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THE PLANNER

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

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TABLE OF CONTENTS

An Overview of Estate Planning

Our clients expect their estate planning will cause their property to go to whom they want, the way they want, when they want and that it will minimize the impact of taxes, professional fees and court costs. They also expect their estate planning will help them keep control of their property while they are alive and well and provide for themselves and their loved ones if they become disabled.

Traditional estate planning often falls short of some of these goals. In this issue of The Planner, we will examine the traditional estate planning process, some of its shortfalls, how modern estate planning overcomes them, and the pros and cons of modern versus traditional estate planning.

The advisor who understands the advantages and disadvantages of various modern and traditional estate planning techniques will be able to influence not just their client, but their client's family for generations to come, bringing considerable value to both their client and to the advisory team.

Traditional Estate Planning

Traditional estate planning is focused on the transfer of ownership of assets at their owner's death. Its cornerstone is the will. Too often traditional estate planners treated the creation of an estate plan as a transaction. They would also often ignore the client's assets that are not usually subject to probate and focus only on the assets that, with traditional estate planning, must go through the probate process before they can pass to the heirs. It relied on the durable power of attorney to protect the client from having an expensive court ordered and administered guardianship in case of incapacity.

In today's world, with a proliferation of non-probate assets, a more mobile society, and increased longevity, traditional estate planning often falls short of your clients' goals. It does not provide for your client's disability; it does not necessarily give what they have to whom they want, the way they want, and when they want; it will not avoid probate; and it too often ignores or inadequately deals with non-probate assets.

Non-Probate Assets

"Non-probate" assets are those that pass on death in accordance with some contract and thus without being involved in the probate process. In the traditional estate planning days, pretty much the only non-probate asset one ever saw was life insurance. In modern times, the portion of the typical estate that is non-probate assets has dramatically increased.

Where once defined benefit retirement plans for the worker and the worker's spouse were the norm, today the norm is the defined contribution plan, which passes by beneficiary designation. Today's planners must also deal with right of survivorship property, IRAs, and all sorts of annuities. Moreover, non-probate assets are typically a much larger portion of today's client's total wealth than they were in the days of traditional estate planning.

The proliferation of the types of no-probate assets, especially accounts with transfer on death or right of survivorship provisions, have likely led many of your clients to the false conclusion that they do not need to invest their time and money in estate planning to avoid probate and meet their estate planning goals. Nothing could be further from the truth.

Reliance on the most typical non-probate account provision, joint ownership with right of survival, for example, creates risks for the asset owner that are seldom considered.

Adding a joint or co-owner exposes the affected asset to the joint or co-owner's liabilities, increasing the owner's risk of being named in a lawsuit or losing the asset to a creditor of the joint or co-owner. There is also the risk that the joint or co-owner will not be able to resist the temptation to take or use the property while its original owner is still living.

With some assets, especially real estate, all owners must sign to transact business. If a co-owner (including an owner's spouse) is unable to do so because of incapacity, a guardianship may be required to have someone able to act for the incapacitated owner.

With right of survivorship property, when one owner dies, full ownership usually does transfer to the surviving owner without probate; but what if that owner dies without adding a new joint owner, or if both owners die at the same time? Then the asset must pass through probate before it can go to the heirs. And because a will does not control most jointly owned assets, someone in your client's family could become unintentionally disinherited when the property transfers automatically on death.

Planning Tip: Joint ownership with right of survivorship is often relied upon as a probate-avoidance mechanism, but its risks are often not even considered.

Moreover, avoidance of probate is not guaranteed with non-probate transfers. If "my estate" is listed as the beneficiary, or if a valid beneficiary is not named, the affected non-probate assets will have to go through probate, which will determine who gets what part of the estate. So, too, if a minor is the beneficiary, the asset holder will probably insist on there being a court-appointed and supervised guardian to receive the assets and manage them for the minor.

There is, however, one kind of non-probate asset system that has been demonstrated to work exceedingly well to meet all of the client's estate planning goals. That is the revocable living trust. Property that is held in a client's revocable living trust will bypass probate and can be used by the trustee to care for the incapacitated owner without court involvement or interference. Other non-probate assets that name the client's revocable living trust as the beneficiary will also bypass probate.

Modern Estate Planning

Modern estate planning is not a transaction; it is a process. It involves not only your client but many generations. It allows your client to care for their loved ones with resources, love and wisdom. It truly is "wealth counseling." Modern estate planning is not just something done to plan for death – it is planning for life, and life involves changes and uncertainties.

