Insight on Estate Planning

October/November 2009

GRATs: The long and short of it

For a healthy estate plan, know the HIPAA privacy rules

You, your noncitizen spouse and your estate plan

Use a QDOT to preserve marital deduction benefits

Estate Planning Pitfall

You haven't named backup beneficiaries for your life insurance policies

Weinstock, Manion, Reisman, Shore & Neumann

A LAW CORPORATION

1875 Century Park East • Suite 2000
Los Angeles, California 90067
(310) 553-8844 • Facsimile (310) 553-5165
www.weinstocklaw.com
www.trustlaw.la

We welcome the opportunity to discuss your needs and help you meet your estate planning and wealth transfer objectives.

Please call us at 310-553-8844 to let us know how we can be of assistance.

GRATs: The long and short of it

The grantor retained annuity trust (GRAT) can be a powerful estate planning tool. But the appropriate length of a GRAT's term is at times a source of confusion among people planning their estates and a subject of debate among experts.

The issue, as with many financial strategies, boils down to economics: Which type of GRAT — long-term or short-term — is more likely to produce the greatest tax-free transfer of wealth to your family?

How GRATs reduce taxes

A GRAT is an irrevocable trust that you fund with a one-time contribution of assets. The trust pays you an annuity for a specified term of years, after which any remaining assets are transferred tax free to your children or other beneficiaries.

The annuity is either a fixed dollar amount or a fixed percentage of the initial contribution's value. You can also design a GRAT with increasing annuity payments — a back-loaded GRAT. Bear in mind that the scheduled annuity amounts aren't permitted to increase more than 20% from the prior year.

When you establish a GRAT, your initial contribution is subject to gift tax based on the present value of your beneficiaries' remainder interest in the trust. If you set the annuity payments high enough, you can reduce the value of the remainder interest to zero — a "zeroed out" GRAT.

To determine the present value of the remainder interest, the Section 7520 rate — a conservative rate published monthly by the IRS — is applied. The Sec. 7520 rate is merely an assumed rate of return, however — so, to the extent the trust's growth outperforms that rate, the excess passes to your trust beneficiaries gift-tax free.

It's important to bear in mind mortality risk. GRATs work only if you survive the trust term. If you don't, the GRAT assets will be included in your taxable estate.

Short-term isn't short on advantages

It's unusual to set up just one short-term GRAT. The typical strategy is to set up rolling GRATs — a series of short-term GRATs (typically one or two years) in which each new GRAT is funded with annuity payments from the previous ones.

Short-term GRATs have several advantages, such as:

- Minimizing mortality risk, because the shorter the trust term, the more likely it is you'll survive it,
- Allowing you to transfer wealth to your beneficiaries more quickly,
- Providing you with greater control over the amount of wealth you transfer,
- Allowing you to lock in a two-year bull market gain, and
- Typically performing better than long-term GRATs, particularly in volatile markets.

The last advantage listed is probably the most significant one. Suppose you establish a 10-year GRAT when the applicable Sec. 7520 rate is 5%. If the trust's growth rate averages 5% or less during the 10-year term, the GRAT will fail — that is, it will not generate any tax savings.

If, instead, you use a series of rolling two-year GRATs, all it will take is one GRAT outperforming the Sec. 7520 rate for your strategy to be a success. Suppose that in Year 5 you establish a two-year GRAT in a month when the Sec. 7520 rate has dropped to 4%. If that GRAT achieves a 7% return, you'll transfer a significant amount of wealth tax free, even if all of your other short-term GRATs fail.

Long-term is long on benefits

Long-term GRATs also have several important advantages, including:

- Allowing you to lock in a favorable Sec. 7520 rate when interest rates are low,
- Taking advantage of back-loaded annuity payments, which can boost their performance over time, and
- Generally, benefiting more effectively from valuation discounts than short-term GRATs. (See "The power of valuation discounts" at right.)

Long-term GRATs might also have an advantage in the event Congress takes action to reduce or completely eliminate the benefit of this planning strategy. If that happens, it's likely that existing GRATs would be grandfathered in, but new ones would be disallowed.

Consider the economics

To decide between long-term and short-term GRATs, look at the relative likelihood that they'll achieve your objective of transferring wealth to your beneficiaries tax free. To do that, consider a variety of factors, including the current Sec. 7520 rate, your age and health, the nature and projected performance of the assets you plan to contribute, the availability of valuation discounts, and your risk tolerance. Your estate planning advisor can use financial modeling techniques to help you determine the best strategy. ■

The power of valuation discounts

Transfers of minority interests in businesses are often eligible for valuation discounts for lack of control and lack of marketability. The availability of valuation discounts can affect the performance of a grantor retained annuity trust (GRAT).

