's children need not be treated equally.

A client often will have one child whose financial position makes generation skipping appropriate for that child, and another child of more modest means for whom an outright inheritance is appropriate. The client's estate planning documents can easily accommodate both children.

IV. How to Minimize or Eliminate Probate Costs.

A. Introduction. In North Carolina probate costs can be substantial – as much as $6,000 for an estate. In addition, probate fees (which can be as high as 5% of the probate estate) and CPA fees and attorney fees can increase the costs of "probating" an estate. Therefore, the benefits of probate avoidance techniques are not insignificant.

In order to properly plan for avoiding probate costs, we apply different probate strategies depending upon the following considerations:

1. Married couples with a taxable estate of less than $2 Million
2. Married couples with a taxable estate of more than $2 Million
3. Single (and widowed) clients

B. Married Couples With a Taxable Estate of Less Than $2 Million.

Here, we avoid probate costs by advising that the clients own all of their assets jointly or with right of survivorship. Careful planning also is required to make sure that each spouse is designated as primary beneficiary of any IRAs or other "qualified plan" benefits, with the children being designated as contingent beneficiaries. No one should ever name "my estate" as beneficiary of any IRA or other qualified plan assets.

C. Married Couples With a Taxable Estate of Over $2 Million.

For married couples with an estate over $2,000,000, however, we apply a completely different strategy with respect to probate avoidance. In the case of married couples with an estate of over $2,000,000, we never want to have the spouses own assets jointly in this situation. The reason for this is that, at the first death, all jointly-owned assets would then pass to the surviving spouse. Likewise, any assets passing by beneficiary designation will then likewise pass to the surviving spouse. As a result, if the predeceasing spouse does not have sufficient assets in his or her name to fund his or her credit shelter trust, then the estate tax exemption amount will be wasted for the first spouse to die.

Therefore, for these clients, our probate avoidance strategy is for the spouses to divide ownership of all of their assets in roughly equal proportions and to then have each spouse transfer his or her separately owned assets to a probate avoidance revocable living trust. Likewise, we have each spouse name his or her respective probate avoidance revocable living trust as the primary beneficiaries of any IRAs or retirement plan balances. That way, at the death of the first spouse, everything passes directly to the probate avoidance living trust which then divides assets among the credit shelter amount and marital share amounts. That way, we hope to assure that, regardless of which spouse dies first, that spouse will have enough assets to pass to his or her credit shelter trust. And, by using the probate

avoidance revocable trust arrangement discussed below, we can eliminate probate to the extent that assets are transferred to the living trust before death.

D. Single (and Widowed) Clients.

In the case of single individuals, the main probate strategy involves the use of a "probate avoidance living trust." A probate avoidance living trust is a trust document which sets forth the dispositive provisions of an individual's estate plan. The trust is revocable, which means that the client can amend and change it at any time. In addition, the client is the beneficiary and trustee of the trust so the client has access to funds in the trust at all times. Once the client has executed the revocable living trust, the client will then transfer "nominal" ownership of its assets to the living trust. At the client's death, all the trust assets pass to the trust beneficiary and thus probate is avoided - at least to the extent of assets held in the trust at the date of the client's death.

V. Miscellaneous Estate Planning Issues: Planning for Children With Special Needs and Planning for Clients In Second Marriages. Estate planning for wealthy clients often requires considering other tax and non-tax issues. These issues can often be as important in developing an effective estate plan as the traditional estate tax concerns.

A. <u>Planning for Children with Special Needs</u>. Parents of a child with special needs should consider structuring their estate plans to insure that their special needs child will qualify for Medicaid benefits after the parents' death. Children with special needs include children with creditor problems as well as children with unstable marriages and with physical and mental health issues. A special needs child will qualify for Medicaid, if at all, as a disabled adult. Here, the focus is on keeping assets out of the name of the disabled adult.

