Advanced Planning Strategies

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Dear Reader,

There has been little progress on much of the tax legislation proposals that we've been reporting over the last several months. A new bill has been proposed by Senators Graham and Santorum that would permit individuals to receive a tax credit for the purchase of health insurance (S. 1570). The size of the credit would be limited to $1,000 per individual and $3,000 per family. The sponsors feel that employer-provided health insurance receives a significant federal tax subsidy and that more relief should be available to individuals who must acquire their own coverage.

The IRS has provided long-awaited sample charitable remainder annuity trust (CRAT) documents (Rev Procs. 2003-53 to 60, 2003-31 I.R.B. 230-274). The model forms contain terminology required for CRATs that will receive tax-deductible donations. The forms cover CRATs in eight different scenarios for varying durations. These forms supersede sample forms last issued in 1990 and were necessitated by tax law changes that took effect in 1997. It is unlikely that individual donors and their advisers will adopt the sample forms exactly as provided. The revenue procedures allow practitioners to add annotations and alternative provisions. For example, an alternative provision to replace the initial charitable organization with another qualified charity by a power of appointment is included. (See the inside report for how this power might be incorporated in the donor's other estate planning documents.) The IRS will not give private rulings for future CRATs unless the form uses terminology substantively different from the sample forms. More guidance will be forthcoming, ideally including sample forms for the more commonly used form of CRTs, the charitable remainder unitrust.

The inside report offers guidance for planning for incapacity and estate planning. The durable power of attorney is an essential tool for most individuals who have begun the estate planning process. We will provide more information about the problem of aging and long-term care expenses in an upcoming letter.

THE DURABLE POWER OF ATTORNEY: AN ESSENTIAL FINANCIAL AND ESTATE PLANNING TOOL

Estate planners warn their clients about the risks of dying without a will. Failing to plan for future incapacity could also result in irreparable harm to an individual and his or her family. Furthermore, the likelihood of a long-term disability is much greater than that of death during much of a person's lifetime. The risk of serious incapacity increases with age, and the demographic trends indicate that the segment of the population over age 65 is growing much faster than the rest of the population. This problem and the uncertainty about the future of the federal estate tax, state estate or inheritance taxes, and other estate settlement costs indicate that estate and financial plans should be flexible for changing needs. The durable power of attorney is an inexpensive device that permits a person to designate a family member or professional adviser to make critical financial and personal decisions and take action to preserve the estate when incapacity occurs.

WHAT IS A POWER OF ATTORNEY?

A power of attorney is a document in which the client (the principal) authorizes an agent (otherwise known as an attorney-in-fact) to act in his or her behalf. The power may be quite limited: for example, permitting the agent only to make deposits to the principal's bank account. Or the power can be broad, authorizing the agent to engage in nearly any transaction that the principal could.

A power of attorney is also limited in its duration. It can be expressly limited in time. For example, the agent may be given a power of attorney that terminates when a specific act is completed. Even if no duration is specified, a conventional or common-law power of attorney becomes inoperative upon the incapacity of the principal. To extend the power beyond the incapacity of the principal, the power must be made expressly durable.

A durable power of attorney takes effect immediately when the document is executed even though it may not be needed until much later, if ever. Some individuals, however, are reluctant to grant an agent broad powers to act at a time when the principal is capable of acting. These people would prefer to use a "springing" durable power of attorney. Recognized in many states, a springing power lies dormant and ineffective until a designated time, such as the principal's incapacity.

WHEN SHOULD A DURABLE POWER BE USED?

A durable power of attorney should be used whenever an individual feels he or she will need someone to make important financial and/or personal decisions after the individual loses capacity. Most individuals will have assets or personal affairs that must be managed should they lose capacity. If the individual has a complex estate plan, the durable power is essential. A wealthy individual who has begun his or her estate plan by making lifetime gifts or charitable donations will need someone to have the power to continue making such gifts or donations after the donor loses capacity. It would often be devastating to the individual's estate plan if the gifts could no longer be made. Recent changes to the federal estate tax rules and the growing federal deficit have raised uncertainty about the level of tax in the future. In addition, many states have incorporated changes to their estate or inheritance tax system that impose taxes that are not fully allowable as a credit on the federal estate tax return. The durable power of attorney provides a mechanism to make the necessary changes to an estate plan without court approval for a legally disabled principal.

For example, suppose the individual makes regular contributions to an irrevocable life insurance trust. A durable power must be in effect for the premiums to be paid from the principal's funds after the principal loses capacity. Otherwise, the principal's family might have to pay the premiums from their own funds for the rest of the principal's

life. This, of course, would be counterproductive to the principal's estate plan. Or, suppose the principal has a living trust with terms that have become inappropriate due to tax law changes. The attorney-in-fact can be empowered to revoke or amend the trust as necessary.

