Insight on estate planning

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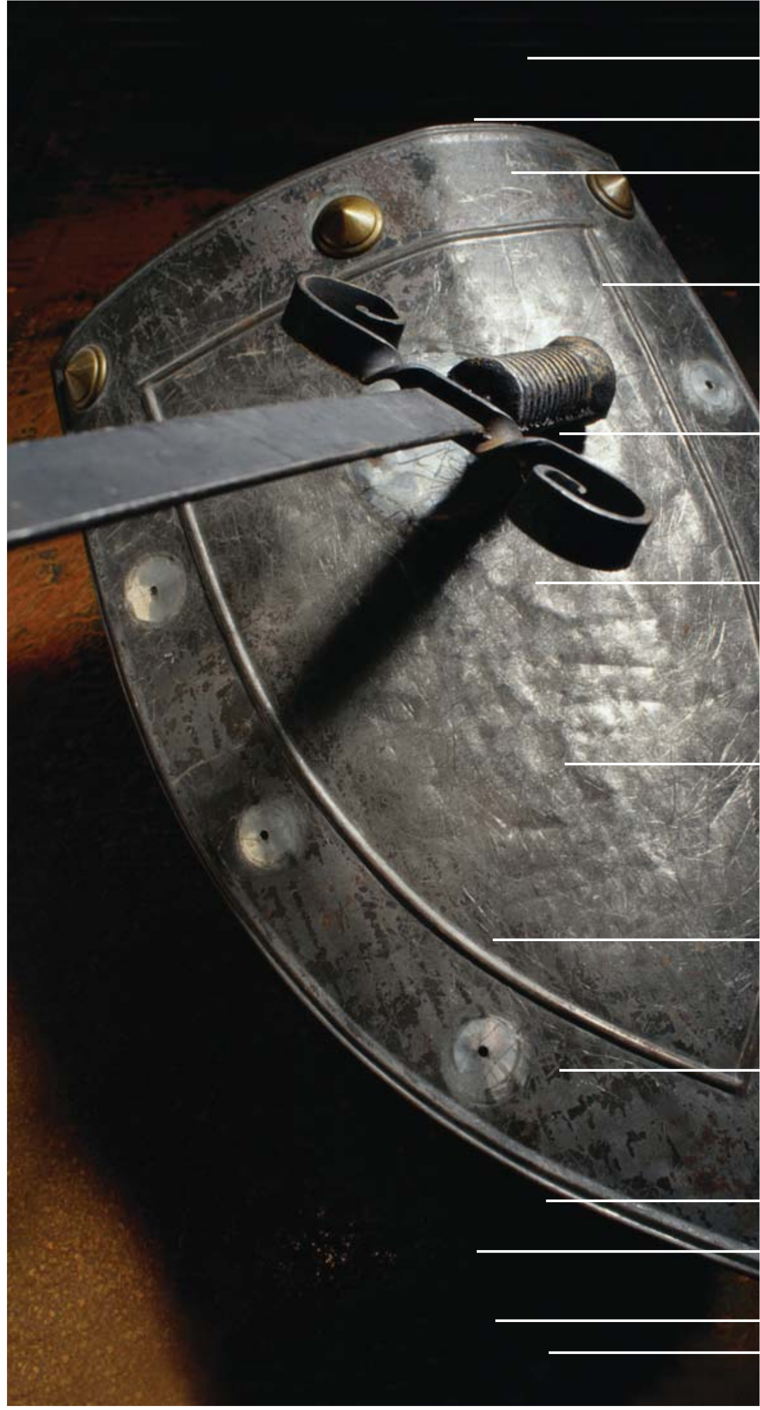

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Plus!

Estate Planning Pitfall:

Your real estate is worth more to an outsider, but you want to keep it in the family

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Asset shield

An ILIT protects life insurance proceeds

If someone should ask what constitutes your taxable estate, chances are you'd list your home, business, 401(k), IRAs and other securities, as well as assets such as art and jewelry. It's quite possible you'd neglect to include a major asset — your life insurance.

For some, the proceeds from life insurance can mean the difference between a nontaxable and taxable estate. One way to protect life insurance proceeds from estate taxes — and creditors — is to use an irrevocable life insurance trust (ILIT).

Ownership is key

The key to determining whether your life insurance proceeds will be included in your estate is knowing the ownership of the policy. Simply put, if you have "incidents of ownership" in the policy, you own it and the proceeds will be included in your estate. If you don't, the proceeds will not be included.

In the case of a life insurance policy, incidents of ownership is a fairly straightforward concept: If you have the right to name the beneficiary, you own the policy. If you have an estate that will be subject to estate tax at a 46% marginal rate, owning a $2 million policy translates to an extra estate tax of $920,000.

