COMMITMENTS NEEDED TO SOPHISTICATED ESTATE PLANS

Sophisticated estate planning tools can offer significant tax savings, creditor protections and other benefits. However, their success depends on considerably more than a properly executed well-drafted document. Skilled professionals are needed to file gift, estate and generation-skipping transfer ("GST") tax returns at the appropriate times, to make proper elections on those returns, to file documents with County Assessors in order to claim exclusions from property tax reassessments, and to give advice on how to avoid breaches of fiduciary duties and the tax consequences of the exercise of different powers under the estate planning documents.

Perhaps the most important component of a successful estate plan is your commitment to obtain and follow professional advice and to abide by the rules and regulations that apply to particular trusts and entities. Absent this commitment and the right professional advice, mismanagement is likely. If a trust or entity is not managed properly, tax savings or creditor protections that would otherwise be available may be lost.

The question becomes, how many complications can you tolerate and handle well in order to achieve your estate planning goals? The answer varies from person to person.

This article looks at tools commonly used in the world of sophisticated estate planning and cardinal rules to be followed in their management. It concludes with things to consider in matching the right person with the right estate plan and tried and true tips for the success of an estate plan.

Irrevocable Life Insurance Trusts ("ILITs")

- Abide by the Trust terms.

- The Trustee cannot be the insured.

- If a new policy of insurance will be purchased, the Trustee applies for and purchases the policy. Any existing policy should be assigned to the ILIT (i.e., the owner should be changed to the Trustee). If an insured dies within three years of his/her transfer of the policy to the ILIT, the estate tax benefits of the ILIT will not be reaped.

- If gifts to the ILIT (including the value of policies assigned to it) exceed or do not qualify for the present interest gift tax exclusion, Gift Tax Returns must be filed. Gift Tax Returns may also have to be filed to allocate or refrain from allocating generation-skipping transfer exemption to the ILIT.

- The Trustee opens a bank account. (Taxpayer identification number may be needed.)

- The insured does not pay premiums. Instead gifts are made by the insured to the ILIT and the Trustee pays the premium from the Trust account.

- Insureds or their spouses should not engage in premium financing without first obtaining advice on the tax consequences from a qualified tax advisor.

- Whenever gifts are made, the proper letters are sent to beneficiaries informing them of their withdrawal rights (if withdrawal rights are given to the beneficiaries to qualify gifts for the present interest annual gift tax exclusion).

- Make sure any borrowings against a policy of insurance to be transferred to the ILIT do not exceed the income tax basis in the policy. If borrowings exceed basis, income tax problems can arise.

- Make sure any Trust income is used to pay premiums if the creator of the ILIT is relying on the Trustee's use of income to pay premiums to make the ILIT a grantor trust.

- If the ILIT is not a grantor trust, Fiduciary Income Tax Returns may have to be filed. A qualified tax professional should be consulted about the tax consequences of the existence of any withdrawal rights and the beneficiaries' failure to exercise their withdrawal rights.

- The Trustee should review policies owned by the ILIT periodically with a qualified insurance professional and alter coverage, if feasible and advisable.

Irrevocable Gift Trusts

- Abide by the Trust terms.

- Transfer assets to the Trustee of the Trust using the appropriate legal document (e.g., deed, assignment or check). Make sure delivery is made in the proper year.

- If California real property will be transferred to the Trust, evaluate whether a change in ownership (and reassessment) for property tax purposes will occur by virtue of the transfer. File any documents necessary to claim available exclusions from reassessment.

- Make sure there are no contractual or other restrictions on the transfer of assets to the Trust. If there are restrictions, abide by the restrictions.

- A taxpayer identification number will have to be obtained if not a grantor trust.

- Whenever gifts are made, the proper letters are sent to beneficiaries informing them of their withdrawal rights (if withdrawal rights are given to the beneficiaries to qualify gifts for the present interest annual gift tax exclusion).

- If gifts to the Trust exceed or do not qualify for the present interest gift tax exclusion, file Gift Tax Returns. Gift Tax Returns may also have to be filed to allocate or refrain from allocating generation-skipping transfer exemption.

- Make sure any debt associated with a gifted asset does not exceed its income tax basis. If debt exceeds basis, income tax problems can arise.

- If the Trust is not a grantor trust, Fiduciary Income Tax Returns may have to be filed. A qualified tax professional should be consulted about the tax consequences of the existence of any withdrawal rights and the beneficiaries' failure to exercise their withdrawal rights.

- If the Trust is a grantor Trust, the Trustee should consult a qualified tax professional about the income tax consequences before powers are surrendered that may convert the Trust from a grantor Trust to a non-grantor Trust.

