Insight on estate planning

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PLUS!

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Irrevocable life insurance trusts

5 things you need to know about to save taxes

A properly structured irrevocable life insurance trust (ILIT) can save you estate taxes while benefiting your spouse and other loved ones. In a nutshell, because the ILIT owns your life insurance policy and pays the premiums, when you die, the policy's proceeds pass into the trust and aren't included in your estate for federal estate tax purposes.

1. The insurance policy

To fund the trust, you can transfer an existing policy to it. The ILIT's trustee — typically your spouse — then signs a change of beneficiary form naming the ILIT as the policy's new beneficiary. In addition, even though your spouse is the ILIT's primary beneficiary if he or she survives you, the trust will not be included in your spouse's estate on his or her subsequent death. However, you must live for three years after the date you transfer the policy. If you don't, the policy proceeds will be included in your taxable estate.

If you can fund the trust and then have the trust buy a new insurance policy, that's probably a better option. The three-year rule doesn't apply to a policy that's owned from its inception by an ILIT.

2. Premiums

To keep insurance proceeds out of your estate, the ILIT must pay the premiums. Open a separate checking account for the ILIT to which you can make deposits. Your spouse, as trustee, can pay the insurance policy's premiums from that account. Your spouse shouldn't contribute to the ILIT's checking account if he or she also is a trust beneficiary. It would cause a portion of the trust assets to be included in your spouse's estate for estate tax purposes.

3. Gift tax deductions and exclusions

The value of any cash or other property you contribute to the ILIT will be considered a gift for gift tax purposes. Accordingly, the cash value of any policy you transfer to the ILIT and the amount you contribute to pay future policy premiums are considered gifts for gift tax purposes.

To qualify all or a portion of your gift to the ILIT for the gift tax marital deduction, your spouse can have the right to withdraw all or a portion of the gift. But his or her right to withdraw contributions has to be limited; otherwise a portion of the ILIT would be included in his or her estate for estate tax purposes. Your spouse's right to withdraw has to be limited to the greater of 1) the first $5,000 contributed to the ILIT in each calendar year or 2) 5% of the amount contributed to the ILIT each year.

Using insurance proceeds to provide estate liquidity

You may include life insurance in your estate plan to provide liquidity for your estate and family, thus preventing the forced disposition of other assets to pay estate taxes, expenses and debts. Keep in mind that an ILIT cannot instruct the trustee to pay your estate any cash needed to pay debts, expenses and taxes, because this would cause the insurance proceeds to be included in your estate for estate tax purposes.

Solve this problem by authorizing, but not directing, the trustee to lend money to, or purchase assets from, your estate. Loans and purchases improve your estate's liquidity while keeping the estate's assets within your family. Neither loans nor purchases, however, cause the insurance proceeds to be included in your estate for estate tax purposes.

If property in excess of those amounts is contributed in any calendar year, additional beneficiaries, such as children or grandchildren, may be given withdrawal rights so the contribution won't be subject to gift taxes. These withdrawal rights let contributions in excess of the amount subject to the spouse's withdrawal rights qualify for the gift tax annual exclusion ($11,000 per recipient for 2004) and not be taxable.

4. Withdrawal right notices

To protect the gift tax deduction and exclusions, the ILIT must require that each person entitled to make a withdrawal be notified by the trustee of his or her right. The trustee may give notice after each ILIT contribution, once annually for all contributions, or otherwise as the trustee deems advisable — but no later than Dec. 31 of the calendar year in which the contribution is made.

This notice must be in writing unless actual notice already exists. Because your spouse, as trustee, will have actual notice of his or her right of withdrawal, he or she need not be given written notice. If property in excess of your spouse's withdrawal right is contributed in any calendar year, any beneficiaries age 18 or older should be given written notice. Your spouse, as guardian for your minor children, would have actual notice so no written notice would be necessary.

5. GST tax exemption

If after your and your spouse's deaths you'd like the ILIT to stay in existence for the lifetimes of your children and grandchildren, allocate a portion of your generation-skipping transfer (GST) tax exemption ($1.5 million in 2004) to the ILIT. By annually allocating this exemption to the ILIT in an amount equal to your contributions, the insurance proceeds can be kept exempt from GST tax.

Leveraging the exemption this way can significantly increase the amount that can pass estate-tax free on the death of your child (or later descendant) because no estate tax will be incurred on the ILIT assets at that time.

Before 2002, you would have had to allocate GST tax on your annual gift tax return. A new law, effective Jan. 1, 2002, allows the GST tax exemption to automatically be allocated to an ILIT. Thus, filing a gift tax return to allocate GST tax exemption to an ILIT is no longer required.

