Insight on estate planning

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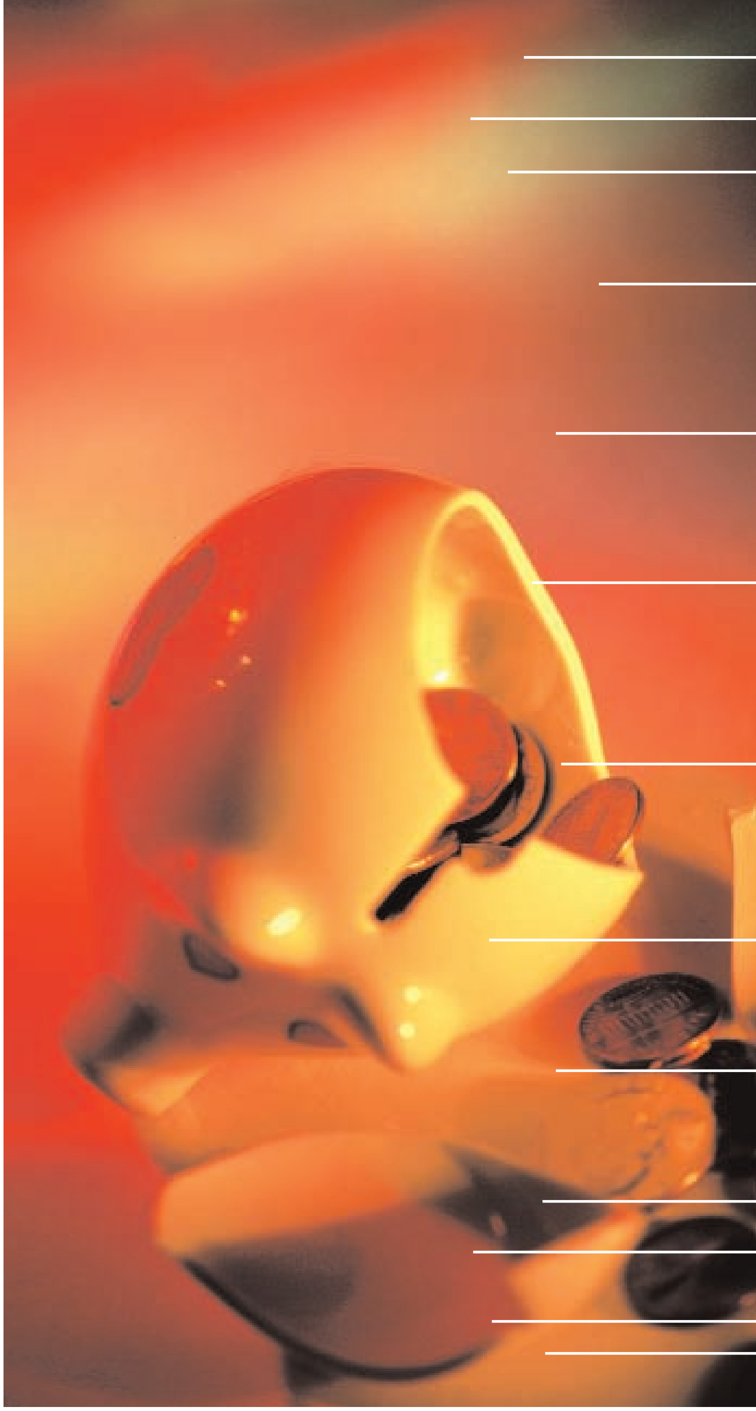

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Is a TRU right for you?

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Plus!

Estate Planning Pitfall:
Improperly titled assets and out-of-date beneficiary designations

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An intentionally defective grantor trust lets you transfer assets tax-efficiently

A primary estate planning goal is *maximizing* the amount of assets left to heirs and *minimizing* the amount left to Uncle Sam. To this end, gifting often is a big part of an estate planning strategy. But if you've already used up your $12,000 annual gift tax exclusions for the year — and, perhaps, dipped into your $1 million lifetime gift tax exemption — you may be looking for another way to tax-efficiently shift more assets to your children and grandchildren.

One solution is to create an intentionally defective grantor trust (IDGT), which allows you to sell assets without the estate and income tax ramifications that would otherwise accompany a sale.