Although it is desirable to keep assets out of the disabled adult's name, it is also desirable for a pool of assets to be available for the benefit of the disabled adult, to the extent possible. There are two general approaches to accomplishing the dual objectives of keeping assets out of the disabled adult's name so that the adult can qualify for Medicaid and of making assets available for the benefit of the disabled adult, to meet the needs of the disabled adult that are not met by government benefits. These approaches include disinheriting the disabled adult or, in the alternative, placing the inheritance of the disabled adult in a trust that will not prevent him or her from qualifying for Medicaid. Many of the planning strategies discussed below also will apply to children who face creditor problems or who are in unstable marriages.

i. Disinherit the Disabled Adult. The first approach is for the parents and other relatives to disinherit the disabled adult. The inheritance that otherwise would pass to the disabled adult passes to siblings or other relatives of the disabled adult, with the understanding that such persons will use the assets for the benefit of the disabled adult. This approach may be undesirable because there is no legal obligation for the relative to use the assets for the benefit of the disabled adult. Because the obligation is purely a moral one, and there is no guaranty that the wishes of the parents of the disabled adult will be fulfilled. In addition, if the relative (who receives what would otherwise be the inheritance of the disabled adult) predeceases the disabled adult, the assets pass as part of the decedent's estate. Thus, unless the decedent has made special provisions for the benefit of the disabled adult, the assets pass one step further away from the disabled adult. If the decedent leaves the assets directly to the disabled adult, then the original purpose in disinheriting the disabled adult will have been undone and the disabled adult will be disqualified for Medicaid benefits until the inheritance has been dissipated.

The benefit of this approach to Medicaid planning for the disabled adult is that it is simple and straightforward. Where there are family

members whom the parents feel comfortable will carry out their wishes, this approach to Medicaid planning may be appropriate. However, for the most part, the second approach discussed below is preferable.

ii. Luxury or Supplemental Needs Trust. It is possible in North Carolina (though not in every state) for assets to be placed in a discretionary trust for the benefit of a Medicaid recipient (other than the grantor or the grantor's spouse) without the assets being deemed available for the Medicaid recipient for the purposes of Medicaid qualification. If the trust is established by the Medicaid recipient, a discretionary trust (one in which the trustee has discretion to distribute income and principal) will disqualify the Medicaid recipient unless the terms of the trust provide that the remainder of the trust will pass to the state upon the death of the recipient. If the trust is established by someone other than the Medicaid recipient or the Medicaid recipient's spouse, however, the Medicaid recipient can have access to principal and the trust will not disqualify the recipient for Medicaid benefits. This type of trust is intended to supplement the government benefits available to the disabled adult/Medicaid recipient by providing only for "extras" not provided for by such government benefits. Thus, this type of trust often is called a "luxury" trust.

1. Terms of Trust. For a trust to be excluded from the disabled beneficiary's assets for Medicaid qualification purposes, the trust should meet the following requirements:

-**Discretionary Trust.** The trustee must have absolute discretion to determine when distributions will be made to the beneficiary. In addition, the trustee must have the discretion to make no distributions from the trust. If the terms of the trust provide for mandatory distributions of income or principal to or for the benefit of the disabled adult, the assets that are required to be distributed to the disabled adult will be viewed as "countable" for Medicaid eligibility purposes.

-**Spendthrift Trust.** The trust should contain a provision to the effect that the trust assets are not available for the payment of the debts and expenses of the beneficiary. Case law in North Carolina makes it clear that discretionary trusts with spendthrift provisions cannot be tapped for the purposes of paying the medical expenses of the beneficiary, and thus will not disqualify the beneficiary for Medicaid benefits.

-**"Self-destruct" Provision.** A "self-destruct" provision probably should be included in the trust. Pursuant to this provision, the trust will terminate and assets will be distributed to the remainder beneficiaries in the event the trustee is required to distribute assets out of the trust in satisfaction of expenses of the disabled adult that should otherwise be met by government benefits.

2. Availability of Trust for Beneficiary. During the beneficiary's life, the trustee may distribute assets to or for the benefit of the beneficiary for needs of the beneficiary that are not met by government benefits. For example, Medicaid covers only very limited dental, eye and psychological care for a Medicaid recipient. In addition, government benefits do not provide clothing, vacation or gift allowances. Trust assets can be tapped for all of these purposes. While the trust assets are available for all of these purposes, the trustee, as noted above, has absolute discretion to decide whether distributions will be made from the trust for any of the beneficiary's needs.

3. Distribution of Trust Upon Death of the Beneficiary. The trust should also contain provisions for the distribution of the trust on the beneficiary's death. For example, the parents of the disabled adult might provide that upon the disabled adult's death, the trust will be distributed to the parents' remaining issue.