Be sure to keep records of the amounts you contribute to the ILIT so on your death there is a record of how much GST tax exemption you allocated to the ILIT. If you don't want to allocate GST tax exemption to your ILIT, notify the IRS.

Finding refuge with an ILIT

Federal gift and estate tax can consume as much as half of an estate. Using an ILIT can shelter transfers beyond the $1 million gift tax exemption and the $1.5 million estate tax exemption. In addition, you can fund it with $11,000 annual exclusion gifts. But to achieve these results, the trust must be drafted and funded according to the rules. ∎

Should a trust be the beneficiary of your retirement plan?

Under the minimum distribution rules, after your death, assets in a qualified retirement plan, such as a 401(k), generally may be distributed over the life expectancy of your plan's designated beneficiary. Without a designated beneficiary, your plan will have to be distributed more quickly, losing the benefits of extended tax-deferred growth. Although the general rule is that a designated beneficiary must be an individual, a trust may be the beneficiary and its beneficiary may be considered the designated beneficiary for purposes of the minimum distribution rules.

Naming a trust as beneficiary

Why name a trust as your retirement plan's beneficiary? First, you may want your spouse to benefit from your plan but not be able to control who'll receive the balance of such benefits on his or her subsequent death.

Generally, if you name your spouse as beneficiary, he or she will roll over your retirement benefits to an IRA and then be free to designate the IRA's beneficiaries on his or her death. This is particularly important if your spouse remarries after your death. Second, if you want your children to benefit from your retirement plan's benefits, you may create a trust and name your children as beneficiaries if they're young or not capable of managing money.

5 rules

Your trust beneficiaries will be treated as your retirement plan's designated beneficiaries if you follow these IRS rules:

1. The trust must be valid under state law.
2. The trust must be irrevocable or must, by its terms, become irrevocable on your death.
3. The trust's beneficiaries must be identifiable from the trust instrument.
4. You must provide trust documentation to the retirement plan administrator.
5. All trust beneficiaries must be individuals.

Planning for adopted descendants

If you wish to include a trust beneficiary who is a descendant by virtue of legal adoption on the same basis as a natural descendant and enjoy the advantages extending retirement plan payouts over the life of the designated beneficiary, there is a potential for IRS rule violations. After your death, one of your descendants could adopt someone who was born earlier than the person who was the oldest beneficiary of the trust when you died. It's unclear whether the IRS would raise this issue, but to avoid the problem, include language in the trust providing that older individuals can't be added to the class of trust beneficiaries by legal adoption. Instead, implement other estate planning strategies to benefit such individuals.

Rules three and five are where problems can easily occur, so let's take a closer look at them.

Identifying beneficiaries

This rule is more flexible than you might think. If you name more than one trust beneficiary, for example, the members of the beneficiary class will be treated as being identifiable as long as the trust labels the oldest class member. Why? Because that's whose life expectancy the IRS will use as the measuring period for required distributions after your death.

If the trust beneficiaries are "all your descendants living from time to time," the members of that class still are considered identifiable, even though the class isn't closed, because no person with a shorter life expectancy can be added later. The IRS can determine the oldest class member because any descendants who are born after your death are by definition younger than the oldest descendant who is living at your death.

But there are pitfalls. The mere possibility that an older beneficiary could be added to the trust can raise an IRS red flag, regardless of whether any such older beneficiary ever is actually added.

Ensuring beneficiaries are individuals

One common mistake is indirectly naming the estate as one of the trust beneficiaries. An estate isn't considered an individual for retirement plan designated beneficiary purposes. So, if any part of the trust's interest in the benefits will pass to your estate, there is no designated beneficiary.

This means your retirement plan assets would have to be distributed within five years after your death. Even indirectly allowing benefits to pass to your estate — as through a trust provision directing the

Power play

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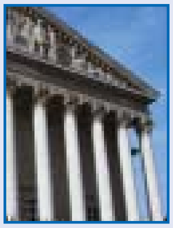

One benefit of a living trust, in addition to avoiding probate for trust assets, is that you can name a trustee to manage your estate if you become incapacitated. But a living trust can't hold, for example, qualified retirement plans. Such plans require you, the participant, to be the owner.

So if you become disabled and your family needs access to your 401(k) plan, an incompetency proceeding would be necessary. Fortunately, you can avoid this time-consuming and potentially unpleasant step by executing a durable power of attorney for property while you're healthy.

To do so, you simply appoint, in writing, another person, such as a trusted family member, as your agent. He or she then has the authority to make decisions regarding any property you couldn't transfer to your living trust.