A gift isn't a gift when it's a sale

An IDGT is merely an irrevocable trust with special provisions that allow it to be treated differently for estate and income tax purposes. It's a separate legal entity for estate tax purposes; therefore, once the sale is completed, the assets are no longer included in your estate.

IDGTs from the IRS's point of view

When intentionally defective grantor trusts (IDGTs) were initially introduced, there was a nagging question of whether you, the grantor, were making a gift whenever you paid tax on the trust's income. After all, you didn't receive the income, and had no right to it. In Revenue Ruling 2004-64, the IRS clarified this — and other — issues.

If neither state law nor the trust language requires you to be reimbursed for taxes paid on income attributable to the trust, and the trust language doesn't permit such reimbursement, there is no gift. Indeed, in such a case you would be legally obligated to pay the taxes.

There are still a few traps with respect to the IDGT. Most notably, if the trust either requires or allows the trust to reimburse you for taxes paid, the whole plan may crumble because the entire value of the trust could be included in your estate.

An IDGT takes its name from the fact that there is a built-in flaw in the trust language that causes the trust assets to be treated, for income tax purposes, as owned by you, the grantor.

Because you are treated as the owner, you aren't liable for the gain on the sale to the trust. The catch is that any income generated by the trust is taxed to you. But any increase in value of the assets belongs to the trust. Plus, each time you pay tax on the trust's income, you further increase the benefit because ultimately more assets will go to your heirs. In fact, a recent IRS Revenue Ruling specifically addressed this issue. (See the sidebar "IDGTs from the IRS's point of view" above.)

IDGT in action

Here's an example of how you might incorporate an IDGT into your estate plan. Let's suppose your company is valued at $4 million, and you have other assets worth $2 million. The noncompany assets stay relatively flat throughout the years, factoring in the way those assets grow and the fact that you're using them to provide your living expenses, pay your taxes and make annual exclusion gifts to your family. If the company is growing at an average of 12% per year, in just 10 years its value will be almost $12.5 million.

Suppose you set up an IDGT and sell 49% of your shares in the business to it. A valuation of the shares shows that they're worth $1.5 million. Most likely, the trust would pay some amount to you as a down payment and the balance as a note payable to you during a period of time.

During the time the note is outstanding, the interest is paid by the cash flow generated by the shares. At the end of the period, the note is paid off. Using the 12% growth rate, the shares are worth in excess of $6 million. The value of the note hasn't increased. Thus, you'll have transferred more than $4.5 million out of your estate. Plus, you'll have been paying the income tax attributable to the earnings on the 49% of the company owned by the trust, which would further reduce your estate.

Fix the language, if necessary

An IDGT can be a powerful tool in your estate planning arsenal. It's advisable to have an estate planning attorney draft the trust to ensure it meets your objectives.

A gift that keeps on giving

Instilling fiscal responsibility in your children or grandchildren

One of the best legacies you can leave to your children or grandchildren is financial savvy. It's important to teach younger family members fiscal responsibility as early as possible, especially if you plan to gift or bequeath them a significant inheritance that you want to be sure will be well managed. Let's examine several financial issues and how you can make sure your children or grandchildren understand them.

Start young

People are creatures of habit. If at an early age a youngster is aware of the difference between saving and spending, as he or she gets older the child likely will continue to understand that there are choices to be made with respect to money. And, it's a good way for you to instill your values with respect to wants vs. needs, and to encourage charitable giving.

With a young child, a good place to start is his or her allowance. For example, Jack gives his five-year-old daughter, Jenny, $1 a week allowance. When Jenny sees a stuffed animal she wants, Jack encourages her to save her allowance to buy it. He explains it in terms that are age appropriate, saying "That will take 10 weeks of allowance." Obviously, each child is different, and you must gear the lesson accordingly.

The power of compounding

As Jenny grows up and gets her first part-time job, Jack further encourages the idea of saving. Plus, this is an ideal time to teach her about income tax — explaining to her that $8 per hour at 10 hours a week doesn't equal an $80 paycheck.

On the saving side, Jack might show Jenny how putting money into an IRA can help her for the future. Of course, getting a 16-year-old to think about retirement might not be easy, but the lesson is simple — the sooner you start investing, the more opportunity you'll have to accumulate wealth because of compounding growth.

