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Planning Potpourri

■ General Power Trap: There is another growing trust landmine that anyone engaging in matrimonial planning should be aware of. When a taxpayer dies, appreciated assets owned by that taxpayer get a step-up in income tax basis. This means unrealized capital gains are eliminated. If the taxpayer had paid $10 for an asset that grew to $100,000 the new tax basis on death becomes $100,000. To capture the most basis step-up elixir some use general powers of appointment more frequently to cause this basis-step estate inclusion. If a taxpayer did not own an asset on death, but had the power to appoint that asset to her estate, creditors or the creditors of her estate, that power alone will suffice to pull the assets into that taxpayer's estate and generate the sought after basis step up. With the likely growth in the use of these powers, be alert to who may hold a power to redirect assets, whether such powers are themselves reachable in a matrimonial action as marital assets, and whether prenuptial agreements should address the exercise or non-exercise of these powers. Should a prenuptial agreement acknowledge that the spouse not holding a power of appointment has no claims or rights, or ability to mandate an exercise of a power held by the other spouse?

■ Charity Letters: The IRS challenged a recent claim for a conservation easement deduction where the taxpayer received a side letter that promised to refund a cash portion of the donation, and even rescinding the easement if the tax deduction was denied. Graev v. Commissioner, 140 T.C. No. 17 (June 24, 2013). The use of letter agreements to confirm how donations will be used is growing. Be careful not to torpedo your tax deduction by overreaching agreements.

■ New York: NY has proposed increasing its estate tax exemption to approximate the federal exemption, reduce its rate to 10%, factoring post 4/1/14 gifts into the estate tax calculation and more.

■ Revocable Living Trusts: ► If you reside in a decoupled state and set up a revocable trust, consider granting someone the right to revoke your rights in the trust to trigger a completed gift of non-appreciated assets to minimize state estate tax. ► Another Point: Revise your living trust to make it a powerful tool to address your needs as you age. Review trustee selection and consider adding an institutional trustee, integrate a care manager to provide independent valuations and reports, and more. PP

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PRACTICAL PLANNER®

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Update Your Documents

Summary: Some Vikings want to know what's in your wallet, but Viking lawyers want to know what's in your will! Now that commentators have digested the implications of the sea-change 2012 Tax Act, what might you want to include in your estate planning documents? Real people want to know "Can I finally have my documents revised and not have to do so again in six months?" The law is now "permanent" (quotes courtesy of Congress!). The new tax paradigm certainly seems like it will have a reasonable shelf-life. Regardless, the changes discussed below are so different from what exists in many documents that for anyone that hasn't had a make-over now is the time. When you revise your documents this time, make them flexible enough to address future changes (e.g., state's changing their estate tax rules).

■ Power of Attorney: Permitting your agent to make those annual gifts, $14,000 per person in 2014, has been standard boilerplate in powers. But boilerplate is only okey dokey when it makes sense for you. That old boilerplate was a decent default approach for many in the past, but it may no longer be. ► For most folks a gift power may prove to be a dangerous spigot for an agent to commit elder financial abuse. Don't kid yourself, this stuff even happens in "good" families and is committed by trusted loved ones. ► For wealthy folk living in a decoupled state, like NJ, permitting gifts to minimize state estate tax, well in excess of $14,000, might make sense. In NJ and other decoupled states where there is no gift tax your agent might gift away assets before your death to reduce state estate tax. ► For the wealthiest taxpayers you might authorize your agent to make gifts up to the remainder of your federal exemption amount. This is $5,340,000 in 2014 and is inflation adjusted each year. Even if you've used up your full exemption the annual inflation adjustments will create valuable gifting opportunity in future years. This is a new and now permanent feature of the tax laws that did not exist when most powers of attorney were created. ► For any gift provision agents might be warned about gifting highly appreciated assets that might be best retained in your estate to qualify for a basis step-up. ► Yesterday's standard gift provision will rarely be what you want today. ► Another Change: Be your new power addresses digital assets which no one may have addressed in the past.