All states authorize the health care power of attorney. This durable power permits the agent to make health care decisions for the principal if the principal loses capacity. Many individuals prefer the health care power of attorney to a living will; some use the health care power in conjunction with a living will.

WHAT CAN A DURABLE POWER ACCOMPLISH?

One of the primary uses of a durable power is the delegation to an agent of the management and control of the principal's financial affairs during his or her incapacity. The following is a sample of the types of property management powers that might be considered for a power of attorney:

- to make deposits and withdrawals from bank accounts
- to sign tax returns and appoint an agent to represent the principal with the IRS
- to make investment decisions
- to deal with retirement plans, including IRAs
- to have access to the principal's safe-deposit box
- to create a living trust or fund a previously created living trust
- to revoke or amend a living trust or to direct the trustee to make distributions
- to revoke or change beneficiary designations
- to forgive or collect the principal's debts
- to enter into contracts on behalf of the principal
- to make gifts on behalf of the principal
- to disclaim gifts or bequests made to the principal
- to deal with life insurance on the life of the principal

WHY MUST THE DURABLE POWER BE DRAFTED CAREFULLY?

An individual might be tempted to avoid attorney's fees by purchasing a durable power document form from a business supply store or using consumer-oriented computer software to draft the power. However, a power of attorney is useful only if it works as intended. The likelihood of success is far greater if the appropriate professional advice is sought.

Because the possibility of abuse exists when the agent is managing the principal's financial assets, financial intermediaries such as banks, stock brokers, and insurers are often hesitant about complying with broad powers granted to an agent. State law often construes the power very narrowly to prevent the abuse of the power. If court intervention is required, it will be costly and will perhaps further limit the agent’s flexibility to use the durable power because the courts are likely to construe the power narrowly. Drafting the document so that the powers granted the agent are very specific is helpful in persuading third parties to enter into transactions with the agent. The more specific the language, the more likely it is that third parties will honor the power because the principal’s intent is expressly stated in the document.

Another important point is the effectiveness of the exercise of a power of attorney for tax purposes. The

IRS has successfully challenged and denied the annual gift tax exclusion for gifts made under broad-form powers of attorney in which the agent was not expressly empowered to make the gifts. A similar result should occur if the agent attempts to disclaim property inherited by the principal. The IRS may treat the disclaimer as invalid for tax purposes. A power of attorney granted without these express powers would render these estate planning techniques ineffective and increase the amount of estate taxes the principal's family will have to pay.

RECENT CASES AND RULINGS

RETIREMENT PLAN BENEFICIARY DESIGNATION MUST BE PLANNED CAREFULLY

The use of a “disclaimer trust” is often recommended to provide a postmortem adjustment to the beneficiaries of a qualified retirement plan or IRA. Normally, a married participant or account owner will name his or her surviving spouse as the primary beneficiary of the plan or IRA. A living trust or a trust created under the participant’s will could be the successor or contingent beneficiary. This trust would generally be designed to be free of estate taxes through the use of the deceased participant’s unified (applicable) credit against estate taxes (currently the credit exempts $1 million from tax, but it increases to $1.5 million in 2004). In many instances, the surviving spouse is the income beneficiary for life of the unified credit trust. Pension and IRA regulations permit a trust to be the designated beneficiary of the plan or account with a “look-through” provision to allow the mandatory taxable distributions to be spread over the lifetime of the oldest beneficiary of the trust (Treas. Reg. Sec. 1.401(a)(9)-4). A disclaimer by the surviving spouse as primary beneficiary of the plan would cause the benefit to be paid to a disclaimer trust to take advantage of the unified credit.

In a recent private ruling (Ltr. 200327059), the beneficiary designations did not permit the look-through provision after the surviving spouse disclaimed a portion of the deceased spouse’s IRA. In this instance, the surviving spouse was the primary beneficiary, but the residuary estate was the beneficiary after the disclaimer. Even though the look-through trust was the beneficiary of the residuary estate, the estate (not the trust) was determined by the IRS to be the beneficiary of the disclaimed portion of the IRA. The income tax result is painful. The IRA must be distributed to the trust over a period that can be no longer than 5 years after the year of the decedent’s death. Due to trust income rules, much of the taxable distribution will probably have to be incurred by the trust for income tax purposes and trusts reach the highest income tax bracket at $9,350 (in 2003). How could this plan have been improved? The trust should have been named as the successor or contingent beneficiary. Most experts believe that the beneficiary designation along with disclaimer provisions should be incorporated directly in the IRA or plan document.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

Positioning our clients for the future

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