

Insight on **estate planning**

year end 2006

Estate planning across the generations

Thanks, but no thanks

Use a disclaimer to let a gift
or bequest to you pass on to someone else

Keeping the family peace

Blended families can benefit from a QTIP trust

Plus!

Estate Planning Pitfall:

It's year end, and you haven't
made annual exclusion gifts



Estate planning across the generations

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ffective multigenerational estate planning considers both how to transfer family wealth and the effects of such a transfer on future generations. Gifting to your children is one way to transfer wealth tax-efficiently, but you have other options.

Transferring assets without gifts

On your death, you're allowed to transfer up to \$2 million to loved ones — other than your spouse — estate-tax free. (There is an unlimited marital deduction for transfers to spouses.) This amount, however, is reduced to the extent you used your \$1 million lifetime gift tax exemption. And, don't forget to be aware of state estate taxes, as the state exemption amounts vary.

But let's suppose you have assets of less than \$2 million. Rather than conclude that there's no benefit in estate planning because your estate won't be subject to the estate tax, look beyond your situation and focus on your children and grandchildren.

Take Joe, for instance, an 85-year-old widower with one child. He's comfortable that his \$1 million retirement nest egg will remain fairly constant the rest of his life because, between Social Security, his pension and modest investment return, he has more than enough cash flow on an annual basis. Further,

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his daughter, Betty, is successful in her own right. She and her husband, Rob, have a combined net worth of approximately \$5 million, and the extra \$1 million they stand to inherit from Joe won't have a substantial impact on their lives. But, it will, under the current estate tax structure, considerably increase their estate tax liability.

Rather than give the assets outright to his daughter, Joe can create a trust that will allow Betty to have access to the funds during her life without her actually owning the assets. At Betty's death, the assets will pass to Joe's grandchildren estate-tax free. And, if Joe creates a perpetual trust, the assets will pass for his grandchildren's use without being included in their estates.

As useful as this can be for Joe, think of how much more powerful it can be if each subsequent generation does the same thing. That is, Betty and Rob both set up such trusts, passing (under current law) \$2 million each to their children to accumulate estate tax free for *their* grandchildren or, in the case of a perpetual trust, all of their descendants.



Gifts to parents

Typically, gifting focuses on transferring assets to future generations. After all, why would you make a gift to a parent if the asset is just going to eventually come back to you? But there are situations where such gifts can benefit everyone.

Suppose, for instance, your parents are financially secure but not in a position to gift assets to you or your children. However, they do have traditional IRAs that you stand to inherit. Your parents are in a low

income tax bracket and you're

in a high bracket, so you'll owe significant

income tax on the inherited IRAs. You might suggest to them that they convert their IRAs to Roth IRAs.

With a Roth IRA, distributions are income-tax free, meaning that, after your parents have passed away and you inherit the Roth IRAs, you won't owe income tax on the funds. Plus, unlike traditional IRAs,

Roth IRAs have no required minimum distributions for the creator of the account.

You can then gift your parents the money they'll need to pay the income taxes that will be due as a result of the conversion. Be wary of how much your parents will owe, and plan carefully to avoid the possibility that their income tax bill will exceed the amount you can give them tax-free under the annual gift tax exclusion — \$48,000 (\$12,000 x 4, because you and your spouse can each gift each of your parents \$12,000). If it will, consider gifting a portion of the expected tax in the year of conversion and the balance the following year, when the tax will be due.

You also might consider helping out your parents in future years. To the extent that they'd otherwise take a distribution from their Roth IRAs, gift them the amount they need. That way, their cash flow isn't diminished and their entire Roth IRA can continue to grow tax-free, allowing you to inherit a greater amount that will be income-tax free to you.

Estate planning for today *and* tomorrow

Multigenerational estate planning requires you to take into account your financial situation as well as your parents' and your children's. The key is to think creatively and to develop a plan that works for you and your family. ■



Thanks, but no thanks

Use a disclaimer to let a gift or bequest to you pass on to someone else

If you were asked “How do you benefit by not benefiting?” you might think you were being challenged to unlock a mysterious riddle. But by taking advantage of an estate planning tool called a disclaimer, you could indeed benefit significantly by not benefiting at all.

What's a disclaimer?

By making a disclaimer, you're saying that assets gifted or bequeathed to you should instead pass *through* you as though you were no longer alive.



