

Alphabet Soup of Estate Planning

I. Advanced estate planning focuses primarily on reducing transfer taxes and income taxes. Under current federal law, there are three taxes that are imposed on the transfer of assets: the gift tax, the estate tax, and the generation-skipping transfer tax ("GSTT"). The gift tax applies to transfers made during life, the estate tax applies to transfers at death, and the generation-skipping transfer tax applies to transfers during life or at death that skip the children's generation and pass to "skip persons", who are generally grandchildren and those in lower generations.

A. Gift Tax: A donor can give assets with unlimited values to spouses and charities. Currently, gifts totaling up to \$14,000 can be made to any number of individuals in each calendar year. "Taxable gifts" are all gifts other than those that qualify for the (a) marital deduction, (b) charitable deduction, or (c) the annual exclusion; however, no out-of-pocket gift tax has to be paid until a donor's cumulative lifetime gifts exceed the "applicable exclusion." After the applicable exclusion amount has been exceeded, the federal gift tax rate is 40% (during 2013 and beyond). The gift tax is paid by the donor out of assets remaining after the gift.

B. Estate Tax: Upon death, the decedent's gross estate includes the then current fair market value of all property interests held by the decedent at the time of his or her death. There are deductions for debts, administrative expenses, qualified transfers to spouses, and transfers to qualified charities. The net amount is the taxable estate. To the extent the applicable exclusion has not be utilized for lifetime gifts, it will be applied to the taxable estate. The portion of the estate that exceeds the unused applicable exclusion will be taxed.

C. Generation-Skipping Transfer Tax: Congress enacted the generation-skipping transfer tax (GSTT) which applies to transfers to "skip persons," which are grandchildren and lower generations. The GSTT is a one-rate tax equal to the highest applicable estate tax rate, and it applies in addition to any applicable gift or estate tax. Each transferor has a GST exemption, which is the same as the "applicable exclusion" for estate tax purposes.

II. Unlimited Marital Deduction

A. Because transfers between spouses are entitled to an estate tax deduction, leaving assets to a surviving spouse can defer estate taxes until the survivor's death. However, from an estate tax perspective, it is possible to leave too much to the surviving spouse.

B. If the value of the combined estate of the couple exceeds the applicable exclusion, leaving all assets to the surviving spouse can waste the applicable exclusion of the spouse who dies first (“predeceased spouse”) and push the surviving spouse’s estate into higher estate tax brackets.

C. For example, assume a couple has a combined net taxable estate of \$8 million, all of which is community property. If the surviving spouse receives everything, there will be no tax when the first spouse dies, but the surviving spouse ends up with a \$8-million-dollar estate. After applying a single \$5 million exclusion, the estate pays a federal estate tax on the remaining \$3 million. Because everything went outright to the surviving spouse, the predeceased spouse’s exclusion was wasted.

III. A/B Trust

A. Revocable trusts can be structured to reduce the estate tax and the generation-skipping transfer tax. In the example above, the federal estate tax came from unnecessarily wasting the predeceased spouse’s exclusion. To utilize the predeceased spouse’s exclusion, a revocable trust can be drafted to defer estate tax upon the death of the first settlor to die by allocating trust assets into two separate subtrusts. Sometimes the trusts are called “Trust A” and “Trust B”, and the entire arrangement is referred to as an “A/B Trust”.

1. “Trust A” or the “Survivor’s Trust” remains revocable and contains the survivor’s property interests, and the surviving settlor has total control. If the survivor is the deceased settlor’s spouse, this trust usually receives all assets that exceed the applicable exclusion, and this qualifies for the marital deduction, thus deferring any estate tax until the surviving settlor’s death.

2. Trust B or the “Credit-Shelter Trust” is irrevocable. For a married couple, the Credit-Shelter Trust contains the deceased settlor’s assets that can pass tax free, equal to the unused applicable exclusion.

IV. Qualified Terminable Interest Property Trust (QTIP):

A. A “qualified terminable interest property” trust or “QTIP” trust is a Marital Trust that is often used when a married couple’s assets exceed the combined applicable exclusion.

1. Trust A or the Survivor’s Trust contains the surviving settlor’s assets only.

2. Trust B or the Credit-Shelter Trust contains the amount that can pass free, which is equal to the unused applicable exclusion.