- If the Trust is a grantor Trust and a sale is made by the creator to the Trust, make sure the sale is documented properly and the purchase price and terms resemble an arm's length business transaction (to avoid bad tax consequences). Consider filing a Gift Tax Return to report the sale in order to start the clock running on the time taxing authorities have to audit the transaction and classify it as a taxable gift in part (e.g., because they deem the purchase price insufficient).

Legal Entities (Family Limited Partnerships, Limited Liability Companies and Corporations)

- Have a business purpose for forming the entity and treat the entity like a business in all respects. For example, a primary or personal vacation residence should *not* be transferred to the entity and personal expenses should *not* be paid from the entity.

- Abide by the terms of the entity's organizational and other documents (Bylaws, Operating and Partnership Agreements, etc.).

- Real estate owned by the entity should be titled in the name of the entity (not individuals).

- Separate Income Tax Returns should be filed for the entity and the reporting should be consistent with other records maintained by the entity.

- Before transferring real property to an entity, consult a qualified tax advisor about all of the tax consequences.

- Once California real property has been transferred to the entity, a new set of property tax rules (the legal entity rules) apply. As gifts or sales of interests in the entity are made or owners die, there may be a change in ownership for property tax purposes and real property owned by the entity may be reassessed. When an owner dies or gifts or sales of business interests are made, reports may have to be filed with the California State Board of Equalization, within certain periods of time. If the reports are not filed on time, penalties may be assessed.

- LLC Operating Agreements, Partnership Agreements and Corporate Buy/Sell Agreements should be carefully coordinated with estate plans. With a family business, if certain requirements are not met in conjunction with the purchase of a deceased, disabled or retiring owner's interest, there can be bad tax consequences. Sometimes restrictions are placed on a client's ability to transfer his or her ownership interest to family members or to a revocable trust.

- Gifts of interests in business entities may not qualify for the present interest exclusions from the federal gift and generation-skipping transfer tax even if the beneficiaries are given withdrawal rights over the gifts. This can be true if significant restrictions are imposed on transfers by the donee of the gifted interest or if the donee is not assured of receiving a reasonable income from the interest.

Qualified Personal Residence Trusts ("QPRTs")

- Abide by the Trust terms. Be aware that upon the occurrence of certain events (for example, the sale of the home that is the subject of the QPRT), there are deadlines for taking certain actions.

- Deed the real property that is the subject of the QPRT to the Trustee of the QPRT when the QPRT is signed.

- If the creator of a QPRT continues to pay the mortgage after the real property is transferred to the QPRT, the principal part of each mortgage payment represents an additional gift to the Trust.

- There are restrictions on the number and kinds of residences that can be transferred to a QPRT. There is also a limit on other kinds of property that can be transferred to the QPRT. Make sure that federal tax rules and regulations are followed in this regard.

- Since a QPRT is an irrevocable Trust, if the creator wishes to refinance real property transferred to the QPRT and cannot find a lender who will make a loan to a Trust, unlike a revocable trust, the property should not be removed from the QPRT for purposes of refinancing it.

- If the QPRT creator wishes to continue to occupy the home beyond the term of years during which he or she has the right to do so, the creator will have to pay market rent to the persons or trusts succeeding to the home after the term ends, if the creator's estate is to realize the transfer tax savings QPRTs have to offer. An arm's length lease should be entered into with respect to the rental.

- When the QPRT term ends, if the real property is to be distributed outright to beneficiaries, the home should be deeded to them.

- When the QPRT term ends, California real property may be reassessed for property tax purposes unless a claim is timely filed with the County Assessor for an exclusion from reassessment (if the transfer qualifies for an exclusion).

- A QPRT may be a grantor trust (for income tax purposes) some of the time and a non-grantor trust the rest of the time, requiring income tax reporting to be done differently at different times. A qualified tax professional should be consulted.

- Gifts to QPRTs do not qualify for the present interest annual gift tax exclusion. Therefore, every time a gift is made to a QPRT, a Gift Tax Return has to be filed.

- Generation-skipping transfer exemption cannot be allocated to the QPRT until the creator's benefits from the QPRT end.

<u>Grantor Retained Annuity Trusts ("GRATs") and Grantor Retained Unitrusts ("GRUTs"</u>

- Abide by the Trust terms.

- Convey the assets that are the subject of the GRAT or GRUT to its Trustee, using the proper legal document, on its establishment.

- The annuity or unitrust payments <u>have</u> to be made to the GRAT's or GRUT's creator. (The creator cannot be given an I.O.U. if the Trust is short of cash.) Figure out how to do that <u>before</u> the GRAT or GRUT is established and funded.

