Insight on estate planning

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Try it on for size

If a private foundation is too large, a DAF may be the perfect fit

Plus!

Estate Planning Pitfall:
A special needs trust is improperly drafted

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Heavy moving

Transfer significant amounts of wealth using a GRAT or IDGT

If your estate will be subject to significant estate tax on your death and you wish to pass as much wealth as possible to your heirs, there are many ways to do so. Even though the gift tax may dissuade you from making large gifts outright, there are two strategies available to transfer significant wealth to loved ones at a low — or even at no — gift tax cost. Both involve the concept of a grantor trust. You, as the grantor, create an irrevocable trust to effectuate the transfer.

GRATs

One strategy is the grantor-retained annuity trust (GRAT). Briefly stated, with a GRAT you make a gift to a trust for the benefit of your children or other loved ones and receive the right to annuity payments. At the end of the annuity period, any remaining assets are distributed to the beneficiaries according to the GRAT's terms.

Because you have the right to define virtually all of the GRAT's terms, you can work backward. That is, you choose the gift you're willing to make and then define the terms to help you meet your objective.

The one aspect of the GRAT you cannot define is the IRS Section 7520 rate, which is the rate of return presumed to be earned by trust assets throughout the life of the GRAT. The value of your gift, and ultimately the success of the GRAT, is a function of the Sec. 7520 rate and a multitude of other factors, including the:

- Amount you initially transfer,
- Annuity amount,
- Scheduled duration of the GRAT,
- Age (or ages) of the annuitant(s), and
- Actual investment results.

Remember that the Sec. 7520 rate is a *presumed* return. By setting the terms of your GRAT appropriately, you can structure it so the value of your gift is zero. To the extent the actual return exceeds the Sec. 7520 rate, the trust will grow larger than anticipated, and the beneficiary will receive the additional value free of gift or estate tax.

A downside of a GRAT is that you must survive the trust's term. If you don't, the GRAT is disregarded and all of the assets are included in your estate.

IDGTs

An intentionally defective grantor trust (IDGT) also offers flexibility in design. A typical scenario involves you, as grantor, making a gift to an irrevocable trust followed by a sale of assets to the trust. The trust makes a down payment of, say, 10%, and issues a note payable to you for the balance. The interest rate is based on the applicable federal rate (AFR) which, ideally, is relatively low in comparison to the expected return on the assets. Typically, the gift you make is a taxable gift, so it will reduce your available lifetime exemption amount.

The objective of an IDGT is for the assets remaining in the trust at the end of the term to far exceed the amount needed to repay the trust's debt to you. The assets in excess of the debt will pass to the IDGT beneficiaries estate tax free.

The fact that a sale is involved is a key advantage of an IDGT over a GRAT — regardless of whether you survive the repayment period, the assets are out of your estate. Until the trust repays the note, though, any remaining balance will be included in your estate.

The trust's "intentionally" defective nature leads to an interesting result — it's treated differently for estate tax purposes than it is for income tax purposes. The trust is a separate legal entity for estate tax purposes, so anything sold to the trust is effectively removed from your estate. For income tax purposes, however, the trust isn't treated as distinct from you, meaning that any gain on the sale isn't considered income and therefore isn't subject to income tax.

In addition, income earned by the trust is taxed to you, not to the trust. But all income attributable to the trust assets remains in the trust. Further, any appreciation on those assets remains in the trust as well.

Even though there was some uncertainty as to whether a grantor's tax payment on trust income could be considered an additional gift to the trust, the IRS clarified its position by saying that, as long as the trust doesn't require the grantor to be reimbursed for taxes paid, there's no additional gift by the grantor.

Allowing trust assets to grow unencumbered by income taxes otherwise attributable to earnings on those assets is a significant benefit. Plus, every time you pay tax without receiving the income, you further reduce the value of your estate.

Make your choice

The bottom line is that GRATs and IDGTs can be powerful tools to transfer significant wealth. But bear in mind that each trust type has its own idiosyncrasies, and the establishment of either requires the assistance of an estate planning attorney. Consider your circumstances before choosing either a GRAT or IDGT.

4 choices

Which retirement savings vehicle is best for your estate plan?

When it comes to retirement accounts, you have many choices, including a traditional IRA, a Roth IRA, a 401(k) and, now, a Roth 401(k). You can use these retirement savings vehicles for estate planning purposes as well.

Weigh the choices

The main difference between traditional and Roth accounts lies in the tax treatment of the contributions and distributions. Even though contributions to traditional accounts generally reduce your taxable income, distributions are subject to tax. Roth contributions, on the other hand, don't provide a tax benefit, but distributions generally are tax free.

Whether you even qualify to make tax-deductible traditional IRA contributions or any Roth IRA contributions depends on a variety of factors. See the chart on page 5 for more information. If you qualify for both, should you choose a traditional or a Roth IRA? By extension, if your employer offers a Roth 401(k), should you choose a traditional or a Roth 401(k)? The decision hinges on two main factors: 1) the tax benefit now vs.

tax-free withdrawals later, and 2) the flexibility of contributions and distributions after age 70½.

