

Insight on Estate Planning

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Finding stability amid uncertain estate tax law

Defined-value gifts can limit tax exposure

Should you move your trust?

Family matters

Dealing with incapacity guardianship/conservatorship
issues and your elderly parents

Estate Planning Pitfall

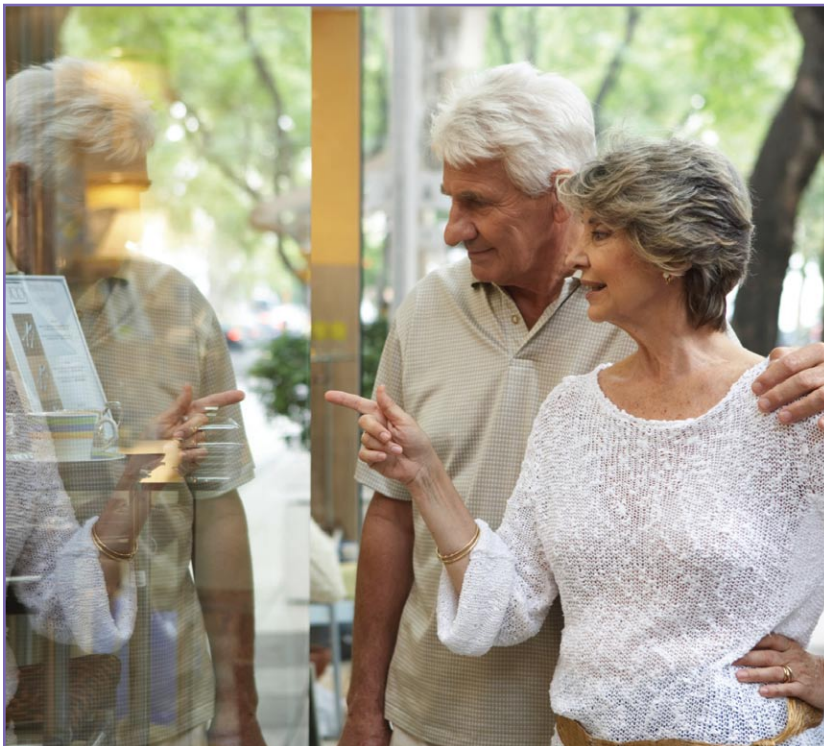
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Finding stability amid uncertain estate tax law

Defined-value gifts can limit tax exposure

The estate and generation-skipping transfer (GST) taxes disappeared on Jan. 1 (temporarily, anyway), but the gift tax lives on. As of this writing, for 2010 the top gift tax rate is 35%, with a \$1 million gift tax exemption and an annual exclusion of \$13,000 per recipient. Next year, the estate and GST taxes are scheduled to return, with a top tax rate of 55% and an exemption amount of \$1 million (though the GST tax exemption will be indexed for inflation). The top gift tax rate is also scheduled to go up to 55%, with the exemption remaining at \$1 million.



It's likely that Congress will overhaul the estate tax regime this year — it may even have done so by the time you're reading this. (Check with your estate planning advisor for the latest information.) But regardless of what happens, it makes

sense to explore strategies for minimizing gift taxes. One strategy that can be effective is the defined-value gift. The IRS isn't a fan of these gifts, but they recently have gained approval in the courts. (See "Tax Court endorses defined-value gifts" on page 3.)

More predictable tax consequences

Tax planning for certain gifts — such as interests in a closely held business or family limited partnership (FLP) — can be a challenge because your tax liability depends on the value of the gift, and there's no guarantee the IRS will accept your valuation. Consider this example:

Alice sets up an FLP to consolidate the management of her real estate holdings and other investments and to facilitate the transfer of fractional interests to her children while maintaining control. She transfers 30% limited partnership interests to each of her three children, retaining a 10% general partnership interest.

Alice hires a professional appraiser, who determines that the fair market value of the FLP's assets is \$5 million. The appraiser values each gift at \$900,000 by taking 30% of \$5 million (\$1.5 million)

and deducting a 40% discount for lack of control and lack of marketability. Assuming a 35% gift tax rate and an unused \$1 million exemption (and ignoring the annual exclusion), Alice's gift tax liability is \$595,000.

Now, suppose the IRS challenged the valuation of the FLP interests and applied a discount of only 20%. In that case, each gift would be valued at \$1.2 million, and Alice's gift tax liability would jump to \$910,000.

If Alice wants to limit her gift tax exposure and is charitably inclined, she could use a defined-value gift that provides for any excess value to go to a charity. Rather than give her kids 30% interests in the FLP, she would give each child a \$900,000 interest.

If her valuation holds up, each child receives a 30% interest. But if the IRS limits the valuation discount to 20%, each child receives a 25% interest. The remaining interest (15%) goes to charity and, therefore, doesn't trigger any additional gift tax liability. To avoid losing control of that interest, the FLP may be able to buy it back at fair market value.

