# Insight on estate planning

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## New Year's resolution: Make annual exclusion gifts

## Is a charitable remainder trust still a viable option?

### All in the blended family

A QTIP trust can keep everyone happy

## Deciding who gets what

Consider the income tax on inherited assets when creating an estate plan

Weinstock, Manion, Reisman, Shore & Neumann
A LAW CORPORATION

1875 Century Park East • Suite 1500
Los Angeles, California 90067-2516
(310) 553-8844 • Facsimile (310) 553-5165
www.weinstocklaw.com

# New Year's resolution: Make annual exclusion gifts

As a new year begins, your thoughts should turn to creating your annual gifting strategy. The first quarter of the year is an excellent time to determine to whom you wish to make annual exclusion gifts because on Jan. 1 your exclusion amount resets to $11,000. Also, making gifts early in the year will allow them more time to appreciate in your beneficiaries' hands, rather than yours. (Note that, because the exclusion is an annual amount, whatever you don't use by Dec. 31 doesn't carry over to the next year.)

Using your annual exclusion can be an effective way to remove assets from your estate tax-free without tapping your gift and estate tax exemptions. Plus you can watch your loved ones enjoy their gifts. But before finalizing your strategy, consider how you can maximize the benefit of annual exclusion gifts.

## Assets other than cash

One way to make the most of your annual exclusion is to give assets other than cash. For instance, let's say you and your spouse would like to transfer $22,000 to each of your two children but don't have $44,000 in cash readily available. One option is to liquidate a portion of your investment portfolio.

Assuming your securities have appreciated, you and your spouse must sell more than $44,000 of assets to have enough to both cover the tax on the capital gains and make the $44,000 gifts. A wiser plan may be to transfer the securities to your children. This works particularly well if your children are subject to a lower capital gains rate or aren't planning to immediately sell the assets.

**One way to boost the value of your annual exclusion is to transfer an asset to heirs *before* it increases in value.**

## Unappreciated assets

Another way to boost the value of your annual exclusion is to transfer an asset to heirs *before* it increases in value. Of course you never know for sure what the future holds, but in some situations you can make a good prediction.

An example of this is giving your children stock in your young company that you anticipate will experience rapid growth, go public or be sold at a premium. The amount of your gift of company stock will be based on its value at the time of the gift. Thus,

any appreciation after the transfer will increase the eventual value of your gift for your children.

### Life insurance policies

When you give a loved one your life insurance policy, its value for gift tax purposes is its interpolated terminal reserve value. The gift won't be subject to gift tax as long as this value doesn't exceed $11,000.

When you die, the policy's death benefit, which is likely many times the cash surrender value, also is excluded from your estate because you aren't the owner. Remember that simply changing the beneficiary isn't sufficient; you must surrender ownership to remove the asset from your taxable estate.

### Valuation discounts

By giving interests in a closely held business, you can reap the benefits of valuation discounts and give away more than $11,000 per recipient under the annual exclusion — as long as the gift is less than 50% of the total shares of the business.

Because your children will be minority shareholders, they won't have control of the business's activities. In addition, sale of their interests may be restricted. These limitations can translate to a reduced value of the limited partner interests for gift tax purposes.

To better understand how this technique works, here's an example: You want to give each of your children a gift of interests up to the $11,000 annual exclusion amount. A formal valuation yields an appropriate discount of 30%, so you can give each child approximately $15,700 [$15,700 – ($15,700 x 30%) = $10,990].

You also may be able to benefit from valuation discounts by setting up a family limited partnership (FLP). Bear in mind that, even though creating and maintaining an FLP is more complicated than simply gifting shares or writing a check and handing it to your children and grandchildren, the benefits may make it well worthwhile.

### Take baby steps, if necessary

With the annual exclusion, you may give up to $11,000 per year per recipient ($22,000 for married couples who elect to split the gift) without incurring any gift tax or using up any of your $1 million lifetime gift tax exemption. (Remember, this amount isn't scheduled to increase as the estate tax exemption increases, and the gift tax isn't scheduled to be repealed with the estate tax.) But just because the amount is available doesn't mean that you must use all of it.

You can maintain your gifting comfort level by giving smaller amounts with particular goals in mind. For example, consider giving each of your children $3,000 so they can make the maximum annual contribution to a traditional IRA. Depending on their situation, they may be able to take an income tax deduction for the contribution, thus increasing the real value of your gift.

If your children don't qualify to deduct traditional IRA contributions, they might qualify to make Roth IRA contributions. Even though your family members won't receive an income tax deduction, you're helping them provide for their retirement because the Roth IRA assets grow tax-free. Depending on the recipients' ages, today's gift can grow to be a much more significant amount over time. Keep in mind that, when giving gifts, time is often your best ally.

### Maximize your giving power

Although many people equate estate planning with transferring their assets on their death, it's also a way to give assets to loved ones during their lifetime. Taking advantage of your annual exclusion gifts can benefit you and your beneficiaries: You remove large amounts of funds from your estate, thus reducing your estate tax liability, and the assets can help your children or grandchildren get on their financial feet. But don't forget about your lifetime gift tax exemption and other ways to transfer assets tax-free, such as by directly paying your children's or grandchildren's medical or tuition expenses.