Generally, valuation discounts are a more significant advantage for long-term GRATs. Why? Because short-term GRATs have much higher annuity payments, and typically don't generate enough cash to make such payments without tapping into the trust principal. Thus, the trust will have to supplement by making in-kind distributions using the assets that were subject to the discount.

The following example illustrates how valuation discounts can boost the performance of a long-term GRAT. Suppose you contribute $1 million to a 10-year GRAT when the Section 7520 rate is 3.4%. To zero out the GRAT, you'd need a $119,636 annuity payment. If your return on the trust assets is 3.4%, matching the Sec. 7520 rate, your tax-free transfer will be $0.

Now suppose the assets are entitled to a 25% valuation discount, so that your contribution is reduced to $750,000. This would reduce the required annuity to $89,727. Assuming the same 3.4% return, the GRAT will achieve a tax-free transfer of approximately $350,000.

For a healthy estate plan, know the HIPAA privacy rules

Health issues play an important role in a variety of estate planning situations. Typically, many estate planning documents and document provisions are triggered by a physician's certification that a person lacks the capacity to make decisions. But this requirement may be at odds with the privacy provisions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Let's take a closer look at HIPAA's requirements and examine ways to address them in your estate plan.

HIPAA restrictions

One of HIPAA's key objectives is to protect patients' rights to confidential medical information, known as protected health information (PHI). HIPAA privacy rules prohibit physicians, hospitals and other health care providers from discussing a patient's condition or releasing his or her medical records to third parties without the patient's written consent.

The penalties for HIPAA violations are harsh: In addition to civil penalties of up to $25,000 for violations, there are criminal penalties. One might face a $50,000 fine and imprisonment for up to one year, increasing to $100,000 and five years if the violation involves false pretenses. Violators who intend to sell or otherwise use PHI for commercial gain or malicious harm are subject to a $250,000 fine and up to 10 years' imprisonment.

The privacy rules contain several exceptions. For example, a provider can disclose PHI if it's reasonably necessary for a patient's treatment, to secure payment for health care services or pursuant to a court order. Also, as discussed below, a provider can disclose PHI to a patient's personal representative.

HIPAA pointers

What types of documents do you have that might be affected? A health care power of attorney or advance directive, for one. This document authorizes your personal representative to make medical decisions on your behalf if you're unable to do so.

It's a good idea to review this document to be sure that HIPAA's privacy rules won't interfere with its smooth operation. If health care providers are unable or unwilling to provide the information needed to make a determination regarding your incapacity, critical medical decisions may be delayed while your family or representatives seek a court order.

HIPAA permits a personal representative — that is, someone who is authorized under applicable

law to make health care decisions on a patient's behalf — to access PHI. Personal representatives can include:

- Parents of minor children,
- Legal guardians of mentally incompetent adults, and
- Agents named in health care powers of attorney or advance directives.

If you've already executed a health care power of attorney or advance directive, consider adding HIPAA-specific language. Technically, a properly drafted document should be sufficient to authorize a physician or other provider to disclose PHI to a representative. But, given the severe penalties for violating the privacy rules, many physicians may be reluctant to comply. To avoid this situation, consider updating your power or directive to expressly authorize providers to release PHI to your representative in accordance with HIPAA.

HIPAA and trusts

If your estate plan includes one or more trusts, they may give a successor trustee the power to remove the current trustee if he or she is no longer competent to serve.

In this case, additional documentation may be desirable to anticipate HIPAA obstacles. Suppose, for example, that you establish a trust for the benefit of your children. You appoint your spouse as the initial trustee, but the trust document also provides that a successor trustee can remove the current trustee if two examining physicians certify in writing that he or she is no longer competent to serve.

The problem here is that HIPAA restricts the successor trustee's ability to obtain the medical information needed to evaluate the current trustee's competence. To avoid this obstacle, consider requiring trustees to sign written authorizations that permit successor trustees to access PHI to the extent necessary to determine their competence.

The HIPAA regulations set forth several requirements that must be met for such an authorization to be valid. Among other things, it must describe the health information to be disclosed and the purpose of the disclosure, specify who should make the disclosure and when the authorization will expire, and state that the signer retains the right to revoke the authorization.

One of HIPAA's key objectives is to protect patients' rights to confidential medical information, known as protected health information.

To discourage trustees from revoking a HIPAA disclosure authorization, consider providing in the trust documents that such a revocation constitutes a resignation as trustee.

Give your estate plan a health checkup

These are just a few examples of situations in which HIPAA's privacy rules can delay or obstruct the operation of your estate plan. To avoid these and other headaches, review your estate plan with your attorney for potential PHI issues. He or she can revise your documents as needed to ensure that you or your representatives will have access to critical medical information. ■

You, your noncitizen spouse and your estate plan

Use a QDOT to preserve marital deduction benefits

A major benefit of getting married — in addition to the love and companionship, of course — is that married couples can take advantage of the unlimited marital deduction for estate tax purposes. This powerful estate planning tool allows you to pass an unlimited amount of assets (through lifetime gifts or bequests at death) to your spouse free of gift and estate taxes. The only snag is that your spouse must be a U.S. citizen.

