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**Application of Estate Planning**

**Concepts**

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## Introduction

Estate planning is very broad in scope and can be dense with details. It is often the intensity of details that makes it difficult to grasp the basic concepts that form the core of any estate plan. For that reason, this module will focus *only* on the fundamentals.

The good news is that estate planning is an area where a little knowledge goes a long way. The basic principles that are covered in this module address the most common estate planning opportunities. Thus, in a relatively short time, one can master the skills necessary to address most situations, while building a solid foundation for continued learning. However, when discussing estate planning concepts with clients, it is important to remember that the client's attorney needs to be consulted in deciding the final course of action to be taken, as well as in the drafting and execution of estate planning documents.

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| Objective  After completion of this module, you will learn about:   * The purpose of estate planning * The basic resources and most common techniques for estate tax minimization, such as:   + Credit Shelter Trusts   + General Power of Appointment (POA) Marital Trusts   + QTIP Trusts   + QDOT Trusts   + Lifetime Gifting Strategies   + Charitable Trusts   + Grantor Retained Trusts   + Irrevocable Life Insurance Trusts * When the use of trusts is preferable to relying on portability of the Deceased Spousal Unused Exclusion (DSUE) * Why it is important to review estate plans that were created prior to 2011, when portability of the DSUE was implemented * The importance of your not engaging in the practice of law and your role in working with the estate planning attorney who is ultimately responsible for estate planning |

## What is Estate Planning?

When people think of estate planning, most people think of writing a will. Others might include creating a trust. And still others might think in terms of minimizing estate taxes. But all these considerations miss the point that estate planning is really about fulfilling one’s personal goals regarding one’s financial resources and assets.

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| **Purpose of Estate Planning**   * To give what you want, to whom you want, when you want * To minimize taxes and administrative costs * To minimize probate expenses * To provide protection for one’s self and beneficiaries * To provide control after death |

Defining Personal Goals

The process should always begin with the very personal task of identification of goals. Some of these goals may be lifetime goals, such as protection against incapacity by establishing a living trust; others might extend beyond the grave, such as providing for the continued care of a child or dependent with special needs. Along the way, the estate planner (i.e., the attorney) can facilitate the process by informing the client of options and costs associated with the goals identified; but always, the person’s personal goals should reign supreme.

Only when the goals are identified can the planner begin identifying the most tax efficient means of achieving those goals. This will be the focus of this module, identifying the basic tools and techniques that can improve the tax-effectiveness of the estate plan.

Implementation

Once personal goals are identified, implementation of an estate plan to accomplish those goals requires the drafting of legal documents that take into consideration, where necessary, strategies to minimize estate taxes. Therefore, in its strictest sense, it involves the practice of law, with the client's attorney ultimately responsible for the plan. But an effective financial adviser works in concert with the attorney, facilitating the development of a viable plan, while avoiding the unauthorized practice of law.

This course will examine those legal documents and some of the fundamental strategies that are employed to minimize estate taxes.

## Key Documents

Generally speaking, every adult needs to consider having certain estate planning documents in place. Failure to do so can significantly jeapordize personal goals, expose survivors to unnecessary risk, and, for large estates, may result in higher transfer taxes. Key documents that everyone should consider are listed below. While other documents may be employed in the estate plan to accomplish specific goals, such as trusts that are established while a person is alive, the following list should be considered by everyone: **Click each document to learn more.**

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| **Will** |
| Unless they are prepared to have their assets distributed in accordance with state statutes, everyone needs a will to direct distribution of assets upon death. Wills are also useful when desiring to set up testamentary trusts to provide benefits for survivors. We have already discussed some of the uses and benefits of trusts, but will have more to say on the use of trusts in estate planning in the pages that follow.  Generally, for married couples, it is very important to coordinate the couple’s wills (in fact, to coordinate their entire estate plans) to assure that they work together to achieve established goals, particularly since it is impossible to predict which spouse might die first. |
| **Durable Power of Attorney** |
| A Durable Power of Attorney is a document that allows you to appoint another person or persons to manage your affairs and make financial decisions on your behalf if you become incapacitated. It is important to include a durability provision to have these powers continue if you become incapacitated or mentally incompetent; otherwise, its powers will cease.  The powers given may be either “general” or “special” (aka, “limited”). If “general,” your chosen attorney has extensive powers over your affaits; a “special” Power of Attorney is limited to specifically-defined tasks. |
| **Living Will** |
| A living will allows you to state your wishes about certain types of medical care and life-prolonging procedures. The document only takes effect if you cannot communicate your own health care decisions. The benefit of a living will is that you do not put your family in the position of having to make difficult decisions and you also ensure your health care wishes are carried out. |
| **Durable Power of Attorney for Health Care/Health Care Proxy** |
| A Durable Power of Attorney for Health Care (health care proxy) is a document that lets you appoint another person to make medical decisions on your behalf if you become unable to make those decisions yourself. This document may resolve any potential conflicts over your medical treatment and helps ensure your wishes are respected. Unlike a living will, this document covers a broad range of health care decisions. |

## The Resources of Estate Planning

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| Resources of Estate Planning Graphic | Having discussed the fundamental documents that are involved in developing an estate plan, we now turn our attention to the strategies that are utilized to minimize estate taxes. The primary resources available for minimizing estate taxes are to be found within the transfer tax system itself. Buried within the volumes of obtuse tax codes and regulations is a staggering array of possibilities. Fortunately, most tax-saving resources can be grouped into the three categories that appear to the left. There are other categories, to be sure, and the list of possible tools or techniques within some categories can be extensive. But for the majority of estate planning opportunities, these three suffice.  These resources are available to everyone; but their benefits are not necessarily automatic. Careful planning is often necessary, and specific tools or techniques have been developed to obtain their optimum benefit for various situations. We will discuss those, but first, let’s do a quick review of the resources themselves. |

## Applicable Credit/Exclusion Amount

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| * **Applicable Exclusion Amount is the value that is offset by the Applicable Credit Amount, which is the credit against the gift and estate tax.** * **The Applicable Exclusion Amount, which is adjusted annually for inflation, is $5,450,000 in 2016, and assets beyond that amount will be taxed at 40%.** * **Lifetime Gifts:**   + While in prior years the portion of the Applicable Exclusion Amount that could be applied to lifetime gifts was capped at $1,000,000, beginning in 2011 this “cap” was removed. Today, the entire 2016 Applicable Exclusion Amount of $5,450,000 can be used for lifetime gifts. * **Portability of the Applicable Exclusion Amount:**   + Beginning in 2011, portability of the Applicable Exclusion Amount between spouses is allowed, making it possible for a surviving spouse to inherit any unused portion of the deceased spouse’s Applicable Exclusion Amount. Previously, such inheritance was not possible and any portion that remained unused by a deceased spouse’s estate was forfeited. Thus, a surviving spouse can now add to his/her Basic Exclusion Amount the Deceased Spousal Unused Exclusion (DSUE) Amount. |

This is the beginning point; it is as close to automatic as one can get. The only planning required to benefit from this resource is to be born. Each person is given a credit against transfer taxes, known as the Applicable Credit Amount, which offsets the tax that would otherwise be due on taxable transfers. The amount of transferred assets protected by the credit is known as the Applicable Exclusion Amount. In other words, the Applicable Exclusion Amount tells how much a person can transfer, which would otherwise be subject to transfer tax, without having to pay a tax.

## Estate Tax Deductions

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| * **The amount that can be transferred to a U.S. citizen spouse without tax is unlimited.** * **Transfers to charities are deductible.** |

A quick examination of the estate tax return reveals that there are two unlimited deductions available:

* The unlimited marital deduction
* The charitable deduction

No transfer tax is assessed against these transfers and none of the Applicable Credit/Exclusion needs to be applied on a gift tax return or estate tax return to protect these transfers from taxation.