Typically durable powers of attorney for property are drafted to become effective only if the creator becomes incompetent, as most people don't want their agents to act for them until that time. For example, you may add a provision stating that your property power of attorney becomes effective only after your doctor certifies in writing that you're unable to manage your business affairs. Alternatively, some situations may warrant the property power of attorney to become effective on its execution. To be effective, the durable power of attorney must be properly drafted, so professional legal advice is critical.

use of trust property to pay your debts or probate expenses — may be treated the same as naming your estate as beneficiary and could result in having no designated beneficiary for retirement plan purposes.

To ensure your trust complies, prohibit its use of the retirement plan assets, or require that no such payments be made from the retirement plan on or after Sept. 30 of the year after the year of your death. (Such payments before that date are permitted.)

Making your choice

You have two choices when designating the beneficiary of your qualified retirement plan: an individual or a trust. When choosing a trust, its beneficiaries are considered the designated beneficiaries for purposes of the minimum distribution rules. Because the IRS regulations are complex, make sure your advisor explains them before you make your choice.

Providing estate plan flexibility with powers of appointment

If you have a traditional estate plan, on your death it calls for the creation of two trusts for your spouse should he or she survive you: 1) a family trust that doesn't qualify for the estate tax marital deduction and is funded with assets equal to the estate tax exemption, and which isn't included in the surviving spouse's estate on his or her subsequent death, and 2) a marital trust that does qualify for the marital deduction and is funded with the balance of your assets.

Typically, on the surviving spouse's subsequent death, the two trusts are combined and divided into separate, equal trusts for the children. You may add flexibility to your estate plan by giving your surviving spouse — as well as your children — a power of appointment.

Spouse's power

Granting your surviving spouse a power of appointment lets him or her make appropriate revisions to your estate plan, such as redistributing assets remaining in your children's trusts. This is important because on your surviving spouse's death — which could occur many years after your death — there may be reasons to not treat the children equally. For example, a child may not be in contact with your surviving spouse. Or one child could be wealthy and the other may have financial needs.

Children's powers

If you intend for your children's trusts to be kept in existence for their lifetimes, consider providing powers of appointment for them in their trusts. Why? To give your children the flexibility to revise the trusts to, for example, redistribute funds to their children (your grandchildren).

In addition, you could give them the power to appoint the assets in their trusts to trusts for their spouses. Your children may want to exercise such a power if they have good marriages and a large portion of their standard of living comes from trust distributions.

Peace of mind

Giving your spouse or adult children a power of appointment in your will or living trust allows them to redistribute trust assets. This estate planning flexibility can give you peace of mind that your loved ones will be properly cared for after you're gone.

Navigate your FLP through post-*Strangi* waters

Family limited partnerships (FLPs) are a popular estate planning technique to reduce federal estate taxes. FLPs generally have held up in court despite IRS challenges. But last year, a U.S. Tax Court ruled against FLPs. The ruling's fallout is greater IRS scrutiny of FLPs than ever.

Chart your course

In the case of *Albert Strangi*, the court ruled that the property value he transferred into his FLP be included in his estate for federal estate tax purposes. Among other things, the court found that Strangi had maintained too much control over the partnership, including how income was distributed among the partners. As of this writing, the case is on appeal to the Fifth Circuit Court of Appeals.

If you have created an FLP, whether you should wait to take any action until the appeal is heard, or reduce or even give up control over FLP assets by making adult children the general partners, depends on your particular situation.

But in the meantime, the *Strangi* case, and several other cases, set the following guidelines that may help you increase the chance that your FLP will pass IRS scrutiny:

- Create the FLP and make gifts of the limited partnership interests while you're in good health.
- Avoid transferring personal assets, such as a house, into the FLP unless you pay a fair market rent to continue to live there.
- Don't transfer everything to the FLP. Instead, retain sufficient assets to provide for your support.
- Establish a separate bank account for the FLP.
- Make pro rata distributions of income to all partners.
- Don't pay the partners' personal expenses from the partnership.

At a minimum, review how your FLP operates and have your attorney review your partnership agreements.

Weather the sea change

Creating or maintaining an FLP is complicated, even more so after the *Strangi* ruling. Nevertheless, an FLP continues to be a viable estate planning tool to reduce estate tax liability. By minding *Strangi* and other FLP decisions, you can help ensure your FLP withstands IRS scrutiny.

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Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 10 of our 13 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 150 years of combined experience to the services we provide. The stability of our firm enables our lawyers to work closely together with business specialists to give clients outstanding individualized attention.

Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.

We welcome the opportunity to discuss your needs and help you meet your estate planning and wealth transfer objectives.

Please call us at 310-553-8844 to let us know how we can be of assistance.