Insight on **estate planning**

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Qualified disclaimers provide opportunity for postmortem planning

Estate planning fountain of youth?

Innovative technique may eliminate a GRAT's mortality risk

Special rules for noncitizens limit estate planning options

PLUS!

Nothing is certain when it comes to state death taxes

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An offer you *can* refuse

Qualified disclaimers provide opportunity for postmortem planning

Once someone dies, most estate planning opportunities are lost. But there are a few postmortem planning strategies that give you a second chance to make tax-saving changes.

One of the most effective techniques is the qualified disclaimer, which a beneficiary can use to refuse a bequest and allow the property to pass to someone else. Ordinarily such a move would be considered a taxable gift to the person who receives the property. But if you meet the requirements for a qualified disclaimer, you can accomplish your objective without negative tax consequences.

How disclaimers reduce estate taxes

Consider this example. Bill dies in 2004, leaving a $3 million estate. Bill's estate plan consists of a simple will that leaves everything to his wife, Sally — or, if Sally doesn't survive him, to their children.

Because all of Bill's assets pass to his wife, the unlimited marital deduction shelters his estate from federal estate taxes. But all of the assets will be included in Sally's taxable estate when she dies, which means Bill's federal estate tax exemption ($1.5 million in 2004) is wasted. If Sally dies in 2005 and the assets are still worth $3 million, her estate will be liable for more than $500,000 in estate taxes.

If Sally had disclaimed the right to receive half the assets, or $1.5 million, when Bill died, that amount would have passed tax-free to their children, making full use of Bill's estate tax exemption. Then when Sally died, the remaining $1.5 million would pass tax-free using her estate tax exemption. The bottom line: A qualified disclaimer would have saved more than half a million dollars in estate taxes.

How to qualify

Qualified disclaimers are subject to six strict requirements:

1. The disclaimer must be in writing.
2. The disclaimer must be irrevocable.
3. The disclaimer must be delivered to the transferor or the transferor's representative (for example, an executor or trustee) within nine months of the date of transfer (or, if later, the date the disclaimant reaches age 21).
4. The disclaimant must not have accepted any interest in the disclaimed property or enjoyed any of its benefits.
5. The disclaimant must not direct the disposition of the disclaimed property.
6. Except in the case of a surviving spouse, the disclaimed property must pass to a person *other* than the disclaimant.

The fifth requirement is particularly important. The disclaimant can't have any say over who receives the property. Once the disclaimer is made, the disposition of the property is controlled by the terms of a will or trust or by the laws of intestate succession.

Building flexibility into your estate plan

Qualified disclaimers can be used to correct deficiencies in an original estate plan, as in the example above. But they can also be used to build flexibility into your estate plan.

Many estate plans are designed to ensure that your estate tax exemption isn't wasted. A common technique is to provide for funds equal to the applicable exemption amount to be placed in a bypass trust, which provides benefits to your spouse and children, but is not included in your spouse's taxable estate. Your exemption shelters the funds from estate tax and, when your spouse dies, the trust assets can be distributed to your children tax-free.

In some cases, however, it may be advantageous to fund a bypass trust with *more* than the applicable exemption amount. This may be the case, for example, if equalizing a couple's estates would reduce their overall tax burden by taking advantage of lower marginal tax rates. To allow for this contingency, you might provide that any assets disclaimed by your spouse will go into the bypass trust. This allows your spouse to use qualified disclaimers to ensure that the bypass trust has the right amount of funding to minimize the impact of federal estate taxes.

Spell out who gets what

Remember that the disclaimant can't determine who receives disclaimed assets. Once a disclaimer is filed, the assets' disposition is controlled by the terms of your estate plan or by operation of law. By carefully specifying who will receive disclaimed property, you give your spouse or other heirs the ability to use qualified disclaimers to fine-tune your estate plan.

Estate planning fountain of youth?

Innovative technique may eliminate a GRAT's mortality risk

One of the most tax-efficient vehicles for transferring wealth to your family is a grantor retained annuity trust (GRAT). Plus it provides you, the grantor, with an income stream. But there's a major drawback to this estate planning strategy: If you don't survive the trust's term, the assets are included in your estate and taxed as if you had never created the trust.

Over the last few years, a number of estate planners have begun using an innovative new technique — the guaranteed GRAT — in an effort to eliminate this mortality risk. This strategy is designed to let your family take advantage of a GRAT's substantial tax benefits without worrying the benefits will be lost if you die unexpectedly.

Keep in mind, however, that guaranteed GRATs have not yet been accepted by the IRS or the courts. Before using this strategy, be sure to discuss the pros and cons with your estate planning advisor.

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GRAT basics

A GRAT is an irrevocable trust you fund with a one-time contribution of assets. The trust pays you an annuity for a specified number of years, and at the end of the term any remaining assets are transferred tax-free to your children or other beneficiaries.

The annuity can be a fixed percentage of the initial contribution's value or a fixed dollar amount. You also may design it with predetermined increases. You must report the annuity payments on your individual income tax return.

