Insight on Estate Planning

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Defective by design

Weighing the ins and outs of income defective and estate defective trusts

For decades estate planning has focused on avoiding or minimizing federal estate, gift and generation-skipping transfer taxes. During the last several years, however, *income* tax has taken on a more significant role. That's not to say income tax wasn't a factor before. But until recently, it was overshadowed by transfer tax considerations.

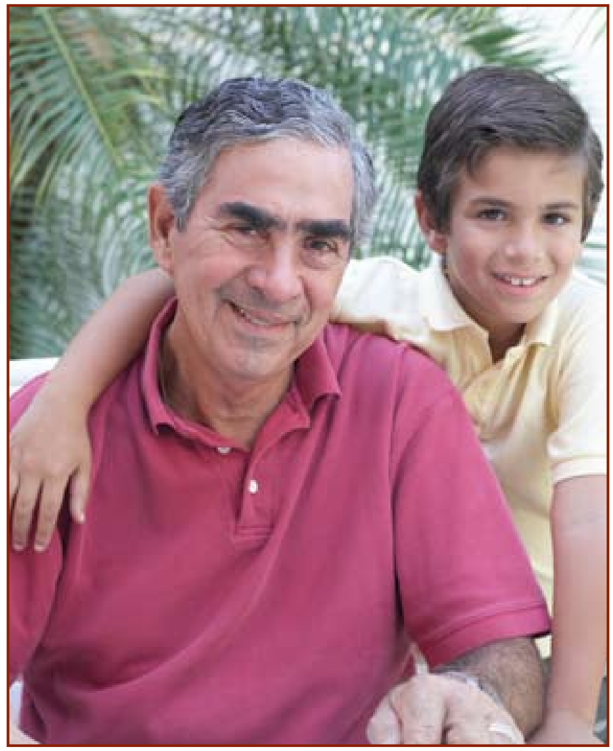
Now that the federal estate tax exemption has climbed to $3.5 million, fewer people are subject to federal estate tax. If you're among those for whom estate tax has become less of a concern, it's a good idea to review your situation and consider such estate planning strategies as income defective and estate defective trusts.

Income defective trusts

Irrevocable trusts have long been a highly effective tool for minimizing transfer taxes. When you contribute assets to an irrevocable trust, you freeze their value for transfer tax purposes. Although you're subject to gift tax on their fair market value, the assets are removed from your estate so that future appreciation in value passes to your children or other beneficiaries tax free. There are, however, certain situations where the assets can be returned to your estate.

An intentionally defective irrevocable trust allows you to transfer even more wealth tax free. With careful drafting, you can ensure that the trust assets are removed from your taxable estate while rendering the trust "defective" only for income tax purposes.

By reserving certain minor powers over the trust — such as the right to exchange trust assets with property of equal value or to borrow from the trust without adequate security — you ensure that the trust will be treated as a "grantor trust" for income tax purposes without bringing the trust assets back into your estate for estate tax purposes.



This is significant because you are treated as the owner of a grantor trust for income tax purposes, which means that you report the trust's net income on your individual tax return. As a result, the trust assets grow without being eroded by income taxes, leaving a greater amount of wealth for your beneficiaries. Essentially, by paying the trust's taxes, you make an additional tax-free gift to your heirs.

This type of "income defective trust" can be a powerful tool for reducing estate taxes, but it also comes at a potential income tax price, because the basis in the recipient's hands will be the lesser of your basis or fair market value at the date of transfer. In contrast, when assets are transferred at death, they receive a "step-up" in basis. In other words, an asset's tax basis is reset to its fair market value at the time of the transfer at death. Thus, if your heir sold the asset immediately after your death at the same fair market value, the sale wouldn't trigger any capital gains taxes.

Suppose, for example, that you place $500,000 in assets in an income defective trust for the benefit of your child, and your basis in the assets is $400,000. When you die, the trust assets, which are distributed to your child, are valued at $1.5 million. If your child sells the property, he or she will realize a $1.1 million capital gain, resulting in $165,000 in income tax (presuming the current long term, 15% rate and ignoring any state tax).