- A GRAT or GRUT may be a grantor trust (for income tax purposes) some of the time and a non-grantor trust the rest of the time, requiring different kinds of income tax reporting to be done at different times. A qualified tax professional should be consulted.

- Gifts to GRATs and GRUTs do not qualify for the present interest annual gift tax exclusion. Therefore, every time a gift is made to a GRAT or GRUT, a Gift Tax Return has to be filed.

- Generation-skipping transfer exemption cannot be allocated to the GRAT or GRUT until the creator's benefits from the GRAT or GRUT end.

<u>Dynasty/Generation-Skipping Transfer ("GST") Plans</u>

- Abide by the Trust terms. This can be challenging if the Trust contains exotic powers designed to save transfer taxes, like a power vested in an independent Trustee or Trust Protector to grant a beneficiary a general power of appointment over his or her trust (to cause trust assets to be subject to estate tax rather than generation-skipping transfer taxes at the beneficiary's death). It may be difficult to find an independent Trustee or Trust Protector, whose fees are affordable and who is willing to hold such limited but tricky powers.

- If the Trust is an irrevocable Trust established during the creator's lifetime, additional considerations come into play, for example, whether the GST transferor changes as a result of the lapse of a Crummey withdrawal right. It is important that the Trustee be sophisticated enough to spot and address these issues.

- It is critically important that a qualified professional having significant experience with GST taxes prepare the Estate Tax Return and all GST Tax Returns. Persons lacking this experience may overlook important elections, like the reverse QTIP election, or may fail to file a GST Tax Return when it is due. This can result in a loss of significant tax savings and/or the imposition of penalties.

- Who will serve as Trustee for multiple generations of beneficiaries? If you do not wish to name a bank or trust company to serve as Trustee or successor Trustee it becomes virtually impossible to come up with a line of successor Trustees with whom the creator is acquainted who will live long enough. Building flexibility into the Trust terms (for example, by allowing acting Trustees to designate their successors) is key.

- The considerations under "Irrevocable Gift Trusts" also apply to gifts to a dynasty or GST Trust during the creator's lifetime. Many of those considerations also apply to gifts made to a dynasty or GST Trust after the Settlor's death.

Split Interest Charitable Remainder Trusts and Charitable Foundations

- Abide by the Trust terms or organizational documents.

- Annual reports have to be filed that bear no resemblance to Fiduciary Income Tax Returns and certain minimum distributions have to be made from private foundations. Make sure your accountants are intimately familiar with tax-exempt organizations.

- Unrelated business taxable income rules and private foundation prohibitions that apply to these Trusts and entities (with respect to self-dealing, excess business holdings, attempts to influence legislation and the like) are a second language. It is critically important that you receive the proper advice lest you engage in a transaction that may cause the Trust or entity to be fined or worse.

- Negotiating or entering into a contract to sell assets not yet transferred to a charitable remainder trust may result in the recognition of gain on the sale even though the Trust is tax-exempt and even if the sale closes after the transfer of the assets to the Trust.

Tips to Help an Estate Plan Succeed

- Make sure you know what you will have to do, on an ongoing basis, to administer a Trust or legal entity properly after it is established. Have your advisors provide you with written instructions in this regard.

- Make sure you understand all of the pros and cons of a particular vehicle. Be careful not to let your advisors' biases influence you. You need to make your own decisions based on your own personal circumstances.

- Are you too cost conscious? Remember that sometimes less expensive professionals may not have the right credentials to advise you on more sophisticated estate planning vehicles.

- Are the Trustees being proffered sophisticated enough to understand the estate planning vehicle and administer it well? Do they have the time to administer it well? "Big picture people" who don't want to be bothered with details or people who are overextended oftentimes do not make good Trustees.

- Are you only forming an entity or establishing a split interest charitable trust for the tax savings, rather than a legitimate business purpose or out of a sense of benevolence? If so, you may be more likely to regard the entity or trust as your own personal pocketbook, increasing the likelihood of mismanagement.

- Genuine rivalry among the beneficiaries of a trust or between a Trustee and beneficiaries (as with some stepparents and stepchildren) can make the proper administration of a Trust more difficult.

- Build flexibility into any irrevocable Trust so that the Trustees and Trust Protectors have the powers they need to cope with changing and unforeseen circumstances.

- Significant elements of control and beneficial enjoyment usually have to be surrendered in order to realize transfer tax savings or to obtain protection from creditors. Be careful not to jeopardize your own financial security in the process.

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