4. Benefit of Trust. Under current law, the use of a Medicaid trust established for the benefit of a disabled adult by someone other than the disabled adult or his or her spouse does not cause the disabled adult to lose his or her eligibility for Medicaid benefits. In addition, because government benefits will not insure a standard of living for the disabled adult comparable to that which he or she enjoyed during the parents' lifetime, the trust serves the important purpose of providing a source for funding a more comfortable lifestyle than that afforded by government benefits alone. The trust may permit the beneficiary to take vacations, travel to visit friends or relatives, give gifts at holidays and other special occasions and in general provide the beneficiary with the "extras" the beneficiary had during his or her parents' lifetime.

5. Other Issues in Planning for Children with Special Needs.

-**How much of parents' estate in trust for beneficiary?** An issue with which many parents of special

needs children wrestle is the decision of how much to place in trust for the benefit of their special needs child. While their other children may be financially independent, there may also be a desire on the part of the parents not to disinherit their other children in favor of the special needs child. On the other hand, because their other children are financially independent and the special needs child is likely not to be, there may also be a strong desire to leave the bulk of the parents' estate in trust for the benefit of the special needs child. Following the death of their special needs child, the trust can be left to the parents' remaining issue.

-**Who establishes the trust?** The discretionary Medicaid trust is effective only if it is established by someone other than the Medicaid recipient or the spouse of the Medicaid recipient. Thus, if the disabled adult owns assets in his or her own name, the disabled adult cannot establish a discretionary trust for his or own benefit and thereby become qualified for Medicaid.

6. Other Relatives. Other relatives should also be made aware of the existence of the trust for the benefit of the special needs child. No inheritance should be left outright to the special needs child, since such an inheritance may well undo the Medicaid planning engaged in for the benefit of the child.

B. <u>Blended Family Planning</u>. Individuals who marry more than once may face problems reconciling their desires to provide for their present spouse and family with their wishes for giving financial assistance to children from their prior marriages. Second marriages can create complex family situations, and more than most, require customized estate planning.

1. Failure to Remove Prior Spouse from Beneficiary Designations. In general, under North Carolina law, unlike the law with respect to wills, retirement plan accounts and life insurance proceeds will pass to the ex-spouse, even if that is not what was intended. Also, ex-spouses also will benefit from trusts created before marriage. Therefore, it is imperative that the beneficiary designations with respect to those assets be changed and that any trusts be redrafted after divorce. On the other hand, naming the current spouse as the beneficiary of the retirement plan or life insurance may result in disinheriting the children from the prior marriage (see below).

2. Potential Disinheritance of Children from a Prior Marriage. Many people want to provide financial security for their current spouse, yet leaving everything to the surviving spouse in a will may disinherit the children from the prior marriage. This would suggest setting up a QTIP or marital trust for the benefit of the current spouse during his or her lifetime, with the ultimate beneficiaries being all of the individual's children, whether from the current or prior marriage. On the other hand, this needs to be balanced against a concern created when the present spouse is not significantly older than the children from a prior marriage. In this event, the children from the prior marriage may have to wait almost their entire lifetimes to receive their inheritance.

3. Subsequent Spouse's Right to Claim Statutory Share. In North Carolina, an individual cannot disinherit his or her spouse. A surviving spouse has the right to dissent against the decedent spouse's will, and claim a portion of the estate (determined by reference to the intestacy laws). N.C.G.S. 30-1. Thus, by remarrying, an individual ensures that not all of his or her estate will pass to children from a prior marriage. The better practice is to execute a **premarital agreement** in which both spouse's waive their right to inherit from the other. Then, if the marriage works out, the couple can always add each other to their estate plans.

4. Premarital Agreements Ineffective for Medicaid Purposes. A second marriage later in life, can have unintended negative consequences with respect to nursing home expenses. As everyone knows, nursing home expenses are increasing every year, and once an individual's assets are exhausted, Medicaid will pay for nursing care home. Unfortunately, if the assets of the new spouse are exhausted, the government may require the other spouse's assets be used before the spouse in the nursing home qualifies for Medicaid benefits. Moreover, premarital agreements among spouses are ignored for Medicaid purposes.

C. Using the "Total Return" Trust to Balance Interests of Current Beneficiaries and Remainder Beneficiaries for Second Marriage Situations.

1. Introduction.

The "Total Return" Trust sounds like a complicated trust arrangement, but its goals really are simple: to balance the clients' competing desires to fairly treat both the current trust beneficiary (the "Second Spouse") and the children by the first marriage (the "Remainder Beneficiaries").