This price may be worth paying if, assuming a 45% marginal rate, it would avoid the $450,000 in estate taxes on the appreciation in value of the trust assets. But what if your wealth is within the $3.5 million exemption amount, so that removing the appreciation from your estate would yield no tax benefit? Under those circumstances, a different strategy might be called for.

Estate defective trusts

An estate defective trust is the opposite of an income defective trust: It's designed so that your beneficiaries are treated as the owners for income tax purposes, and the assets remain in your estate for estate tax purposes. This allows you to take advantage of two important income tax planning benefits:

1. You can use an estate defective trust to shift income to family members in a lower tax bracket.
2. By retaining the trust assets in your estate, your beneficiaries will enjoy a stepped-up basis in the assets, reducing or eliminating capital gains taxes if they sell the assets.

Consider this example: John, who is in the 28% federal income tax bracket, owns property that generates $30,000 annually. His tax basis in the property is $300,000, but its fair market value has grown to $900,000. John's net worth is well within the $3.5 million estate tax exemption amount, so he's not concerned about estate taxes.

John transfers the property to an estate defective trust for the benefit of his daughter, Beth, a 25-year-old graduate student with no other income. By shifting the income to Beth, the family saves more than $5,500 per year in federal taxes. State tax savings could further add to the benefits. Bear in mind, though, that there may be other factors to consider when deciding whether this type of income shift is beneficial.

In addition, because the property remains in John's estate, Beth receives a stepped-up basis in the property when John dies, avoiding $600,000 in capital gains (or more, if the property has appreciated further).

Keep in mind that the success of an estate defective trust depends on the assumption that you'll have little or no estate tax liability. If that assumption proves wrong — because, for example, your wealth increases unexpectedly or Congress reduces the estate tax exemption — this strategy could backfire.

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The future of estate tax laws

As of this writing, absent new legislation, the estate tax (but not the gift tax) will be repealed in 2010 and then reappear in 2011 with a top rate of 55% and an exemption amount of only $1 million. Also, in 2010, a stepped-up basis will be available for only a limited amount of property.

If these changes take place, the estate defective trust will lose some or all of its appeal. But it's widely believed that Congress will revise the estate tax laws this year.

Plan carefully

The effectiveness of the estate defective trust and other estate planning strategies depends on what Congress and the president decide to do about the federal estate tax laws. Keep an eye on legislative developments and talk with your advisors about their implications for your estate plan. ▮

Don't let your Crummey trust crumble

The annual gift tax exclusion is a deceptively powerful estate planning tool. It allows you to give up to $13,000 per year (adjusted regularly for inflation) to an unlimited number of recipients. If you elect to split gifts with your spouse, the limit doubles to $26,000. Best of all, the annual exclusion lets you remove a substantial amount of wealth from your taxable estate without tapping any of your $1 million lifetime gift tax or $3.5 million estate tax exemptions.

There's just one catch: The annual exclusion applies only to gifts of a *present* interest — that is, the recipient must have all immediate rights to the use, possession and enjoyment of the gifted property or of the income from such property. But gifts to a trust are, by definition, gifts of *future* interests. So how do you make annual exclusion gifts to a trust? One way is to provide trust beneficiaries with Crummey withdrawal rights.

A Crummey solution

Named after the taxpayer who first used the strategy successfully more than 40 years ago, Crummey rights allow beneficiaries to withdraw trust contributions for a limited period of time (30 days, for example) after they're made. By providing these rights, you can convert a future interest into a present interest even if the withdrawal rights are never exercised.

For this strategy to be effective, however, the trust must be drafted carefully, and its provisions must be followed to the letter. Among other things, you must provide beneficiaries with a timely, detailed written notice of their withdrawal rights.

The IRS has never liked Crummey trusts, and it may challenge annual exclusion gifts if it believes the arrangement is a sham or that there's an express or implied understanding between you and your beneficiaries that Crummey rights won't

be exercised. It's OK to talk to your beneficiaries about the financial benefits of keeping assets in the trust, so long as you don't imply that withdrawals are prohibited.

Fact vs. fiction

To withstand an IRS challenge, Crummey rights must provide beneficiaries with a real opportunity to withdraw funds from the trust. For example, Crummey rights typically are incorporated into irrevocable life insurance trusts (ILITs) so that insurance premiums can be funded with annual exclusion gifts. But a common mistake is to make contributions to an ILIT that are equal to the annual insurance premium and then to use those funds immediately to make the premium payment.

