Estate Planning Ideas

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I have written for years in this and many other publications and many of you have decided to put "your house in order" by implementing many of the techniques discussed over the years. I would like to share a few more advanced strategies that are commonly employed in today's environment. That said, a few things to keep in mind:

- Don't be seduced by intriguing strategies or what someone else did with their estate plan. Your estate plan should begin and end with your personal goals and desires, both tax and non-tax—after all, it's your estate.
- Sit down with a qualified estate planner who's up to date on the latest statutory, regulatory and judicial developments. You may even want to combine the strengths of a qualified CPA (to map the most tax-efficient strategy) and an experienced estate planning attorney (to draft the legal documents and provide additional insights).
- Beware of strategies that seem too good to be true, such as excessive valuation discounts, promises of tax-free offshore deals, and the like.

Now, on to the strategies.

Using the unlimited marital deduction more efficiently

Typically, spouses will use a credit shelter (bypass) trust to preserve the first-to-die's estate tax exemption. Assets beyond that amount can pass to the surviving spouse outright, or via a marital trust, without any current estate taxation (provided the surviving spouse is a U.S. citizen).

Qualified terminable interest property trust

The most flexible marital trust is the QTIP trust. With a QTIP trust, the executor can decide how much of the estate qualifies for the unlimited marital deduction. The surviving spouse's needs and living expenses are still taken care of during his or her lifetime but the eventual distribution of trust assets to the first spouse's children is protected. This is an especially attractive tool for individuals with children from a prior marriage, or when there's concern over what might happen should a surviving spouse remarry.

Gifting strategies

Qualified personal residence trust (QPRT)

A QPRT allows the transfer of a residence into trust for gift purposes, while retaining the right to live there for a period of years. At the end of the term, the residence is transferred to the beneficiary.

Here's what makes this strategy effective: The value of the transfer for gift tax purposes is calculated as the present value of the remainder interest. The right to stay in the house has value, and that value is deducted from the gift. What's more, any future appreciation after the transfer to trust is not included in the grantor's estate. The grantor may also arrange to stay in the house at the end of the term at fair market rent.

There are a couple of caveats here. First, the QPRT strategy works better when interest rates are higher, because a higher discount rate (the IRS determines the discount rate) means the present value of the portion of the home subject to gift tax is lower. Also, the longer the term of the QPRT, the smaller the gift will be for tax purposes. But, the grantor must outlive the trust's term or the value of the home will be brought back into the gross estate, so you'll need to plan accordingly for this trade-off.

Grantor retained annuity trust (GRAT)

With a GRAT, the grantor transfers assets to a trust for a period of years. During the term, the grantor receives an annuity from the trust and at the end of the term the remaining assets pass to the beneficiary.

The annuity payments reduce the gift's value for gift tax purposes, which is determined at the time of transfer into the trust. As long as the assets in the trust perform better than the discount rate, this can be an extremely effective transfer strategy. A low interest rate environment is better for GRATs because the assets will have a better chance of outperforming the hurdle rate. Additionally, GRATs work especially well with assets that are currently depressed in value but have the potential for significant appreciation.

Warning: Even though a GRAT can be set up for a relatively short period of years, if the grantor dies during the trust's term the assets are brought back into the gross estate.

Crummey power trust

One of the tax principles of gifting is that in order for the gift to qualify for the annual $13,000 exclusion ($26,000 for spouses), it must be a present interest—in other words, the recipient must have present use of the gift, not some future interest.

However, there are some exceptions to this rule when it comes to children. With a minor's trust (under section 2503(c) of the Internal Revenue Code) or a custodial account (UTMA or UGMA), the gift counts for purposes of the annual exclusion even though the minor doesn't get control of the assets until age 21.

The Crummey power trust (named after the taxpayer who first utilized the strategy) provides more flexibility. Transfers to the trust qualify as a present interest, and you can write in your own rules about when and how the beneficiary ultimately receives control of the assets.

The beneficiary of a Crummey power trust gets a limited period of time during which he or she can withdraw the annual contribution to the trust, after which the contribution becomes subject to the provisions and terms of the trust. As long as this "Crummey power" is available, the gift qualifies for the annual exclusion, whether the power is exercised or not (if the beneficiary hopes to enjoy future contributions to the

trust, he or she would typically not exercise the power). Crummey powers are often utilized with irrevocable life insurance trusts.

Irrevocable life insurance trust
Life insurance is often used in estate planning to provide liquidity in the case of closely held or hard-to-sell assets (a family business, family farm, significant real estate holdings, etc.) or as a wealth replacement vehicle to provide for family members in the face of estate tax liabilities or charitable bequests.

However, even though life insurance proceeds are generally income tax free to the beneficiary, they're included in the decedent's gross estate as long as the decedent owns the policy.

The most effective way to avoid this problem is with an irrevocable life insurance trust. As long as the trust owns the policy, the proceeds are outside the estate and will pass free of both income and estate taxes. The best strategy is for the trust to purchase the policy, because the transfer of an existing policy within three years of death will bring the proceeds back into the estate.

Family limited partnership
An FLP can be an effective way to manage and control family assets while providing for the tax-effective transfer of wealth to others.

In the typical arrangement, mom and dad gift the majority of the partnership to family members in the form of limited partnership interests. Because limited partners have no say in running the partnership and usually can't sell or borrow against their interests, valuation discounts arising from lack of liquidity and marketability will apply for gift tax purposes. Additional valuation discounts may apply to the assets themselves (for example, illiquid small business, undivided interests in real estate, etc.).

Structured correctly, FLPs can be a valuable planning tool. However, overly aggressive structures that seek unreasonable valuation discounts or run afoul of the rules in some other respect may invite unwanted scrutiny from tax authorities. For this reason, it's very important to work with a reputable expert when considering a family limited partnership.

Other strategies

Roth conversion
For those who qualify (adjusted gross income of $100,000 or less in the year of conversion), converting all or part of a traditional IRA into a Roth IRA could be a useful estate planning technique—if you think you won't need your traditional IRA for your own living expenses.

Although the value of the Roth will still be included in your gross estate, there are no required minimum distributions, allowing the account to grow larger than it otherwise might under the traditional IRA rules. Also, your beneficiaries will be able to take withdrawals free of income tax.

What's more, the income tax you pay on conversion (preferably from assets other than the IRA) will reduce your gross estate. In effect, you're making a gift by prepaying the income tax on behalf of the beneficiaries without it really counting as a taxable gift. This could be particularly advantageous to the heirs in situations where there's no taxable estate to speak of anyway, because in such instances there would be no future income tax deduction available to the beneficiaries for previously paid estate taxes.

Even when a future deduction for estate taxes attributable to the inherited IRA would be available, there might still be some advantage, primarily because the converted Roth would not be subject to minimum distributions during the original account holder's lifetime—and therefore the balance could potentially grow much larger. Obviously, this strategy requires some serious number crunching.

Charitable remainder trust and charitable lead trust (CLT)
We talked about CRTs in Smart Strategies For Charitable Giving. A CRT is primarily a diversification and income tax strategy, although the charitable gift component will have an impact on reducing your gross estate.

A testamentary CLT, on the other hand, is typically more appropriate for estate planning purposes, rather than as a lifetime income strategy. At death, a portion of your estate is placed into the testamentary CLT, reducing your gross estate. The charity you choose receives an annuity for a period of years. At the end of the term, your heirs receive the remainder interest.

Again, we've highlighted just a few of the many estate planning ideas available. As you consider these and other transfer strategies, be sure to work with trusted professionals who can help you put together an estate plan based on your particular needs and goals.

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