Careful planning required

To withstand a challenge, defined-value gifts require careful planning. One reason the IRS doesn't like them is that it views them as prohibited "price-adjustment clauses." These clauses attempt to eliminate gift taxes, typically by providing for any excess value to be returned to the donor. Essentially, they allow a donor to "undo" a portion of a gift if it turns out to be taxable.

A well-designed defined-value clause is distinguishable from a price-adjustment clause. The value of the gift — and, therefore, the amount of tax — is fixed, so it's not possible for the "price" to be adjusted based on subsequent events. The only thing left unsettled is the relative interests received by the donees.

It's not necessary to donate the excess to charity — any gift-tax-exempt recipient will do, including your spouse (assuming he or she is a U.S. citizen and thus the unlimited marital deduction applies). Keep in mind, however, that the IRS may be suspicious of such an arrangement.

Tax Court endorses defined-value gifts

In *Estate of Petter*, T.C. Memo 2009-280, the U.S. Tax Court gave its blessing to defined-value gifts. Anne Y. Petter set up a family limited liability company (LLC) to hold a large amount of publicly traded stock. She allocated a fixed number of LLC units to herself, a fixed dollar amount to certain trusts for the benefit of her children, and the rest to charities.

The amount allocated to the trusts was based on formula clauses tied to the maximum amount that could be transferred gift-tax free. The formula clauses also provided for reallocation of beneficiaries' interests, if necessary, based on values "as finally determined for federal gift tax purposes."

The IRS determined that the initial allocation was based on inappropriately low values and sought to impose gift tax on the excess, arguing that the formula clauses were void. The Tax Court upheld the formulas, making a distinction between "a donor who gives away a fixed set of rights with uncertain value," as in this case, and "a donor who tries to take property back," which would be prohibited.

It's a good idea to place assets that are the subject of a defined-value gift in an escrow trust. This ensures that the assets are preserved until their value — and, therefore, their proper allocation — has been finally determined (by settlement or mediation of an IRS challenge, or expiration of the statute of limitations).

A respite from estate tax uncertainty

In an estate planning climate marked by uncertainty, defined-value gifts can be a welcome respite. Structured properly, these gifts may help you avoid tax surprises down the road. ■

Should you move your trust?

In some cases, it may be desirable to move a trust to a more favorable jurisdiction. But moving a trust from one state to another also presents significant risks, so attempting to do so without considering all the benefits, limitations and risks and obtaining professional advice isn't recommended.

Why move a trust?

There are several reasons for moving a trust to another jurisdiction, such as:

- Avoiding or reducing state income taxes on the trust's accumulated ordinary income and capital gains,
- Taking advantage of trust laws that allow the trustee to improve investment performance,
- Extending the trust's duration — for example, by moving it to a state that permits dynasty trusts,
- Obtaining stronger creditor protection for beneficiaries, and
- Reducing fees and administrative expenses.

Many people retire to states with more favorable tax laws. But just because you move to a state with no income or estate taxes doesn't mean your trusts move with you.

For individual income tax purposes, you're generally taxed by your state of domicile. The state to which a trust pays taxes, however, depends on its situs.

Can your trust be moved?

Moving a trust means changing its situs from one state to another. Generally, this isn't a problem for revocable trusts. In fact, it's possible to change situs for a revocable trust by simply



modifying it. Or, if that's not an option, you can revoke the trust and establish a new one in the desired jurisdiction.

If a trust is irrevocable, whether it can be moved depends, in part, on the language of the trust document. Many trusts specify that the laws of a particular state govern them, in which case those laws would likely continue to apply even if the trust were moved. Some trusts expressly authorize the trustee or beneficiaries to move the trust from one jurisdiction to another.

If the trust document doesn't designate a situs or establish procedures for changing situs, then the trust's situs depends on several factors. These include applicable state law, where the trust is administered, the trustee's state of residence, the domicile of the person who created the trust, the location of the beneficiaries and the location of real property held by the trust.

Depending on applicable law, it may be possible to move a trust by replacing the current trustee with a trustee in the desired state and moving the trust's assets, books and records to that state.

The actual process of moving the trust may entail creating a new trust to which the existing trust's assets are transferred, merging the existing trust

into a new trust or modifying the existing trust to designate the new state as its situs.

Depending on the trust's terms and applicable state law, the move may require court approval or the unanimous consent of the trust's beneficiaries.

What are the risks?

Moving a trust presents several potential traps for the unwary. For example:

- If your trust is grandfathered for generation skipping transfer (GST) tax purposes — for example, if it became irrevocable on or before Sept. 25, 1985 — moving the trust may be considered a trust modification that could trigger GST tax liability.
- If you move a trust from a state that permits perpetual trusts to one that doesn't, you may inadvertently limit the trust's duration.

- Some states tax all income derived from a source within the state. If your trust holds real estate or interests in a business located in such a state, that state may tax the income regardless of the trust's situs.
- In some cases, conflicting state laws may cause the same income to be taxed in more than one state.