Gift tax savings

A GRAT's tax-saving power lies in its ability to minimize or eliminate gift tax. The present value of the heirs' remainder interest in the trust assets is subject to gift tax. That value is determined using the Section 7520 interest rate, published monthly by the IRS.

The annuity amount can be designed to minimize the value of the remainder interest — or even eliminate it altogether (a so-called "zero-out GRAT") — for gift tax purposes. Then any actual appreciation beyond the IRS's "assumed rate of return" passes to the heirs tax-free. (See "GRATs are great in a low interest rate environment" above for an illustration.)

GRATs are great in a low interest rate environment

Grantor retained annuity trusts (GRATs) can be especially attractive when interest rates are low. Let's take a closer look at an example that illustrates why.

Susan, age 60, transfers $2 million in assets to a five-year GRAT that provides for five annual annuity payments of $449,000 (22.45% of the value of the initial contribution). At the end of the term, the remaining assets pass to Susan's daughter, Caroline. Assume that the Section 7520 rate for the month the GRAT is established is 4%, and the actual rate of return on the assets is 10%.

Based on the assumptions, the gift tax value of the transfer is $65,484 even though nearly $500,000 is transferred to Caroline. The gift is potentially significantly less in light of a recent decision involving the Sam Walton family. It's still too early, though, to rely on that decision. Please contact your professional advisor to help you determine how this decision may affect your estate plan.

The key to reducing gift tax with a GRAT is to fund the trust with assets you expect to outperform the Sec. 7520 interest rate, such as real estate or securities with great appreciation potential. A GRAT also can be a viable strategy for transferring assets that are subject to valuation discounts, such as limited partnership interests or closely held business interests (especially if the company may be sold or go public in the future).

The guarantee

As discussed earlier, if you don't outlive its term, assets remaining in the trust will be included in your taxable estate. To avoid this downside, consider creating a guaranteed GRAT. How? First, you establish a GRAT and retain a contingent reversion interest, which means that if you don't survive the term, the remaining trust assets will be paid to your estate. Shortly after you form the GRAT, you and your children enter into an agreement for them to purchase the equivalent of your contingent reversion interest at fair market value. Because the purchase price is set at the time you draft the GRAT, it should be only a fraction of the value of the assets your children ultimately receive.

If you die before the end of the trust's term, the remaining assets are distributed to your estate, but under the purchase agreement, the estate is contractually obligated to pay an equal amount to your children. Even though the assets are included in your estate, the estate is entitled to an offsetting estate

tax deduction for the amount it's required to pay to the children. In effect, the children receive the remaining trust assets tax-free as if you had outlived the trust.

Exercising caution

Properly structured, this strategy lets your family take advantage of a GRAT's substantial tax benefits without worrying the benefits will be lost if you die unexpectedly. A guaranteed GRAT can give you peace of mind that your family will be able to take advantage of your GRAT's tax benefits if you die suddenly. But like any new estate planning technique, the guaranteed GRAT is relatively untested, so it's important to consider potential risks of an IRS challenge. And keep in mind that traditional GRATs also are subject to complex rules and regulations, so careful planning is necessary. ▮

Nothing is certain when it comes to state death taxes

The phaseout of the federal estate tax doesn't spell the demise of death taxes. A number of cash-strapped states whose estate or inheritance taxes are linked to the federal estate tax are "decoupling" from the federal tax in an effort to boost revenues.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually increases the federal estate tax exemption and lowers the top estate tax rate until the tax disappears completely in 2010 (only to return in 2011 absent new legislation). Before EGTRRA, estates received a dollar-for-dollar credit, up to 16% of federal estate tax liability, for estate or inheritance taxes they paid to a state. Rather than create a separate tax system, most states simply imposed death taxes in an amount equal to the federal credit. These were called "pick-up" taxes because the state would pick up the amount allocated as a credit under federal law.

As federal estate taxes decline, the benefit of a state pick-up tax system is gradually eliminated. What's more, to offset some lost tax revenue, EGTRRA reduced the amount of the state death tax credit by 25% in 2002, 50% in 2003, and 75% this year. In 2005, the credit is eliminated, replaced by an estate tax deduction for state death taxes actually paid. The deduction provides a modest benefit to the estate, but is of no assistance to the state taxing authority.

To offset lost revenues, many states with pick-up taxes have decoupled from the federal estate tax and established their own estate or inheritance taxes (or are considering doing so). Some states, however, are letting their death taxes die along with the federal estate tax.

What this means is that state tax considerations now play a much more prominent role in estate planning. If you live in a state that has established its own estate tax, you could conceivably owe more estate tax than you would have before EGTRRA.

Residency issues have also become more important. If you're thinking about retiring to a warmer climate, you'll need to consider the impact of state death taxes, which now vary considerably from state to state.

Many of the new state laws take effect next year, so it's a good idea to consult your estate planning advisor now to review your plan and discuss strategies for minimizing your tax burden. If you're thinking about relocating, or if you have homes in more than one state, be sure to discuss both the estate and income tax implications of shifting your residency.