3. Trust C is a Marital Trust, which qualifies for the marital deduction, contains the amount that exceeds the deceased settlor's applicable exclusion.

B. The most common type of marital trust is the QTIP Trust.

a) The surviving spouse must be entitled to receive all of the trust's income during the survivor's lifetime;

b) The surviving spouse must be able to compel the trustee to make unproductive assets produce income; and

c) No one but the surviving spouse may be a beneficiary until after the surviving spouse's death.

C. A QTIP trust is appropriate where a settlor with children from a prior marriage wants to provide for the spouse and to defer estate taxes without leaving the surviving spouse the power to eliminate the children.

D. A QTIP trust can be a spendthrift trust, making the principal exempt from lawsuits and other claims that may arise against the surviving spouse after the death of the predeceased spouse.

V. Irrevocable Life Insurance Trusts (ILIT)

A. Life insurance proceeds are not generally subjected to the federal income tax, but they are included in the insured's estate at his or her death if the insured had "an incident of ownership" in the policy within three years of death. Ironically, the tool frequently used to pay estate taxes often increases those taxes.

B. To avoid estate taxation, an ILIT can be made the owner and beneficiary of the life insurance.

C. Estate taxation can be escaped by having someone other than the decedent own the policy and all of its attendant rights. An irrevocable trust can be made the owner and beneficiary of all life insurance, removing the proceeds from the estate of the insured and the insured's spouse.

D. An irrevocable life insurance trust is better than ownership by a spouse or children because it is shielded from creditors and is more effective at reducing transfer taxes.

1. The spouse can be a beneficiary of the trust if contributions to the trust come from the insured's separate property and other strict formalities are followed.
2. The trustee must be an independent trustee. This cannot be the settlor, the settlor's spouse, or certain of the settlor's relatives. The settlor should be careful not to retain control over the trust.
3. Existing insurance policies can be transferred to the trust, but if the insured dies within three years of transferring a policy to the trust, its proceeds will be subject to the federal estate tax.
 - a) To avoid triggering the three-year-of-death rule, it is best if the settlor can contribute cash to the trustee of the trust so that the trustee can be the original purchaser of a new policy.
 - b) If the settlor has an existing policy and is uninsurable (or a new insurance policy is unaffordable), it is important to transfer the existing policy to the ILIT as soon as possible so that the three-year inclusion period starts to run as soon as possible.
4. A potential beneficiary should not make contributions to the ILIT, so if the insured's spouse is a potential beneficiary, all contributions must be made by the insured from the insured's separate property. The payment of premiums from community property or other joint accounts can unnecessarily subject the projects to estate taxes upon the spouse's death.
5. Contributions to an ILIT are taxable gifts. Unless a beneficiary has a right to withdraw contributions, contributions will use up the contributor's applicable exclusion for gift tax purposes. To allow gifts to qualify for the \$14,000 annual exclusion, it is common to include withdrawal rights, and each beneficiary must be notified of their right of withdrawal (and given adequate time to exercise that right). This notification is often called Crummey Letters.

VI. Generation-Skipping Transfer Tax: Years ago, Congress decided that generation skipping was reducing the amount of estate tax collected, and it imposed the federal generation-skipping transfer tax ("GST Tax").

- A. The GST Tax is imposed on transfers to grandchildren and lower generations, who are referred to in the law as "skip persons".

1. Gifts (other than gifts in trust) that qualify for the \$14,000 annual gift tax exclusion are also excluded for GST Tax purposes.

B. Once the exemption has been exhausted, the GST Tax applies in addition to any applicable gift or estate tax.

VII. Generation-Skipping Trust (GST)

A. A "generation-skipping trust" is a trust that continues more than one generation. An amount equal to the GST exemption can be placed in a trust that allows beneficiaries from the children's generation to receive the income from and use of trust assets without having those assets included in their estates.

1. After the death of the children's generation, beneficiaries from the grandchildren's generation receive the income from and use of trust assets without having those assets included in their estates.

B. The beneficiaries can have the following rights and privileges without having the trust's assets included in their estates:

1. Income. The beneficiary may receive all trust income.

2. Principal. The beneficiary may receive trust distributions in the trustee's discretion.

3. "5 or 5 Power". The beneficiary may have the noncumulative right to withdraw up to 5% (or \$5,000, if greater) of the trust each year.

a) This power is not usually included if the beneficiary has a taxable estate because if the beneficiary dies holding this power, the amount over which the power could have been exercised will be included in the beneficiary's taxable estate.