## Gift Tax Exclusions

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| * **No gift tax on lifetime transfers to U.S. citizen spouses (known as the unlimited marital deduction)** * **No gift tax on lifetime transfers to charities** * **Annual gift tax exclusion of $14,000 in 2016, indexed for inflation in $1,000 increments**   + Must be completed, irrevocable gift   + Married couples can "split gifts," for a combined gift of $28,000 without regard to source of funds   + Unlimited number of individuals can receive gifts   + Since there is no unlimited marital deduction for transfers to a non-citizen spouse, there is an enhanced annual gift tax exclusion for that purpose, which is $148,000 in 2016 (adjusted annually for inflation)   + Not added back to donor’s estate upon death * **Gift tax exclusion for tuition**   + Independent of the annual gift tax exclusion   + Must be paid directly to the school and only for tuition   + No limit on amount or number of individuals   + Not added back to donor’s estate upon death * **Gift tax exclusion for medical care**   + Independent of the annual gift tax exclusion   + Must be paid directly to the care provider   + No limit on amount or number of individuals   + Not allowed for amounts reimbursed by insurance   + Not added back to donor’s estate upon death |

For taxable estates, one of the best ways to manage transfer tax exposure is through lifetime gifts. Making non-taxable gifts like those listed on this page can be a means of achieving long-term goals while also reducing the size of the estate that is potentially subject to taxation. Even lifetime gifts that are “taxable” and use up part of one’s Applicable Exclusion Amount to avoid paying a tax can be a means of transferring future appreciation out of one’s estate.

In 2016, there are no taxes due on gifts up to $14,000 per year ($28,000 if gifted by a married couple), no gift tax on gifts to a U.S. citizen spouse, and no gift tax on gifts to charities. Furthermore, gifts made in direct payment of tuition and medical care are also excluded from gift taxes when paid directly to the school or medical service provider. None of these gifts require use of the Applicable Exclusion Amount to avoid transfer taxes and none of them will be added back at death as post-1976 taxable gifts to be included on the estate tax return.

## Planning to Minimize Estate Taxes has Gotten Much Simpler for Most Americans

Legislation in recent years has made the estate planning process much simpler for most people. This is due to two key changes: **Click each change to learn more.**

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| **Growth of the Applicable Credit/Exclusion Amount** |
| In 2000, each individual received a credit against the gift and estate tax that protected the first $675,000 from the transfer tax. At the time, that was the largest credit in history, and it had taken 15 years for it to go from protecting $400,000 to protecting $675,000.  But since 2000, the Applicable Credit/Exclusion amount has risen rapidly to protect the first $5,450,000 from taxation. This has virtually eliminated the federal transfer tax from being a planning issue for the vast majority of Americans. |
| **The Introduction of Portability** |
| In 2016, a married couple’s combined Applicable Exclusion Amounts can protect $10,900,000 of assets from transfer taxation. Even if everything is left to the surviving spouse, the executor merely files an estate tax return “porting” over the Deceased Spousal Unused Exclusion Amount; no further planning is required. This combined amount is more than sufficient to protect the vast majority of married couples from having to worry about paying a federal estate tax.  Prior to 2011, it was not possible for a deceased spouse to pass on his or her Unused Exclusion Amount to a surviving spouse. This meant that any Unused Exclusion Amount in the first estate would be forever lost as an opportunity for protecting assets from the transfer tax. This resulted in the need for significant planning to optimize the use of both spouses’ Applicable Exclusion Amounts whenever their combined estates exceeded a single Applicable Exclusion Amount, as illustrated in the following example:   |  | | --- | | Example:  In 2009, Joe and Martha Average, a married couple who were both U.S. citizens, had a combined estate of $3.7 million. They had very simple wills whereby they left everything to the survivior.\*  The Applicable Exclusion Amount in 2009 was $3.5 million. Together, they had a combined Applicable Exclusion Amount of $7 million – more than enough to protect their combined estate. However, this is what would have happened if both spouses died in 2009 when portability was not available:  Unlimited Marital Deduction Flowchart  Because the assets passed by way of the unlimited marital deduction, the first spouse’s Applicable Exclusion amount goes unused and the surviving spouse’s estate is left with all the assets and only a single Applicable Exclusion Amount to protect them from taxation. The result is that $200,000 of assets go unprotected, resulting in a tax bill of $90,000.  Clearly, in the days before portability, which allows the surviving spouse to inherit the Deceased Spousal Unused Exclusion (DSUE) amount, this simple plan could be quite costly.  *\* The characters and scenarios in this case study are fictitious and purely for purposes of illustration.* | |

## Preserving the Applicable Exclusion Amount in the First Estate Prior to Portability

On the previous page, we provided the example of Joe and Martha Average, who needed additional planning to optimally utilize both spouses’ Applicable Exclusion Amounts in the days before the advent of portability. On this page and the next few that follow, we introduce you to planning techniques that were developed in the pre-portability years to accomplish this.

It is important that you become familiar with these planning techniques since they continue to have application in today’s environment, as we shall later explain. It is also important that you be familiar with these concepts because many clients you will encounter established their estate plans pror to 2011 when portability went into effect, and these plans will likely reflect these techniques.

### The Credit Shelter Trust

Continuing with the the example of Joe and Martha Average from the previous page, they had a combined estate of $3.7 million in 2009 and each spouse had an Applicable Exclusion Amount of $3.5 million. How could they make use of both Exclusion Amounts to fully protect their combined estates?

This was typically accomplished by NOT leaving everything to the surviving spouse! One option was to leave the assets that are covered by the Applicable Credit/Exclusion Amount to other heirs, but then the assets would not be available to provide for the needs of the suriving spouse. Instead, most people preffered to utilize a Credit Shelter Trust.

The ***Credit Shelter Trust*** (sometimes referred to as the *Applicable Exclusion Trust*; also known as a *"By-Pass Trust*" because it by-passes the surviving spouses estate or a "Family Trust" because the entire family is often named as beneficiaries) is typically created upon the death of the first spouse.

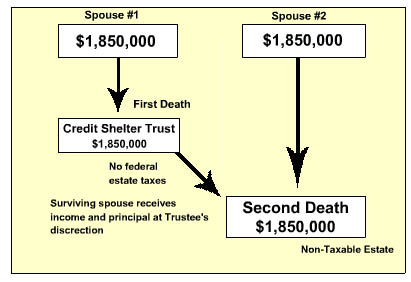
Here is how it works:

* When the first spouse dies, the Applicable Credit Amount is generally applied against as much of the deceased spouse’s estate as possible.
* These "sheltered" assets are transferred into a "Credit Shelter Trust." Since the surviving spouse cannot control these assets, his will keeps them out of the surviving spouse’s estate and protects them from being taxed when the second spouse dies.
* Any remaining assets, which are not covered by the deceased spouse’s Applicable Credit Amount, are transferred to the surviving spouse (or, as we shall explore on the following page, into a trust for the surviving spouse that will be included in the surviving spouse’s estate). These remaining assets will be protected from taxation upon transfer due to the unlimited marital deduction.
* The surviving spouse generally receives income from the Credit Shelter Trust and, if the document allows, can receive principal at the trustee's discretion.
* The Credit Shelter Trust can also be used for the children. For this reason, it is often referred to as a **"family trust."** In fact, after the death of the surviving spouse, the trust can continue for the benefit of the children.
* The end result is that both Applicable Credit Amounts are utilized and the surviving spouse does not have to forego benefit of all the assets.

**Important Note** – For this strategy to work, both spouses need to have assets in their individual names. This is because it is impossible to know which spouse will die first. For example, if the first spouse dies not owning assets, then there is nothing with which to fund the trust. For this reason, most couples adopting this strategy will split assets to the degree necessary for the strategy to be optimized for either death.

### Illustration

If Joe and Martha Average had divided their assets equally (since they couldn’t predict which of them would die first) and utilized the Credit Shelter Trust technique in their estate planning documents, the end result would be **no estate taxes** if they both died in 2009, at a savings of $90,000. This is because half of the assets would have been “sheltered from taxation upon the first death and excluded from the estate of the surviving spouse,



For many years, this was one of the most powerful estate planning techniques available for couples, and its features were second nature to the planner.

For a more detailed summary of the Credit Shelter Trust, proceed to the next page.