2. The "Traditional Second Marriage Trust" Arrangement.

Under traditional methods for drafting trusts to benefit both the "Second Spouse" and the "Remainder Beneficiaries," clients often have drafted a trust for the Second Spouse which obligates the Trustee to

- pay all trust income to the Second Spouse;
- use trust principal for the "needs" of the Second Spouse for health, maintenance and support; and
- distribute the remaining trust assets to the Remainder Beneficiaries at the death of the Second Spouse.

3. The Trustee's Dilemma.

This all sounds easy enough, but what would you do if you were the Trustee? How would you invest trust assets – in income producing assets or would you invest in stocks or funds with future appreciation potential? And, how would you decide on whether or not to make distributions to the "Second Spouse"? What are the appropriate "needs" of the Second Spouse for "health, maintenance and support?"

4. Enter the "Total Return Trust."

The "Total Return" Trust concept is the potential answer to the Trustee's dilemma. Under this Trust Arrangement, the Trust instrument usually specifies that the Trustee is obligated to distribute a specified percentage of trust assets each year to the Second Spouse. Thus, there is no requirement for mandatory distributions of trust income nor are there mandatory distributions of trust principal to provide for the health, maintenance and welfare of the Second Spouse.

Instead, the Trustee is given instructions to distribute a fixed percentage of Trust assets to the Second Spouse each year. And, the Trustee is given autonomy to invest the trust assets into those investments which are most likely to insure that the trust assets will be sufficient to allow for the mandatory fixed percentage distributions to the Second Spouse, while also insuring that the trust corpus will be preserved for the Remainder Beneficiaries.

5. The "Total Return" Trust Only Works If The Trustee Can Rely Upon Sound Investment Advice.

The Total Return Trust can accomplish the competing objectives of the client only if the Trustee relies on the sound advice of a professional investment advisor. Thus, the client should make sure the Trustee will seek the advice of the client's trusted financial advisors while administering the Trust.

VI. Minimizing Income Taxes.

A. The Income Tax Benefits of Tax Basis Step-Up

Section 1014 provides that, at the death of the decedent, his or her heirs receive an income tax basis step-up equal to the fair market value of the inherited assets as of the date of death. As a result, if they wanted to, the heirs could then sell all the decedent's assets, free of capital gains taxes. The same result also applies in the case of "loss assets" - i.e. those assets that have depreciated in value. That is, with respect to assets that have decreased in value, the heirs will receive an income tax basis equal to the fair market value as of the date of death - even if this amount is less than the decedent's original tax basis in the asset. Therefore, as a general rule, you never want to have clients die holding "loss" assets in their name.

An example will illustrate how these rules apply.

Let's assume that Dad owns Microsoft stock that he bought for $10 which now has a fair market value of $100. Dad also owns Baby Bell stock which he purchased for $30 and now has a value of $5. If Dad dies owning the Microsoft and Baby Bell stock, then his heirs will then be able to sell the Microsoft stock at no taxable gain.

However, they also will not be able to sell the Baby Bell stock and recognize the capital loss. Instead, the heirs will "take over" the Baby Bell stock with a new basis of $5 per share. So, where we discover that clients are holding "loss" assets, we usually recommend that they transfer the loss assets soon before death - that is where the clients know which spouse will likely die first.

Unfortunately, in those cases where it appears that one spouse may have a relatively short life expectancy, it is not always possible to take advantage of the tax basis step-up rules by transferring assets to that spouse. Under Section 1014(f), heirs do not receive a tax basis step-up for any assets transferred by them to the decedent within one year of the decedent's death.

Thus, for example, assume that Mom owns the Microsoft stock with a value of $100 and a tax basis of $10. The family discovers that Dad has a terminable illness. Therefore, Mom transfers Microsoft stock to Dad who then dies a month later. The Microsoft stock then passes back to Mom under the terms of Dad's Will. To Mom's surprise, however, Mom **does not** achieve a tax basis step-up in the Microsoft stock because of the rules of Section 1014(f). Instead, Mom keeps her original tax basis of $10 in the Microsoft stock.

Arguably, however, it may be possible to accomplish a tax basis step-up in the example above by restructuring Dad's Will so that, at Dad's death, the Microsoft stock will pass to a **trust** for Mom's benefit, rather than directly to Mom. Arguably, this arrangement should allow for at least a partial income tax basis step-up - at least to the extent of Mom's life estate interest in the stock trust.