How does an ILIT work?

An ILIT is a vehicle designed to own life insurance. The benefit is that, because it is a separate legal entity, a properly designed trust will allow you to keep all of the life insurance proceeds out of your estate.

Although you can transfer an existing policy (see "Transferring a life insurance policy into an ILIT" on page 3), the best course of action is to have the ILIT purchase a new policy. You'll need to transfer cash or other

assets that the ILIT will sell to generate the funds to purchase the life insurance. Such transfers will be considered gifts.

But if the trust language provides a Crummey withdrawal right, which gives the trust beneficiaries the ability to make withdrawals of gifts made to the ILIT, those gifts will qualify for the annual exclusion to the extent that the total gifts to each beneficiary, including those through the trust, don't exceed the annual exclusion limit.

As the policy's owner, the ILIT designates itself as beneficiary. At your death, the proceeds are payable directly to the trust, thus keeping the proceeds out of your estate. Your heirs — or whomever you designate as ILIT beneficiaries — have the funds available for their use, consistent with the trust's terms.

And depending on where you create the trust, you may designate it as a perpetual, or dynasty, trust. Laws differ across the states, but the general idea is that the dynasty trust could last forever. And as long as it's in existence, it usually won't be subject to estate tax.

So, for instance, if you designate your children as beneficiaries of the dynasty trust but they don't need the funds, they can allow them to remain in the trust and continue to grow. On the death of your children, your grandchildren become the beneficiaries, and so forth.

Protection from creditors

Coupled with the estate tax savings is the ILIT's ability, as with most irrevocable trusts, to provide a strong measure of creditor protection for your beneficiaries. And if you create a dynasty trust, the creditor protection would carry through to subsequent generations. The protection feature comes from trust language.

Making the most of life insurance

Life insurance is a valuable estate planning tool, and an ILIT can make it even more powerful. It can reduce your estate tax liability and protect assets from creditors. ∎

Transferring a life insurance policy into an ILIT

Suppose you own a life insurance policy. If you're now uninsurable because of a change in your health condition, you may be faced with having to transfer your existing policy into an ILIT. The value of the policy, for purposes of determining the gift, is the policy's interpolated terminal reserve, which is generally slightly higher than the policy's cash surrender value. Your insurance company will be able to provide this figure to you.

The danger of transferring an existing policy lies with the look-back period for gifts made within three years of death. If the gift's value exceeded the annual exclusion amounts and you should die within three years of the gift, the gift will be disregarded — and the policy's full face value will be included in your estate. Thus, the gift will have been in vain. But if you survive the three-year period, the proceeds will not be included in your estate.

Double duty trusts

Achieve both charitable and noncharitable goals with a CRT or CLT

Would you like to find estate planning solutions to help yourself and your favorite charity? Then investigate sophisticated — yet uncomplicated — charitable trust strategies.

Split interest trusts

Both charitable remainder trusts (CRTs) and charitable lead trusts (CLTs) are split interest trusts because of their dual, though not necessarily competing, beneficial interests. Specifically, the trusts have beneficiaries that are qualified charities and noncharitable beneficiaries, such as you or your heirs.

A CRT provides the noncharitable beneficiaries with exclusive rights to all distributions until their interests have terminated. At that time, the charitable beneficiaries receive the *remainder* — the assets left over in the trust.

A CLT, on the other hand, reverses the timing of when the charitable and noncharitable beneficiaries receive distributions: The charitable beneficiaries receive the initial distributions and the noncharitable beneficiaries the remainder.

CRT benefits

To better understand the benefits of a CRT, let's look at an example.

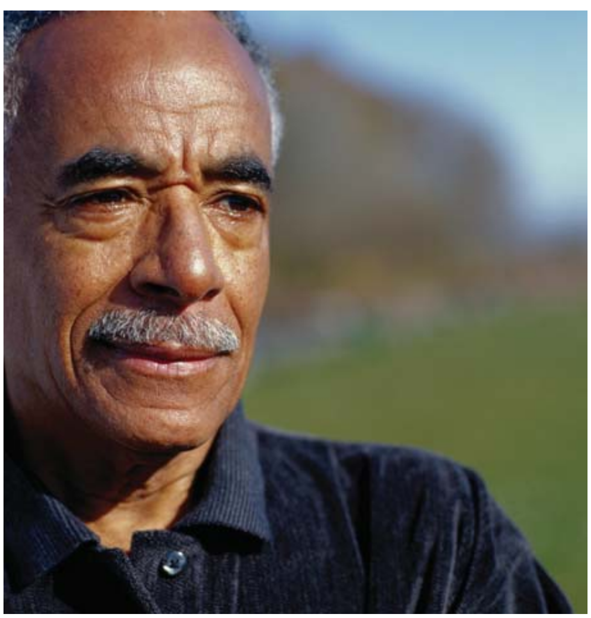
Suppose you're 70 years old and wish to divest yourself of an asset — such as a publicly traded security you've held for a long time — that has substantially increased in value since you purchased it but currently generates no annual revenue. You'd like to sell the asset to create a diversified portfolio that will generate cash flow for you to live off of for the rest of your life. And, you believe, the time is right to sell.