## Credit Shelter Trust – Summary

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| **Credit Shelter Trust** |
| **WHAT?**  An irrevocable trust that is funded with assets that are covered by the Applicable Credit Amount. Typically used to "shelter" assets from the surviving spouse's estate for federal estate tax purposes.  **WHEN?**  Typically, funding takes place after death.  **HOW?**  Typically, when the first spouse dies, those assets that are covered by the Applicable Credit/Exclusion Amount are transferred into the trust. No federal estate tax is paid on these assets, and they are not included in the surviving spouse's estate for federal estate tax purposes.  The remaining assets are transferred to the surviving spouse or into a Marital Trust. Since there is an unlimited marital deduction, no taxes are paid on this transfer, but these assets will be included in the surviving spouse's estate.  Often created in conjunction with a Marital Trust (often referred to as an A-B trust arrangement, where the "A" trust is the Marital Trust and the "B" trust is the Credit Shelter Trust).  It can be created in the will or upon the death of the grantor of a revocable living trust, where the living trust splits into an A-B trust.   |  |  | | --- | --- | | WHY? | WHY NOT? | | Before portability, it allowed married couples to make use of both individuals' Applicable Credit Amounts without denying the surviving spouse the benefit of the combined estate. | Not necessary if the combined estates of husband and wife are below the Applicable Exclusion Amount. Also, not necessary beginning in 2011 when portability of the Applicable Exclusion Amount allows the surviving spouse to inherit the Unused Spousal Applicable Exclusion Amount. | | Since portability came into effect in 2011, it may still be an effective tool for specific situations, such as second marriages, protection against creditors, or to create a generation-skipping transfer (GST) trust (since the GST exemption is not portable). |  | | While a Credit Shelter Trust may not be needed for federal estate taxes, it might still be needed for state taxes where portability does not exist. |  |   **OTHER CONSIDERATIONS.**  To prevent the assets from being included in the surviving spouse’s estate, the surviving spouse cannot have unrestricted control (or have a general power of appointment) over the assets of the Credit Shelter Trust. However, the surviving spouse may act as trustee and may receive benefits from the trust per the terms of the trust.  This is typically thought of as a "family trust", providing benefits for the surviving spouse and children, while keeping it out of the surviving spouse's estate. It can terminate upon the surviving spouse's death or continue for other members of the family, whichever the grantor/testator prefers.  While the Credit Shelter Trust will shelter assets from the federal estate tax, there may still be a state estate tax on the assets. State estate tax ramifications will vary from state to state. |

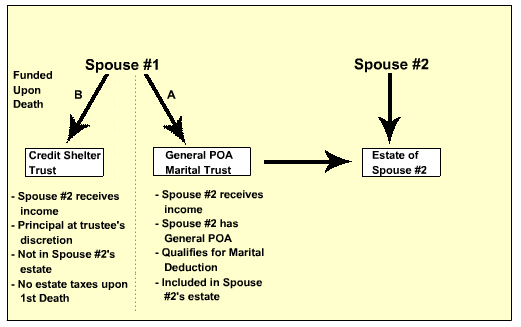
## Planning for Larger Estates of Married Couples Before the Advent of Portability

Let’s now examine a pre-portability example of a larger estate to learn some additional techniques that were widely utilized in conjunction with the Credit Shelter Trust prior to the advent of portability, but which have continued utility for today.

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| **Example of Mr. and Mrs. Dollar (2009)**  In 2009, John and Susan Dollar, both U.S. citizens, were both in their 70's. John was in poor health and was concerned that he might predecease Susan, who has never handled any of the financial affairs, and he feared she would be overwhelmed by having to handle things herself. They had four grown children, all of whom were married with children of their own. Their youngest son had recently been diagnosed with Amyotrophic Lateral Sclerosis (Lou Gehrig's Disease), and John and Susan Dollar were providing financial assistance to him and his family.  John and Susan's combined estate was currently valued at $9.5 million. Each had an Applicable Exclusion Amount in 2009 of $3.5 million. How might they plan to minimize their estate tax exposure?\* The following is how this was typically done:  **1. Split Assets**  Since they could not predict which would die first, they would typically divide up assets, making sure that each spouse could use as much of their Applicable Exclusion Amount as possible upon the first death. In our example, let’s assume that John and Susan divide assets equally, with each spouse owning $4.75 million each.  **2. Create a Credit Shelter Trust Upon the First Death**  Assuming the first spouse died in 2009 when the Applicable Exclusion Amount was $3.5 million, then $3.5 million would go into the Credit Shelter Trust upon the first death.  **3. Transfer Remaining Assets to the Surviving Spouse**  After funding the Credit Shelter Trust, the first estate has a taxable balance of $1.25 million. Rather than pay taxes in the first estate, the taxes could be deferred by passing them on to the surviving spouse through use of the unlimited marital deduction. This would provide the surviving spouse time to do additional tax planning to reduce the size of the taxable estate, which we shall discuss, prior to the assets being taxed upon the second spouse’s death.  While transferring the remaining assets to the surviving spouse would defer taxation, many clients preferred not to transfer assets outright in the hands of a surviving spouse. This could be because the surviving spouse was not familiar with handling assets and the client did not want to burden the surviving spouse. Alternatively, this might be a second marriage and, while the client wished to adequately support the surviving spouse, there was also the desire to assure that the assets went to the deceased’s own children from a prior marriage. So, how does one defer taxation of assets that exceed what can placed in the Credit Shelter Trust by utilizing the unlimited marital deduction, yet not make an outright transfer to the surviving spouse?  **3. (Alternative) – Transfer Assets to a Marital Trust**  The answer that was commonly deployed was to utilize a ***Marital Trust***. This was typically referred to as A-B Trust planning, whereby a Credit Shelter Trust was set up for the Family (the A Trust) and a Marital Trust (the B Trust) would be set up for the benefit of the surviving spouse.  The terms of the Marital Trust would be such that the assets would be included in the surviving spouse’s estate, thereby qualifying the trust for the unlimited marital deduction. In this manner, taxation of the Marital Trust would be deferred until the second death, just as occurred with an outright transfer to the surviving spouse.  Two types of Marital Trusts were commonly used: the **General Power of Appointment (POA) Marital Trust** and the **Qualified Terminal Interest Property (QTIP) Marital Trust**. Both continue to have utility today for those situations where the preference is NOT to leave assets outright to the surviving spouse. We will discuss each type on the following pages.  *\* The characters and scenarios in this case study are fictitious and purely for purposes of illustration.* |

## The General Power of Appointment (POA) Marital Trust

The oldest type of Marital Trust is the ***General Power of Appointment (POA) Marital Trust***.



In this arrangement, the surviving spouse has a “General Power of Appointment” over the assets in the Marital Trust. What that means is that the surviving spouse can appoint those assets to whomever he/she chooses, even to himself/herself. This arrangement would certainly address Mr. Dollar's concern that his wife be protected from the burden of handling the finances, since the assets can be handled by a competent trustee. The terms of the trust could also read that upon the death of the surviving spouse, provided the General Power of Appointment is not exercised, the trust is to continue for benefit of the son who has Lou Gehrig's disease until his death, the terminating and being distributed to the children or their surviving families.

For a more detailed summary on the General POA Marital Trust, proceed to the next page.

## General Power of Appointment (POA) Marital Trust – Summary

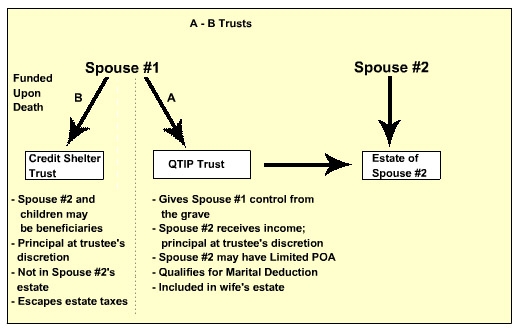
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| **General Power of Appointment (POA) Marital Trust**  **WHAT?**  An irrevocable trust for the surviving spouse that qualifies for the marital deduction by giving the surviving spouse a general power of appointment over the trust assets (thereby including the trust assets in the surviving spouse’s taxable estate).  **WHEN?**  Funding takes place after the first spouse's death.  **HOW?**   * May be created in the will or upon the death of the grantor of a revocable living trust. * The surviving spouse must receive the net income, which must be paid at least annually. * The surviving spouse must have a general power of appointment to appoint the property to anyone, including himself/herself. Depending on the trust document, this power may be exercisable only during life (if unexercised, it is distributed as the trust dictates), at death, or both.  |  |  | | --- | --- | | WHY? | WHY NOT? | | Qualifies the remaining assets for the marital deduction, thereby deferring any potential tax liability until the surviving spouse’s death. | Donor has no control over final disposition of assets | | Frees the surviving spouse from the burden of managing the assets. | When both spouses are remarried, each with children from a former marriage, donor may prefer to designate that assets ultimately transfer to donor's own children. | | When it is considered desirable for the named remainder beneficiaries to be aware that how they treat the surviving spouse could impact whether or not he/she exercises the general power of appointment to take away their interest in the trust. | If there is risk that the surviving spouse may be subject to undue influence regarding the POA. |   **OTHER CONSIDERATIONS.**   * By giving a lifetime power of appointment, the surviving spouse can further reduce the size of the estate through lifetime gifts. * If given a general power of appointment at death, the optional lifetime power may be limited (for example, only allowing for gifts to children). * If the spouse doesn't exercise the general power of appointment, the trust document will direct the final transfer of assets. |

## Introducing the QTIP Marital Trust

The General Power of Appointment Marital Trust has historically been a very popular planning technique, but the price of qualifying it for the marital deduction is to give up control over how the assets might ultimately be transferred by the surviving spouse. As our society has changed, with divorce and remarriage becoming increasingly common, this has become increasingly unacceptable. Therefore, estate planners needed a technique that would allow the Marital Trust to qualify for the marital deduction without having to give the surviving spouse control over the ultimate disposition of the trust assets.