B. Income Tax Planning for IRAs, Using the "Look Through" Trust for IRA Beneficiaries

1. Introduction.

Oftentimes, clients will have large IRA Accounts that they wish to leave for their children at the second death. In order to prevent the children from having to liquidate the IRA account within five (5) years after the IRA Owner's death, advisors have long recommended that clients divide their IRAs among their children, so that the children (as IRA beneficiaries) could withdraw inherited IRA balances over the joint life expectancies of the client and each child. This arrangement allowed the client to maximize income tax deferral for the benefit of his/her children.

2. The Stretch IRA Limitations

Of course, this traditional "stretch IRA" arrangement has a significant drawback, in that the child may elect to withdraw all amounts at once for purposes of using the IRA funds for inadvisable purposes.

So, clients have been asking: How can I name a trust for my child as beneficiary of my IRA and still achieve "stretch IRA" benefits of income tax deferral.

3. The Benefits of the "Look Through" Trust

Under a "Look Through" Trust Arrangement, the client will create one or more trusts for his/her children and will then name the trusts as beneficiaries of the IRA. The goals of the "Look Through" Trust are to

(a) achieve the tax deferral benefits of the "Stretch IRA" concept; and

(b) allow each child to take advantage of his/her life expectancy without having to withdraw amounts based upon the life expectancy of the oldest child; and

(c) to protect the IRA benefits inside the trust.

4. How to Structure a "Look Through" Trust.

Based upon recent IRS guidance, it appears that the following requirements must be met to achieve all of these goals:

(i) the trust must be valid under state law;

(ii) the trust must be irrevocable when the IRA owner dies;

(iii) the trust beneficiaries must be identifiable under the trust instrument;

(iv) proper documentation must be provided to the IRA Custodian.

In addition, the client has only 2 options for an IRA to benefit multiple trust beneficiaries who are not close in age:

- Divide the single IRA into separate IRA accounts during the owner's life, with each account designating a separate trust beneficiary; or

- Create separate trusts during the owner's life, with one trust for each beneficiary. The IRA form still must provide for separate shares.

5. Relying Upon A Professional Investment Advisor

Does this all sound complicated? Yes, it is, because a "Look Through" Trust can only hope to pass IRS scrutiny if all IRS requirements are met. So, if you are interested in establishing a "Look Through" Trust, you need to select a financial advisor who understands how to guide through the maze of IRS rules and regulations.

VII. Asset Protection Issues

This portion of the outline is intended to outline some of the asset protection strategies you may want to consider implementing (or developing further).

At the outset, we would make the following comments about the asset protection planning process:

1. Asset protection is subject to the interplay of a number of state and federal laws, thereby adding complexity and uncertainty to the process.

2. In order to increase the likelihood that planning will be effective, asset protection efforts should be taken when there are no pending or threatened creditor claims against someone. In addition, any asset protection steps must not violate fraudulent conveyance laws.

3. Judges and juries have substantial latitude in "doing justice" in any particular case. As with any case, the more sympathetic the plaintiff and less sympathetic the defendant, the more likely that the judge or jury will try to undercut an asset protection plan. Thus, the longer the time frame between the implementation of the plan and the potential claim, and the more "legitimate" the purposes associated with the plan (e.g., estate planning, income tax planning, etc.), the more likely the plan will be respected.

4. Even though there are many areas of asset protection planning that are not foolproof, the good news is that many asset protection efforts may provide some settlement benefit. In other words, even if a plan did not completely protect the assets, it may be possible to convince a plaintiff to compromise his or her claims rather than spend a great deal of time, trouble, and effort attempting to attack the plan.

This being said, some of the asset protection strategies you might consider include the following:

1. Life Insurance for the Benefit of Spouse and Children. The North Carolina Constitution protects certain life insurance policies from the claims of creditors. Thus, life insurance that either of you owns for the benefit of the other and your children should be protected from the claims of creditors, as long as you do not name your estate as the beneficiary of these policies. If you have significant life insurance coverage, you may also want to consider a life insurance trust for asset protection and estate tax reduction reasons.

2. Retirement Plan and IRA Accounts. In general, state and federal law protect retirement plan and IRA accounts from the claims of creditors. Therefore, accumulating wealth in your ERISA retirement and IRA accounts is a good asset protection strategy. In addition to the annual amounts permitted to be contributed on a pre-tax or deductible basis, you may want to consider making nondeductible IRA contributions, since those funds would receive creditor protection even if the contributions are made with after-tax funds.