# Is a charitable remainder trust still a viable option?

Charitable remainder trusts (CRTs) historically have been recognized as a way to do well while doing good — even for those who weren't necessarily charitably inclined. But today, with still-near-record-low interest rates, attractive long-term capital gains rates, low income tax rates and an estate tax that's phasing out, can CRTs have worn out their welcome?

## CRT flexibility

A CRT is a vehicle where you, as the grantor, transfer assets to a trust in which you retain the right to an income stream. You designate the trust's terms, within the parameters permitted by law, including the:

- Annual payout percentage, which must be at least 5% but not more than 50%,
- Payout type — an annuity based on the original value of the trust or unitrust payments based on the value each year,
- Term, which is limited to 20 years unless the trust is to continue for the lifespan of the last surviving noncharitable beneficiary, and
- Beneficiary or beneficiaries, which can be any noncharitable beneficiary living when you create the trust and, ultimately, at least one charitable institution.

The value of your charitable deduction is calculated using the Internal Revenue Code Section 7520 rate — a presumed rate of return on the trust assets — and other factors, such as your age and the terms you designate.

In today's low interest rate environment, the presumed return is lower than it would be if rates were higher. This means that, with all else being equal, the presumption is that less will be left to the charity and therefore the charitable deduction will be lower.

## Tax consequences

When you initially transfer appreciated assets to the trust, you avoid immediate recognition of the gain because the trust isn't subject to tax. The gain is essentially deferred, although you might never have to pay any tax on that gain.

This is because, each year, the trust beneficiary pays tax on the trust distributions based on the character (ordinary income, short-term capital gains, long-term capital gains or nontaxable income) the income has in the trust, with the highest taxed income coming out first. So, if your distributions never exceed your income so much that they

get to the point where the deferred gain is taxed, effectively you've avoided tax on the gain.

Whether your goal is to maximize the charitable contribution or the annuity, you can design a CRT to meet your needs. There are a few requirements with respect to how much of the trust assets must pass to the charitable institution. The projections must show that at least 10% of the trust assets are scheduled to pass to the charity and there must be no more than a 5% probability that the trust assets will be exhausted before the trust ends.

Keep in mind that the calculations are done at the trust's inception. The trust's validity is determined at that point, and regardless of what happens, the trust will not subsequently be disregarded.

## The current view

It's important to note that a CRT can diversify your portfolio, increase cash flow and, ultimately, leave a charitable legacy. The tax benefits often far outweigh the charitable benefits.

Although the interest rate and income tax climate may be less conducive than in the past, a CRT can still make sense. It may not be as applicable to as wide a variety of situations as it has in the past, but it's still useful, especially in light of its flexibility.

For example, let's say Frieda is 65 years old with a large estate that puts her in the highest marginal bracket. Plus, her estate includes an unrealized gain in securities that don't pay dividends. She's in the highest income tax bracket and isn't particularly charitably inclined.

**A CRT is a vehicle where you, as the grantor, transfer assets to a trust in which you retain the right to an income stream.**

Frieda wants to increase her cash flow and is considering whether to liquidate her shares of stock and, as much as she is against doing so, pay tax on the $900,000 capital gain. A CRT could be the answer.

If Frieda wishes to create an annuity for the rest of her life, and assuming a Sec. 7520 rate of 5%, she'll be able to set up an annuity trust designed to pay her $64,130 per year, or 6.413% of the initial $1 million transfer, for as long as she lives. She'd receive an initial charitable deduction worth $323,490, which she'd be able to claim on her income tax return for the year in which she established the trust.

If instead she set up a unitrust, her percentage payout would be 21.445% of the value of the trust each year, meaning that she'd get an initial payout of $214,450 — which is much greater than what she'd get in the first year of the annuity trust. But, she'd get a charitable deduction of just $100,770, which is significantly less.

Of course, whichever option she chooses, Frieda is subject to income tax on the distribution. If 100% of the distribution were subject to the highest ordinary income tax rate of 35%, she'd pay $22,446 (35% of $64,130) under the annuity trust example and $75,058 (35% of $214,450) in the initial year of the unitrust example.

If instead Frieda invested 100% of the trust in tax-exempt income, then each year the distribution would be treated as using her deferred gain and therefore would be subject to the 15% tax until the total cumulative distributions reached the amount of the deferred gain.

## The prognosis

The CRT is alive and well. With the tax law changes and the reduced interest-rate environment, CRTs remain a viable estate planning option if you wish to help both yourself and others. ▮

# All in the blended family

**A QTIP trust can keep everyone happy**

If you're one of the many who are getting married for the second (or later) time, congratulations. Before the big day, it's wise to review your estate plan — especially if you or your fiancé have children. Why? Because financial conflicts between your future spouse and children from previous marriages may arise. To head these problems off at the pass and maintain family unity, consider a qualified terminable interest property (QTIP) trust.