The technique that accomplished this is known as a **QTIP** (Qualified Terminable Interest Property) Marital Trust. A terminable interest in property is one that will terminate upon death. For example, if a person receives income from a trust during life, but at death the assets are distributed to other beneficiaries according to the terms of the trust, then that person has an interest that terminates upon their death. Such "terminable interests" are not ordinarily included in a person's estate. But as long as certain technicalities are met, a Marital Trust can be constructed with a terminable interest, yet qualify for the marital deduction.

In other words, it is possible, in our previous illustration, for John and Susan Dollar to plan for Marital Trusts that will direct the ultimate disposition of the assets to their children, prevent the surviving spouse from changing the distribution, and still qualify the trust for the marital deduction. That is truly control from the grave! That is why this continues to be a very popular planning technique today, especially in cases of second marriages. Here is a diagram of how it works:



Among the technicalities is the requirement that the surviving spouse **must** receive all income from the trust. But unless the donor desires to give the surviving spouse a limited power of appointment (for example, limiting the ultimate distribution to the children, but allowing the surviving spouse to decide how it is to be prorated among them), **it is the donor who will decide how the assets ultimately transfer, not the surviving spouse**.

For a more detailed summary on the QTIP Marital Trust, proceed to the next page.

## The QTIP Marital Trust – Summary

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| **QTIP (Qualified Terminable Interest Property) Trust**  **WHAT?**  An irrevocable trust for the benefit of the surviving spouse that qualifies for the marital deduction, while limiting the power of the surviving spouse to appoint the assets, either during life or at death.  **WHEN?**  Funding takes place after the first spouse's death.  **HOW?**  In funding the Marital Trust, the executor makes the QTIP election on the estate tax return.  The surviving spouse *MUST* receive the net income.  Principal can *ONLY* be used for the benefit of the surviving spouse.   |  |  | | --- | --- | | WHY? | WHY NOT? | | Qualifies assets for the marital deduction without giving up control over their final disposition. | For smaller estates, it may be more cost effective to make the transfer outright to the surviving spouse. | | Especially useful when both spouses have been previously married, with children from prior marriages, and they want to keep their respective estates separate for their children while taking advantage of the marital deduction. | If the surviving spouse might potentially need to use the assets to assist other family members, a General POA marital might be preferred because of the restriction on a QTIP Marital Trust to use principal exclusively for the surviving spouse. | | Also useful to protect the estate from a subsequent remarriage. |  |   **OTHER CONSIDERATIONS.**  The surviving spouse may have a limited power of appointment. In this regard, it is most typical to give the spouse a testamentary power to appoint the assets among the children. This is particularly useful when there are minor children involved. This way, as they grow and mature, the surviving spouse can make adjustments on the basis of need, merit, or to adjust for assistance they previously received. In some circumstances, such testamentary power might provide assurance that the surviving spouse would not be neglected by adult children due to their fear of being disinherited if they did so. |

## What if the Surviving Spouse is not a U.S. Citizen?

Thus far, we have assumed that the surviving spouse is a U.S. citizen. That is a big assumption because there is no marital deduction for gifts to a non-citizen spouse. However, the annual amount that can be transferred to a non-citizen spouse without gift taxes is $148,000 in 2016. This amount is indexed for inflation, and may change from year to year. So, while this makes it possible to make lifetime transfers, there is no unlimited marital deduction that can be used to fund a Marital Trust. This limit exists to prevent the surviving spouse from inheriting everything and then transferring the money out of the country and away from taxation.

For a surviving spouse who is not a U.S. citizen, the most popular solution is a Qualified Domestic Trust (QDOT). Essentially, a QDOT accomplishes four things.

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| 1. **It defers taxation on assets until the non-citizen surviving spouse dies.** |
| Unlike the Marital Trusts previously discussed, it does not transfer assets to the non-citizen spouse's estate. Thus the assets remain part of the deceased spouse's estate, and will be taxed accordingly upon the surviving non-citizen spouse's death. |
| 1. **It pays income to the surviving spouse.** |
| Since the income was not part of the deceased spouse's estate, there is no estate tax imposed upon income distributions. |
| 1. **It allows for discretionary distributions of principal.** |
| Unless distributions of principal are for hardship situations, estate taxes must be withheld and paid on any principal distributions during the surviving spouse's lifetime.  If hardship is involved, and there are no other funds readily available to the surviving spouse, then no tax is imposed. Hardship distributions must be for the health, maintenance, education or support for the surviving spouse or for someone the surviving spouse is legally obligated to support, such as a son or daughter who is a minor. |
| 1. **It prevents the surviving spouse from removing the funds from the country and thereby avoiding estate taxes.** |
| Obviously, not transferring assets to the surviving spouse's estate and taxing non-hardship distributions to the spouse goes a long way toward preventing this. But in addition, two other steps were taken to protect against the possible loss of tax revenue:  **A. One of the trustees must be a U.S. citizen or U.S. corporation.** This is the trustee who must make all decisions regarding distribution of principal and who has the power to withhold estate taxes on the distribution. In fact, this trustee is personally liable for the tax.  **B. If the U.S. trustee is not a U.S. bank, then the trustee may be required to furnish a bond or security to the IRS**. This is not required if the QDOT is $2 million or less, provided there is a clause in the trust that restricts investments in foreign real property to no more than 35% of the FMV of the trust, as determined annually. In all other situations, the non-bank U.S. trustee must furnish 65% of the FMV of the trust assets, as determined at the time of death. |

For more detailed information regarding the QDOT trust, proceed to the next page.

## Qualified Domestic Trust (QDOT) - Summary

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| **QDOT (Qualified Domestic Trust)**  **WHAT?**  An irrevocable trust used to defer payment of estate taxes through the lifetime of a surviving spouse who is not a U.S. citizen.  **WHEN?**  Used when the surviving spouse is not a U.S. citizen, which prevents funding of a Marital Trust through use of the unlimited marital deduction.  **HOW?**   * Executor must make the election on the estate tax return. * The terms of the trust must be such that the transfer of assets would meet the same deductibility requirements that would be required with a domestic spouse. For example, the terms would be such that it would meet the requirements of a Marital Trust except for the fact that the surviving spouse is not a U.S. citizen. * The surviving spouse receives the income, but principal distributions must be at the discretion of a trustee who is a U.S. citizen or U.S. corporation with the power to withhold taxes on distributions of principal. In fact, the U.S. trustee is individually liable for the tax. * Estate taxes must be withheld and paid on all distributions of principal that occur, provided they are not for hardship situations where there is no other readily available source of funds. Hardship distributions must be for the health, maintenance, education or support for the surviving spouse or for someone the surviving spouse is legally obligated to support, such as a son or daughter who is a minor. * Estate taxes will be due on the assets of the trust upon the death of the surviving non-citizen spouse. * If the U.S. trustee is not a U.S. bank, the IRS may require a security arrangement. This is not required for QDOTs of $2 million or less, provided the trust prohibits investments in foreign real property from exceeding 35% of the FMV of the portfolio, as determined annually. But in all other situations, the non-bank U.S. trustee must furnish a bond or security to the IRS in the amount of 65% of the FMV of the trust assets, as determined at the time of death of the decedent.  |  |  | | --- | --- | | WHY? | WHY NOT? | | To defer payment of taxes on the estate. | If the non-citizen surviving spouse lived in the U.S. at all times after the death of the decedent and desires to become a U.S. citizen, it may be preferable to change citizenship prior to the filing of the estate tax return. In that case, the normal marital deduction applies. | | To provide income for the surviving spouse. | Not to be used if it is preferable to pay the tax and give the surviving spouse unrestricted access to the funds. | | To provide for discretionary distributions of principal. |  | | From the government's perspective, to protect against assets leaving the country without paying the estate tax. |  |   **OTHER CONSIDERATIONS:**   * Estate and Gift tax treaties may exist between the U.S. and certain other countries, e.g., Canada, that may provide more flexibility than the QDOT. * If a QDOT was not provided for by the decedent or the terms of a trust to provide for the life of the surviving spouse do not meet its requirements, a QDOT can be established or revisions can be made to the trust prior to filing the estate tax return to remedy the situation. * The surviving spouse can be the sole trustee for all decisions other than distributions of principal, for which there must be a U.S. trustee. * Annual gifts of up to $148,000 (in 2016) to a spouse who is not a U.S. citizen are excluded from transfer taxes. This provides an excellent opportunity to make lifetime transfers free of taxes. * The laws of some countries may prohibit the creation of trusts. In those cases, the IRS will generally accept legal arrangements that have substantially the same effect as a trust. |