Typically, a disclaimer is warranted when the expected estate tax ramifications of accepting a gift or bequest would outweigh the benefit of keeping the asset. For clarification purposes, let's examine three scenarios under which a disclaimer would be appropriate, so long as the person contemplating the disclaimer was fully aware of the consequences:

The rich uncle. Your mother, 85, is a widow and has an estate well in excess of the \$2 million lifetime estate tax exemption.

As a result, she's been gifting regularly for years and is making arrangements to implement other wealth transfer strategies. Her only sibling, your uncle, has never married and has no children. Although your mother has encouraged your uncle to do some estate planning of his own, he has never taken any action. At your uncle's death, your mother stands to inherit everything.

Rather than be upset with your uncle, your mother uses a disclaimer to accomplish for him posthumously what she couldn't accomplish while he was alive. By disclaiming her entire interest in your uncle's estate, your mother causes his entire net worth to pass directly to you and your siblings.

The underused lifetime exemption. Your parents have amassed substantial wealth, but haven't done a great job of estate planning. As a result, most of their assets are either held jointly or in your father's trust. After your mother's death, the jointly held property passes to your father by operation of law. Regrettably, your mother's entire \$2 million lifetime estate tax exemption is wasted.

A disclaimer can be the answer. Suppose the joint account has \$4 million of assets. By your father disclaiming, your mother's half of the account will pass directly to you and your siblings as though your father had predeceased her. The balance, the remaining \$2 million, is retained by your father. Remember, a disclaimer doesn't apply to assets other than those that are disclaimed.

For those in community property states, it's important to verify that the ability to disclaim assets held jointly isn't in any way compromised, and to be certain to do everything necessary to preserve the validity of the disclaimer.

Stretching out an IRA. Suppose in the first example that your mother didn't have substantial assets, and your uncle's funds would actually be quite helpful to her. Further suppose that half of your uncle's assets is in the form of an IRA. Your mother thinks the \$500,000 in securities she'll inherit is sufficient to allow her to get by. She isn't enamored with having to increase her taxable income by virtue of receiving taxable IRA distributions.

By making a disclaimer, you're saying that assets gifted to you should instead pass *through* you as though you were no longer alive.

If your mother retains the IRA, she'll be required to withdraw the assets over her life expectancy. At 85, life expectancy tables would require her to take \$65,789 per year ($\$500,000/7.6$) from a \$500,000 account. By contrast, if your mother disclaims to you, and you're age 50, your required distribution is based on your life expectancy of 34.2 years, yielding an amount of \$14,619 per year.

Before disclaiming an IRA, be sure the contingent beneficiary is consistent with your objectives. In your uncle's case, your mother was listed as primary beneficiary and you as contingent beneficiary. In fact, if the beneficiary designation states that the contingent beneficiaries are you and your siblings, per stirpes, there may be additional opportunities for further disclaimer. ("Per stirpes" means that, if you're deceased at the time that you inherit, your children stand in your place.) That, of course, opens up the possibility that you could, in turn, disclaim to your children.

How do you disclaim?

A disclaimer must be executed correctly or its value will be lost. Disclaimers are authorized by federal law, but there may be state laws that govern certain aspects, so be aware of whether your state has any

applicable rules. On the federal level, a "qualified" disclaimer must:

- Be in writing and indicate your irrevocable refusal to accept the property,
- Be received by the person making the transfer, the transferor's legal representative or the person who holds legal title to or possession of the property no later than nine months from the day the transfer is made or the date of the decedent's death (or, if later, the date the beneficiary turns 21 years old),
- Pass either to the spouse of the decedent or to a person other than the disclaimant without any direction on behalf of the person making the disclaimer (an exception is that, if a spouse disclaims, the interest may pass to a trust in which he or she has an income interest), and
- Be made before the person making the disclaimer has received the property or any benefit from the property.

In addition, the entire interest — or an undivided portion of the interest — must be disclaimed.



Know who's receiving disclaimed assets

When done properly and in the appropriate circumstances, a disclaimer can be a powerful tool in your estate planning arsenal. But bear in mind that, once you file the disclaimer, the assets' disposition is controlled by the terms of the decedent's estate plan. Therefore, make certain your estate plan specifies who will receive property if it's disclaimed. ■

Keeping the family peace

Blended families can benefit from a QTIP trust

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ajor life events require you to review and, if needed, revise your estate plan. One such event is getting married for the second (or later) time. Before the big day, consider creating a qualified terminable interest property (QTIP) trust — especially if you and your fiancé have children from previous marriages. Why? Financial issues between your future spouse and your children may arise after your death. A QTIP trust may be the solution to keep the peace.

