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Gifting offers certainty in uncertain times

Ascertainable standards: What you need to know

Is your spouse a U.S. citizen?

If not, consider using a QDOT

Estate Planning Red Flag

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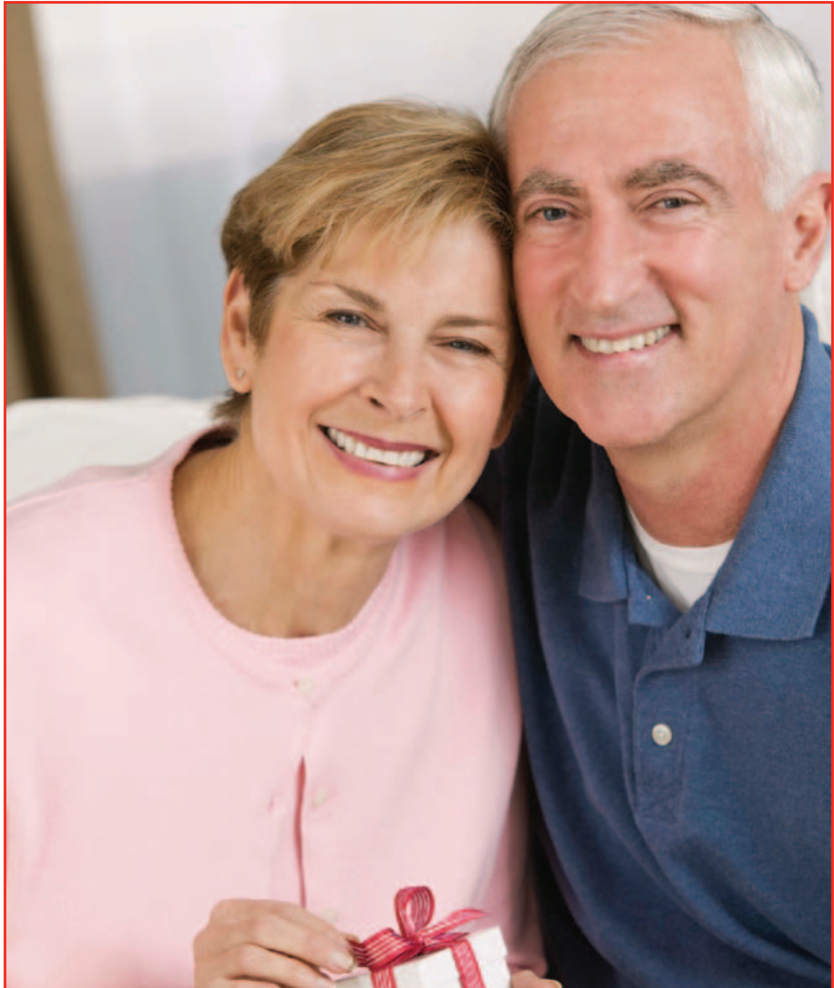
Gifting offers certainty in uncertain times

Uncertainty about the future of the estate tax makes planning a challenge. Estate-tax-reduction strategies will be unnecessary, for example, if the tax is permanently repealed — though this is unlikely.



As of this writing, a 2010-only estate tax repeal is in effect, and the estate tax is scheduled to return in 2011 — with higher rates and a lower exemption. But Congress is expected to take action on the estate tax, perhaps repealing the repeal and extending 2009 rates and exemptions. (Check with your estate planning advisor for the latest information.)

Planning based on the exemption amount is difficult when it's not clear what that amount will be — or if there even will be an estate tax. Fortunately, gifting remains a powerful tool that can provide significant benefits regardless of what Congress does. The best strategy is to make the most of tax-free gifts — but even taxable gifts make sense in some cases.

Leveraging the annual exclusion

The annual gift tax exclusion currently allows you to give up to $13,000 per year tax free to any number of recipients without using any of your $1 million lifetime gift tax exemption. If you elect to split gifts with your spouse, the exclusion doubles to $26,000 per recipient. To qualify for the annual exclusion, the transfers must be "present interest" gifts, meaning that the beneficiary has an immediate right to the asset gifted.

These gifts are removed from your estate, so their value (including any future appreciation) is shielded from estate tax on your death regardless of what happens with the estate tax repeal. They're also generally exempt from the generation-skipping transfer (GST) tax, which also has been repealed this year but is scheduled to be reinstated next year along with the estate tax.

Annual exclusion gifts allow you to transfer a substantial amount of wealth tax free. Suppose, for example, that you have three children and six grandchildren. You and your spouse can transfer up to $234,000 tax free this year without using any of your lifetime exemptions.

Hedging your bets with a QTIP trust

With the estate tax up in the air, now may be a good time for a qualified terminable interest property (QTIP) trust. Such a trust can be used to take advantage of the unlimited marital estate tax deduction at your death while ensuring that the assets remaining at your spouse's death pass according to your wishes — to children from a previous marriage, for example. QTIP trusts can also protect the trust assets from the surviving spouse's creditors or financial shortcomings. When the surviving spouse dies, the assets are taxed as if they were part of his or her estate.

