



# Advanced Planning Strategies

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Dear Reader,

The tax extenders bill including the temporary relief from AMT had not yet passed at the time this letter was written. The extenders bill would have reenacted a number of items that were set to expire at the end of 2007; some items expired at the end of 2006. It is expected that this bill will pass, maybe even in 2008 with retroactive effect. The IRS indicated in a recent webcast that return processing would not begin until February at the earliest. It will attempt to issue the tax forms as soon as possible following the passage of the bill, but programming software to process the returns will cause the delay. This will obviously impede individuals who are seeking early filing and early refunds.

Other important items loom on the horizon, but passage may be difficult in an election year. The federal estate and generation-skipping transfer taxes have a \$2 million exemption in 2008, but this is scheduled to increase to \$3.5 million in 2009. This change creates an unusual circumstance concerning the timing of an estate owner's death. For an individual with a \$3.5 million estate, there would be no tax due if his or her death occurs on January 1, 2009, but \$675,000 due if death occurs at 11:59 p.m. on December 31, 2008. It is likely that a change in the law will get serious consideration before life support decisions will be affected by taxes.

The IRS released the inflation adjustments for 2008 and although we cannot report the full list, we can include some highlights. The standard deduction is \$10,900 for joint filers (\$5,450 for single taxpayers). The personal exemption is \$3,500. The itemized deduction phaseout begins at adjusted gross income of \$159,950 for most taxpayers. The 28 percent marginal bracket begins at taxable income over \$131,450 for joint filers (\$78,850 for single taxpayers); the 33 percent bracket will be reached at taxable income over \$200,300 for joint filers (\$164,550 for single taxpayers); and the 35 percent maximum bracket will be reached at taxable income over \$357,700 for most taxpayers.

We will continue to provide you with useful tax information as it occurs in the New Year.

**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 of 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's 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 a "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 can 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. 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 Sec. 2503(c) minor's trust. This trust permits the grantor to shelter a gift to an accumulation trust with the \$12,000 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 powerholder's gross estate. 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) 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 married individual's will 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 Trusts.** A credit shelter trust is designed to be sheltered from estate taxes by the decedent's applicable credit amount. Currently, this tax credit will shield \$2 million from estate taxes (in 2008, \$3.5 million in 2009). 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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