## Review Exercise

Before proceeding, check your familiarity with some of the most frequently used planning techniques, some of which have been utilized for decades. **For each question, select the appropriate answer.**

1. For Credit Shelter Trusts to be an effective strategy in estate planning for couples, it is generally important that:

* Assets should be held in joint name with right of survivorship.

Incorrect. Try again.

* Each spouse needs to own assets in their own name (typically equalized up to the amount that can be protected by each spouse’s Applicable Credit Amount)

Correct! The trust cannot be funded if the decedant does not own assets in their own name.

* All assets be left to the surviving spouse when the first spouse dies.

Incorrect. A Credit Shelter Trust will be established upon the first death with assets that do not pass to the surviving spouse. Try again.

1. A Credit Shelter Trust can provide benefits for:

* The spouse only

Incorrect. Try again.

* The children only

Incorrect. Try again.

* The entire family (spouse and children)

Correct! The Credit Shelter Trust is unrestricted regarding the beneficiaries who can be named in it.

1. A General Power of Appointment Trust will be included in the surviving spouse’s estate, thereby qualifying for the unlimited marital deduction, because:

* The trust document declares that assets are to be included.

Incorrect. Try again.

* The surviving spouse can appoint (i.e., distribute) the assets to whomever desired, even to himself/herself

Correct! This is essentially unrestrained control over the assets by the beneficiary. Such control causes the assets to be included in the beneficary’s estate.

* Because the trust assets are titled in the name of the surviving spouse

Incorrect. Trust assets are never titled in the beneficiary’s name. Try again.

* Because the surving spouse receives benefits from the trust.

Incorrect. Receipt of benefits from a trust is insufficient reason for the trust assets to be included in the beneficiary’s estate. Try again.

1. The primary distinguishing characteristic of the QTIP Marital Trust vs. a non-QTIP Marital Trust is:

* It gives the first spouse to die the ability to name ultimate beneficiaries, while utilizing the marital deduction.

Correct! The distinguishing feature is that the trust can defer taxes by use of the marital deduction even though the deceased spouse retains "power from the grave" to direct the ultimate distribution of the assets.

* It provides additional estate tax savings.

Incorrect. It provides no more tax savings than a General Power of Appointment Marital Trust; both allow for deferral of estate taxes. Try again

* It provides income for the surviving spouse.

Incorrect. While it does provide income for the surviving spouse, so does a General Power of Appointment Marital Trust. Try again.

* It provides income for the children.

Incorrect. A QTIP Marital trust cannot provide income for the children. Try again.

* It provides discretionary principal distributions for the entire family.

Incorrect. Only the surviving spouse can receive principal distributions from a QTIP Marital Trust. Try again.

1. QTIP stands for:

* Qualified Transitional Interest Property

Incorrect. Try again.

* Qualified Terminal Interest Property

Correct!

* Qualified Trust Income Property

Incorrect. Try again.

* Qualified Taxable Income Property

Incorrect. Try again.

## When NOT to Rely on Portability

Certainly, things have become simpler since 2011 when portability of the DSUE was introduced. This in no way negates the use of the Credit Shelter Trust or Marital Trust in today’s environment. In fact, there are situations when they are still preferred to relying solely on portability of the DSUE. The following is a list of some common situations where one should not overly rely upon portability. **Click each situation to learn more.**

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| **Second Marriages Involving Children of a Prior Marriage** |
| When this is the case, it will typically be desirable to create a Credit Shelter Trust or an A-B Trust arrangement where a Credit Shelter Trust is coupled with a QTIP Marital Trust. In this manner, all the assets can be available to support the surviving spouse, but each spouse will be able to ultimately preserve their own assets for children of a prior marriage. |
| **States with an Estate Tax and No Portability** |
| Many states have an estate or inheritance tax. They generally provide a credit against the tax, similar to the Federal Applicable Credit Amount, but the size of the credit is typically much smaller (e.g., protecting $1 million) and states have been slow to adopt the concept of portability of the credit between spouses.  For situations where there is a state tax but no portability of the state tax credit, a Credit Shelter Trust should be considered. This trust would be funded up to the limit that can be protected by the state credit. Part of the Federal Applicable Credit/Exclusion Amount would also be applied to the Credit Shelter Trust, thereby protecting the trust from both state and federal taxes. The balance of the DSUE can then be “ported” over to the surviving spouse or placed in a marital trust for the surviving spouse’s benefit. |
| **Accomplishing Personal Goals** |
| There may be times when it is desirable to fund trusts at death to support personal goals, such as the care of a handicapped child or the establishment of a trust for grandchildren. In such situations, it may be preferred to use the Applicable Credit/Exclusion Amount (either in total or in part) to protect these trusts from transfer taxation, allowing the balance to be deferred through the unlimited marital deduction. |
| **A Non-Citizen Spouse** |
| While it is beyond the scope of this course, portability is not available when the surviving spouse is not a U.S. citizen. In this situation, special planning is needed. |

## Why Should Older Estate Plans be Reviewed to Consider Utilizing Portability?

On the previous page, we discussed the fact that there is still a role to be played by Credit Shelter Trusts and Marital Trusts. That is not to say, however, that all pre-2011 plans that made use of these techniques are still optimal now that we have the option of utilizing portability of the DSUE. These older plans should be reviewed for a number of reasons to make sure they are still optimally meeting client goals. **Click each reason to learn more.**