Typically the cornerstone of a modern estate plan is a revocable living trust, because a properly funded revocable living trust can avoid both the huge expense of guardianship if the client becomes incapacitated and the expense and delays of probate when the client dies. But a revocable living trust plan is not a Ronco appliance – your client can't just "set it and forget it." Over time your client's assets change, their family members' circumstances change, and the law changes. There is truth in the saying, "There is nothing as certain as change." Failure to fund a revocable living trust and keep it properly maintained is an almost sure fire way to get to a probate court.

The modern estate planning process, therefore, includes education, design, drafting of the documents, and implementation. Like traditional estate planning, modern estate planning includes medical directives. Today those include a health care power of attorney, a living will, and a HIPAA authorization. For asset management if the client becomes incapacitated, modern estate planning uses a revocable living trust, backed up by a durable power of attorney.

Planning Tip: A living will lets physicians know the kind of life support treatment your client would want in case of a terminal illness or injury. But its scope is limited, and in some states physicians are under no legal obligation to follow it. A health care power of attorney is broader; it lets your client give legal authority to another person in advance to make any health care decisions for your client—including the use of life support—should your client become unable to make them.

Revocable Living Trust

A living trust-centered estate plan is more likely to achieve your client's goals in today's world. It plans for your client's disability, provides for your client's loved ones, contains your client's caring instructions, addresses your client's fears, and reflects your client's love and values. It can also avoid probate, is valid in every state, and is more private and confidential than a will. For all these reasons, a living trust-centered plan has become the plan most preferred by estate planning professionals and clients alike.

Planning for Disability

Planning for disability with a living trust is superior to relying solely on a durable power of attorney. Today, many financial institutions and other third parties will not accept a durable power of attorney unless it is recently signed and on their own form. But they will, and indeed must, accept the instructions of a trustee (or successor trustee) named in a revocable living trust concerning the trust assets. This makes it less likely that a guardianship/conservatorship will be needed for your client. (Note: A will has no effect at disability because it can only go into effect after your client dies.)

Planning Tip: Usually, several successor trustees are named in a trust, in the order in which the grantor wants them to serve. It is a good idea for your client to also have a durable power of attorney with the same successors named, in the same order, for even more ease of acceptance.

Why a Revocable Living Trust Works

The concept is simple. When a revocable living trust is established, the name on the titles to the client's assets is changed to the trustee of the trust. Legally, the individual no longer owns the assets; the trustee of the trust owns them. Thus, when the individual becomes disabled or dies, there is no reason for the court to become involved. The trustee (or successor trustee) already has the legal authority to transact business with the assets. The trust is made revocable so the client retains the power to change his or her mind as well as adapt their plan to changes in their assets, their family, and the law.

Planning Tip: Most people name themselves as trustee of their revocable living trust so they can keep control of their assets, naming a successor to step in when they can no longer conduct business due to incapacity or death. Many include a corporate trustee as co-trustee for professional asset management.

Avoiding Probate

Probate administration is very state specific; procedures and costs vary greatly from state to state. Wills do not avoid probate. Assets titled in the client's name at death and assets that are directed by a will must go through the probate process before they can be distributed to the heirs. If a client dies intestate (without a will), their assets will be distributed according to the probate laws in that state, which will almost certainly not be what the client would want. If a client owns out-of-state real property, probate is usually required in each state in which the client owned real property at death.

As explained earlier, many assets (survivorship and pay-on-death property, life insurance, IRAs, defined contribution retirement plans, and annuities) are designed to pass outside of probate. That can result in an uncoordinated estate plan. Moreover, many clients—and even attorneys and professionals—fail to understand the importance of asset titling and beneficiary designations, and it is not unusual for a non-probate asset to become a probate asset because of a title or beneficiary designation that is incorrect or out of date.

Living trusts can avoid the need for probate altogether if the titles of all assets have been vested in the trustee and all beneficiary designations have been changed to the trustee of the trust. However, probate avoidance requires rigorous maintenance of titling and beneficiary designations. All it takes to require probate is for your client to open a bank or brokerage account in their individual name instead of as trustee. Also, because living trusts are valid in all states, the need for multiple probates can be eliminated.

