# *PLANNING FOR UNCERTAIN TIMES*

**Financial and estate planning**

**Ideas to preserve wealth, instill family values, and achieve charitable objectives**

**Charitable remainder and lead trusts, private foundations and advised funds**

**Charitable giving income tax limits**

**The future of estate and gift tax**

**The future of income tax rates**

**Presentation**
**Sponsored by**

**The National Capital Gift Planning Council**


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After practicing 12 years as a tax/estate planning/trusts and estates partner at two large law firms, one in Washington, one in Virginia, Fred Tansill started his own firm, Frederick J. Tansill & Associates, in 1997 in McLean/Tysons. Fred graduated from Brown University and received both his law degree and his masters degree in tax law from Georgetown. He is the only person to ever Chair both the Virginia and D.C. Bar Sections on Wills, Trusts and Estates. He has been a Fellow of the American College of Trust and Estate Counsel (ACTEC) since 1991 and was listed by *Washingtonian Magazine* in 2002 and 1997 as one of the ABest Lawyers in Washington under the Estates and Trusts category. He was just selected for the 10th year in a row to be listed in the book Best Lawyers in America. He is frequently quoted in *The Washington Post* on estate and trust and tax matters, and has been quoted in many other publications, including *The Wall Street Journal*. He lives in McLean, has three children, and has practiced in Northern Virginia for 26 years. He is celebrating his 35th year at the Bar.

Fred Tansill has specialized expertise in:

1. Sophisticated Charitable Planning, including

    a. Private Foundations
    b. Charitable Lead Trusts
    c. Charitable Remainder Trusts
    d. Advised Funds at Community Foundations

2. Asset Protection Planning, Domestic and Offshore

3. International Estates and Offshore Trusts

4. Closely-Held Businesses/Tax Planning

5. Premarital and Post-Marital Agreements

6. Sophisticated Planning to Reduce or Avoid Estate Tax, Gift Tax, Generation-Skipping Transfer Tax

## INTRODUCTION

### I. THE TRANSFER TAX SYSTEM

A. We have one integrated transfer tax system for lifetime gifts (gift tax) and transfers at death (estate tax)

1. There is a flat tax rate of 45% on the excess over $2 million of cumulative lifetime gifts and death transfers in 2008

2. $12,000 annual gift tax exclusion per donee per year ($24,000 from couple) in 2008, $13,000 ($26,000 per couple) in 2009, next month.

3. There is an exemption available during life to offset gift tax on cumulative lifetime gifts (above $13,000/$26,000 per year per donee annual gift tax exclusion) and at death to offset estate tax on testamentary transfers

   $2 million for persons dying in 2008 (But gift tax exemption remains frozen at $1 million indefinitely)
   $3.5 million for persons dying in 2009 (will Congress postpone this?)
   (Estate tax exemption amount uncertain for persons dying in 2010 and thereafter, but not less than $2-$3.5 million)

   Predictions: Especially because of the cost of the war in Iraq and the burgeoning federal deficit and the impending claims of baby boomers upon social security and medicare and the financial crisis of the last three months --

   a. estate tax will <u>not</u> disappear in 2010, or ever
   b. exemption will <u>not</u> revert to $1 million in 2011 as current law provides. It will never go below $2 million again.
   c. it is possible that the new, higher $3.5 million limit could be retroactively postponed as late as September 2009, but we should probably have a good indication if it might be by June 2009; but, on the other hand, there is broad political consensus today for the $3.5 million exemption, which President-Elect Obama supported, and it is more likely than not that the exemption will go to $3.5 million in 2009, or within a few years if it does not.
   d. Based on a bill that almost became law right before the

last Congressional election in 2006, it is possible that eventually for estates under $25 million, the top bracket will be reduced from 45% to something like 25%. And for estates over $25 million, the tax rate will be reduced to something like 35%. But this will probably not happen for a few years, until the financial crisis passes.

4. There is an unlimited exemption for lifetime or death transfers to a spouse or to charity. Transfer to spouse may be outright or in trust (QTIP Trust) from which spouse must receive all income.

5. State estate tax and inheritance taxes will persist and possibly grow in some states. D.C. and Maryland continue to have an estate tax with a $1 million exemption; Virginia has abolished its estate tax.

B. The Federal Generation-Skipping Transfer (GST) Tax System

Just to make matters more confusing, there is a third variety of federal transfer tax, in addition to estate tax and gift tax:

1. A separate, additional transfer tax on transfers to those two or more generations younger than the donor

2. There is a $2 million aggregate exemption in 2008, a $3.5 million exemption scheduled for 2009 (expansion of the GST exemption will be postponed if the expansion of the estate tax exemption to $3.5 million is postponed.)

3. the top estate tax rate (45%) will be imposed <u>in addition to</u> the gift tax or estate tax

4. If the combined estates of husband and wife are in excess of $5 million and there are grandchildren or grandchildren expected, use GST exemption and try to leverage the exemption. <u>Never exceed the GST exemption and incur GST tax</u>! EXAMPLE: This year $2 million is exempt from GST tax. If a grandparent made a mistake and left his entire estate of $3.5 million to grandchildren whose parents are alive, $2 million passes exempt from any transfer tax; $1.5 million is subject to estate tax at 45%, or $675,000. The $825,000 balance remaining would be subject to GST tax of 45% or $371,250. The total tax is $1,046,250 or 70% of $1.5 million.

## II. THE GOALS OF THE ESTATE PLANNING PROCESS

A. Save taxes

B. Avoid or minimize court-supervised estate administration/probate

C. Provide for the management of your health and finances in the event of short- or long-term incapacity

D. Pass your property at death to those you want to receive it in a way suitable to your wishes and their needs.

E. Protect your assets from your own potential future creditors and those of your family members

## III. TRUSTS

Many tax planning, charitable and asset protection strategies require trusts. Always draft them with the flexibility to accommodate unexpected future events.