Also consider other taxes that may have an impact, such as intangibles taxes, property taxes, taxes on dividends and interest, and securities transfer taxes.

Don't try this at home

Depending on your circumstances, moving a trust can offer tax savings and other benefits. Keep in mind, however, that the laws governing trusts are complex and vary considerably from state to state. Your estate planning advisor can help you determine whether the benefits outweigh the risks. ■

Family matters

Dealing with incapacity guardianship/conservatorship issues and your elderly parents

As parents age, their adult children need to pay close attention to not only their parents' physical health, but also their mental health. Why? Because advanced age or an illness can impair their intellectual wherewithal to manage day-to-day activities.

If you observe a parent's declining mental condition, you may have to make an emotionally difficult decision to have him or her declared incompetent. A judge will then appoint a guardian/conservator to oversee his or her affairs.

Capacity vs. incapacity

The legal definition of "capacity" varies from state to state, but generally it's the mental ability to adequately function. More specifically, it's the ability to continue to live in the manner to which one is accustomed.

A person is presumed competent unless an adjudication process determines otherwise. That is, a judge must declare a person incompetent. Factors leading to such a decision will depend on the circumstances. Often, one barometer of whether



whom he or she wants to act as his or her guardian/conservator.

The guardianship/conservatorship will specify if the guardian/conservator has been appointed for the management of all aspects of your parent's life or if there's a narrower applicability, such as for only financial matters. Whatever the decision, the guardian/conservator will owe a duty of care to your parent and will be held accountable by the court for showing that the actions he or she takes are appropriate.

someone is able to adequately function is the person's ability to understand basic financial matters. Another is whether a person is able to adequately attend to his or her own health needs.

What a guardian/conservator does

If you've made the gut-wrenching decision to have an incapacity determination and the judge agrees your parent is no longer competent, the court will appoint a guardian/conservator. The guardian/conservator will be responsible for managing your parent's affairs on his or her behalf.

The legal definition of "capacity" varies from state to state, but generally it's the mental ability to adequately function.

More often than not, a child or adult grandchild is appointed guardian/conservator. But the guardian/conservator doesn't have to be a family member. In some states a person can designate

Asking for help

Sometimes an elderly parent knows he or she needs assistance and asks for it. This is an ideal circumstance because you can avoid the expense and emotional toll of a guardianship/conservatorship proceeding — and your parent will receive the help he or she needs.

Here are a few areas in which you can help your elderly parents:

Bill paying. If you or a sibling is unable to write checks and pay your parent's bills, you can hire a bank or other professional firm to provide the service. The expense of paying someone to help your mother or father may be worth the increased sense of control he or she feels by delegating the work and freeing up time and energy for other things.

Powers of attorney. If your parent consents to giving you or another trusted individual power of attorney over his or her financial and health care matters, the result is similar to what you would achieve through the guardianship/conservatorship process. The difference is that your parent is still treated as legally competent to make decisions, though he or she is providing someone else with the legal right to act on his or her behalf.

Joint ownership. Your parent could add someone as joint owner of his or her accounts to provide that person rights similar to those of the parent's agent under the power of attorney for property and the trustee under the living trust.

The major difference is that, while the agent and trustee are merely managing assets on your parent's behalf, the joint tenant is treated as a joint owner of the property.

Difficult decision made somewhat easier

You love your parents and want to help them as much as they've helped you throughout your life. This includes making tough decisions such as having your mother or father declared legally incompetent should the time come when the parent can't manage his or her own affairs. If you face this decision, understanding the role of a guardian/conservator makes it somewhat easier. ■

Estate Planning Pitfall

You haven't recently reviewed your retirement plan beneficiary designations

If you have an IRA or employer-provided retirement plan and haven't reviewed your beneficiary designations recently, it's possible the designations are no longer appropriate. This could result in undesirable consequences, especially if your plan holds substantial wealth. If your ex-spouse is still beneficiary of your 401(k) plan, for example, he or she may receive a large inheritance regardless of the terms of your will, living trust or divorce decree.

Undesirable income tax consequences also can occur if the tax implications of your beneficiary designations aren't reviewed regularly. The rules surrounding inherited IRAs and retirement plans are complex, but distributions generally are taxable as ordinary income (except for Roth account distributions).

Unless your family needs the funds for living expenses, the best strategy is probably to defer distributions as long as possible. So designating your estate as beneficiary is likely a bad idea because the account will have to be distributed within five years after you die.

Your spouse may be the best choice. Why? Surviving spouses can roll the funds into their own IRAs and defer distributions until they reach age 70½.

Nonspousal beneficiaries don't have that option, but they may be able to roll the funds into an "inherited IRA" and stretch distributions over their life expectancies. Thus, the younger the beneficiary, the greater the tax deferral you can achieve. If your employer's plan doesn't allow nonspousal rollovers, consider rolling the funds into your own IRA during your lifetime.

Another alternative, if you're charitably inclined, is to donate your retirement plan to charity. Doing so avoids taxable distributions altogether, and you can use other assets to provide for your family.



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