However, you have virtually no basis in the $1 million asset. Though the capital gains rate for federal income tax purposes isn't unattractive at 15%, you're not enamored with the thought of paying $150,000 in tax. Plus, depending on where you live, state taxes may further erode your net proceeds.

By creating a CRT and naming yourself the noncharitable beneficiary, you can:

Divest yourself of the asset. You can transfer the asset to the CRT.

Diversify your portfolio and increase your cash flow. The CRT can sell the asset and use the proceeds to purchase income-producing, diverse assets, and the annuity payments increase your cash flow.



Defer capital gains tax on the sale of the $1 million asset. You pay tax only as you receive CRT distributions.

In addition, you'll enjoy an immediate income tax deduction on creation of the trust, calculated as the present value of the charity's remainder interest, and gain recognition within the charitable organization(s) and community as a result of the contribution, unless you prefer to donate anonymously.

And don't forget to consider the estate tax implications. At your death, the trust terminates, and the remaining assets belong to the charity. These assets won't be included in your estate for estate tax purposes.

If you're worried that in the event of your inopportunely timed death your heirs won't receive the amount of funds you intended, two potential solutions are available.

First, you can set up the CRT to be a term of years and name your heirs as contingent beneficiaries. Then, regardless of whether you live for one day or the entire term, you'll know that you've done everything possible to protect your loved ones. That is, either you or your heirs will receive the annual distributions for the whole term.

Or, you can hedge your bets by purchasing a life insurance policy to make up for the shortfall your heirs might experience. You'll want to do an analysis of how much insurance you'll need, as well as how long you'll need it. Typically, this insurance policy should be held in an irrevocable trust, so the insurance proceeds won't be included in your estate for estate tax purposes. (See "Asset Shield," on page 2, for more on irrevocable life insurance trusts.)

CLT benefits

Designed to accomplish a different goal, a CLT is appropriate where an asset generates substantial income every year, you don't need the current income and you wish to pass assets to your heirs. A CLT allows you to generate an income stream for the charity every year during the trust term. At your death, the asset passes to your noncharitable beneficiaries — typically your heirs.

A CLT works similarly to a CRT in that you're able to get an immediate income tax deduction on the transfer of assets into the trust. In subsequent years, however, the income generated by the CLT is taxable to you. The CLT may be particularly appropriate, therefore, in a year in which you enjoy a one-time spike of income and are interested in maximizing the income tax deduction for that year.

Unlike a CRT, though, a CLT has a gift tax component, which is calculated as the present value of the noncharitable beneficiary's remainder interest. Fortunately, because of the flexibility in designing a CLT, you can tailor it to appropriately meet your needs with respect to the gift tax, the charitable deduction and the expected annual income.

Charitable trusts can work wonders

Depending on your needs, either the CRT or CLT might help you to reach your estate planning goals. The important thing to remember is that both of the strategies, despite having the word "charitable" so prominently displayed, can help you to achieve many of your noncharitable goals as well. ▮

DRAmatic changes for Medicaid planning

The Deficit Reduction Act of 2005 alters the rules

Long-term care is expensive and, because it's not covered by Medicare, can rapidly drain even a large nest egg. Medicaid provides a safety net once a person runs out of assets. So, many engage in Medicaid planning, with the goal of qualifying for Medicaid sooner so loved ones still receive some of their assets.

As of Feb. 8, 2006, the Deficit Reduction Act of 2005 (DRA) became law, and with it Medicaid rules — and thus Medicaid planning — changed dramatically.

Pre-DRA planning

A typical example of Medicaid planning went something like this: After George's death, the health of his wife, Martha, deteriorated to the point where it was obvious she needed to enter a nursing home. Even though she wasn't destitute, Martha's assets weren't substantial enough for her to afford the care she needed *and* leave anything for her loved ones. So Martha gifted a significant amount of her assets to her two children because she knew they would use the funds to provide for any care she needed that wasn't paid for by Medicaid.

The pre-DRA law held that, because of the 36-month "look-back" period, Martha was ineligible for Medicaid for the next three years. During that time, Martha would spend down the assets she retained, so by the time she was "out" of money, she'd be eligible for Medicaid.

Even though her children still might have significant assets that came from her, Martha was nonetheless eligible for Medicaid following the "look-back" period because she personally had little or no assets for Medicaid purposes.