Reasons to create a QTIP trust

A QTIP trust gives your spouse access to your assets after your death, but restricts his or her ability to direct how the assets remaining at his or her death will be distributed. A QTIP trust can be beneficial if you wish to provide for your current spouse while ensuring that your children from a prior marriage receive the assets you intend

them to receive. With so many blended families today, this isn't an unusual scenario.

Even if the relationship between your spouse and your children from your previous marriage is cordial, a QTIP trust may be warranted. After all, there's the possibility that your spouse, without being nefarious, might not make provisions to provide for your children in his or her own estate plan. Following your death, everything you've accumulated will pass to your spouse's children on his or her death.

QTIP trust provisions

A QTIP trust has special provisions that provide for the benefit of your spouse after your death. The assets in the trust will qualify for the marital deduction and, thus, will not be subject to estate tax at your death. Rather, they'll be included in your spouse's estate on his or her death. What's left in the trust when your spouse dies will go to your children (or other beneficiaries you have named).

A QTIP trust must include the following provisions:

- All income from the trust must be payable to your surviving spouse for his or her lifetime on at least an annual basis,
- During your spouse's lifetime, nobody can have the power to shift the trust assets to someone other than your spouse, and
- Your spouse must have the right to compel the trustee to invest the trust in income-producing assets.

The QTIP trust treatment must be elected on your estate tax return; otherwise, it will not be considered to be a valid QTIP trust.

QTIP trusts and splitting of assets

Estate planning often involves the shifting of assets between spouses to take full advantage of their estate tax exemptions (\$2 million each in 2006). With a QTIP trust, you avoid the need to split assets, but there are two important caveats.

First, if you live in a community property state, you need to be certain that there are no unintended consequences. For instance, the ownership of your assets might be deemed to be equally split between you and your spouse, rather than by you alone. Second, if your spouse predeceases you and has less than the \$2 million estate tax exemption in his or her name, you'll lose the ability to maximize the amount that will be passed estate-tax free to your children.



Family harmony intact

A QTIP trust is intended to make life easier for your survivors. Too often, there's friction between children and surviving spouses, regardless of whether the surviving spouse is the children's parent.

In the case of a second (or later) marriage, however, the need to walk the tightrope between your spouse's needs and those of your children can be burdensome. A QTIP trust can alleviate that concern and, perhaps, help everyone to see that you have their best interests at heart. ■



Estate Planning Pitfall



It's year end, and you haven't made annual exclusion gifts

With the approach of the end of the year, the time for making annual exclusion gifts is rapidly slipping away. Such gifts are an ideal way of transferring large amounts of wealth to your family, but they're a "use it or lose it" proposition. When the year is over, so is your gifting opportunity for the year.

In 2006, you may transfer up to \$12,000 per recipient in "present interest" gifts without having the gifts subject to gift tax. Present interest gifts are those which the recipient has a current right to use. Thus, giving cash or marketable securities directly to your child would qualify as a present interest gift; gifts to a trust of which your child is a beneficiary generally wouldn't qualify.

So why should you make annual exclusion gifts? Suppose you have an estate that greatly exceeds the lifetime estate tax exemption amount, currently \$2 million. Any assets that remain in your estate at your passing will be taxed at the highest estate tax rate. Every dollar you can transfer out of your estate to your heirs will mean that more will go into their pockets — and less will go into Uncle Sam's.

For example, let's say Janet is an 80-year-old widow with a \$5 million estate. She has two children, both of whom are married, four grandchildren, one of whom is married, and one great-grandchild. By gifting to all seven descendants and their spouses, Janet can transfer \$120,000 per year gift-tax free. If Janet then dies on New Year's Eve, the \$120,000 that she transferred will reduce her estate tax by 46% of the gift amount, or \$55,200.

If Janet lives to distribute an additional \$120,000 in 2007 before passing away later in the year, she will have reduced her estate by \$240,000. Because in 2007 the highest marginal estate tax rate is 45%, she will have reduced her estate tax by \$108,000.