Planning Tip: It is important to avoid any asset or beneficiary designation not being changed to the trust. If one is forgotten, or the valid reason for not putting it into the trust to begin with no longer exists, probate may become necessary. If that happens, the client's "pour-over" will, a standard accompanying document to a living trust, will redirect the asset into the client's trust. The asset may have to go through probate first, but it can then be distributed according to the client's instructions in the trust.

Planning Tip: It is usually advisable to transfer a client's home and all their other valuable assets to their trust to make sure they all become part of the unified trust-based estate plan.

Privacy and Confidentiality

Once filed for probate, a will becomes a public document. Moreover, many states have a statutory requirement to file a decedent's will even if there is no probate. With rare exceptions, probate files are open to the public, and private information has become a commodity. Do clients really want the planning they have put in place for their loved ones and what their loved ones will inherit to become public information?

Living trusts are not a matter of public record. While some states now do require some notices, a living trust provides more privacy than any other estate planning mechanism.

How to Distribute Assets to Heirs

Distributions made outright to your client's heirs have no protection from the variety of risks to which personally-held assets are exposed. Once distributed, the heirs can use those assets however they choose and the assets can be subject to their creditors' claims. However, bequests that are kept "in trust" for the benefit of the heirs enjoy protection from creditors, predators (including ex-spouses), irresponsible spending (protection from "self") and future estate taxes. Assets kept in trust can also provide for individuals with special needs without affecting their entitlement to valuable government benefits.

Basic Estate and Gift Tax Rules

Proper estate planning should always consider estate and gift tax rules. The estate and gift taxes are transfer taxes. They apply to everything your client owns unless their transfer falls under a tax exclusion. Here are the rules for federal transfer taxes that, unless changed, will be in effect until the end of 2012:

- Estate transfers and gifts are taxed at a flat 35%.
- There is a $13,000 annual exclusion for present interest gifts to each individual. (Amount is indexed for inflation.)
- There is an unlimited marital deduction applicable to gifts to a U.S. citizen spouse.
- There is a $5,120,000 unified exclusion for gifts and death transfers not covered by annual exclusions or a marital or charitable deduction. Under current legislation, it becomes $1 million in 2013.
- There is an unlimited charitable deduction.

Of course, any exemptions that are not used in planning are lost when the client dies or tax laws change. Speaking of change, there is a major change scheduled for December 31, 2012.

Under current law, on January 1, 2013, the maximum transfer rate will increase from 35% to 55% and the unified exclusion will be reduced from $5,120,000 to $1,000,000.

What can we expect between now and 2013? This is definitely a political issue, and one that the House Democrats have targeted. Possibilities bandied about include a $5 million unified exclusion and 35% tax rate; $3.5 million unified exclusion and 45% tax rate; permanent repeal; the end of the unified exclusion; and a $1 million exclusion with graduated rates up to 55%.

Planning Tip: Some states have their own death/inheritance tax in addition to the federal transfer taxes. Often they begin at a much lower level than the current unified exclusions. So, while a client could be exempt from federal taxes, their estate may have to pay state transfer taxes. Make sure you know your state's laws.

Conclusion

Many clients put off estate planning, thinking they have plenty of time to do it before they die. But the truth is that none of us knows how long we have. We only have to watch the nightly news to be reminded of that. And, estate planning should be a process, not a transaction. The advisor who understands this, as well as the advantages and disadvantages of the various estate planning mechanisms, will be able to provide an invaluable service to their clients and their families.

Using Advanced Irrevocable Trusts for Income and Estate Tax Savings: Making 2012 Count

The next nine months are an exceptional window of opportunity for your clients to make family wealth transfers. The federal gift and estate tax exemption is $5,120,000, and both income tax rates and interest rates are at the lowest point in a generation. With federal deficit spending also at record levels, tax and interest rates seem sure to rise. Unless the President, the Senate, and the House of Representatives all agree otherwise, income and estate taxes will increase dramatically on January 1, 2013.

There is also the risk that long-used planning strategies such as charitable deductions and valuation adjustments will soon be eliminated or limited. Advisors who understand this situation will be well positioned to help their clients take full advantage of this estate planning opportunity while it lasts.

In this edition of The Wealth Counselor, we will explore how the current deficit spending is making the case to increase taxes, what your clients can expect in 2013 unless the President, the Senate, and the House of Representatives all agree otherwise, and how you can help your clients use advanced irrevocable trusts now to take advantage of this opportunity and save income and estate taxes.

