



Advanced Planning Strategies

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January 2005

Dear Reader,

A new Congress will undoubtedly have an impact on important economic and other domestic issues that we hope will be of interest to you in the coming year as you receive this letter. As we indicated in previous letters, the President has prioritized making the temporary tax cuts enacted in 2001, 2003, and 2004 permanent. Among these provisions are the reduced rates for ordinary income, long-term capital gains and qualified dividends; the reduction of the marriage penalty; the child tax credit; and relief from the alternative minimum tax (AMT).

Additional proposals from the President include a tax relief plan that would put an average of \$1,600 in the hands of a typical family of four. These proposals include

- creating an income tax rate structure with marginal brackets of 10, 15, 25, and 33 percent
- doubling the child tax credit to \$1,000 per child and applying this credit to the AMT
- eliminating the federal estate tax
- expanding the charitable deduction to taxpayers who don't itemize deductions
- making the research and experimentation tax credit permanent

The growing federal deficit has caused some concern in Congress about enacting tax relief without revenue offsets. These offsets have stymied even popular bipartisan tax proposals in the past 2 years, such as the bill to enhance charitable contributions. Some revenue offsets that have been discussed include eliminating the deductions for state and local income taxes and employer-provided health insurance. But, remember, the Treasury looks at every tax benefit as a possible source of funds, and not every deduction can be eliminated without serious political consequences.

A couple of estate tax cases discussed in earlier letters were affirmed on appeal. In *Smith v. United States* (5th circuit), the court refused to permit a valuation discount for the income tax liability in an IRA that was included in the decedent's gross estate. In *True v. Commissioner*, the 10th circuit court of appeals agreed with the Tax Court and held that price provisions in the family buy-sell agreement served as a testamentary device and were not controlling for gift or estate tax purposes.

Knowledge is not power. Only knowledge in use is power.

WHO DO YOU TRUST?

A DISCUSSION OF GRANTORS, TRUSTEES, BENEFICIARIES AND PERMISSIBLE POWERS

Trusts and similar arrangements are often used as part of the estate plan. The purposes for the trusts vary, but generally control of the trust principal by a selected trustee is a major goal. A difficult choice must be made between the grantor, a family member, and a completely independent trustee (such as a corporate trust department). The dispositive goals of the grantor of the trust and the accomplishment of tax objectives often limit the possibilities. The following discussion is intended to provide an overview of the choices and limitations for some common estate planning techniques.

REVOCABLE LIVING TRUSTS

The goal of most living trusts is to transfer trust property outside of probate, not to provide current tax savings. The grantor is generally the initial trustee of his or her revocable living trust unless the grantor has the need or desire to have immediate assistance in managing the trust funds. Because a revocable trust is not intended to be a completed gift, no adverse estate or gift tax consequences are associated with the grantor serving as trustee.

Most revocable trusts have provisions for successor trustees in the event of the grantor's disability. The successor could be a family member or a professional trustee. Of course, the revocable trust becomes irrevocable at the grantor's death and a successor trustee will be named at this contingency. We'll discuss the possibilities for successor trustees in the event of the grantor's death when we discuss testamentary marital and credit shelter trusts below.

IRREVOCABLE LIVING TRUSTS

Most irrevocable trusts are intended to result in current completed gifts. The goal of these trusts is to remove the trust property from the grantor's taxable estate. Generally, the grantor cannot serve as trustee because most discretionary powers held by a trustee would render the gift incomplete for gift and/or estate tax purposes. For example, a gift will be incomplete if the grantor has the power to change beneficiaries or determine the shares distributed to individual beneficiaries of the trust. The grantor's estate will also include all property in which the grantor retains the right to use trust funds to satisfy his or her legal support obligations.

If the grantor insists on serving as trustee, adverse estate and gift tax consequences will be avoided only if the grantor's powers are restricted. Court cases have concluded that a grantor-controlled trust will be excluded from the grantor's estate only if the grantor's power to determine the shares provided to beneficiaries is limited by an "fixed or ascertainable" standard. The reasoning is that the grantor cannot affect beneficial enjoyment if the power to determine shares is based on a standard that could be measurable in the applicable state court. For example, "support in the beneficiary's accustomed standard of living" should be an acceptable ascertainable standard. However, the benefits of the trust should not be used to satisfy a legal support obligation of the grantor. Quite often naming a co-trustee to serve with the grantor and vesting the distribution decisions in the co-trustee answers these concerns. A grantor-controlled irrevocable trust requires careful drafting and strict adherence to the ascertainable standards.