A. A creation of English Common Law

B. Available generally only in English-speaking countries (not France, Germany, Spain, Switzerland, Latin America)

C. You, the Settlor or Grantor, create the trust, which is a contract between you and a second party, the Trustee, who agrees to hold certain property under agreed terms for the exclusive benefit of a third party, the Beneficiary. There may be two classes of Beneficiaries, one with an interest in the trust's income for a fixed or determinable period -- the holder of the income interest -- and the other with the right to the remaining principal at the end of the income interest -- the remainderman. The trust describes whether the named trustee can be discharged and replaced and by whom, how long the trust arrangement lasts, under what circumstances the Beneficiaries receive income and principal, whether the Settlor may revoke or amend the trust or not. Sometimes there is a 4th party, the Trust Protector or Advisor, who may fire the trustee, change jurisdictions, select investment advisors, maybe change beneficiaries, maybe provide non-binding advice. This may be Settlor's sibling, trusted friend or lawyer.

D. Trustee must be more than prudent. The Trustee has a fiduciary

duty --

1. of loyalty to beneficiaries

2. to preserve principal of Trust
3. to balance interests of life tenants vs. interests of remaindermen

4. to invest prudently, in accordance with Portfolio Theory

E. Who May Serve

1. Institutional Trustees, e.g.,

   a. Trust Companies

   b. Banks with Trust Powers

   c. Other Non-Bank Trust Companies

2. Lawyers, Accountants, Financial Planners

   Caution: it is unethical for an attorney to suggest himself or herself as fiduciary

3. Friends

4. Family Members (but consider conflicts of interest and tax issues, e.g., not a second spouse for children of first marriage)

F. Revocable Trusts

Should a revocable trust be the basic estate planning document? See the article on my website: Are Revocable Trusts Overused and Oversold? (www.fredtansill.com)

- The older you are
- The wealthier you are
- The single-er you are

the more you need a revocable trust. The decision also depends upon

- the value and nature of your assets

- your dispositive estate plan
- the probate law of your state
- your comfort level with a little complexity

G. Trustee Fees

1. To serve as trustee, banks and trust companies typically charge 1% of value of assets per year at $3 million, somewhat more on assets less than $3 million, with a declining percentage below 1% above $3 million. This fee includes the investment management fee. This is the same fee the institution would charge simply to manage the money if it was not the Trustee. In effect, there is no extra charge for the bank or trust company to serve as Trustee.

2. Individuals should probably charge on hourly basis, as trustee fee will be in addition to investment management fee. Generally there is no fee savings in naming an individual to serve as Trustee, because you hope the individual will engage an institution to manage the money, and the institution will charge to manage the assets the same as it would charge to serve as Trustee.

H. We are going to discuss below two particular types of trusts, Marital/QTIP Trusts and Discretionary Spendthrift Trusts. Who should be Trustee of a Discretionary Spendthrift Trust or QTIP Marital Trust?

Consider whom do you want to trust, whom do you want to put in charge.

1. If you trust the beneficiary and want the beneficiary to control the Trust, for instance your spouse in a Marital Trust

2. Make the beneficiary Co-Trustee with an independent Co-Trustee

3. Give the beneficiary the power to fire and replace the independent Co-Trustee (This is almost always a good idea in trusts.)

4. The beneficiary will have to agree to investments

5. <u>Note</u>: Only the independent trustee can make

discretionary distributions; the beneficiary who is Co-Trustee may not participate in that decision

I. If you do not trust the beneficiary and want the Independent Trustee to control the Trust

1. Make an institutional fiduciary sole Trustee

2. Permit the beneficiary to replace the Trustee discharged only with another institutional fiduciary or an attorney (This is frequently a good idea in trusts.)

3. The Trustee will control investments and distributions as a completely neutral third party

## IV. CHARITABLE GIVING TECHNIQUES

### A. Charitable Remainder Trusts
(See article on website: www.fredtansill.com)

In a Charitable Remainder Trust (CRT) the donor gives certain property to a charity, but retains the right to income from the property for a term of years, or for his or her life, or for the joint lives of the donor and the donor's surviving spouse. A charitable income tax deduction is available in the year of the gift calculated by subtracting from the current value of the property given the actuarially calculated value of the income interest retained. So, for example, an income interest retained for the joint lives of a 75 year old couple would be much less valuable than the income interest retained by a 50 year old couple, and the charitable income tax deduction would be much larger for the 75 year old couple.

The second tax advantage to the donor is that appreciated property donated to and sold by the CRT is not subject to capital gains tax, so the gross proceeds are available to generate income for the donor. If the donor simply sold the property, only the net proceeds after paying capital gains tax would be available to generate income. (If in the future capital gains tax rates increase, for instance from 15% to 20% as President-Elect Obama has suggested he might recommend, that will somewhat increase the advantages of this strategy.) So by making a CRT gift the donor will actually generate more income for himself or herself for life than by selling the property and retaining the proceeds. The downside is that at the death of the donor(s), the balance remaining of the gift belongs to the charity, and the heirs of the donor will take nothing. To offset this consequence donors will sometimes take out life insurance payable to their heirs (perhaps owned by an irrevocable life insurance trust to avoid the inclusion of the insurance in the insured's taxable estate) to offset the value of the property donated.

CRTs are a useful strategy when selling a business, to diversify a concentrated

highly appreciated position in one stock or one piece of real estate and to generate liquidity from such an illiquid asset, because the donated property will be sold tax-free and reinvested in a diversified portfolio which will, in turn, generate the income. It is particularly useful to generate retirement income.

There are two forms of CRTs, Charitable Remainder Annuity Trusts (CRATs) and Charitable Remainder Unitrusts (CRUTs). CRATs distribute annually a sum certain that is not less than 5% nor more than 50% of the fair market value of the assets initially placed in the trust. As the annual distribution is based on the original value, the income stream to the annuitant of a CRAT will lose value over time to inflation. So this approach favors the charity. In contrast, with a CRUT the specified annual distribution must be a fixed percentage not less than 5% nor more than 50% of the fair market value of the trust assets, valued annually. If a CRUT is properly invested, the income stream from a CRUT will increase over time to keep pace with inflation. So this approach favors the donor/annuitant. The value of the charitable remainder may not be less than 10% of the original value of the gift, based on a present value calculation. The payout on a CRT is normally 5% or 6% per year.