What to do if your husband or wife isn't a U.S. citizen? The most effective solution is for your noncitizen spouse to become a U.S. citizen. If that's not possible (or not otherwise desirable), you can preserve marital deduction benefits using a qualified domestic trust (QDOT).

QDOT defined

With a QDOT, the assets you designate are transferred on your death estate-tax free to the trust. Your noncitizen spouse receives the trust income during his or her lifetime.

When your spouse dies, the assets remaining in the trust are taxed as though they had been included in your estate at the time of your death, and pass to your designated beneficiary or beneficiaries.

At least one of the QDOT's trustees must be a U.S. citizen or a domestic corporation, such as a bank or trust company.

Additional requirements

To ensure estate tax is paid, additional security measures are required if the value of assets you

transfer to a QDOT exceeds $2 million. In determining whether the $2 million threshold is met, your executor may elect to exclude up to $600,000 in value attributable to a personal residence (including furnishings) the QDOT owns.

Additional security measures also are required for a QDOT valued at $2 million or less if more than 35% of its assets consist of real property located outside the United States.

You may satisfy the additional security requirements in one of three ways:

1. The trust provides that at least one trustee is a U.S. bank or a U.S. branch of a foreign bank.

2. The U.S. trustee furnishes the IRS with a bond in an amount equal to 65% of the fair market value of the trust assets (determined without regard to indebtedness).

3. The U.S. trustee supplies the U.S. government with an irrevocable letter of credit in an amount equal to 65% of the fair market value of the trust assets (determined without regard to indebtedness).

Consult with your professional estate planning advisor to determine which option is best for you.

Other considerations

Bear in mind that QDOTs have some significant disadvantages. For example, except in cases of hardship, your noncitizen spouse can't receive distributions of principal unless the trustee withholds estate taxes. Plus, any assets remaining in a QDOT when your noncitizen spouse dies are taxed as if they had been included in your taxable estate — effectively wasting the exemption that would otherwise be available if your spouse were a citizen.

If you die without having established a QDOT, your noncitizen spouse can either become a U.S. citizen or establish his or her own QDOT to hold the assets before the due date of your federal estate tax return.

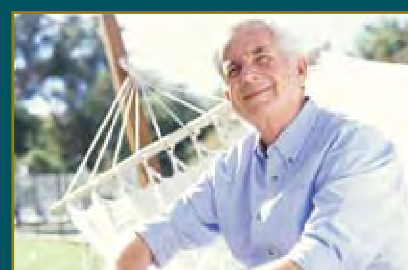
Achieve your goals

No matter what the circumstances, estate planning can be difficult. If your spouse isn't a U.S. citizen (or you aren't), you need to be especially careful when drafting your plan to ensure it will achieve your goals.

Keep in mind that several countries have treaties with the United States that address estate taxes, so before establishing a QDOT you should determine whether there is an applicable treaty. Your estate planning professional can help you determine if a QDOT is right for you and your spouse. ▮

Estate Planning Pitfall

You haven't named backup beneficiaries for your life insurance policies



For most people, one or more life insurance policies are key components of their estate plans. Life insurance not only provides your loved ones with the liquidity they need to pay estate taxes and other expenses, but it also creates new wealth for your family.

A life insurance policy's beneficiary designation is extremely important but easily overlooked. Many people make the mistake of naming their estate as beneficiary, which can result in state inheritance taxes, exposure of the insurance proceeds to creditors of your estate, needless expense and delay as the proceeds go through the probate process, and, potentially, an estate tax liability where there otherwise would be none.

By properly choosing your beneficiary, you'll likely avoid all of these problems. But don't let this give you a false sense of security. If your beneficiary dies before you, and you don't designate a replacement, the insurance proceeds likely will be paid to your estate just as if you had named your estate as beneficiary in the first place. This can happen, for example, if you forget to update the beneficiary designation or if, tragically, you and the beneficiary die in the same accident.

The solution? Designate at least two backup (or contingent) beneficiaries. That way, even if the primary beneficiary dies before you do, the life insurance proceeds will go to a backup, avoiding probate and shielding the proceeds from creditors' claims and unnecessary taxes. You might even consider having a life insurance trust acquire and own the policies on your life. Doing so could further assist you in avoiding the potential problems caused by having your policy survive longer than its beneficiary.

Weinstock, Manion, Reisman, Shore & Neumann

A LAW CORPORATION

Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 13 of our 15 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.
- Protect the interests of beneficiaries or fiduciaries in estate, trust or conservatorship matters.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 250 years of combined experience to the services we provide. The stability of our firm enables our lawyers to work closely together with business specialists to give clients outstanding individualized attention.

Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.