3. Tenancy by the Entirety Real Property. North Carolina law appears to exempt any real property owned by a husband and wife as "tenants by the entirety" from the claims of a creditor of only one spouse (other than the IRS), but not the creditor of both spouses. Thus, acquiring real estate of any kind (i.e., not just a personal residence) in your joint names would be a good asset protection strategy in protecting assets from the claims of creditors of either, but not both, of you.

4. Transfer Assets to the Spouse at Lower Risk of Creditor Claims. If one spouse is more at risk with respect to future creditors than the other, the "at risk" spouse may wish to transfer property to the other spouse so that spouse will have some property left if the "at risk" spouse is sued or filed for bankruptcy. Please note that fraudulent conveyance laws and equitable distribution laws (discussed briefly below) apply to such transfers. Nonetheless, it is fairly common practice for the "at risk" spouse to transfer to or acquire assets in the name of the other spouse. Although this strategy is not foolproof, since either spouse could be sued for an automobile accident or similar incident, it may be a reasonable part of an overall asset protection plan.

As mentioned above, one should always consider equitable distribution laws before engaging in transfers between spouses. In general, assets accumulated prior to marriage and assets received by gift or inheritance, regardless of whether received before or during marriage, are considered separate property for equitable distribution purposes. Also, in general, assets accumulated during marriage (except by gift or inheritance), are considered marital property. As a general rule, marital property is subject to division in an equitable distribution proceeding, while separate property is not subject to division. Transfer of separate property from one spouse to the other or into the joint names of the spouses may convert separate property into marital property, thus subjecting it to equitable distribution. Although these are general rules, and this is not intended as an explanation of the classification of a particular asset or the consequence of a particular transfer, these rules should always be considered in contemplating a transfer of assets.

5. Liability Insurance. It probably goes without saying that owning sufficient business and personal liability insurance should be a fundamental component of any asset protection plan.

6. Gifts to Children and Grandchildren. Again, assuming fraudulent conveyance laws are not violated, gifts to children and grandchildren, or trusts for their benefit, can provide asset protection benefits. Given that there are other valid purposes for making gifts, such as tax planning and estate planning, gifts can be a good component of an asset protection plan.

7. Revise Parents' Estate Planning Documents. Once someone receives an inheritance outright, the inherited assets would then be subject to his or her potential creditors. We often counsel clients to request that their parents change their own estate planning documents to leave a client's inheritance in a special lifetime trust. This type of planning is discussed on pages 38 through 41 of this paper.

8. FLPs and FLLCs. LLCs and limited partnerships may provide creditor protections for assets held inside such entities (such as real estate and stocks and bonds).

Although there have been some recent indications that such protection is limited, an LLC may be a good vehicle for assets not otherwise addressed in the asset protection plan. FLPs and LLCs are discussed on pages 13 through 17 of this paper.

9. Domestic and Foreign Asset Protection Trusts. Certain states and countries tout their laws as providing special asset protection benefits. Delaware and Alaska are examples of states that claim to offer such asset protection to trusts created in those states. Some foreign countries claim to have even more extensive protections from the claims of creditors.

10. Revised Estate Planning Documents to Create a Discretionary Trust for the "At Risk" Spouse. If the "at risk" spouse inherits property outright from the other spouse, then that property becomes subject to the claims of creditors of the "at risk" spouse. Therefore, consider revising your estate planning documents to provide that any property the "at risk" spouse was to inherit from the other spouse would be held in a special discretionary trust for the "at risk" spouse's benefit. Discretionary trusts are discussed in page 38 through 41 of this paper.

11. Prepayment of Mortgages and Other Debts (including nondischargeable debts). Assuming no fraudulent conveyance laws are violated, another potential strategy would be prepaying debts on (1) property that is owned as tenants by the entireties (if only one spouse is "at risk") or (2) debts that would be nondischargeable in bankruptcy anyway.

12. Leased Property. Where appropriate consider leasing rather than buying property, since leased property is not subject to seizure, because the asset is not owned by you. Based on the difficulty in determining a debtor's equity in a lease with a purchase option, most creditors will leave such property alone. Thus, you should consider, where appropriate, leasing motor vehicles, boats, equipment, and other property.