Trusts for Minors and Custodial Accounts One commonly used irrevocable trust is a Section 2503(c) minor's trust. This trust permits the grantor to shelter a gift to an accumulation trust with the \$11,000 annual gift tax exclusion. The remaining trust principal must be payable or made available to the beneficiary at age 21. The grantor cannot be the trustee of a Sec. 2503(c) trust without adverse estate tax consequences. In addition, the parent obligated to support the minor should not serve as trustee if the parent's estate taxes are a concern. The right to distribute trust funds to satisfy a support obligation is a general power of appointment. Property subject to a general power of appointment will be included in the gross estate of powerholder. Thus, a grandparent should not make a gift to a Sec. 2503(c) trust and name the minor beneficiary's parent the trustee unless the parent's estate and gift taxes are not a major concern. If a gift is made to a uniform gift (transfer) to minor's account (UGMA/UTMA), similar reasoning should apply to naming a custodian for such account.

Irrevocable Life Insurance Trusts (ILITs) ILITs are often used to transfer life insurance benefits free of estate taxes. The insured should not serve as trustee under an ILIT to avoid inclusion of the proceeds in the insured's gross estate. If a husband and wife are joint-insureds in a survivorship (second-to-die) life insurance policy owned by an ILIT, neither spouse should serve as trustee.

Can the noninsured spouse serve as trustee of an ILIT created by the insured spouse? The answer is yes, with caution. Generally speaking, the surviving spouse will receive significant benefits from an ILIT created by the insured spouse. To avoid inclusion of the ILIT in the noninsured spouse's estate, access to the funds must be limited. The surviving spouse can be provided with all trust income plus the ability to have principal distributed to him or her under a limited (nongeneral) power of appointment. A limited power of appointment includes the ability to invade principal subject to an ascertainable standard. The power of appointment regulations provide that ascertainable standards include the power to appoint for "support in reasonable comfort or support in his or her accustomed manner of living, etc." Thus, the surviving spouse should be able to serve as sole trustee of an ILIT created by the insured spouse if the power to invade principal is limited to a standard based on support, health, and education of the surviving spouse. However, the surviving spouse should not be permitted to invade trust funds to satisfy his or her legal support obligations. Again, if there is concern that the actions of the spouse-trustee will exceed the limits of the ascertainable standards provided by the trust terms, perhaps a co-trustee could be named to determine distributions to the surviving spouse.

TESTAMENTARY TRUSTS

Marital Trusts. A will of a married individual often creates testamentary trusts, normally a marital trust and a credit shelter trust. The living revocable trusts that we discussed earlier often provide for distributions to a marital and credit shelter trust at the grantor's death. An estate tax marital deduction is available for property that passes to a surviving spouse in a qualifying manner. Several types of trusts will qualify for the marital deduction. Generally, the surviving spouse can serve as sole trustee or co-trustee of the marital trust. Unlimited invasion rights or a general power of appointment ensures qualification for the marital deduction. If the ability of the surviving spouse to manage the trust funds is a concern, a professional trustee could be named to serve as co-trustee. If the testator wishes to limit the powers or access of the surviving spouse over the trust principal, an independent trustee should be named. If the surviving spouse is limited to the marital trust's income without current invasion rights to principal, the surviving spouse must be provided with the ability to compel the independent trustee to sell unproductive property and invest in income-producing property.

Credit Shelter TrustsA credit shelter trust is designed to be sheltered from estate taxes by the decedent's applicable credit amount. Currently, this tax credit will shield \$1.5 million from estate taxes (in 2005). One goal of the credit shelter trust is to avoid qualification for the estate tax marital deduction. However, benefits to the surviving spouse from the credit shelter trust are often desirable. The key is to provide the surviving spouse with limited access. Again, as with the ILIT, the surviving spouse can be given the right to all income and principal as necessary for support, health, and education. If the rights to principal are limited to such an ascertainable standard, the surviving spouse is able to serve as sole trustee of the credit shelter trust. The surviving spouse, however, should not be permitted to invade to satisfy a legal support obligation. Again, the terminology of the trust should be carefully drafted and the surviving spouse should not exceed the ascertainable limited powers of invasion. If this is a concern, a co-trustee could be appointed to determine distributions of principal to the surviving spouse.

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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