Even if you're not concerned about children from a previous marriage or potential mismanagement, a QTIP trust may be preferable to an outright bequest to your spouse. Why? It provides a way to hedge your bets while waiting for Congress to act. (See main article.)

For a QTIP trust to work, your executor or other personal representative must make a QTIP trust election on your estate tax return. If you die and the estate tax has been reinstated, your representative can make the QTIP trust election to qualify the trust for the marital deduction and avoid estate taxes on your death. (If your spouse isn't a U.S. citizen, special rules apply to the marital deduction. See "Is your spouse a U.S. citizen?" on page 6.) When your spouse dies, the assets will pass to your children or other beneficiaries and will be taxed as part of your spouse's estate.

If you die when there is no estate tax, no QTIP trust election is made. The trust provides for your spouse for life, and the remaining assets pass to your children tax free — even if the estate tax has been reinstated.

Using other gifting strategies

If you're uncomfortable making outright gifts to family members, you can put the funds into one or more trusts. To be considered a present interest and therefore qualify for the annual exclusion, such trusts typically include "Crummey" powers (named after the court case in which they were introduced). Crummey powers give beneficiaries the right to withdraw contributions for a limited period of time after they're made (30 days, for example) and require you to notify beneficiaries of this right.

You might also consider setting up a family limited partnership (FLP) or a family limited liability company (FLLC). By placing assets in one of these entities and giving family members minority interests, you may be able to take advantage of valuation discounts to transfer more wealth to your family within annual exclusion limits.

Be aware that, as recently as last year, bills that sought to reduce or eliminate valuation discounts for intrafamily transfers were introduced in Congress, though as of this writing such bills are dormant. If you have an FLP or FLLC, the best defense against an IRS attack is to ensure that your entity is properly created and managed.

Making taxable gifts

Usually, the best approach is to make the most of the annual exclusion and payments of tuition and medical expenses, while preserving your $1 million lifetime exemption. (Use of your lifetime exemption reduces your available estate tax exemption dollar-for-dollar.) If your estate is very large, however, it might make sense to make gifts within, or even beyond, your lifetime exemption.

The top gift tax rate currently stands at 35%, but it may go up to 45% or even 55% next year. (Again, check with your estate planning advisor for the latest information.) The value of your assets may increase as well. So you may enjoy

significant tax savings by making gifts now rather than later, even if you have to pay gift tax on them.

Of course, this strategy could backfire if the estate tax is permanently repealed. Similarly, taxable gifts may lose their advantage if Congress increases the gift tax rate retroactively.

A safe bet

In uncertain times, annual exclusion gifts and direct payments of tuition and medical expenses seem like a safe bet. They offer significant tax savings regardless of what the future holds. Taxable gifts may also provide an advantage, but it's a good idea to consult your estate planning advisor to determine whether they're worth the risk. ✤

Ascertainable standards: What you need to know

To design an effective estate plan, you need to strike a balance between minimizing taxes and retaining control over how your wealth is distributed. In doing so, the language used in wills, trusts and other estate planning documents is critical. One area that demands precision is the use of ascertainable standards, which limit distributions to amounts needed for a beneficiary's health, education, support and maintenance.

Why does it matter?

Suppose you place stock and other assets into an irrevocable trust for the benefit of your children. To ensure that the assets are managed properly, you appoint yourself trustee. The danger here is that, if you have too much control over trust assets, they may be pulled back into your estate and be subject to estate taxes. (Even though, as of this writing, an estate tax repeal is in effect for 2010, the estate tax is scheduled to return in 2011. Plus the repeal may be repealed. Check with your estate planning advisor for the latest information.)

Internal Revenue Code (IRC) Section 2036, for example, provides that assets are included in your estate if you retain "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

One way to avoid this problem is to have the trust provide for mandatory distributions of specific amounts at specific times. But that means beneficiaries will receive distributions even if they don't need them, depleting the trust and making it harder to preserve its assets for future generations.

A better solution may be to authorize distributions based on ascertainable standards. The idea is that ascertainable standards are objective, so they limit the trustee's discretion and allow a court to determine whether distributions are appropriate or should be compelled. Because you, as trustee, have little control over the amount and timing of distributions, it's difficult for the IRS to argue that the assets should be included in your estate.

Another alternative is to appoint an independent trustee who can have even greater flexibility to make distributions based on changing circumstances and your beneficiaries' specific needs. Still, it may be a good idea to use ascertainable standards or other guidelines to ensure that the trustee acts in accordance with your wishes.

Ascertainable standards also come into play in several other estate planning contexts, including powers of appointment and beneficiaries who serve as trustees.

Which standards are ascertainable?

The IRC recognizes several ascertainable standards, including:

- Support,
- Support in reasonable comfort,
- Maintenance in health and reasonable comfort,
- Support in one's accustomed manner of living,
- Education, including college and professional education,
- Health, and
- Medical, dental, hospital and nursing expenses and expenses of invalidism.

Whichever language you choose, careful drafting is critical. Seemingly subtle differences can have significant implications. For example, "maintenance in health and reasonable comfort" would be a legitimate ascertainable standard, while "comfort, welfare or happiness" would not.