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| **Freedom in Planning** |
| In past years, planning to minimize taxes often led to estate plans that were a compromise between what the client might prefer and what a client felt he/she needed to do to save on taxes. With the elevated Applicable Exclusion Amount, clients should re-examine their estate plans to see if they might want to do things differently in a world where estate taxes are not as much of a concern.  For example, a client who previously established an Irrevocable Life Insurance Trust to provide liquidity for estate taxes may no longer have a taxable estate. In that case, the Life Insurance Trust should be reviewed to see what options are available under the terms of the trust. |
| **Potentially Adverse Effect of Credit Shelter Trusts** |
| Many clients have pre-existing estate plans that will fund a Credit Shelter Trust upon death. Many of these were set up primarily for tax reasons and should be reviewed to make sure the plan continues to meet the goals of the client AND to make sure there are no unanticipated or adverse consequences of leaving them in place.  One potential problem is the funding formulas that were commonly used to fund the Credit Shelter Trust. These formulas typically instructed the executor to fund the Credit Shelter Trust with the maximum amount that could be protected by the Federal Estate Tax Credit. If, for example, the estate plan had been put together in 1997, Credit Shelter Trust funding for deaths in that year would have been $600,000. In 2016, it could be as much as $5,450,000. A client adopting an estate plan in 1997 would never have anticipated that the Credit Shelter Trust could be funded with so large an amount. This could result in an unanticipated and undesirable shift in allocation of funds going to various beneficiaries.  For example, the client may have felt comfortable at the time with a portion of the estate going into the Credit Shelter Trust to minimize taxes, knowing that the largest share would go to the surviving spouse. However, in 2016, if the estate is under $5,450,000, the entire estate will go to the Credit Shelter Trust and none to the surviving spouse. This may no longer represent the client’s preferences.  Another potential problem with leaving a Credit Shelter Trust in place in an older estate plan is that the assets of a Credit Shelter Trust will not get a step-up in tax basis upon the second spouse’s death. With portability of the Applicable Exclusion Amount, some clients may prefer to not utilize a Credit Shelter Trust and instead have everything included in the surviving spouse’s estate to receive the step-up in tax basis on the combined estate upon the second death.  For reasons such as these, clients would do well to review their existing estate plans with an estate planning attorney to see if changes need to be made in light of the new rules. |
| **Enhanced Gifting Opportunities** |
| For clients who have taxable estates, lifetime gifting continues to be an excellent means for reducing the size of the taxable estate and for keeping future appreciation out of the estate.  Given that the Generation-Skipping Transfer (GST) Tax Exemption has also risen to $5,450,000 in 2016, it may be especially attractive to set up trusts for grandchildren. In this regard, it is important to note that there is no portability of the Generation-Skipping Transfer Tax Exemption. If the desire is to use both spouse’s exemption for this purpose, it will be important to make plans for utilization of the exemption in each spouse’s estate, since the surviving spouse cannot inherit the GST exemption from the deceased spouse. |
| **Disparity Between Federal and State Taxes** |
| While we now have a federal estate tax exclusion of $5,450,000 in 2016, many states have a much smaller exclusion amount, e.g. $1,000,000. Thus, state transfer taxes have received renewed attention and clients may need to pursue planning strategies with their estate planning attorneys to minimize those taxes. These plans might still make use of the Credit Shelter Trust, which might have to be balanced against the potential cost of not receiving a step-up in basis on the trust assets upon the second spouse’s death. |
| **Asset Protection Trusts** |
| While testamentary trusts may no longer be needed for minimization of estate taxes, they might nonetheless continue to be useful vehicles for asset protection, e.g., to protect the assets from the creditors of a surviving spouse. This might be a good reason, for example, for leaving a previous estate plan that funds a Credit Shelter Trust in place. |

Given the amount of change that has taken place in recent years, clients should be encouraged to review their estate plans with their estate planning attorney. The good news in all of this is that they will have more freedom to make plans that best suit their personal goals than they have ever had before.

## Tax Minimization for Very Large Estates

Thus far, we have only discussed estate tax planning for assets that are covered by the Applicable Credit/Exclusion Amount (combined amounts for spouses). What about very large estates that exceed these amounts? These are estates that are large enough to actually owe an estate tax, even after full use of the Applicable Credit/Exclusion Amount(s). Is there any planning that can be done to reduce that tax exposure?

Actually, there is a great deal that can be done because the tax code provides numerous other resources we can leverage, such as the annual gift tax exclusion and the ability to make non-taxable transfers to charities.

On the following pages, we will discuss some of these strategies, all of which aim at reducing the amount of assets that will be included in in the estate upon death. In particular, we shall discuss:

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| 1. Lifetime Gifting 2. Charitable Trusts 3. Grantor Retained Trusts 4. Irrevocable Life Insurance Trusts |

This list is certainly not exhaustive, but should give you a general understanding of the types of techniques that are available for reducing the tax exposure of very large estates.

## Lifetime Gifting

One of the simplest and most personally rewarding strategies for reducing estate tax exposure is to make lifetime gifts. **Click each type of gift to learn more.**

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| **Annual Exclusion Gifts** |
| For 2016, the annual gift tax exclusion amount is $14,000. Thus, the first $14,000 gifted to any person is covered by this exclusion amount. Spouses can do “split” gifts, doubling the amount to $28,000. What is more, there is an equivalent exclusion available for the Generation-Skipping Transfer (GST) Tax, making it possible to make annual exclusion gifts to grandchildren (or other skip persons).  For example, a couple with three children and 7 grandchildren could gift $280,000, free of transfer taxes. Do that for a number of years, and a client can significantly cut into a large estate’s tax liability. |
| **Medical and Tuition Expenses** |
| Further reductions in the size of the taxable estate can be made by paying medical and tuition expenses on behalf of others. These payments must be made directly to the provider.  These gifts are totally independent of annual exclusion gifts. Both an annual exclusion gift AND a tuition payment AND/OR medical payment can be made for the same person, and none of them are taxable gifts. |
| **529 Plans** |
| 529 Savings Plans are excellent vehicles for saving for a child’s education. Not only does a 529 Plan qualify for annual exclusion gifts on behalf of the child or grandchild, but it also allows for accelerated gifting. Up to 5 years worth of annual exclusion gifts can be contributed at one time as a lump sum without triggering a Gift or GST Tax. One caveat to making this election is if total contributions to each beneficiary exceeds five times the annual gift tax exclusion, the excess amount is treated as a taxable gift in the year of contribution. |
| **Charitable Gifts** |
| Direct gifts to charities are also an excellent means of reducing the size of the taxable estate, as these gifts are not subject to transfer taxes. |

## Rules of Thumb for Gifting Programs

Here are some considerations to keep in mind regarding gifting strategies:

1. Consider making lifetime gifts where estate tax exposure exists in the future, but in most cases payment of a gift tax is to be avoided

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| **Illustration**  Lifetime gifts are a valid consideration as long as there is potential estate tax exposure. The potential donor certainly needs to weigh the cost associated with no longer having control of the funds against the potential estate tax exposure. But where such exposure exists, making tax-free gifts through use of the annual gift tax exclusion, gifts for tuition and medical care, and gifts to charities can result in significant estate tax savings.  For sizeable estates, where the donor can safely part with the money, consideration can also be given to gifts in excess of the annual gift tax exclusion, so long as the cumulative amount does not exceed Applicable Exclusion Amount of $5,450,000 (in 2016). Gifts in excess of the gift tax Applicable Exclusion Amount are generally not advisable, as they will result in payment of a transfer tax that could be deferred if the excess was retained in the estate. |

1. When making gifts to reduce the size of the estate, property with high likelihood of future appreciation should generally be gifted first

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| **Illustration**  Assume that a client owned real estate that is located in a rapidly developing area of town. The property is currently valued at $700,000, but is expected to double in value over the next 5 years. By transferring that property as soon as possible to his children, he could effectively keep the future appreciation out of his estate. He could use a combination of his annual Gift Tax Exclusion (claiming one annual gift tax exclusion per child) and his Applicable Exclusion Amount to avoid paying taxes on the gift. |

1. When gifting to family and friends, generally avoid gifting low-basis securities

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| **Illustration**  This time, assume a client holds stocks with a market value of $500,000 and a basis of $25,000. The client’s remaining securities have had negligible appreciation.  If the client transfers these low-basis stocks during life, the client must value the transfers at their current market price for gift tax purposes; but the client will also be transferring their low basis. When the children go to sell the stocks, they will have to pay the capital gains tax.  If the client has no plans to sell the stocks during life, then the client would be better off holding them until death, when the estate receives a step-up in tax basis. By doing so, approximately $100,000 in capital gains taxes could be avoided. |

1. When gifting to charities, it is generally preferable to give low-basis securities

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| **Illustration**  With charities, first consideration should be given to highly appreciated securities, i.e., low-basis securities.  For example, suppose a client decided to make a lifetime charitable gift of $50,000 to a church, using $50,000 of stocks with a tax basis of $5,000. The gift would be valued at $50,000, for which the client could potentially take a deduction on the income tax return. The charity would receive the $50,000 of stocks, with its basis of $5,000, but could sell the stocks without having to pay capital gains taxes since it is a charity.  This is truly a win-win scenario. The client makes the gift, gets the deduction on income taxes on the full value of the asset, and avoids the capital gains tax; the charity is then free to sell the asset and receives the full value of the gift with no capital gains tax. |

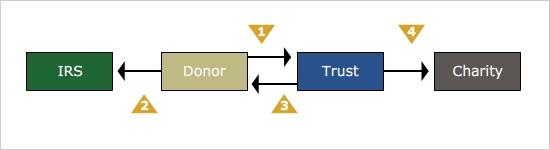
## Charitable Remainder Trusts

If a person has charitable intent, then that person can also make charitable gifts. These gifts are not subject to gift taxes and, obviously, they reduce the size of the donor’s estate.