The problem with this approach is that, practically speaking, the beneficiaries couldn't exercise their Crummey withdrawal rights even if they wanted to. The IRS would likely view the arrangement as a sham and deem the contributions ineligible for the annual exclusion.

To avoid this result, maintain sufficient liquid assets in the trust to fund any potential Crummey withdrawals. Alternatively, the trustee should wait to make premium payments until the withdrawal period has expired.

Beware of the "5&5 rule"

Under the "5&5 rule," unless a beneficiary's withdrawal rights are limited to the greater of $5,000 or 5% of the trust principal, a beneficiary who allows Crummey rights to lapse will be considered to have made a gift to the remainder beneficiaries of the trust. The result can lead to a variety of gift and estate tax problems, because the beneficiary's gift will likely be treated as a future interest gift and thus won't be eligible for the annual exclusion.

A common mistake is to provide beneficiaries with withdrawal rights equal to the annual gift tax exclusion. If the trust principal is $260,000 or less, the Crummey rights will be greater than 5%, violating the 5&5 rule. To avoid this risk, the trust should include language providing that Crummey withdrawals cannot exceed the greater of $5,000 or 5% of the trust principal.

Avoid the pitfalls

A Crummey trust can be an effective estate planning tool, but to pass muster with the IRS it needs to be designed and operated carefully. Review "Crummey trust dos and don'ts" below, and be sure to have your trust documents drafted by your estate planning advisor.

Crummey trust dos and don'ts

Here are some tips for protecting your Crummey trust against an IRS challenge:

Don't:

- Establish a fixed dollar amount for Crummey withdrawal rights,
- Pay insurance premiums prior to the expiration of the withdrawal period unless the irrevocable life insurance trust (ILIT) has sufficient funds to pay the premium without the current contribution,
- Have an agreement with beneficiaries, either oral or written, that they'll refrain from exercising their withdrawal rights,
- Allow beneficiaries to waive their withdrawal rights before you make a contribution and send a notice,
- Provide Crummey rights to beneficiaries with little or no economic interest in the trust, or whose interests are so remote that the IRS could claim the trust is a sham, and
- Make contributions to the trust so late in the year that the withdrawal period straddles two tax years (to avoid confusion over which year the gift is made).

Do:

- Strictly comply with the trust's notice and other provisions,
- Send Crummey notices using certified mail,
- Specify in the trust that notices may be sent to minor beneficiaries through their parents or legal guardians and that the parents or guardians can exercise withdrawal rights on the minor's behalf,
- Fund an ILIT with sufficient liquid assets to cover all withdrawal rights,
- Be sure that the ILIT, not you as grantor, makes all premium payments,
- Specify a withdrawal period of 30 days or more (if the period is too short, the IRS may argue that withdrawal rights are illusory),
- Set withdrawal rights by reference to the current annual exclusion amount (subject to the 5&5 rule's limits), and
- Talk to your advisor about generation-skipping transfer tax planning if your beneficiaries include grandchildren or other "skip" persons.

Bankruptcy and your estate plan

When assets are transferred is key

Asset protection is an important component of most estate plans. Some estate planning tools — such as domestic and offshore asset protection trusts — are primarily intended to protect your family's wealth against frivolous or unreasonable creditor claims. Others — such as family limited partnerships (FLPs), family limited liability companies (FLLCs), tax-deferred retirement accounts and certain trusts — offer some level of creditor protection as one of many potential benefits.

These estate planning tools provide some peace of mind that your assets will be there when your family needs them. But don't be lulled into a false sense of security. Asset protection is never absolute, particularly when bankruptcy is involved. To minimize your risk, it's important to consider bankruptcy issues as you plan your estate.

How can an estate plan be affected?

There are three ways that bankruptcy can affect your estate plan. First, you might become a bankruptcy debtor, either by filing for bankruptcy yourself or by an involuntary bankruptcy petition by your creditors. Second, you might receive a transfer of property (repayment of an intrafamily loan, for example) from someone who is or becomes a bankruptcy debtor. Finally, you might own stock or some other interest in an entity that is or becomes a bankruptcy debtor.