Ascertainable standards are objective, so they limit the trustee's discretion and allow a court to determine whether distributions are appropriate or should be compelled.

For extra protection, most trusts also contain a "savings" clause. This clause "saves" the trust in the event that the IRS or a court determines that the trust's distribution provisions aren't based on an ascertainable standard. A typical savings clause expressly prohibits the trustee from making discretionary distributions other than for a beneficiary's health, education, support or maintenance and from making distributions that would benefit the trustee.

Even IRS-endorsed ascertainable standards can lead to disputes among beneficiaries and make the trustee's job difficult. For example, if your trust allows distributions for education, does it make a difference if the beneficiary goes to a state university or an Ivy League school? If the trust provides for "support in one's accustomed manner of living," is that fair to beneficiaries who are students or work in low-paying jobs? To avoid disputes and ambiguity, consider including more specific language in the trust.

Double-check trust language

As you review your estate plan, think about potential scenarios in which beneficiaries may need financial assistance. Then be sure that the language used in your trusts and other documents is consistent with your estate planning goals and sufficiently precise to guide a trustee or a court. ✤

Is your spouse a U.S. citizen?

If not, consider using a QDOT

When Dan married Isabel, a citizen of Spain, he didn't realize the estate planning consequences of the fact that his wife wasn't a U.S. citizen. This means that, even though Isabel is a permanent U.S. resident, Dan can't take advantage of the unlimited marital deduction without additional planning.

The marital deduction allows you to transfer property, either through lifetime gifts or bequests at death, to your spouse gift- and estate-tax free. But if Dan transfers assets to Isabel outright, it may trigger immediate tax consequences. Fortunately, Dan and Isabel can take advantage of the deduction by using a qualified domestic trust (QDOT).

QDOT in action

A special marital deduction is allowed for assets that pass to a QDOT. (Even though, as of this writing, an estate tax repeal is in effect for 2010, the gift tax remains and the estate tax is scheduled to return in 2011. Plus the repeal may be repealed. Check with your estate planning advisor for the latest information.)

A QDOT typically is created in a will or in a separate trust document before the citizen spouse's death, but there is some flexibility to the rules. The executor of your estate or your surviving spouse can create a QDOT — within certain time limits — even after your death.

Once your assets are transferred to the trust, your surviving spouse can receive *income* from the trust estate-tax free. Distributions of *principal* to your spouse, however, will be subject to estate taxes — and the trustee must withhold funds equal to the amount of tax.

The 2010 estate tax repeal, however, temporarily changes the landscape. Although unsettled, it appears that during the repeal there are no estate tax consequences of transferring assets outright to a noncitizen spouse. It's important to be mindful of pre-2010 estate tax law, though, because the estate tax may revert to 2009 levels.

Further, under prerepeal estate tax law, there are estate tax considerations for when the trust terminates or other distributions are made. These consequences also appear to fall by the wayside until the estate tax is reinstated. But again, this area isn't settled. So, if it applies to you, tread carefully before taking any action that could cause an adverse tax impact.

Additional rules

For transfers to a QDOT to qualify for the marital deduction, the QDOT must have at least one trustee who's a U.S. citizen or a domestic corporation (for example, a bank or trust company) and require the trustee to approve all principal distributions. In addition, the trust must be designated as a QDOT by an election on the U.S. citizen spouse's federal estate tax return and retain enough property in the United States to cover any estate tax payable at the noncitizen spouse's death.

If the QDOT's assets are worth more than $2 million at the death of the first spouse, the U.S. trustee must be a domestic bank or, alternatively, the individual U.S. trustee must furnish the IRS with

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a bond or letter of credit in an amount equal to 65% of the QDOT's value.

Taking the next step

Returning to the opening example involving Dan and Isabel's estate planning situation, it may be worth Dan's while to consider a QDOT. But he should consult an estate planning advisor experienced in international tax before taking any action. ✤

Estate Planning Red Flag

Your plan doesn't name a backup guardian for your minor child

If you have minor children, arguably the most important estate planning decision you have to make is choosing a guardian for them should the unthinkable occur. You've likely put much thought into this decision to ensure your children would be cared for as you wish. But if you don't also choose a backup guardian, your children still might not be cared for according to your wishes. Why? If your first choice dies or is unable or unwilling to serve for some other reason, a court will appoint a guardian.

Here are a few issues to consider when evaluating potential guardians:

- Do they want to serve as guardians?
- Does your estate plan provide sufficient resources so that caring for your children won't cause an economic hardship?
- Do they share your values and parenting philosophy?
- If they're married, is the marriage stable?
- If they have children, do your children get along with them?
- How old are they in relation to the children? A grandparent or other older person may not be the best choice to care for an infant or toddler, for example.
- Are their homes large enough to make room for your children?

Keep in mind that a court's obligation is to do what's in the best interest of your children. The court isn't bound by your guardian appointment but will generally honor your choice unless there's a compelling reason not to. It's a good idea to prepare a letter explaining the reasons you believe your appointees are best equipped to care for your children.

In addition to naming a backup guardian, your estate plan should list anyone you wish to *prevent* from raising your children.

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