This might also open the door to talk about basic investing strategies. Jack refers to the chart below, which shows how much one is able to accumulate by investing just $1,000 per year, using certain assumptions.

Managing credit

Soon after Jenny celebrates her 18th birthday, Jack decides to start her down the path of establishing and maintaining good credit. He decides that a credit card — albeit one with a very low credit limit — or even a bank loan might be appropriate.

He helps her get a credit card, and explains that it can help to build a good credit history. He stresses that, if the balance is paid in full each month, no finance charges will be assessed.

Jack also shows Jenny an example of how quickly the interest can add up if she carries a balance, and warns that charging more than she can pay is a good way to get into financial distress. By starting her slowly, he is confident that she'll have the discipline to not get in over her head and that she'll develop good credit habits.

Amount accumulated by age 70 if $1,000 is saved per year

Starting at age:	6% return	8% return	10% return
15	$395,567	$854,028	$1,897,779
25	$212,744	$386,506	$ 718,905
35	$111,435	$172,317	$ 271,024
45	$ 54,865	$ 73,106	$ 98,347
55	$ 23,276	$ 27,152	$ 31,772
65	$ 5,637	$ 5,867	$ 6,105

The employer "match"

After graduating from college, Jenny gets her first "real" job. She asks Jack about "this 401(k) thing" and mentions that there is a "match or something." Jack enlightens her, explaining that the match is basically free money.

For every dollar she contributes up to 6% of her salary, her employer will match 50%. This means that, for every $11,111 of salary, $1,000 will go to retirement if Jenny puts away 6% of her salary. That is, 9% of $11,111 is $1,000. The chart below shows that, if Jenny is 25, she will accumulate a sizable amount by age 70. Plus, it presumes that just $1,000 is being contributed each year. As Jenny contributes more money, she can accumulate more.

The ins and outs of a mortgage

A few years later, Jenny is newly married. She and her husband are considering the purchase of a home and ask Jack for advice. He tells them that the amount they borrow, the interest rate and the term will dictate their monthly payment.

A $200,000 mortgage at, for instance, 6%, and repayable monthly over a 30-year period, will be retired in 360 payments of $1,199.10. But, he warns, they might have to pay more than that amount each month. Why? First, the mortgage company might require an escrow for real estate taxes and insurance.

Second, the mortgage might include private mortgage insurance (PMI), the extra fee that is charged on mortgages in excess of 80% of the home purchase price. Jack tells them that, unless they proactively try to get PMI waived, it will continue even after the mortgage balance drops below 80% of the property value.

He also tells them about "points," and that they're really nothing more than a fee paid upfront to have a lower mortgage rate. Whether it's worthwhile to pay the points requires an analysis of the fee, the interest rate reduction and, importantly, a guesstimate of how long they intend to stay in the property. He also cautions that, if there is a likelihood of refinancing anytime soon, they should factor that into their decision as well.

A good education goes a long way

Jack beams with pride that Jenny will soon have her very own home and he reflects on how the lessons he's imparted have helped her to reach this milestone. He also feels confident that he can start an annual gifting program to Jenny and her husband with the confidence that his money will be well managed. Then Jenny tells him that there is another big event on the horizon — he is going to be a grandfather. Jack is thrilled, and looks forward to sharing his wisdom — and his wealth — with his grandchild.

Is a TRU right for you?

Balance the needs of current and future beneficiaries with a total return unitrust

A dilemma that faces many trustees is balancing the needs of a current income beneficiary with those of the future beneficiary of the assets that remain at the income beneficiary's death. Traditionally, a trustee focuses on ensuring the trust portfolio generates enough income to meet the income beneficiary's needs. Thus, the investment strategy generally is more heavily weighted to income-producing assets, such as bonds.

But by borrowing a concept used by charitable remainder trusts, a total return unitrust (TRU) can give the beneficiary an income stream based on the total value of the trust rather than on a rigid definition of income. A TRU is viable in the many states that have adopted the 1997 Uniform Principal and Income Act's (UPIA's) provisions that expanded the total return concept to non-charitable trusts. Even if your state hasn't adopted the UPIA, you may still be able to use a TRU.

What to do with a TRU

Although technically a trustee may be able to invoke UPIA language for an existing trust, it's likely that, absent specific trust language, a trustee would hesitate to do so. A better option is to create a new trust. To set up a TRU, you designate that the annual payout from the trust be a function of the trust's value. So, regardless of whether there is an element of traditional income — such as interest and dividends — the income beneficiary still will receive an annual payout.