It is also possible to establish a CRT at death -- a testamentary CRT -- that will last for the life of a surviving spouse or child, and then pass to charity at the death of the annuitant. In that case the estate tax value of the property is reduced by the actuarially calculated value of the charitable remainder, and estate tax savings is effected.

EXAMPLE: I had a client worth $400 million-plus with whom I worked to develop an estate plan several years ago. He viewed his plan in three categories: his children; his spouse (not the mother of his children); and the private foundation he wanted to establish. He roughly left 1/3 to his children in lifetime CRUTs; 1/3 to his spouse in a lifetime CRUT; and 1/3 outright to establish a private foundation to be run by his children and eventually his grandchildren. The private foundation took the remainder of the CRUTs from the children and spouse. There you are: the estate tax was only about $12 million on the $400 million-plus; the spouse and children received multi-million dollar annual annuities; and 90%-plus of his estate ultimately will end up in the hands of a family-controlled charity.

How to evaluate a possible CRT. Do not think of a CRT as a gift to the charity of the full amount contributed to fund the CRT. Rather, in evaluating a lifetime CRT, realize that the only part you are giving away is the actuarially calculated (on special software) present value of the remainder gift in the future, which is the same as the amount deductible for income tax purposes. This will usually be a relatively small portion of the total gift. (Recently the author assisted a Georgetown University alumnus who, to satisfy a million dollar pledge, made two CRT gifts to Georgetown at about age 58: a $500,000/20-year CRAT (he retained a 20-year income stream), and a $500,000 joint and survivor lifetime CRUT (he retained a lifetime annuity for himself and his spouse). His wife, who threatened to kill him when he proposed a $1 million gift, dropped her

objections when she realized that the actual present value of these two combined CRT gifts was only $250,000. Economically the husband and wife in effect were able to retain 75% of the value of the property donated, while meeting the terms of a million dollar pledge. But Georgetown was happy, because at the end of the day it will receive a full one million dollars, or maybe even more depending on the investment performance. This is a win-win scenario. Frequently the charitable remainderman will serve as trustee for no fee. Frequently the charitable remainderman will provide a sample CRT document to the donor's lawyer and assist that lawyer.

Large CRT gifts may be effective vehicles for naming opportunities in new construction, to endow chairs and scholarships, or for other specific purposes, e.g., to support particular programs.

NIMCRUTs and FLIPCRUTs. These are more sophisticated types of CRUTs:

NIMCRUTs: (Net income with make-up CRUTs) -- For illiquid assets whose liquidity date is uncertain, like real estate, closely-held stock, where there may be no income stream to pay out for an indefinite period of time after the CRT is created. When the asset finally is liquidated, the post-creation income payout obligation which could not be satisfied is made up.

FLIPCRUTs -- which accumulate but do not pay out income for a period of time, but then flip, e.g., at retirement age 65, to begin payout of the enhanced principal at a higher level.

Special Opportunities in the Present Economic Turmoil. Lifetime CRUT gifts may be more attractive to both Amiddle class millionaires (net worth of $2-15 million) and to high net worth individuals (HNWI, net worth above $15 million) in the present environment for the following reasons:

- The 5%-6% (or higher) lifetime payout rate may be very attractive in an environment when both income and growth are hard to come by.

- Fixed lifetime annuities are generally more attractive in a time when speculative investment seems less attractive.

- Clients may want to push for his/her returns to depress the actuarial value of the charitable remainder as close to the 10% minimum as possible.

B. Charitable Lead Trusts

In a Charitable Lead Trust (CLT) the donor gives property to a charity, which receives income from the trust principal for a fixed period of time, after which the principal itself passes to individual remaindermen. Typically a grandparent might establish a CLT with income to a charity for 10-30 years with the remainder passing at

the expiration of that period to children or grandchildren. A CLT may be established during life or at death. For various tax reasons lifetime CLTs are rarely used, but a charitable income tax deduction may be available in the year of gift calculated by subtracting from the value of the property given the actuarial value of the remainder. In the case of a testamentary CLT an estate tax charitable deduction will be available for the actuarially calculated (on software) present value of the charitable lead interest. The larger the charitable lead interest, the greater the charitable deduction. At some point, typically around 30 years, the value of the remainder interest has no material actuarial present value in a CLAT, maybe only 10% of initial value in a CLUT (although it has potential huge actual value, potentially much greater than the original gift), and the charitable income tax deduction or estate tax charitable deduction approaches 100% of the value of the gift or bequest. The potential efficacy of CLTs in eliminating virtually all estate tax has caused commentators to observe that the estate tax is a voluntary tax. Bill and Melinda Gates could, and probably plan to, pass $50 billion to children and grandchildren tax-free at the cost of a 35-year delay by using a 35-year CLAT paying out to their Foundation.

As with CRTs, property sold by a CLT is not subject to capital gains tax, so the CLT is a useful strategy to diversify a concentrated, highly appreciated position in one stock or real estate, because the donated property may be sold tax-free and reinvested in a diversified portfolio which will, in turn, generate the income for the charitable annuitant and hopefully appreciation of principal for the individual remaindermen.

Like CRTs, CLTs generally have two forms, one in which the charity receives annually a fixed percentage of the original value of property donated (CLAT -- this favors the individual remainderman), one in which the charity receives annually a fixed percentage of the value of the trust property valued annually (CLUT -- this favors the charity), but the CLT is not bound to be more than 5% but less than 50% of any value.