The Case for New Taxes

The U.S. government is spending a lot more money than it is taking in, creating the largest deficits in our history. The projection for 2012 is:

U.S. Tax Revenue.. $2,310,000,000,000
U.S. Government Spending... $3,614,000,000,000
NewDebt..$1,303,000,000,000
National Debt..$15,114,000,000,000
Recent Federal Budget Cuts..$385,000,000,000

These are staggeringly large numbers. It's easy to lose sight of their meaning because there are so many zeros at the end of each one. But if you drop eight of the zeros and consider this to be the budget for a young family or single adult, the numbers take on real meaning:

Annual Income..$23,100
Money Spent.. $36,140
New Credit Card Debt... $13,030
Outstanding Credit Card Debt..$151,140
Total Budget Cuts... $3,850

Both are train wrecks waiting to happen. Spending is more than 150% of income, yet budget cuts planned are less than 17% of income. Talk about "Another day older and deeper in debt"!

For the federal government, it seems that either deeper budget cuts will have to be made, or income…in the form of taxes …will have to increase. The federal government can also print more money, which will eventually lead to inflation.

Taxes…Now and in Nine Months

In 2012, the federal estate, gift, and generation-skipping transfer tax (GSTT) exemptions are all $5,120,000 and the tax rate on any excess is 35%. Unless the President, the Senate, and the House of Representatives all agree otherwise, on January 1, all three exemptions will drop to $1,390,000 plus an adjustment for 2012 inflation and the tax rate on any excess will start at 45% and increase to 55%. In addition, the estate and gift tax "portability" provision will expire.

Unless the President, the Senate, and the House of Representatives all agree otherwise, taxes on income, dividends, and long-term capital gains, will also increase on January 1. In addition, a new 3.8% healthcare surcharge will go into effect for married taxpayers with adjusted gross income (AGI) of $250,000 or more ($200,000 or more for single taxpayers). Here's a chart to show the income tax rate change:

	Long Term Gains		**Ordinary Income & Short-Tem Gains**	
	2012	2013	2012	2013
Top Federal Tax	15%	20%	35%	39.8%
Healthcare Surcharge	0%	3.8%	0%	3.8%
Total	**15%**	**23.8%**	**35%**	**43.6%**

Unless the President, the Senate, and the House of Representatives all agree otherwise, your clients' favorable tax-planning window will close in January:

The most favorable estate/gift tax we have ever had will be gone ($5 million exemption to $1 million; 35% rate to 55% rate).

- Interest rates, now at lows not seen in our lifetimes (2% overall, 1.4% AFR for intra-family gifts), will almost surely increase.

- Charitable deductions, now fully deductible, may be limited to those in a 28% income tax bracket.

- Long-term capital gain rates will increase from 15% to 20%.

- Dividend rates will increase from 15% to ordinary income rates, which can be as high as 43.6%.

- Valuation adjustments for family controlled limited partnerships and limited liability companies may be legislated or regulated away.

Planning Tip: Encourage your clients to complete their planning before the end of 2012 to take advantage of this unique planning window.

Irrevocable Trusts Can Help Your Clients

There are a wide variety of irrevocable trusts that your clients can use now to help save income and estate taxes. These include:

- 2503(c) Minor's Trust: Used instead of a Uniform Transfers to Minors Account (UTMA) or Uniform Gifts to Minors Account (UGMA), must provide that any remaining trust assets will pass to the child on reaching age 21.

- Family Bank Trust: An inter vivos bypass trust that mimics the tax avoidance benefits available after one spouse passes away but lets you have these benefits while someone is living.

- Gifting Trust: Used for lifetime annual exclusion gifts (currently $13,000 per donor per donee) to children, grandchildren, and others to avoid the problem of the beneficiary having full control of sizeable assets at age 18 or 21.

- Health and Education Exclusion Trust (HEET): Requires a significant charity beneficiary. For non-charity beneficiaries, distributions are limited to payments directly to an institution that is providing health care or education. Because of these limitations, neither contributions to nor distributions from the HEET are taxable. The HEET is especially useful when the client's GSTT exemption has already been used.

- Intentionally Defective Grantor Trust (IDGT) or Intentional Trust: Allows your client to use taxes on trust income to reduce his or her estate taxes. The grantor's paying the income tax due because of the trust's income is not an additional gift to the trust.

- Inheritor's Trust: Created at the beneficiary's request for the benefit of a beneficiary. Typically used when a grandparent or parent doesn't want to go to the trouble to create a trust that would keep their resources out of the beneficiary's estate when they die. (E.g., the physician beneficiary who already has a taxable estate and wants asset protection for the inheritance.) The beneficiary's child, sibling, friend, or spouse can set up the inheritor's trust.