If, for instance, the trust distributes 5% of the assets each year and the trust is worth $1 million, the beneficiary will receive $50,000 for the year no matter how the trust is invested. Should the trust's value increase, the annual payout would increase. Conversely, a decrease in the trust's value would mean a decrease in the trust payout.

To set up a TRU, you designate that the annual payout from the trust be a function of the trust's value.

You have flexibility when designing a TRU. You can set certain limits — up or down — on the payout amount. For instance, you can set the floor at 4% of the value and the ceiling at 8%. Further, the payout can be based on an average value over a period of time, thereby reducing the possibility of a large fluctuation in required payout from year to year.

TRU advantages

A TRU may be of particular value in a situation where there are both a surviving spouse and children from a prior marriage. For example, Steve wants to set up a trust to provide for his second wife, Janet, but at her death he wants the remaining trust assets to be distributed among his children from his first marriage. Janet is more concerned with the current income from the trust, while the children are more interested in maximizing the value of the amount remaining at their stepmother's death.

Too often, a trustee caught between such a rock and a hard place will defer to the needs of the income beneficiary. Doing so, the trustee may invest in a way that's more conservative than warranted — even for the income beneficiary. The income beneficiary, in the long run, likely will be better off with a portfolio that is invested less conservatively.

Using the above example, a TRU may help the trustee to avoid a potential conflict between Janet and Steve's kids. Knowing that her income stream has the potential to increase as the value of the trust increases, Janet may be less inclined to question the trustee's decision to invest in growth-oriented stocks that pay little or no dividend.

Because Janet would receive a payout based on the trust's value, should the trust grow larger because it's invested more aggressively, everybody wins. The trustee is able to invest the funds in the way that is most efficient, Janet receives a larger payout and Steve's children ultimately split a larger pot.

But there is another, potentially significant, benefit enjoyed by the current income beneficiary: He or she may have to pay less income tax. If, for example, the trust pays out $50,000 that is part income and part

return of principal, only the income portion is subject to tax. The beneficiary, therefore, ends up with even more money in his or her pocket.

Bear in mind that there is no guarantee that the value of the trust assets will increase. In setting up a TRU, you must be willing to accept the possibility that the trust value may decline.

Keeping everyone TRU(ly) happy

Whether a TRU is right for you may depend on several factors, such as having the confidence in your trustee's ability to handle more flexibility in investment planning. But if you want to satisfy the income needs of a current income beneficiary and the desires of remainder beneficiaries to maximize their ultimate distribution, consider a TRU as a part of your estate plan.

Estate Planning Pitfall

Improperly titled assets and out-of-date beneficiary designations

The best-laid plans can sometimes go awry. This is particularly true with estate planning. Unfortunately for your heirs, they're left to clean up any mistakes you leave behind. Having the right estate planning documents — no matter how well drafted — will go only so far. You've got to be sure that your assets are properly titled and your beneficiary designations are up-to-date.

For example, let's suppose your objective is to avoid probate and pass your assets equally to your three children and, ultimately, your grandchildren. You have set forth your desires in your estate plan, and your children understand your wishes.

Regrettably, none of your accounts are held in the name of your living trust. Your assets include your home, which is held in your name; an IRA, which names your two older children as beneficiaries; and various other accounts that are either in your name alone, held jointly with your now-deceased spouse or held jointly with one of your children. You also own a life insurance policy that names your deceased spouse as the primary beneficiary and has no contingent beneficiary.

What you've got, in short, is a bit of a mess. The assets that are subject to probate — your home, your insurance proceeds and those assets not held in joint tenancy with your child — might not even make it into the trust. Those assets will be distributed according to the terms of your will. And unless your will provides that your assets are to be transferred into the trust, the trust won't govern their ultimate disposition.

The other assets — your IRA and the assets held jointly with a child — will pass directly to the named beneficiaries or the joint title holder. You'll have unwittingly disinherited your youngest child from the IRA.

These problems, though, are easily prevented by taking the time now to properly title the assets and update your beneficiary designations. That way, everything will pass as you intended, and your heirs will reap the benefit of your foresight.

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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.

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.