Such trusts are normally <u>not</u> used for lifetime giving, to generate an income tax deduction. Typically they are testamentary arrangements established by will or revocable trust, with the goal of reducing or eliminating estate tax. A testamentary CLT may completely eliminate estate tax on the largest multi-billion dollar estate while preserving every penny of such estate for the donor's descendants tax-free. For example, a 35 year testamentary CLT with an income stream in favor of Children's Hospital with the remainder passing to the donor's grandchildren would avoid all estate and gift tax to the donor and his children and vest the entire principal undiminished and possibly substantially enhanced, at the end of 35 years, in the hands of the grandchildren.

<u>How to evaluate a possible CLT</u>. As with a CRT, do not think of a CLT as a gift to the charity of the full amount to be contributed to the trust. Rather, in evaluating a testamentary CLT, realize that the only part you are giving away is the actuarially calculated present value of the charitable annuity interest, which is the same as the amount deductible for federal estate tax purposes. Again, this may well be a relatively

small portion of the total gift. Moreover, and more importantly, even if the deductible portion is a large percentage of the total trust funding, remember that the CLT may be designed to virtually guarantee the return to the donor's family at the termination of the charitable annuity period of the entire amount, or most of it, funding the trust. Again it is a win-win situation: the charity gets a large, protracted income stream it may budget for, the donor avoids huge estate taxes, and the donor's children or grandchildren get virtually the entire gift back into their hands at the end of the charitable annuity period.

Large CLT gifts may be effective vehicles for naming opportunities in new construction, to endow chairs and scholarships or for other specific purposes, e.g., support of particular programs.

New CLUT Form: The IRS published new sample CLUT forms in Revenue Procedure 2008-45, 2008-30, 2008-46 on July 24, 2008.

C. Other Charitable Giving Approaches

Charities typically have other vehicles which are advantageous in particular situations, which the client's lawyer and the charity can help the client identify. Among these are pooled income funds and charitable gift annuities, both of which are additional forms of CRTs. And, of course, the client can make outright lifetime gifts to the charity, which gives the client a charitable income tax deduction for the entire value of the gift. Or an outright testamentary gift, which provides a charitable estate tax deduction for the entire value of the bequest. There is no limit on the estate tax charitable deduction. A prospective donor of a lifetime gift and his or her tax advisors must be conscious of the income tax deduction limits: a taxpayer may deduct gifts to public charities such as those represented in the room in full, but not in excess of 50% of his adjusted gross income for the year of gift, in the aggregate of all such deductions, but any excess charitable deduction above this 50% limit in the year of gift may be carried forward to the ensuing 5 years until it is completely exhausted, in each such year subject to the rule that aggregate charitable contributions may not exceed 50% of adjusted gross income.

There is a special limitation for appreciated property which, if sold, would generate capital gains, i.e., investment property such as stock and real estate. It is deductible at its full, fair market value, but the deduction limit in the year of gift is 30% of the donor's adjusted gross income. Again, any excess may be carried over and deducted in the 5 succeeding years, but never in excess of the 30% limit for such year.

Very wealthy donors may establish Private Family Foundations, or more modestly wealthy donors may establish an Advised Fund at a Community Foundation or commercial gift fund, such as Fidelity or Vanguard or Merrill Lynch, and direct or expect that the trustees will make distributions in the future to other focused charities. Gifts to Private Family Foundations may not be deducted in any year in excess of 20% of adjusted gross income, with the same 5-year carry forward of any excess. An

advantage of an Advised Fund is that it is subject to the higher 50% public charity limits, even though in many ways the fund functions like a private foundation.

D. Rules on Charitable Giving: The Pension Protection Act of 2006 (PPA)

Signed by President Bush on August 17, 2006, the PPA contained many detailed provisions bearing on commonplace and arcane charitable gifting strategies. Virtually anyone who claims a charitable deduction in itemizing deductions on Schedule A of his federal tax return, Form 1040, will be impacted and must be aware of some new rules. Those of broadest application are as follows:

1. Cash Donations -- All cash donations, NO MATTER HOW SMALL, must be documented by a bank record (e.g., canceled check) or a written communication from the charity providing its name, the date, and the amount you gave. So a $50 bill dropped into a collection plate when you are visiting a cathedral in Florence or a church at the beach or your home church is no longer deductible. In your home church you can put cash in the envelopes the church provides you which the church tracks and summarizes for you annually.
2. Donations of Used Clothing and Household Goods -- Under the new rules which took effect on August 18, 2006, the value of such gifts dropped off at Salvation Army or the local clothes bank operated by a charity must be in at least good condition and must have more than Aminimal value. Maddeningly, neither of these terms has yet been defined, but eventually regulations defining these terms may be issued. Taxpayers claim $9 billion of such deductions annually, and Congress wants to make sure the donated items have bona fide uses. Used items worth more than $500 do not need to be in good condition if the value is supported by an appraisal.

   Specialized new rules that may be very important to taxpayers planning to make certain types of gifts, including the following, are very briefly summarized. If you are contemplating a gift along these lines, check with your personal tax adviser for detailed information on how the particular rules may impact on the gift you are contemplating:

3. Gifts Of Up to $100,000 From IRA Initially Restricted to 2006-2007, Then Extended to 2008 and now 2009 -- A donor older than 70-1/2 may make qualified charitable distributions directly from her IRA to a charity. These distributions count toward required withdrawals, but because they are charitable contributions they are not taxed. This rule does not apply to distributions from SEP or SIMPLE IRAs, or to gifts to private foundations or donor advised funds. Such a gift is not deductible. This IRA gift may not be used to satisfy a charitable pledge.

4. Non-Cash Gifts Valued Over $5,000: Overvaluation Penalty -- Such gifts when made must be supported by an appraisal. But under new, stricter rules, if the valuation is challenged on audit and found to be more than 150% of the actual value, a penalty applies.

5. Gifts of Fractional Undivided Interests in Tangible Property, Such as Artwork -- These are now severely restricted by complex new rules.