4. Power of Appointment. The beneficiary may have the power to direct distributions from the trust either during life or at death or both so long as the beneficiary cannot exercise the power in favor of himself/herself, his/her creditors, his/her estate, or the creditors of his/her estate.

C. Trustee. The beneficiary can be the trustee so long as the trustee's discretion to make distribution is limited to amounts appropriate for the beneficiary's "health, education, support, and maintenance."

VIII. Charitable Remainder Trust (CRT)

A. A CRT makes distributions to one or more individuals during their life, and then the trust distributes the remainder to one or more charities.

1. The payments (annual) to one or more individuals can be for their lifetime or during a set term of years (up to 20 years). The annual payments are usually stated in terms of a percentage (e.g., 8%) of the value of the trust's assets, but they can be stated in terms of a specific dollar amount if the amount is at least 5% of the value of the trust's assets.

2. Grantors of charitable trusts can be the life or term beneficiaries.

a) The grantors are entitled to a charitable deduction for the present value of the remainder interest (calculation based on life expectancy or the term of the trust, current interest rates, and the rate used to calculate annual payments for the life or term beneficiaries).

3. A CRT is tax exempt, so the trust does not pay income tax. The life or term beneficiary is taxed on income distributed to the beneficiary.

B. There are two types of charitable remainder trusts: charitable remainder annuity trusts (CRAT's) and charitable remainder unitrusts (CRUT's).

C. A CRAT provides for fixed payments despite asset valuation fluctuations

D. A CRUT allow for payments that can increase with inflation and provide flexibility for the timing of income payments.

IX. Charitable Lead Trust (CLT)

A. A CLT is a trust for a term of years, and during the trust term a specified annual payment (based on a percentage of the trust assets) is paid to one or more charities. Children or other beneficiaries are designated as the remainder beneficiaries who will receive the trust assets at the end of the trust's term.

1. A CLT results in a gift to the remainder beneficiaries based on the present value of the remainder interest.

a) That value depends on the term of the trust and the rate or amount of the specified payment going to the charities.

2. Although the specified payments are made to one or more charities during the trust's term, the asset itself is preserved for the children.

a) While the children may have to wait 5, 10, 15, or even 20 years to benefit from the trust's assets, a CLT can be an effective method to pass assets to beneficiaries without the combined effects of estate taxes and asset liquidation costs.

b) The longer they wait, the lower the value of the remainder interest is for gift tax purposes.

X. Grantor Retained Annuity Trust (GRAT)

A. A (GRAT) is similar to a CRAT. GRAT's permit the gift of remainder interests that are discounted for gift-tax purposes under the IRS valuation tables. While longer annuity terms produce lower remainder values, even short-term GRAT's can produce significant transfer-tax savings. Recent court rulings allow one to design a GRAT that has a near-zero value for gift tax purposes if the payments to the grantor can continue to the grantor's estate if the grantor dies before the end of the annuity term.

B. Grantor Retained Unitrusts (GRUT's): Grantor retained unitrusts (GRUT's) are similar in structure to charitable remainder unitrusts. GRUT's are similar to GRAT's in their general purpose, but GRUT's are not considered as effective as GRAT's where the trust's assets are expected to appreciate.

XI. Qualified Personal Residence Trust (QPRT)

A. A QPRT is a trust where a grantor transfers his or her primary residence or even a qualifying vacation home to a trust that allows the grantor to reside in the home for a designated period. At the end of the designated period, the property passes to (or remains in trust for) remainder beneficiaries.

1. The gift of the home to the trust is subject to the federal gift tax, but the value of the gift is the present value of the remainder interest, determined after taking into consideration the term of the grantor's retained interest, the grantor's age, and the applicable interest rate.