While gifts can be made directly to the charity, it is also possible to establish and fund a Charitable Trust, with a charity as the beneficiary. This can be created in either of two primary forms: a Charitable Remainder Trust (CRT) or a Charitable Lead Trusts (CLT). These can provide significant benefits beyond making direct gifts to charities, and we will discuss each in turn.

The ***Charitable Remainder Trust*** ***(CRT)*** provides current income to the creator of the trust, the grantor, and future benefit to the charitable beneficiary. Here is how a charitable remainder trust works, based on sample trusts that have been issued by the IRS to guide attorneys in drafting charitable remainder trusts that will qualify for the income tax charitable deduction. These trusts are characterized by the following:

1. The trust can provide income for one or more beneficiaries. Generally, only the grantor or the grantor and his/her spouse are named as the income beneficiaries, so as to avoid transfer tax issues associated with naming anyone else.
2. The trust can be written to terminate upon the death of the income beneficiary or upon their combined deaths if more than one. Alternatively, the trust can be written to terminate at the end of a specific number of years, not to exceed 20 years.
3. Income distributions to the beneficiary(ies) can begin immediately or may be deferred to begin at a future date.
4. The trust may be drafted so that the charitable beneficiary designation can be changed without losing the tax advantages of the trust, as long as the change is to another qualified charity.
5. The annual payout to the income beneficiary(ies) cannot be less than 5% or more than 50% of the value of the trust. **Click each to learn more.**



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| 1 - The donor can fund the trust with any type of asset, but it is generally advisable to not use property that has declined in value from its purchase price, as such assets will be valued at their current market value and the possibility of using the loss to offset income taxes will be lost. Generally speaking, appreciated property should be given first priority. This is because no capital gain taxes are payable when the property is donated. If the trust later sells the asset, again there are no capital gain taxes. Only if the capital gain gets paid out to the income beneficiary would the beneficiary be subject to the tax. As long as there is sufficient ordinary income to cover the payout requirements, the capital gains generated in the trust will remain in the trust until final distribution to the charity. This will provide the advantage of making the contribution at FMV without having to pay taxes on the gain.  Note that the deductible value of the contributed property must be at least 10% of its value; anything less will prevent the trust from qualifying as a charitable remainder trust. |

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| 2 - The donor gets an immediate federal income tax deduction. The tables that are used to calculate the amount that may be deducted will take into account the number of years before termination and distributions to the donor. If the trust is for the lifetime of the income beneficiary(ies), the tables will also take into consideration life expectancy. |

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| 3 - Income distributions are generally taxed in the year they are paid out. The income calculation can be structured as an annuity, based on the initial valuation of the trust (a Charitable Remainder Annuity Trust or CRAT) or the calculation can be computed annually based on the market value in each successive year (a Charitable Remainder Unitrust or CRUT). |

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| 4 - Upon termination, the charity receives the corpus of the trust. This amount may be more or less than was originally contributed, depending upon investment performance and the degree to which income was allowed to accumulate and principal was not encroached to make required payments to the income beneficiary. |

## Using a Charitable Remainder Trust

Obviously there must be charitable intent for charitable remainder trusts to be considered. But where that is the case, they take some of the risk out of making lifetime gifts for persons who are concerned about loss of income. In fact, they can be particularly advantageous in certain circumstances.

Highly Appreciated or Low Income Producing Property

The greatest benefit to utilizing a Charitable Remainder Trust is when you are dealing with highly appreciated long-term capital gain property and/or property that provides a very low income. Both of these factors are illustrated in the following scenario.

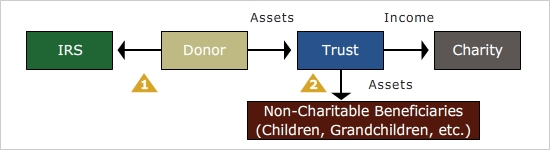
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| **Mrs. Thurmond’s Story**  Mrs. Thurmond was given 100 shares of ABC Company on her 18th birthday. That was 60 years ago! Affected by the Great Depression, this is the only stock she has ever owned. It has split eight times since she received it, now giving her 25,600 shares with a market value of approximately $1,000,000. Her basis is only pennies per share.  Her estate is worth $8 million, some of which is land that she plans to pass on to her children. And her current income is $200,000 per year, of which ABC stock provides $20,000. Her arthritis is requiring her to have some live-in assistance, and she needs to generate an additional $50,000 of income to cover all expenses. She would not be opposed to selling the ABC stock, but does not want to pay the tax bill that will be generated by the realized capital gain on the sale.  Her will states her intent to give a substantial portion of her estate to charity, but she has been rather hesitant to give much during her lifetime out of fear of not having enough to meet her needs.\*  DocumentationIcon_32px**Click the icon to view the solution.**  *\*This scenario is fictitious and purely for purposes of illustration.* |
| **Solution**  Mrs. Thurmond creates a Charitable Remainder Annuity Trust with a 7% payout. The trust can then sell the security, diversify the portfolio, and distribute $70,000 per year to her. Mrs. Thurmond now has the income she needs. No capital gains tax will be generated by the transfer, although over time the gains may be distributed back to her as they are needed to supplement the accumulated investment income in order to meet the required payout, but at least they will be deferred. She may expect to also pay far less income taxes in the current year due to the charitable deduction. More important, she has met both her income need and fulfilled her charitable intent. |

## Charitable Lead Trust

The ***Charitable Lead Trust*** ***(CLT)*** operates somewhat like a Charitable Remainder Trust, only in reverse. With a Charitable Lead Trust, the charity enjoys the income from the property for a period of time, and the trust distributes the property to the beneficiary(ies) when the trust terminates.

The following features are found in the trust document of a charitable lead trust:

1. Similar to a Charitable Remainder Trust, a Charitable Lead Trust may be structured to pay income either as a ***Charitable Lead Annuity Trust (CLAT)*** or ***Charitable Lead Unitrust (CLUT).*** However, they are typically structured as annuity trusts to keep the valuation simple.
2. The trust may last for the lifetime of the donor or another individual named by the donor, or for a specific number of years. Unlike a CRT, there is no limit to 20 years if a specific number of years is chosen.
3. For the donor to receive an immediate income tax deduction for making the gift, the charity's interest must be guaranteed by the document and the donor must be taxed on the income generated by the trust. If these conditions are met, the donor receives an immediate income tax deduction for the present value of the future income stream that will go to the charity; then, each year, the donor will be taxed on the trust income with no offsetting charitable deduction.
4. Unlike a CRT, no minimum payout is required. **Click each numbered bullet to learn more.**



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| 1 - A taxable gift may be involved in assigning the remainder interest of the trust assets. For gift tax purposes, the value of the remainder interest will be determined by subtracting the present value of the income stream to the charity from the market value of the assets when placed in the trust. Thus, by giving the charity years of income, the value of the transfer to the remainder beneficiaries can be greatly reduced. |

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| 2 - Upon the termination of the trust, the remainder beneficiaries receive assets from the trust. Since any transfer taxes were taken into consideration when the trust was funded, this final transfer takes place with no additional gift or estate taxes. This is quite significant, indicating that any appreciation in the market value of the assets within the trust will transfer to the beneficiary(ies) free of gift or estate taxes. The same is true of any accumulated income that was not needed to make the required payments to the charity. |

The Charitable Lead Trust is an excellent way to support charities while making discounted, deferred transfers to heirs. For example, with federal tax table rates at 5.4%, a 10-year CLAT, paying 7% annually (as valued when the trust was funded) to a charity, offers a 54% discount from market value on the assets that will go to the remainder beneficiaries. If the trust lasts for 15 years, the discount increases to 72%. Increase the trust to 20 years, and the discount rises to 86%. These discounts can result in substantial estate and gift tax savings for high net worth clients whose estate values are significantly above the amount that can be covered by their Applicable Credit/Exclusion Amount and where leverage is needed to maximize reductions in the size of their taxable estates with minimum use of their Applicable Credit Amount on lifetime transfers.

## Grantor Retained Trusts

Like the Charitable Lead Trust strategy, a ***Grantor Retained Trust (GRT)*** is essentially a technique for transferring a future interest to the remainder beneficiary(ies). The asset is placed in an irrevocable trust for a period of time, during which time the grantor enjoys income from the trust or enjoys the use of the asset. When the trust terminates, the asset is transferred to the remainder beneficiaries, such as the grantor's children.