Special rules for noncitizens limit estate planning options

If you or your spouse is not a U.S. citizen, it's essential that you inform your estate planning advisors and discuss the implications. The federal estate tax laws impose several onerous restrictions on noncitizens, so if citizenship is an option, now may be the time to take the plunge.

Marital deduction restricted

For most couples, the unlimited marital deduction is a key estate planning tool. It allows you to transfer any amount of property to your spouse, through lifetime gifts or bequests at death, free of gift and estate taxes. Eventually, these assets will be taxed as part of the recipient spouse's estate.

Even though you can preserve the marital deduction with a QDOT, noncitizen spouses are still at a big disadvantage.

Congress was concerned, however, that a noncitizen surviving spouse might leave the country with the assets and they would escape taxation altogether. To avoid this situation, it provided that when a surviving spouse is a noncitizen, the marital deduction is unavailable unless the assets are placed in a special trust called a Qualified Domestic Trust (QDOT). Assets the noncitizen spouse receives outright — including jointly owned property, life insurance proceeds and retirement benefits — are taxable immediately unless the noncitizen spouse creates his or her own QDOT to hold the assets.

QDOT has many rules

The purpose of a QDOT is to ensure that, when a citizen's estate escapes taxation by virtue of the marital deduction, the United States ultimately collects taxes on the noncitizen spouse's estate. To qualify, therefore, a trust must:

1. Have at least one trustee who is an individual U.S. citizen or a domestic corporation (for example, a bank or trust company),
2. Require the trustee to approve all principal distributions,
3. Be designated as a QDOT by an election on the citizen spouse's federal estate tax return, and
4. Retain enough property in the U.S. to cover any estate tax payable at the noncitizen spouse's death.

In addition, if the QDOT assets are worth more than $2 million, the U.S. Trustee must be a domestic bank or, alternatively, the individual U.S. Trustee must furnish the IRS with a bond or letter of credit in an amount equal to 65% of the QDOT's value.

QDOT provides limited benefits

Even though you can preserve the marital deduction with a QDOT, noncitizen spouses are still at a big disadvantage. Most couples' estate plans include a marital trust, which provides for the surviving spouse and is sheltered from tax in the decedent's estate by the unlimited marital deduction. A surviving spouse who's a citizen can receive distributions of both income and principal from a marital trust without negative tax consequences. He or she can even deplete the marital trust and avoid estate taxes on the assets by spending them or giving them away using the annual gift tax exclusion. When the surviving spouse dies, assets remaining

in the marital trust are taxed as part of his or her estate, but they can be sheltered from tax by the surviving spouse's estate tax exemption.

With a QDOT, it's a different story. Although a QDOT can distribute income tax-free, distributions of principal to the noncitizen spouse are subject to estate tax (except in cases of hardship, which is not clearly defined in the Internal Revenue Code or regulations). The amount of tax is the additional federal estate tax that would have been imposed on the citizen spouse's estate if it had been increased by the amount of the distribution. The noncitizen spouse can't avoid estate tax by spending the principal or giving it away.

In addition, when the noncitizen spouse dies, assets remaining in the QDOT will also be taxed as if they had been included in the citizen spouse's estate. That means the noncitizen spouse can't shelter the QDOT assets from estate tax using his or her estate tax exemption.

Sharing the wealth more difficult

A basic estate planning principle is that each spouse should have assets in his or her own name roughly equal to the federal estate tax exemption. The reason for this is to avoid wasting either spouse's exemption. (There may be asset protection benefits as well.)

Here's an example: Bob is married to Graciela, who is not a U.S. citizen. Bob owns $3 million in assets, but Graciela has no assets in her name. Graciela predeceases Bob. When Bob dies, the excess of the $3 million over his federal estate tax exemption ($1.5 million this year) is subject to estate tax. If the assets had been divided equally between them, Graciela could have used her share to fund a bypass trust for Bob's benefit. The $1.5 million placed in the bypass trust would be sheltered from estate tax by Graciela's exemption and would not be included in Bob's estate when he dies. Bob's share of the assets would be sheltered from tax by his estate tax exemption. But because Graciela isn't a citizen, equalizing the assets between the couple would have been problematic.

Ordinarily, when one spouse owns a disproportionate share of the wealth, the simple solution is for that spouse to transfer assets to the other spouse tax-free under the unlimited marital deduction. The solution isn't so simple, however, when the transferee-spouse is a noncitizen. Because the unlimited marital deduction is unavailable, the transfer would be subject to gift tax. There is a $114,000 annual gift tax exclusion (indexed annually for inflation) for gifts to a noncitizen spouse, but it could take many years to build up that spouse's estate to an amount that equals the federal estate tax exemption (especially as the exemption rises). If the noncitizen spouse dies before that happens, then all or a portion of his or her federal estate tax exemption may be wasted.

Citizenship has its advantages

As you can see, there are significant estate planning advantages to becoming a U.S. citizen. Attaining citizenship can be time-consuming, so if you or your spouse has been putting it off, consider consulting an immigration attorney and beginning the process as soon as possible. ▮

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