6. Gifts of Exempt Use Tangible Property - Strict New Rules -- Generally a gift of tangible personal property to be used by a charity in accomplishing its exempt purpose is deductible at its fair market value. This would apply, for instance, to a gift of a computer or copier or fax machine. Under the new rules if the property is worth more than $5,000 the charity must certify that it will not sell or dispose of the property in the year of gift and must not sell it for three years and must certify that it will put the property to use in connection with its exempt purpose.

7. Elaborate New Rules Restricting Gifts to Donor Advised Funds -- These are too complex and intricate to summarize. Donors using donor advised funds sponsored by community foundations or financial service forms -- e.g., Fidelity, Vanguard, Merrill Lynch -- should carefully review the new rules and his practices with his tax advisor.

E. Who Gives to Charity (What Charities Receive Gifts?)

See EXHIBIT A, U.S. Giving Rises - But Only Slightly, Article reproduced from August 2008 Trusts and Estates Magazine.

F. Giving In An Economic Downturn.

See EXHIBIT B, Take It To the Next Level article reproduced from September 2008 Trusts and Estates Magazine.

## V. PROTECTING ASSETS FROM CHILDREN, THEIR SPOUSES AND THEIR CREDITORS

Always consider asset protection issues in estate planning -- the average American will be sued 5 times. See the outlines on my website: www.fredtansill.com, Why Asset Protection Planning? Protection of Family Assets From Creditors, Offshore Asset Protection Trusts, and Asset Protection for Real Estate. Broadly, there are two

types of possible creditors of family members we worry about: spouses of family members in divorce and at death, and all other types of creditors loved ones may have.

A. Assets inherited by children should be kept by children in their own accounts under their own separate names to protect from divorce property settlement claims. Make your children promise you that they will keep inherited assets in their own names, will not put them in joint name with a spouse. If assets are kept in their own names, generally they may not need prenuptial agreements. Divorce courts generally will not award to another spouse assets received by one spouse by gift or inheritance. However, if gifted or inherited assets are put in joint name with a child or grandchild's spouse, that spouse is likely to be awarded 50% in divorce.

B. Parents of minor or young children should make lifetime gifts to children using Irrevocable Discretionary Spendthrift Trust

1. within $13,000/$26,000 Annual Gift Tax Exclusion

2. within $1 million Unified Gift Tax Exempt Amount

3.a. normally such a trust is a separate taxpayer, only a nominal exemption is available, and it is taxed in 2008 on income it retains at 15% to $2,200, 28% above $5,150, with a top bracket of 35% at only $10,700 of annual income. Income distributed from a trust to a beneficiary is taxed to the beneficiary. Therefore the investment policy of a trust must be coordinated with the tax law and the plan to distribute trust assets to avoid high tax brackets on trust income which will be accumulated and not distributed.

b. if trust is defective parents pay income tax on trust income whether distributed or not and the payment of such tax is NOT considered a gift

4. trust may last for child's life with general testamentary power of appointment for child to exercise in child's Will

5. or trust may last for child's life, and then go automatically to child's children (grandchildren) -- generation-skipping transfer for which very careful planning is required

6. or trust may distribute all income when child reaches mature age, e.g., 21-25, so child becomes accustomed to handling money before receiving any principal

7. and trust may distribute principal in 2 or 3 installments, e.g., 1/3 at 25, 1/2 balance at 30, balance at 35, so if children are foolish when young, they cannot squander all funds in trust

8. while held in trust assets are protected from divorce property settlement, from any other creditor of child, from creditors of donor parents

9. Consider '529 Plans described in VI. (L.) below and UTMA accounts described in VI.(B.-H.) below.

C. What if it is a principal residence or vacation home that you want to give to children and protect? You can uglify a first or second home by transferring it to a Qualified Personal Residence Trust (QPRT) under which parents/transferors retain the exclusive right to use the property for a fixed period of time, at the end of which the children will irrevocably take title to it

1. There is a big discount on the valuation of the gift for gift tax purposes attributable to the retained interest

2. Parent's creditors will not be very interested in pursuing their term interest because children will eventually take

3. Great technique for vacation homes, even principal residences (must be personal use real estate)

4. Parents can rent it back from the children at fair rental value after the trust terminates

5. A home given to a QPRT must be debt-free, so a mortgage may have to be shifted to another residence for the home to qualify.

6. This is an example of the truism that many asset protection techniques involve making an asset less appealing to creditors rather than giving the asset away.

## VI. AT THE DEATH OF PARENTS USE <u>TESTAMENTARY</u> (established at death of parent) DISCRETIONARY SPENDTHRIFT TRUST FOR

**CHILDREN (same design features as Trusts for children created during parent's lifetime) TO PROTECT CHILDREN'S ASSETS FROM THEMSELVES, THEIR SPOUSES, THEIR CREDITORS AFTER YOU DIE**

A. Hold assets until children attain mature age, then distribute income before principal, distribute principal in 2 or 3 installments OR

B. Hold assets for life of child

1. subject to general testamentary power of appointment

   OR

2. then to child's children (grandchildren) in a generation-skipping trust

C. While in trust assets protected from

1. creditors of child

2. divorce property settlement

D. Particularly use Trust where child is disabled or if there is a particular cause for concern: substance abuse, spendthrift, or unmotivated habits, unpleasant spouse. For a disabled child, consider having other non-disabled children as co-beneficiaries of the same trust. This makes it harder for a court to invade the trust to offset governmental programs for the disabled child.

E. A discretionary Trust will always permit the Trust to accelerate distributions or terminate the Trust with liquidating distribution early

F. A typical testamentary plan for the very wealthy, net worth of $15 million or more: $1-$2 million to each child at age 35, balance in lifetime GST and non-GST trusts as a safety net.