## QTIP as a family peacekeeper

A QTIP trust gives you the peace of mind that assets you leave to your spouse won't eventually be distributed in a way that is against your wishes. In other words, it provides lifetime security for your surviving spouse while protecting your children from a previous marriage from disinheritance by your spouse. How does this work? You designate your new spouse as the current trust beneficiary and your children from your previous marriage as the remainder beneficiaries.

Bear in mind that even with a QTIP trust squabbles can erupt between spouses and children about investment decisions that affect how much income the trust will generate for distribution. Some states have total return trust legislation, which allows the surviving spouse to annually receive a fixed percentage of the trust assets in lieu of income.

## A balancing act

When creating a QTIP trust, you must choose a trustee and successor trustee. Your trustees must balance the needs of both your surviving spouse and the children. Often, a corporate trustee is the best choice because he or she provides neutrality.

QTIP trust beneficiaries often have the option of removing a trustee. To ensure that a trustee who favors one beneficiary over another isn't put in place, require both the surviving spouse and the children to agree on any successor trustees.

## Special situations to consider

In some circumstances it may be appropriate to form a contingency plan. For example, let's say your new spouse is considerably younger than you. Under a QTIP trust, your children won't receive their inheritance until your spouse dies, which may be many years after your death. Thus, consider making an immediate distribution of part of your estate to the children in a separate trust, and place only a fraction of the total estate in trust for the surviving spouse.

Although many states treat an ex-spouse as having predeceased you and legally prevent him or her from taking assets under the ex-spouse's will or trust, most laws don't address the consequences of failing to remove an ex-spouse as an insurance or retirement plan beneficiary. In your second marriage, you may wish to designate your revocable trust as beneficiary of your life insurance and retirement plans.

## A clean start for your family

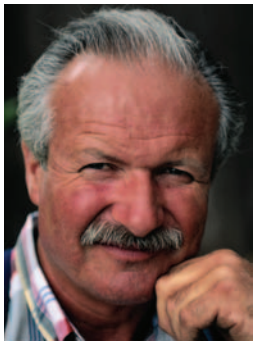
A second or third marriage can be both a joyous and contentious time for you and your family. To smooth over conflicts, consider setting up a QTIP trust to help meet everyone's needs.

# Deciding who gets what

**Consider the income tax on inherited assets when creating an estate plan**

After you die and your loved ones inherit your estate, they're not subject to estate tax on those assets — any estate tax due will be paid by your estate. But your beneficiaries may be liable for income tax if the asset would have been considered income had you received it.

If your heirs had a choice, why would they take an asset that would be subject to income tax? The answer depends on their circumstances and what they plan on doing with the inherited funds.



## A fictional example

Let's say, for example, that Fred's estate is composed of cash, marketable securities, real estate and IRAs. Fred wishes to transfer his estate to his three children: Robin, Jack and Arthur.

Assume Fred's taxable estate equals his lifetime exemption amount of $1.5 million and includes $500,000 in cash and marketable securities, $500,000 in real estate, and $500,000 in a traditional IRA. For the marketable securities and the house, the children will receive a step-up in basis, which means that, if they sell the assets as soon as they receive them, they'll recognize no gain. However, the IRA funds will be subject to ordinary income tax when withdrawn.

If each child received ⅓ of each asset, and they were all in the highest marginal tax bracket, everything would be equitable and each child's net proceeds would be the same. Specifically, each child would net roughly $430,000 (for the cash/marketable securities, $500,000/3 less assumed 2% selling cost, or $163,333; for the house, $500,000/3 less a commission [estimated at 5%] on the sale, or $158,333; and, for the IRA, $500,000/3 less 35% tax [assuming the children are in the top tax bracket], or $108,333).

But if Robin received the cash and marketable securities, Arthur got the house, and Jack the IRA, the children would have different results if they each liquidated the assets they received. Robin, for instance, would net $490,000, using the same 2% cost of selling the securities. Arthur would net only $475,000, assuming the same 5% sales commission. Jack, on the other hand, would net just $325,000 if he were in the top tax bracket because of the 35% tax on the IRA proceeds. So, at first blush it appears that Fred distributed the assets poorly.

Let's explore another possibility. Let's say Robin has an immediate need for the funds, but Arthur and Jack do not. So, Arthur and Jack agree that Robin will get the $500,000 in cash and marketable securities. Arthur will receive the house, and Jack will get the IRA.

Although the IRA is subject to income tax and Jack is required to withdraw a minimum amount each year, it's quite likely that if he pulls out *just* the minimum over the next 20 years, he'll actually have more than $500,000 left at that time. This assumes that the IRA funds return more each year than the required distribution. The tax-deferred growth will prove to be a benefit to Jack notwithstanding the fact that when he withdraws the funds they will be subject to income tax.

## What's the moral of the story?

Depending on their goals, your children may be better served by taking an asset such as an IRA that is subject to income tax. Thus, it's worthwhile to consider the way that you'd like to distribute your assets and what effect your choices may have on your beneficiaries. ▮

# 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 10 of our 13 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.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 150 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.

**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.**