- Life Insurance Trust: Set up by someone to hold life insurance on his or her life. Variations to the single-life insurance policy trust include second-to-die policy trust and spousal access life insurance trust.

- Split-Interest Charitable Trusts: Charitable remainder trusts and charitable lead trusts.

Planning Tip: Current interest rates, as low as they are, make charitable remainder trusts the least attractive, and charitable lead trusts the most attractive, they have been in a very long time, if ever.

- Split-Interest Non-Charitable Trusts: These include grantor retained annuity trusts (GRATs), grantor retained income trusts (GRITs), qualified personal residence trusts (QPRTs) and qualified terminal interest property trusts (QTIPs).

There are also a several types of irrevocable trusts that your clients with particular situations can establish now that have purposes other than saving income and estate taxes. These include:

- Special Needs Trust: Allows for provision of additional benefits and services for family members with special needs (children, parents) without disrupting valuable government benefits.

- Retirement Trusts (Stand Alone): Designed specifically to ensure the maximum stretch out for tax-deferred plans after the participant/owner's death.

Planning Tip: The Advisors Forum provides in-depth programs and additional information on all of these irrevocable trusts. Go to www.advisorsforum.com for more information.

Amending an Irrevocable Trust

Even though an irrevocable trust once established cannot be revoked or amended by the trustmaker, careful planning at its establishment can empower someone other than the trustmaker to make changes. For example, a lifetime power of appointment given to someone other than the trustmaker can allow the term of the trust to be extended or a beneficiary (including a charity) to be added or dropped. Assets can be sold by the trustee to a new irrevocable trust with different beneficiaries and provisions. Non-judicial modification is allowed under the Uniform Trust Code if the trustmaker, trustee, and all beneficiaries agree. Decanting (transferring to another trust for the same beneficiaries) is a trust feature that is now allowed in 14 states, with four more pending.

Planning Tip: A trust protector, whose role differs from a trustee's and is common in offshore jurisdictions, is now often being used in domestic irrevocable trusts to allow for more flexibility without adverse tax consequences.

The Family Bank Trust

An inter vivos bypass trust can create a lifetime benefit for the grantor with assets he or she "gives away." For example, a wife can create a family bank trust with appreciating assets. As the trustee, her husband has access to the assets, can withdraw them and can even lend or give them back to his wife. Because they live in the same household, both will enjoy the benefits. A limited power of appointment can be given to the husband in the event he should die before she does and he can even appoint the property back to his wife.

Generation Skipping Transfer Tax (GSTT) Exemptions

There are two GSTT exclusions. There is an annual exclusion (currently $13,000 per year per done per donor) for outright gifts and gifts to qualifying trusts. To be a qualifying trust, a trust must have only one current beneficiary and have provisions that will cause the trust assets to be included in the beneficiary's estate for estate tax purposes. There is also the lifetime GST exemption ($5,120,000 million in 2012) that can be applied to transfers to non-qualifying trusts such as dynasty trusts and trusts with multiple beneficiaries.

The Lifetime QTIP Trust

This is a split-interest trust. It is created by one "propertied" spouse for the benefit of the other "non-propertied" spouse as a method of equalizing the estates without the propertied spouse giving up control. All income must be paid at least annually to the beneficiary spouse to qualify gifts to the trust for the gift tax marital deduction.

During the life of the beneficiary spouse, the QTIP trust can be a spendthrift trust, but any income that is generated in the QTIP trust is subject to attachment by the beneficiary spouse's creditors.

To qualify gifts to the trust for the gift tax marital deduction, the QTIP election must be timely made on the donor spouse's Form 709 gift tax return and there is no cure if the return filing deadline is missed. The death of the beneficiary spouse before the donor spouse renders the beneficiary spouse the transferor for future trusts to which the QTIP trust assets are appointed. The donor spouse's GSTT exemption can be allocated to the QTIP trust.

Grantor Trusts and Wealth Transfer

The balance of this newsletter will focus on various grantor trusts.

Tax code sections 671-679, which define and govern "grantor" trusts, were written in the 1950s as a deterrent to taxpayers transferring their assets to trusts to remove the assets from their estate to take advantage of the then-lower income tax brackets and rates that trusts enjoyed. If a trust is a grantor trust, these sections cause attribution to the grantor of all income and deductions associated with the trust assets. Some, but not all, trust characteristics that will cause a trust to be a grantor trust will also cause the trust's assets to be included in the grantor's estate for estate tax and GSTT purposes.