## VII. PROTECTING ASSETS FROM GRANDCHILDREN, THEIR SPOUSES AND THEIR CREDITORS

A. Generally, same considerations as for children, lifetime or testamentary discretionary spendthrift Trusts

B. As an alternative to a Trust for minor grandchildren (or minor children), consider custodial account at a bank or trust company

C. Under the Uniform Transfers to Minors Act (UTMA)

D. Set up in Virginia or Maryland, not in D.C.

E. Designate explicitly on account documents AHold to Age 21"

F. Name someone other than parent of child as custodial, e.g., sibling or aunt or uncle

G. Do not accumulate in UTMA account more than can be spent on tuition, etc., before age 21. Whatever remains in the account at age 21 may be withdrawn by child

H. Children pay tax on UTMA account; under 19, children are taxed at parents' top bracket on income in excess of $1,500. Children 19 and older have regular individual brackets. Again, it is important to coordinate investment strategy with the tax law, to generate growth not income in UTMA accounts.

I. To accumulate more assets to older age, use custom trust drafted by lawyer

J. For lifetime transfers and testamentary transfers, beware of generation-skipping transfer (GST) tax, but do take full advantage of $2 million - $3.5 million generation-skipping transfer tax exemption

K. To leverage GST exemption and shelter much more than $2 million for grandchildren from estate and gift tax consider

1. Irrevocable Life Insurance Trust, especially second-to-die policy

2. may hold single life or second-to-die policy

3. may last 100 years or in perpetuity

4. Charitable Lead Trust: makes estate tax optional, even for billionaires.

In very large estates GST planning may seem insignificant, but the effect can be

huge. If the exemption goes to $3.5 million in 2009, and husband and wife combined put $7 million in GST trusts, if it grows at 12%/year after tax, it doubles every 6 years, in the 42 years that the children may survive parents. So the growth in the transfer tax exempt GST trust will be as follows:

| | |
|---|---|
| 6 years out | $14 million |
| 12 years out | $28 million |
| 18 years out | $56 million |
| 24 years out | 112 million |
| 30 years out | 224 million |
| 36 years out | 448 million |
| 42 years out | 896 million to grandchildren TAX FREE |

If you assume only 8% growth, doubling every 9 years, in the 45 years that children survive parents, the growth in the transfer tax exempt GST trust will be as follows:

| | |
|---|---|
| 9 years out | $14 million |
| 18 years out | $28 million |
| 27 years out | $56 million |
| 36 years out | 112 million |
| 45 years out | 224 million to grandchildren TAX FREE |

L. Consider using '529 Plan to provide for higher education of grandchildren (or children)

1. As an alternative or in addition to a trust or UTMA accounts for minor grandchildren (or minor children), consider a '529 College Savings Plan

2. Gifts for the benefit of children or grandchildren may be made to '529 College Savings Plans and Custodial Accounts under the Uniform Transfers to Minors Act (UTMA).

3. Virginia's '529 College Savings Plans are generally completely immune from claims of creditors of the donor or of the beneficiary and are very flexible. Other important characteristics of a '529 account are the following:

   (a) income accumulates tax-free

   (b) distributions for qualified tuition expenses (including room and board and miscellaneous expenses of all kinds for disabled beneficiaries)

are tax-free

(c) a contribution to the plan is a gift and therefore amounts held in a '529 account are removed from the donor's taxable estate and income tax returns

(d) donor may retain control over '529 accounts and remove assets from plan accounts at the cost of paying taxes on the funds withdrawn plus a 10% penalty tax

(e) if first beneficiary does not need or use assets, donor or parent (as provided) may redesignate the plan balance for another family member

donor may use up to 5 years worth of annual exclusions ($12,000 x 5 = $60,000) to make a large '529 gift for a child or grandchild or other, but this must be reported to the IRS.

## VIII. PROTECTING ASSETS FROM SPOUSE, SPOUSE'S CREDITORS, SPOUSE'S OWN CHILDREN (NOT YOURS) AND SUBSEQUENT HUSBANDS AND WIVES

A. There is an unlimited marital deduction for transfer tax purposes: lifetime gifts to a spouse or testamentary bequests to a spouse are NOT subject to federal or state gift tax or estate tax if

1. the transfer is outright OR

2. the transfer is in trust from which the spouse must receive all income for life (QTIP Trust)

3. spouse's income interest may NOT terminate on remarriage

4. spouse may be given generous rights to principal or stingy rights or no rights to principal

5. the balance in a QTIP Trust at the surviving spouse's death is subject to tax at that time

B. Classic Uses of QTIP Marital Trust

1. If your spouse is not the parent of all of your children, provide for the spouse in a QTIP Trust, so you can be assured that at the spouse's death the principal of the trust will pass to your children. Predeceasing spouse controls ultimate disposition of trust principal, not surviving spouse

2. If your spouse is a spendthrift, or cannot or does not want the responsibility of managing inherited assets or is in a business or profession where the threat of lawsuit is always present, e.g., where spouse is an ob/gyn, or where the spouse cannot be trusted to leave all such funds to the couple's children at the surviving spouse's death

3. If one spouse has plenty of assets to take advantage of the unified credit if he or she dies first, but the other does not, during life the wealthier spouse may create a QTIP trust for the less wealthy spouse in an amount sufficient to use up the less wealthy spouse's estate tax credit, so the QTIP Trust assets will pass at the beneficiary spouse's death to the wealthier spouse's heirs tax-free

There is <u>no</u> tax reason to use a Marital Trust. If none of the circumstances described in 1.-3. apply, there is no reason to create a Marital Trust. Leave the property outright to the surviving spouse.

C. Advantages of a QTIP Trust

1. Spouse who sets it up controls where principal of trust passes at beneficiary spouse's death. Beneficiary spouse does not.

2. If beneficiary spouse remarries, that new spouse and the children of the new spouse cannot inherit deceased spouse's money.

3. If beneficiary spouse has children of his or her own (not deceased spouse's children), those children will not inherit deceased spouse's money (unless the spouse establishing the trust wants them to).

4. If beneficiary spouse has creditors, they cannot get at deceased spouse's money placed in the QTIP Trust, the principal of the trust (although they could attack the beneficiary spouse's income stream).