Because the gift to the trust is irrevocable, it is a considered a completed transfer and potentially subject to gift taxes. However, because the remainder beneficiaries do not receive the gift until a passage of time, the gift to them is discounted to a present value. It is this vastly reduced present value that is used for computing the gift tax.

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| Overview | To learn more about these strategies, **click each heading on the left.**  Note: Numerous rules are associated with the structure of these instruments. It is advisable that the client's estate planning attorney be involved in helping make a determination as to their appropriateness. |
| Grantor Retained Income Trust (GRIT) | The grantor continues to receive the income from the contributed assets for the duration of the trust. |
| Grantor Retained Annuity Trust (GRAT) | The grantor receives a fixed annuity from the trust until its termination. |
| Grantor Retained Unitrust (GRUT) | The grantor receives a fixed percentage that is annually applied to the market value of the trust until its termination. |
| Qualified Personal Residence Trust (QPRT) | The grantor transfers a residence, which the grantor continues to use until the termination of the trust. This is essentially a GRIT, but the income is replaced with use of the property. |

## The Irrevocable Life Insurance Trust

Finally, the last strategy we shall discuss for reducing the size of a taxable estate is the deployment of an ***Irrevocable Life Insurance Trust.*** Thisis an irrevocable trust with language that makes it possible for the trustee to buy and hold life insurance. The trust is named the owner and beneficiary of life insurance for purposes of keeping life insurance outside of the grantor's estate. Alternatively, such trusts are often referred to as ***Wealth Replacement Trusts*** or ***Asset Replacement Trusts*** because they are used to replace some of the wealth or assets that are eroded by estate taxes or charitable transfers.

### How it works

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| **Overview** | The process of establishing, funding, and administering an Irrevocable Life Insurance Trust is as follows: **Click each step to learn more.** |
| **1 – Create the trust and transfer or purchase the policy.** | The grantor creates an irrevocable trust, typically naming family members as the trust beneficiaries. Next, the grantor either transfers a life insurance policy(ies) or contributes funds that may be used to purchase life insurance. The trust is named as the owner and beneficiary of the insurance policy. So long as the grantor avoids all incidents of ownership, e.g., is not named as the trustee, has no power to direct the trustee, and has no beneficial interest in the trust, then the insurance policy will not be included in the grantor's estate upon the grantor's death.  **Be aware of the “three-year rule.”** If the policy is transferred by the grantor, the grantor must live three years after the transfer to avoid the three-year rule, which will return the policy back to the grantor's estate if the transfer is made within three years of death. Furthermore, there may be gift tax implications with transferring an existing policy. For these reasons, as long as the grantor is currently insurable, it is generally preferable to have the trust purchase a new policy with contributed cash. |
| **2 – Make contributions contributions to pay the premiums.** | Typically, the sole asset of the trust is the insurance policy. Therefore, the grantor needs to make periodic contributions to the trust, thereby providing the trust with the funds to pay the premiums.  This presents a potential problem because the beneficiaris of the trust receive no benefits until the grantor dies; in other words, they have a “future interest.” Only gifts of a “present interest,” meaning they must have the right to presently use and enjoy the funds, will qualify for the annual gift tax exclusion.  Unless we can find a way to give the benefiaries a “present interest” in the contributed funds, the contributions will be taxable gifts, requiring the grantor to file a gift tax return and use up part of the Applicable Credit Amount. In the next step, we show how we give them a “present” interest, thereby making the contributions annual exclusion gifts and therefore nontaxable. |
| **3 – Send Crummey letters to the trust beneficiaries after each contribution.** | To qualify the contributions for the annual gift tax exclusion, a **"Crummey Power"** is provided to the beneficiaries in the trust document, which gives them a “present interest” for a limited time (typically 30 days) following each contribution, during which the beneficiaries may remove the funds for their own use. Note, the term “Crummey” comes from the last name of the person whom the IRS took to court seeking to outlaw this procedure; the IRS lost the case and the court ruling set the precedent for utilizing this technique.  Therefore, upon receipt of the contributed funds, the trustee writes "***Crummey Letters***" to the beneficiaries, notifying them of the contribution and their temporary right to remove their portion of the contribution. Provided they do not remove the funds, their current interest lapses at the end of the time period, and the Trustee can use the funds to pay the premiums.  **Note:** To qualify the entire contribution as one or more annual exclusion gifts, you need to have sufficient beneficiaries named in the trust to fully cover the amount of the contribution. In other words, the number of beneficiaries multiplied by the amount of the current annual gift tax exclusion amount must total greater than the amount being contributed. |
| **4 – Trust received death benefits when grantor dies.** | Upon the death of the grantor, the trust receives the insurance proceeds and the trustee will administer or distribute the funds as directed by the terms of the trust. |

## Review Exercise

**Answer the following questions by choosing the correct answer.**

1. The deductible value of property contributed to a CRT must be at least \_\_\_\_% for the trust to qualify:

* 5%

Incorrect.

* 10%

Correct.

* 20%

Incorrect.

* 30%

Incorrect.

* 60%

Incorrect.

1. A CRT can terminate upon the death of one or more people, or it can be set up to exist for a specific number of years up to:

* 5 years

Incorrect.

* 10 years

Incorrect.

* 15 years

Incorrect.

* 20 years

Correct.

* 30 years

Incorrect.

1. The annual payout of a charitable remainder trust to the income beneficiaries cannot be less than 5% or more than \_\_\_\_\_.

* 10%

Incorrect.

* 15%

Incorrect.

* 20%

Incorrect.

* 25%

Incorrect.

* 50%

Correct.

1. The duration of a Charitable Lead Trust is either the lifetime of the donor or another individual named by the donor, or for a specific number of years up to:

* 10 years

Incorrect.

* 15 years

Incorrect.

* 20 years

Incorrect.

* Any number of years

Correct.

1. The minimum payout requirement of a Charitable Lead Trust is:

* 3%

Incorrect.

* 5%

Incorrect.

* 10%

Incorrect.

* 15%

Incorrect.

* Nonexistent (there is no minimum)

Correct.

1. The simplest way to keep life insurance out of your estate is to:

* Not own it

Correct!

* Not be named as a beneficiary

Incorrect.

* Not be able to name a beneficiary

Incorrect.

* Not be able to borrow against the policy

Incorrect.

1. The three-year rule states that insurance must be transferred within three years of purchase if it is to be excluded from the owner's estate.

* True

Incorrect. The three-year rule has nothing to do with when a policy was purchased. Rather, it is relative to when the policy was transferred to another owner.

* False

Correct. The three-year rule has nothing to do with when a policy was purchased. Rather, it is relative to when the policy was transferred to another owner.

1. For contributions to an ILIT to qualify for the annual gift tax exclusion, the trust must be a:

* Pour Over Trust

Incorrect.

* Power of Attorney Trust

Incorrect.

* Crummey Trust

Correct!

## Conclusion

This concludes the material for this subject. At this time, you may return to any sections in which you feel the need for further study. As you do so, keep in mind that your role as a financial advisor is not to give estate planning advice. Rather, your role is to gather information from clients regarding their financial assets, personal concerns, and personal goals. From this information, you can draw upon your knowledge, or work with other professionals on your team, to identify potential client needs. You can then assist your client in addressing those needs with estate planning professionals.

In other words, your primary role in the area of estate planning is to ask questions and to listen. What questions? As you go back through this material, you will recognize many areas where clients might have potential needs or where there may strategies to help them achieve their goals. As you encounter these areas, ask yourself, "What questions will I ask to surface whether or not this need exists?" Over time, you will develop your own list, but to help you get started, here are some initial areas to explore:

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| **Key Areas of Inquiry**   * **Family information** – Who are the family members? What are their ages? What concerns are associated with them? * **Legacy goals** – What do clients want to have happen with their wealth after they have died? * **Current estate plan** - What estate planning have they already done? How does it help accomplish their goals? * **Health status** - Are there concerns about maintaining independence or control in case of incapacity? Are there concerns about an untimely death or a child/grandchild with special needs? * **Assets** - What are the assets of both spouses and how are they titled? Are there any beneficiary designations? * **Life insurance** - What life insurance does the client or spouse own? Is the client currently insurable? * **Lifetime gifts** - Has the client been making lifetime gifts? Is the client open to making lifetime gifts if there is need to reduce estate tax exposure? * **Philanthropic interests** - Does the client have a desire to give to charity? Have any plans to do so? |