Any of these situations can affect your estate plan, but for purposes of this article we'll focus on the first.

What are the risks?

One of the biggest risks posed by declaring bankruptcy is that the bankruptcy court will disregard an asset protection vehicle or set aside a transfer to such a vehicle. After a bankruptcy petition is filed, the debtor's assets (with certain exceptions) become the property of the bankruptcy estate, and the bankruptcy trustee has the power to challenge certain transactions as fraudulent or preferential transfers.

The Bankruptcy Code generally allows the court to set aside fraudulent transfers (which includes assuming another person's obligation) within two years before the bankruptcy filing. Covered transfers include *actual* fraudulent transfers — where the debtor intends to defraud, hinder or delay creditors — as well as *constructive* fraudulent transfers. Constructive fraud is when a debtor transfers assets without receiving "reasonably equivalent value" and certain facts exist — such as the debtor's insolvency — from which fraud can be presumed.

Even if a transaction doesn't meet the Bankruptcy Code's definition of a fraudulent transfer, the trustee may be able to challenge it if it would violate applicable state fraudulent transfer laws. State laws often have longer limitation periods, allowing the trustee to attack transfers that occurred more than two years before the bankruptcy filing.

In the case of a "self-settled trust," such as an asset protection trust that names the debtor as a beneficiary, federal law permits a bankruptcy court to look back as far as 10 years and set aside transfers to the trust that involved actual intent to defraud creditors.

The trustee can also challenge preferential transfers. With certain exceptions, a preference is a transfer:

- To or for the benefit of a creditor,
- On account of a pre-existing debt,
- Made while the debtor is insolvent,

- Made within 90 days before the bankruptcy filing (one year in the case of an "insider," such as a family member or business associate), or
- That allows the creditor to receive more than he or she would through bankruptcy.

The distinction between fraudulent conveyances and preferential transfers is important. To void a transfer as a fraudulent conveyance, one must prove intent to defraud. But preferential transfers can be undone regardless of the debtor's intent and even if they would otherwise be lawful.

What should you do?

The best strategy for protecting your plan against attack in bankruptcy (or under state fraudulent transfer laws) is to set up asset protection trusts and other estate planning vehicles as early as possible. By transferring assets well before any creditors' claims or financial difficulties arise, it's more difficult for creditors or a bankruptcy trustee to argue that these transfers were fraudulent.

Whenever possible, carefully document all non-asset-protection purposes for estate planning vehicles. Establishing legitimate purposes for a transfer will help you deflect any claims that it was intended to defraud creditors.

Seek help

Bankruptcy laws are complex and can greatly affect an estate plan. If you're considering filing a voluntary bankruptcy petition, consult your estate planning advisor to discuss any potential estate planning implications before you file.

Estate planning pitfall

You haven't reviewed your estate plan since your divorce

Divorce can be a traumatic experience, and for people going through it, long-term financial and estate planning may be the furthest things from their mind. But if you're divorced, it's a good idea to review your estate plan as soon as possible.

The divorce settlement likely took care of issues such as jointly owned real estate, bank accounts or other property. You may have even amended your will or living trust. But what about life insurance policies and retirement accounts, such as IRAs or 401(k)s? Is your former spouse still named as a beneficiary? If so, you should update the beneficiary designations for those accounts.

Did you previously appoint your spouse as your agent for health care issues or give him or her a power of attorney for financial matters? Perhaps your divorce was amicable and you're comfortable with this arrangement. Will you still be comfortable if your ex remarries and has children with someone else? To avoid unpleasant surprises, consider terminating any agency relationships with your ex-spouse and appointing someone else to handle health and financial decisions on your behalf in the event you become incapacitated.

Have you established any irrevocable trusts that name your former spouse as a beneficiary? If so, do the trust instruments provide that his or her rights to the trust terminate automatically in the event of divorce? If not, the disposition of the trust assets may depend on several factors, including the nature of the trust, applicable state law and the terms of your divorce settlement.

These are just a few of the many significant estate planning issues you should address after a divorce. In fact, you should revisit your estate plan any time there's a major change in your life, including divorce, death of a family member, marriage or the birth of a child. Failure to do so can lead to unexpected — and sometimes unpleasant — consequences.

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**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.