5. Trustee of deceased spouse's choice manages the money, not surviving beneficiary spouse.

D. Now we will turn our attention from exclusively marital trusts to a different type of trust, typically established for the benefit of the spouse and children and grandchildren for as long as the spouse lives, sometimes

called a bypass trust because assets held in it bypass estate tax at the surviving spouse's death, passing to the couple's children tax-free. This is sometimes called a Family Trust or Credit Shelter Trust. The basic estate tax planning technique for couples with assets of $4 million and up is the Testamentary Unified Credit Shelter [Family] Trust which is typically a Discretionary Spendthrift Trust for the benefit of the surviving spouse and children of the deceased spouse, and possibly grandchildren of the deceased spouse. The amount of this Trust is generally up to the exempt amount: $2 million in 2006-2008, $3.5 million beginning 2009.

1. if spouse remarries his or her interest can terminate.

2. spouse's creditors cannot attack his or her interest.

3. if spouse remarries, the new spouse cannot get at trust assets during marriage or in the event of divorce.

4. children's creditors/grandchildren's creditors cannot get at trust.

5. spouses of children/grandchildren cannot get at trust.

6. Trustee of deceased spouse's choice manages the money, decides whether and to whom to distribute income or principal.

7. the balance in a Credit Shelter Family Trust is NOT taxed when surviving spouse/beneficiary dies; the balance passes to children TAX-FREE. So the use of this trust may be dictated by the estate tax laws as they apply to that specific estate.

E. Special Qualified Domestic Trust (QDOT) is Required if Spouse is a Non-Citizen

If, because of uncertainty over the future of the estate tax or the size of your estate at death, you want to do stand-by tax planning, you can leave everything outright to a surviving spouse, but permit the surviving spouse to make an election after the first spouse's death to do tax planning, if it is needed, by disclaiming some assets into a Credit Shelter Family Trust -- a so-called Disclaimer Trust recently touted in the *Wall Street Journal*.

## IX. PROTECTING ASSETS FROM POSSIBLE FUTURE CREDITORS OF YOURSELF

A. Traditional American legal rule: It is against public policy to permit someone to set up an Irrevocable Spendthrift Trust of which he himself is a beneficiary to protect assets from his own creditors.

B. Since 1989 some 18 foreign jurisdictions have adopted laws permitting so-called Self-Settled Spendthrift Trusts, e.g., Cook Islands, Bermuda, Bahamas, Cayman Islands, Isle of Man, Gibraltar. See outline on website: www.fredtansill.com : Offshore Asset Protection Trusts: Non-Tax Issues.

C. Since 1996 Alaska, Delaware, Rhode Island, Nevada, Utah, Oklahoma, Missouri, South Dakota, Wyoming and Tennessee have adopted laws permitting Self-Settled Spendthrift Trust in the U.S. (Also covered in outline cited above.)

   1. These are not as effective as foreign laws

   2. There are substantial exceptions to protection

      (a) will not defeat claim for child support.
      (b) in Delaware will not defeat a claim for alimony or marital property settlement or tort claim.
      (c) can be challenged for at least 6 years after established, probably longer.
      (d) Under latest Bankruptcy Act, may be attacked by bankruptcy trustee for 10 years.

D. I presented a paper at ABA Convention which has been published as an article in the *Journal of Asset Protection* summarizing and comparing the laws of various foreign jurisdictions and Delaware. An offshore asset protection trust is not worth doing for less than $500,000 - $1 million of assets.

E. So-called Asset Protection Trusts -- and, in fact, all asset protection strategies -- work only against prospective future creditors, Do NOT work against current or currently contemplated creditors.

F. Revocable Trusts have no effect against claims of creditors of Trust's Settlor.

G. An Offshore Trust can protect against spouse's claim in the event of a possible future divorce or from a spousal claim at death (spouse is entitled to inherit 1/3 in most jurisdictions).

H. Offshore trust can maintain an account in U.S.; in other words, assets in offshore trusts can remain in U.S., only thing that changes is ownership of account if transferred to offshore trust.

I. Retirement Plan Trusts Under ERISA Qualified Plans -- 401(k), Pension, Profit-Sharing -- are <u>NOT</u> subject to claims of employee's creditors.

1. in Maryland IRAs are protected.

2. in Virginia IRAs are only protected if you do not have a 401(k) or other ERISA plan. If you do have an ERISA plan and an IRA, the IRA will only have <$100,000 of protection, plus federal bankruptcy protection as indicated below.

Under a recent U.S. Supreme Court decision and the 2005 Bankruptcy Act IRAs have expanded, but not unlimited, federal protection. Generally you may assume IRAs up to $1 million or so are protected.

in D.C. IRAs are protected.

SUMMARY RE IRAs: fully protected in D.C. and Maryland, protected to $1 million in Virginia in bankruptcy if you have other ERISA plans, fully protected in Virginia if IRA is only retirement plan you have.

## X. OTHER IDEAS TO PROTECT YOURSELF FROM YOUR OWN CREDITORS (DO THESE <u>EARLY</u>, BEFORE YOU HAVE PROBLEMS)

A. Tenants By the Entirety Property: not subject to claim of creditors of only one spouse. You can set up brokerage or mutual fund accounts as tenancy by the entirety accounts (as opposed to joint).

B. Life Insurance Trust: If you are in financial trouble, provide security for your spouse and children after your death. Moreover the cash value should be protected. When creditor problems go away you may borrow out the cash or redeem the policy for cash.

C. Family Limited Partnership (FLP) and Family Limited Liability Company (LLC). Assets may be held in name of Family Limited Partnership (or LLC). Why is the FLP the Holy Grail of estate planning?

Parent/Grandparent gives property away for income and estate tax purposes, but retains control as Managing Partner. (Generally the price of getting assets out of your estate is loss

of control.)

The donor gets a 40% discount on the gift tax valuation of a limited partnership interest, off the value of the underlying asset.

If the donor by gifts moves into a minority position, his or her estate gets a 40% discount on the estate tax value of the retained interest at death.

Partnership interests are protected from creditors, who cannot get at them.