Today, the grantor trust income and deduction attribution is used by estate planners in several ways to the taxpayer's advantage. For example, a transfer of appreciated assets (real estate, stock portfolio, privately owned business) to a grantor trust is not an income tax recognition event. So, too, transferring assets to a grantor trust before they appreciate allows future appreciation to be removed from the grantor's estate.

Another grantor trust use is the "tax burn," which occurs when the grantor pays the income tax on income the grantor trust generates, thereby removing assets from the estate without using any of the grantor's annual exclusion or lifetime exemption from gift taxes.

The grantor trust is also a permissible purchaser of existing insurance on the grantor's life, which avoids the transfer for value rules.

Planning Tip: Careful drafting of grantor trust provisions can provide certainty while giving more flexibility. For example, should the income being generated by the trust cause the grantor to pay more in income taxes than desired, if the trust is properly drafted the grantor trust provision can be turned off without affecting the estate tax exclusion feature of the trust. The trustee can also be given the discretion to reimburse the grantor for income taxes paid because of the income attribution.

Planning Tip: For income tax reporting, the trust can have its own tax identification number, in which case a Form 1041 is required, or the grantor's social security number can be used with no 1041 required.

Creating Lifetime Benefits

A grantor trust can allow loans to the grantor. For example, the trustee can borrow against a life insurance policy or the trust assets and re-loan the proceeds to the grantor. If adequately documented and secured, there should be no "incidents of ownership" that would cause the trust assets to be brought back into the grantor's estate. The entire loan balance, including any accrued interest at the grantor's death, would reduce the grantor's estate. Making the loan interest commercially reasonable but higher than that required by law can be used to remove even more from the grantor's estate—another example of "tax burning."

Irrevocable Life Insurance Trust (ILIT)

An ILIT lets your client remove life insurance death benefits and policy cash value from your client's taxable estate, control the disposition of the death proceeds, and utilize the annual gift tax exclusion (currently $13,000 per person) for "Crummey" gifts to the trust so it can pay insurance premiums. It provides asset protection for the proceeds and creates liquidity at the grantor's death by giving the trustee authorization to lend proceeds to the estate (to pay estate taxes and other expenses) and to buy assets from the estate.

Planning Tip: In community property states, the non-insured spouse cannot contribute to the trust of which he or she is a beneficiary without causing inclusion in the beneficiary spouse's estate. If the insured spouse does not have separate property sufficient to make the contribution, a partition agreement can solve this issue.

Sales to Grantor Trusts

With the current $5 million gift tax exemption, commercially reasonable installment sales to grantor trusts are now more commonly available to use and so are often preferred to grantor retained annuity trusts (GRATs). A sale provides more tax certainty than a GRAT because, for estate tax purposes, trust assets are included in the grantor's estate if the Grantor dies during the GRAT term.

To make the sale commercially reasonable, the grantor establishes an intentionally defective grantor trust, contributes assets to it and allocates GSTT exemption to the gift. This gift serves as the security for an installment sale of assets having a value many times that of the initial gift. It is common for the grantor's gift to be 10% of the value of the assets sold, but as an alternative, financially solvent trust beneficiaries can guarantee the trust's performance under the sale agreement.

Asset Protection Trusts and Self-Settled Trusts

Whether creditors can reach a beneficiary's interest in an irrevocable trust established by a third party is determined based on the enforceability of the trust's spendthrift provisions, the beneficiary's degree of control of the trust, and whether the beneficiary has an interest in the trust property. Typically, no creditor protection is provided for the grantor of a trust who is also the trust's beneficiary. Such trusts are called "self settled." There are, however, certain states (see below) and some offshore jurisdictions whose statutes provide grantors of certain types of self-settled trusts protection from some or all creditors. Common types of self-settled trusts include revocable living trusts, charitable remainder trusts and grantor retained annuity trusts. A grantor's judgment creditors can reach the grantor's interest in the assets in these types of trusts. Creditors can also reach mandatory distributions to beneficiaries such as the income interest in QTIPs, GRTs and CRTs.

Planning Tip: It is especially important not to include mandatory distributions to a beneficiary from a special needs trust.