2. If the grantor dies before the retained-interest expires, the home reverts to the grantor and is subject to estate taxes, but since any gift taxes paid are credited, there is no true penalty.

a) Example 1: A home worth \$1,000,000 is transferred into a 10-year QPRT for a 58-year-old individual, and the IRS-issued 7520 rate is 6.0 percent. The remainder interest, which is what is being given away, has a present value of \$478,594. If the grantor outlives the 10-year term, no estate tax will be imposed on \$521,406 plus any appreciation. If the grantor's estate is in the 45% estate-tax bracket, this transaction saved over \$234,000 in estate taxes plus the estate tax on any post-transfer appreciation.

b) Example 2: A home worth \$1,000,000 is transferred into a 3-year QPRT for a 70-year-old individual, and the IRS-issued 7520 rate is 6.0 percent. The remainder interest, which is what is being given away, has a present value of \$766,632. If the grantor outlives the 3-year term, no estate tax will be imposed on \$233,368 plus any appreciation. If the grantor's estate is in the 45% estate-tax bracket, this transaction saved over \$100,000 in estate taxes plus the estate tax on any post-transfer appreciation.

B. One psychological drawback to QPRT's is the fact that the grantor no longer has the right to reside in the residence at the end of the term of the grantor's retained interest. To remain in the home, the grantor must make fair-market rental payment according to a lease agreement negotiated after the term has expired. Making lease payments is another good way for the grantor to make an estate-reducing transfer to the trust's beneficiaries.

XII. Asset-Protection Trusts (APT)

A. A “spendthrift trust” is a trust that precludes a beneficiary or his or her creditors from reaching the assets of the trust contrary to the terms of the trust. A “self-settled trust” is a trust created by the settlor for the settlor’s own benefit. Thus, a “self-settled spendthrift trust” or “SSST” is a spendthrift trust that includes the trust’s settlor as a beneficiary.

B. Traditionally, a self-settled trust could not qualify as a spendthrift trust. However Nevada permits a settlor to create a “self-settled spendthrift trust” (SSST) that is exempt from creditors’ claims. Sometimes these trusts are known as “domestic asset-protection trusts” (DAPT).

C. Under Nevada law, the settlor may establish a valid spendthrift trust for his or her own benefit if:

1. There is a connection to Nevada. This requirement is met if one of the following is true:

- a) Some or all of the trust assets or income are in Nevada; or
- b) The settlor is a Nevada resident; or
- c) At least one trustee:
 - (1) Has powers that include maintaining records and preparing income tax returns for the trust, and all or part of the administration of the trust is performed in this state; and
 - (2) Is an individual who is a Nevada resident or is a bank or trust company that maintains an office in this state for the transaction of business and possesses and exercises trust powers.

2. The trust is irrevocable (although the settlor may have a special power of appointment).

3. The trust is not intended to hinder, delay or defraud known creditors.

4. Distributions to the settlor are not mandatory and made only in the discretion of a person other than the settlor.

5. The trust is subject to Nevada's statutory rule against perpetuities.

D. The length of Nevada's look-back period or limitations period — the period during which a creditor may challenge a transfer of assets as being fraudulent or in violation of an enforceable obligation or court order — depends on whether the creditor had a claim when the transfer was made.

1. **Two-Year Default Rule.** A creditor whose claim arises after the transfer to a spendthrift trust must commence an action to challenge that transfer within two years after the transfer.

2. **Existing Claims.** A creditor whose claim arose prior to the time of a transfer to a spendthrift trust must commence an action to challenge a transfer within the later of:

- a) two years after the transfer; or
- b) six months after he discovers or reasonably should have discovered the transfer.

E. The settlor of a spendthrift trust can retain any power (other than the right to make distributions without the consent of another person), including “the power to remove and replace a trustee, direct trust investments and execute other management powers.”

1. A SSST cannot have assets the settlor can spend without someone else’s consent, and so it is not usually wise to put all of one’s assets into it. A two-trust approach is recommended:

2. A revocable “spending-money” trust should be established (or may already exist) to hold the checking account and liquid assets the settlor wants immediate and unfettered access to. In most cases, upon the settlor’s death, the beneficiary of this Trust will be the SSST.

F. Ideally, the irrevocable NAPT should have an independent trustee as the sole trustee, but it is also possible to have the NAPT governed by a board of trustees that includes the settlor (creator) of the trust.

1. The “managing trustee” has control over the investment of the trust assets. It is possible for the settlor of the trust to serve in this role.

2. The “distribution trustee” must authorize any distribution to the settlor and to the use of any trust asset (such as a home) by the settlor. The settlor(s) cannot be the distribution trustee.