Recent bad court cases regarding FLPs are not as bad as they sound.

D. Give it away to other family members.

E. Give it away to charity.

F. Umbrella Liability Insurance

G. Incorporation or Limited Liability Entity. Never operate any business or investment enterprise as a proprietorship or general partnership.

## XI. PROTECTING ASSETS FROM CREDITORS OF PARENTS, AVOIDING DISQUALIFICATION OF IMPOVERISHED PARENTS FROM STATE OR FEDERAL BENEFIT PROGRAMS

Where children want to provide a financial safety net for less financially secure parents who may survive them, the parents may be co-beneficiaries with spouse and children in discretionary Unified Credit Family Trust. If parents need funds, distributions may be made directly to the service provider -- landlord, doctor -- without putting assets in parents' hands which parents' creditors may attack or which may be subject to tax when parents die. Getting your elderly parents to give you all of their assets so they are Medicaid-eligible generally does not work; it is a bad idea. The look-back period for ineligibility is longer, 5 years, and the disqualification period now looks back from the date of application for benefits. See below.

## XII. WILL MEDICAID BENEFITS BE AVAILABLE TO PAY FOR YOUR NURSING HOME CARE? -- NOT LIKELY

Change in Medicaid Eligibility Rules

The Deficit Reduction Act of 2005, signed by the President on February 8, 2006, contains major changes in Medicaid eligibility rules. The legislation aims to reduce Medicaid entitlement expenditures by $10 billion. As approximately sixty percent of the nation's nursing home residents are Medicaid recipients, the impact of this new law will likely be widespread. A few of its more important provisions are summarized below.

Because Medicaid is intended as a welfare program for the truly underprivileged, a person must have assets below a certain threshold in order to be eligible for Medicaid assistance. (Certain assets, such as a home, are generally not taken into account in determining eligibility.) Both the new and the prior rules governing eligibility contained provisions designed to prevent individuals from transferring assets to family members in order to reduce their assets below the threshold for eligibility. These eligibility rules have been toughened considerably by the new law.

<u>Five-Year Look Back/Delayed Start of Penalty Period</u>. Under prior law, a person applying for Medicaid was required to produce financial records dating back three years. If uncompensated transfers had been made within that period, the applicant would be ineligible for Medicaid assistance for a penalty period determined by dividing the amount of the uncompensated transfer by a number representing the monthly average cost of care at a skilled nursing facility in the area where the applicant resides. The penalty period began at the time of the transfer. To illustrate the application of this rule, if in January 2005 an individual applied for Medicaid, he would be required to produce financial records dating back to January 2002. (Uncompensated transfers which occurred prior to January 2002 would not be taken into account in determining the applicant's eligibility for Medicaid.) If the applicant had made a $40,000 gift to a family member in January 2004 and the applicable penalty divisor was $4,000, he would be ineligible for Medicaid for a period of ten months commencing with the date of the gift (i.e., through November 2004), and thus would be eligible for benefits at the time of his application in January 2005.

Under the new rules, however, the applicant would be required to produce financial records dating back five years from the date of the transfer (i.e., to January 2000) and his period of ineligibility, calculated in the same fashion using the amount of the transfer and the applicable penalty divisor, would begin with the date of his application for benefits. Thus if the applicant had made a $40,000 gift to a family member in January 2004, and in January 2005 had assets below the Medicaid threshold, entered a nursing home and applied for Medicaid benefits, he would not qualify for those benefits for ten months following his application, or through November 2005.

Many commentators have suggested that these new rules will cause hardship for persons that are truly needy and should qualify for Medicaid, as well as for nursing homes and hospitals. First, many Medicaid applicants simply will not be able to produce the five years of records now required to document their eligibility. And even if they are able to produce the required records, a relatively small transfer to a family member or charity within the past five years by an applicant who is essentially indigent at the time he seeks Medicaid benefits will result in his being

ineligible for some period of time after he has applied for benefits. Nursing homes will have no means of being paid for their care for such persons for a time, and thus will not want to accept them as residents. Moreover, since nursing homes must provide care for their residents until they can be safely discharged, even if they are unable to pay, they will also be reluctant to accept residents who have modest assets at the time they enter the nursing home but are expected to exhaust those assets after a short period. If such persons cannot immediately qualify for Medicaid when their assets are exhausted either because they cannot produce the necessary records or because they have made a small gift within the five year period, the nursing home will be required to provide them with free care until they do qualify, which may be a lengthy period. Nursing homes may also be tempted to dump indigent persons in hospitals for real or imagined medical services to get them out of their facilities, thus imposing hardships on hospitals.

Other New Provisions. The look-back and delay provisions discussed below are the most significant changes in the new law, but other changes, such as limitations on the use of annuities to avoid Medicaid asset restrictions, and a new rule for calculating the income and resources that may be retained by the spouse of a nursing home resident, have also made eligibility more difficult. Whereas under previous law a Medicaid applicant's equity in his home was not considered available to pay for his nursing home care, home equity in excess of $500,000 is now treated as available (unless a spouse, a minor or a disabled child resides in the home). States will have the option of exempting up to $750,000 of home equity value at their discretion.

The overall effect of the new law is to significantly toughen Medicaid eligibility requirements and make it very difficult to engage in planning designed to qualify oneself for Medicaid benefits. Most people, except those whose assets are substantial enough to pay for nursing home care for a long period, should strongly consider the purchase of long-term care insurance to provide for nursing home care or in-home care.

## XIII. WHERE ARE THE INCOME TAX RATES HEADED?

Income taxes are at the lowest levels we will see in the foreseeable future. Look for the rates to increase in the next few years on dividends, capital gains, ordinary income. If you have a highly appreciated asset you have been thinking about selling, this is a good time to sell. But the increases President-Elect Obama had planned, capital gains increasing from 15% to 20%, the top ordinary income tax brackets returning to the 39.5% level of the Clinton years, from the 35% top bracket under President Bush, may be postponed due to the economic crisis, possibly for two year.