Look-back period changes

DRA extends the "look-back" period for purposes of Medicaid eligibility, and thus requires a reassessment of potential Medicaid planning strategies.

The look-back period relates to the ability of the government to cry foul if you try to divest yourself of your assets at less than fair market value — such as by gifting them to your children. Under the prior law, such a transfer would be subject to a 36-month look-back period, meaning you would be ineligible to receive Medicaid for up to three years following the date of the transfer. (Transfers to certain types of trusts were subject to a 60-month look-back period.)

The new rules expand the 36-month period to 60 months for *all* transfers, meaning that you'll have up to five years to wait before becoming eligible for Medicaid. Further, now the five-year period doesn't start until the later of a) the date of the transfer or b) the date you'd otherwise be eligible for Medicaid.

For transfers that took place before the enactment of DRA, the old rules apply. Suppose, for example, that on Feb. 7, 2006, you made a substantial gift to your child. Because you're subject to the prior rules, you're not eligible for Medicaid until three years after the transfer. If at that point, in 2009, you're in a nursing home and have other assets, you'll first have to spend those assets down before becoming eligible for Medicaid. Once those other assets are gone, though, you'll immediately be eligible for Medicaid because the transfer was more than three years ago.

Contrast that result to the result under the rules now in effect under DRA: If, instead, you made the gift on Feb. 9, 2006, you wouldn't be eligible for Medicaid until, at the earliest, five years later, or Feb. 9, 2011. Further, if you were in a nursing home on that date and had other assets, your 60-month penalty period would not begin until you spent down those assets to the Medicaid eligibility limits. So if you had spent down your other assets by, for instance, Feb. 7, 2010, you'd have to wait 60 months from that date — or until February of 2015 — to qualify for Medicaid.

Changes to the classification of resources

In addition to changes to the look-back period, DRA altered the definition of excluded resources and countable resources. Under the old rules, certain assets were disregarded for purposes of determining Medicaid eligibility. Excluded, for instance, were the primary residence, wedding and engagement rings, clothing, and a very modest amount of cash (limited to $2,000 or $4,000, depending on the state). Now, anyone with more than $500,000 of home equity (or, at the state's discretion, up to $750,000) is ineligible for Medicaid coverage.

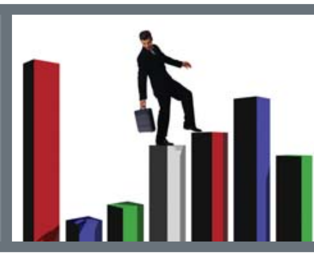
Certain annuities are excluded from the definition of countable resources, but usually only if the state is named as a remainder beneficiary of the contract.

Yet another rule change is that notes receivable, mortgages and loans are included as countable resources, unless the instrument calls for regular payments and isn't self-canceling at the death of the holder.

Plan carefully

DRA dramatically affects the available Medicaid strategies and their implementation. The rules are complicated, and even though this article provides an analysis of some of the basics, the specifics of your situation may suggest other strategies. Thus, be sure to seek professional guidance when searching for a solution for yourself or a loved one.

Estate Planning Pitfall



Your real estate is worth more to an outsider, but you want to keep it in the family

If you have a family farm or business that includes real estate with an intrinsic value that is greater to an outsider but you want to keep it in the family, you face a huge estate tax pitfall: At your death, the IRS will want to value your property at its highest value.

A typical scenario is farmland that would be more valuable if sold to a developer with a condominium development.

Fortunately, you may be able to take advantage of a special use valuation. It allows you to value the property for less than fair market value because of the extenuating circumstances surrounding its use. For example, if you die this year, your estate can be reduced by up to $900,000 as a result of a special use valuation. At a marginal estate tax rate of 46%, that could translate to a tax saving of $414,000.

For your estate to claim a special use valuation, the following conditions must be met:

- You must be a citizen or resident of the United States.
- The real property must be located in the United States.
- As of your death, the property must have been used by you or a member of your family in the business or as a farm, or have been rented by your spouse or descendant to a family member on a net cash basis.
- The real property must be acquired from or passed from you to a qualified heir, which means, essentially, a member of your family.
- The real property, during at least five of the eight years before your death, must have been owned and used in a qualified manner — that is, used for farming or for the family business, or rented for such activity on a net cash basis — and there must have been material participation by you or a member of your family.

Further, for the property to qualify:

- The adjusted value of the business or farm property — both real and personal — must be at least 50% of the adjusted gross estate, and
- The adjusted value of the business or farm real property must be at least 25% of the adjusted gross estate.

Finally, after the special use valuation is claimed, the property must remain in the hands of your family for 10 years.

Personal Legal Services Group

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