Planning Tip: A special needs trust funded with assets that require mandatory distributions (such as a 401(k) or IRA) should not be a "conduit" trust.

The states that currently provide creditor protection for certain self-settled trusts (domestic asset protection) are: Alaska, Delaware, Nevada, Rhode Island, Utah, South Dakota, Oklahoma, Missouri, Tennessee, New Hampshire, Wyoming, and Colorado (a Virginia statute is on the Governor's desk).

Planning Tip: Your client will want to weigh the costs and benefits of a self-settled trust vs. a non-self-settled trust, equitable division in case of divorce, and offshore vs. domestic asset protection trusts.

Split-Interest Grantor Trusts

These are techniques for leveraging gifts with distinct economic interests, with a division over time of ownership and the type of interest. The portion that is given away (the remainder) is taxed as a gift; that which is not given away is a retained benefit and is not taxed as a gift. Common split-interest trusts include charitable remainder and lead trusts (CRTs, CLTs), grantor retained annuity trusts (GRATs) and qualified personal residence trusts (QPRTs).

Chapter 14 of the Internal Revenue Code was designed to reduce intra-family undervaluations of split-interest transfers and valuation provisions were put in place. Fixed annuity or unitrust amounts, exceptions under Code Sec. 2702, are most commonly used.

Planning Tip: Split-interest trust tax calculations are made using the Code Sec. 7520 rate (120% of the federal mid-term applicable federal rate (AFR)) at the time the trust is established. Current low interest rates (mid-term AFR of 1.3% and 7520 rate of 1.56% are record lows) allow a grantor to make very large gifts to his/her family without using the gift tax exemption by using split-interest trusts.

Planning Tip: The GSTT exemption can only be applied at the end of the estate tax inclusion period (ETIP). This is the time during which, if the grantor dies, the property will revert to the grantor's gross estate. For example, if a QPRT is established for a ten-year period, the GSTT exemption can only be determined and applied at the end of the ten years when it is known that the grantor has survived the trust term and the property will not revert to the grantor's estate. As a result, split-interest trusts are not appropriate for use as dynasty trusts.

Planning Tip: A longer term means more risk that the grantor may not survive the term. Life insurance can be used to offset risk. A split-interest trust may or may not be a grantor trust during or after its initial term.

Grantor Retained Income Trust (GRIT)

With a GRIT, the grantor receives income from the trust assets for a certain length of time, then the remainder is paid to or held for the benefit of a remainder beneficiary. There is significant wealth transfer opportunity with low or non-income producing property. GRITs are no longer available to use with transfers to immediate family members, but they can still be used for business situations and for gifts to nieces and nephews, and are especially useful for non-marital life partners.

Qualified Personal Residence Trust (QPRT)

A QPRT lets the grantor make a gift of his/her personal residence to family members while retaining the right to live in the residence for a term of years. QPRT gift tax calculations assume no appreciation of the home during the primary term. A QPRT is a grantor trust during the trust primary term, so the grantor continues to receive the mortgage interest deduction. The grantor also retains the exclusion under IRC Sec. 121 ($250,000 for a single person, $500,000 for a married couple) if the home is sold during the trust primary term. If the grantor dies during the trust primary term, the residence is included in the grantor's gross estate.

Planning Tip: Use multiple QPRTs of minority interests in the home to hedge the risk of the grantor's and take advantage of the valuation adjustment appropriate for gifts of minority interests in real estate.

Planning Tip: QPRTs have not been used as much lately due to low interest rates. However, if the grantor lives in a state that has a state estate tax and wants to make a gift to a child who expects to live in the house, assuming the grantor survives the term, any state estate tax can be eliminated.

Grantor Retained Annuity Trusts (GRAT)

GRATs are less popular now that the gift tax exemption is $5 million. Nevertheless, they are well-suited for appreciating assets and discounts provide leverage. If the grantor dies during the trust term, the property is included in his/her gross estate. Multiple or "rolling" GRATs (e.g., maturing every two years) can lessen risk and, over time, provide remainder benefits for the beneficiary.

Conclusion

Our very favorable planning time—with favorable interest rates, estate/gift taxes exemptions and rates, full charitable deductions, low capital gains and dividend rates, and available strategies—is very likely to end on December 31, 2012. The advisor who understands the various irrevocable trusts explained here and the urgency for clients to implement their plans during the balance of 2012 is in a unique position to help clients save substantial estate and income taxes, and will undoubtedly be a highly valued member of the advisory team.

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