Even though you may not be eligible to make deductible or Roth IRA contributions, there may be an estate planning opportunity with respect to your grandchildren. As they begin their careers, you may be able to encourage them to make retirement contributions today by funding them. This will help your grandchildren to build their retirement accounts and, you hope, get them to focus on their financial future. And don't forget that, if your taxable income drops as you scale back or change careers, you may become eligible to make contributions to a deductible or Roth IRA.

Also consider that, unlike a Roth IRA, a Roth 401(k) has no income limits for contributions. So by forgoing the income tax benefits of contributing to a traditional 401(k), you may position yourself to pass income-tax-exempt funds to heirs.

Tax benefits on contributions vs. tax-free withdrawals

Let's suppose you (or your grandchildren) are permitted to make a contribution to either a traditional IRA/401(k) or a Roth IRA/401(k). By choosing the Roth, you'd forgo the tax benefit that would be available if you had instead contributed to a traditional IRA or 401(k).

If everything else were equal, the decision of which would be better would depend on your income tax bracket in retirement as compared to what it is now. If you expected the bracket to be lower, a traditional IRA/401(k) likely would provide tax savings. If you expected the bracket to be higher, the Roth might be the better choice.

Flexibility on distributions and contributions

With a traditional IRA, you must start taking withdrawals no later than April 1 following the year in which you reach age 70½. And, you may no longer make contributions starting in the year in which

you reach age 70½. There are no such restrictions on Roth IRAs.

Although a Roth 401(k) does have a required minimum distribution, by rolling the account into a Roth IRA you'd have the flexibility of not having to make distributions. By using a Roth 401(k)/Roth IRA combination, you'd also be able to avoid the income tax due on the distribution that would be required if the funds were in a traditional 401(k)/IRA.

Distribution to heirs on your death

Although the distribution rules with respect to a traditional 401(k)/IRA that is inherited can create unwanted income tax consequences, distributions from a Roth 401(k)/IRA aren't subject to income tax. Though there are required minimum distributions for all inherited accounts mentioned, the timing of the distribution and the required amounts will depend on various factors, such as whether the account is an IRA or 401(k), who is the beneficiary, and whether your death was after the required beginning date of distributions. Plus, as long as funds are in a Roth account, they grow (and can be distributed) free of any income tax consequences.

Rolling a traditional IRA into a Roth IRA

Whether you've made direct contributions or rolled 401(k) accounts into a traditional IRA, it may be advantageous to convert your IRA to a Roth IRA. Historically, your income may have been too high to allow you to make the conversion, but, under the Tax Increase Prevention and Reconciliation Act of 2005, the $100,000 income limitation for a conversion will be eliminated in 2010. Thus, in 2010, an individual of any income level can make a Roth conversion.

Once you're eligible, the question is whether it makes sense. Suppose, for example, you have a $1 million IRA. By rolling the entire $1 million into a Roth IRA in the same year, you'll be faced with a federal tax of nearly $350,000 (assuming the current top rate of 35% is in effect), plus any state tax associated with the conversion. And, if you happen to roll the funds in 2010, the law provides that the income — absent certain circumstances — will be reported 50% in 2011 and 50% in 2012, allowing you to somewhat defer the tax impact.

The ability to do a Roth conversion also is a potential "deathbed" strategy. Let's say you roll your IRA into a Roth IRA and then die shortly thereafter. Your heirs receive a $1 million IRA, but, because of the $350,000 tax liability, your incremental estate tax is based on only the net amount of $650,000. Thus, at today's highest marginal bracket of 46%, the estate tax related to the IRA is, on a net basis, only $299,000 (rather than the $460,000 that would have been assessed on the $1 million IRA had it not been converted). The related income tax, in effect, reduced your estate tax liability by $161,000. You receive a subsidy for rolling the traditional IRA into a Roth IRA. Of course, in 2010 this won't be an issue because the estate tax is scheduled to be repealed for that year.

Account for the differences

Bear in mind that there are important differences with respect to traditional and Roth IRAs, as well as traditional and Roth 401(k)s. If you're eligible to make contributions to any or all of the available accounts, consider which is best for your circumstances — not just today but also for generations to come.

IRA contribution phaseout schedule

TRADITIONAL IRA 2006 ADJUSTED GROSS INCOME (AGI) LIMITS*

	Fully deductible	Partially deductible	Not deductible
Single, active participant in employer plan	Up to $50,000	From $50,000 up to $60,000	$60,000 or more
Married filing jointly, both active participants	Up to $75,000	From $75,000 up to $85,000	$85,000 or more
Married filing jointly, one active participant	Up to $150,000	From $150,000 up to $160,000	$160,000 or more

** There is no limit if you (and, if applicable, your spouse) aren't an active participant in an employer plan.*

ROTH IRA 2006 AGI LIMITS

	Fully allowed	Partially allowed	Not allowed
Single	Up to $95,000	From $95,000 up to $110,000	$110,000 or more
Married filing jointly	Up to $150,000	From $150,000 up to $160,000	$160,000 or more

Source: *U.S. Internal Revenue Code*

Try it on for size

If a private foundation is too large, a DAF may be the perfect fit

Jay is charitably inclined and likes the idea of a private foundation. But he's shied away from it because it's costly at the outset and, on a continuing basis, time intensive from an administrative standpoint. Even though Jay is comfortable financially, in no way does he feel wealthy. So he isn't sure a private foundation is right for him. When a colleague refers to a donor advised fund (DAF) as a "light" version of a private foundation, Jay's interest is piqued.

Contributions to a DAF

A DAF is a charitable fund sponsored by a public charity. Funding a DAF is relatively uninvolved. In fact, most brokerage houses have created a charitable arm to act as a plan sponsor. The difficult part is finding the DAF sponsor that's right for you.

Because DAFs qualify as public charities, contributions enjoy the most favorable

income tax benefits allowed under tax law — another advantage DAFs have over private foundations. Where, for instance, cash contributions to private foundations are subject to a 30% of adjusted gross income (AGI) limit for current year deductions, those to a DAF enjoy a 50% limit. Certain noncash contributions, such as appreciated publicly traded securities held long term (more than one year), are deductible in the current year up to only 20% of AGI for private foundation purposes as compared to 30% for DAF contributions.

Like private foundation bequests, contributions you make at death to a DAF qualify for an estate tax deduction and, therefore, reduce your taxable estate.

Bear in mind that most DAFs require you to contribute certain minimums to create the fund, and also may have minimums for subsequent contributions. If you have reason to be concerned that you'll be forced to contribute even when you aren't interested in doing so

DAFs under scrutiny by Congress, IRS

Even though donor advised funds (DAFs) can be a great way to share your wealth, there are those bad apples that threaten to spoil the bunch. Congress and the IRS are looking at ways to make the use of DAFs more regulated — perhaps by requiring reporting similar to that of private foundations — and to put the brakes on those who seek to use their DAFs inappropriately.

"Inappropriately," as far as Congress is concerned, may mean, among other things:

- Not making charitable contributions from the DAF on a regular basis,
- Exerting too much control over the charitable entities the DAF is purporting to serve, and
- Personally benefiting from contributions to the DAF.

To steer clear of potential problems, your DAF should make contributions only to recognized charities and make them at least annually.

for a particular year, learn the rules for the organization sponsoring your DAF.

Donations from a DAF

Also consider how much the DAF will contribute to charity. Private foundations generally are required by law to contribute at least 5% of their assets to charity each year. But most DAFs don't have stated minimums — though, because the idea of a DAF is to be charitable, it certainly is expected that the DAF will make regular charitable contributions.

Most DAFs have rules with respect to giving. More specifically, inquire as to whether there are restrictions on making contributions to certain charities. If your chosen charity isn't on the approved list, you'll want to know that before enrolling. Be forewarned, you cannot use a DAF to make contributions that wouldn't otherwise qualify for a tax deduction, such as those made to a political candidate.

Which way to turn?

Generally speaking, a DAF is significantly less costly than a private foundation, but there can be a wide range of fees charged and services offered. It's incumbent on the donor to create a fund that best suits his or her needs. In Jay's case, he has questions that must be answered to his satisfaction before creating a DAF. His next step is to contact his estate planning professional.

Estate Planning Pitfall

A special needs trust is improperly drafted

Sadly, there are many circumstances under which children or other loved ones are unable to care for themselves. Even sadder, parents who want to do everything possible to help can unintentionally create a situation that ends up hurting — at least with respect to the child's financial condition: They set up a special needs trust but improperly draft it and the child loses government benefits for which he or she would otherwise be eligible.

It's imperative the trust be clear that it's supplemental in nature. Further, there are restrictions on the amount of income a beneficiary can have and still qualify for government benefits.

If the beneficiary's income is too high, he or she could become ineligible for benefits, so it's vital that the trust not jeopardize running afoul of the rules. For instance, if the trust is drafted to distribute income directly to the beneficiary, as opposed to being drafted to pay the beneficiary's allowable expenses, the beneficiary may be ineligible for further government assistance.

Because of the strict rules — and severe consequences for not following them — it's important to consult someone who specializes in this area. Properly designed, the trust can accomplish many of your family's goals.

The trust is intended to benefit your child, but he or she cannot own any of the assets. You must give the trustee the discretion to make decisions with respect to whatever assistance your child receives. The trustee should be given an explanation of the child's conditions and treatment history as a means of providing a framework within which the trustee can work.

Weinstock, Manion, Reisman, Shore & Neumann

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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.