■ Wills and Bypass Trusts: The centerpiece of most wills and revocable trusts has been the one-two punch of a bypass trust to hold assets the surviving spouse can access, but which are outside his taxable estate. The balance of many estates was then left to a trust that qualifies for the estate tax marital deduction. Yawn. But Grandma's bypass trust won't cut the tax-mustard any longer. Revise your will/revocable trust for more flexibility because of changing state laws, increased mobility (where will you live when you die?) and to provide greater flexibility to minimize capital gains to your heirs (income tax rates can now be higher than estate tax rates, so this is a significant change). The magic elixir for many plans is basis step-up -- increase in tax basis (the amount on which capital gains are calculated) of assets owned at death to then fair value. How so? Freshen up your bypass trust with new flexibility: ► Include a "gap" bypass trust that is the amount between the state estate tax exemption and the federal exemption. If you move to a no-tax state or your state changes its laws flexible funding formulas can automatically adjust. This will

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Checklist: Trust Life Insur

Summary: Life insurance is the keystone of many estate plans. If life insurance fails to meet intended objectives it could prove devastating for millions of families. Since the only planning constant seems to be change (changing investment world, changing insurance performance, changing tax laws, changing family dynamics, …) it's a puzzle why most families that buy life insurance then ignore it.

√ Many folks setting up ILITs assumed (remember what happens when you assume!) that the insurance product they purchased was "guaranteed" when it wasn't. That means that they (or their trust) assumed 100% of the performance risk as to how long that life Insurance contract would continue to remain in force. You assume risk with every stock you buy, but that is why you hold a diversified portfolio of many investments and rebalance that portfolio with professional guidance at least quarterly (right?). Your life insurance needs the same diversification and rebalancing.

√ Some people make insurance funding decisions based on limiting their annual "expense." But how much money is invested in a permanent policy will determine how that policy will perform and how long it will last. Pay-

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...Update Your Documents

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give your executor/trustees maximum latitude to plan post-mortem. ▶ Give your surviving spouse the right to withdraw 5% of trust principal to pull appreciated assets back into his estate and achieve a basis step-up. ▶ Give an independent person the right to grant the surviving spouse a general power of appointment (GPOA if you need another acronym) over appreciated assets in the bypass trust to cause them to be included in his estate. ▶ Name an independent trustee and give a broad distribution standard (your spouse as trustee can only distribute pursuant to a more limited standard). This will provide more flexibility to distribute appreciated assets.▶ Add all descendants as beneficiaries so the trustees can sprinkle out income to whomever is in the lowest income tax bracket. Many old bypass trusts only named the surviving spouse, but that limits flexibility on shifting income. This was not so important in the past, but can provide a significant benefit in the current tax environment. This will, however, prevent your executor from qualifying your bypass trust as a QTIP or marital trust should that prove more favorable. ▶ Add charity to the list of beneficiaries to avoid percentage limitations on itemized deductions which individual beneficiaries face but trusts don't. ▶ Investment clauses should be broad enough to permit holding only non-appreciating assets, such as bonds, in a bypass trust. Your family may still have an overall diversified portfolio, but the location of different asset classes within that portfolio can be managed to optimize income tax benefits if the trust permits. If the trust is silent the trustee may be bound by the prudent investor act and have to hold a diversified portfolio, to the family's detriment, to avoid violating her fiduciary duties. ▶ Trust definitions could include capital gains in trust accounting income to permit a trustee to distribute capital gains to beneficiaries in lower tax brackets and avoid the high income tax bracket and 3.8% Medicare Surtax trusts face at about $12,000 of income.

■ Insurance Trusts (ILITs): ▶ Yesterday's insurance trust may have held a survivorship (2nd to die) life insurance policy to pay estate tax on the death of the second spouse. That tax may no longer be an issue. Many other insurance trusts held only term coverage. Now, with such high income taxes, and most wealthy people no longer subject to estate tax, consider insurance trusts that own permanent policies that provide income tax benefits and a ballast for the rollercoaster investment world. This will reflect in changes in trustee selection, distribution provisions and more. ▶ Crummey powers that qualify gifts to trusts for the gift tax annual exclusion have traditionally required an annual written notice ritual. For those unlikely to ever be subject to estate tax a more streamlined procedure may suffice. Beneficiaries might now sign a one-time acknowledgment that they'll accept verbal notification of annual gifts. ▶ Insurance trusts should often be more flexible then in the past, permitting gifts of other assets and serving other purposes. These "multi-purpose" ILITs (MILITs) can minimize the need for other trusts, simplify planning, and lower costs. ILITs can receive gifts of business interests and other assets and thereby reduce state estate tax, serve as a buffer to avoid your tripping over the federal estate tax exemption, provide asset protection benefits and more. ▶ ILITs, since they may own assets other than cash and insurance, should include special provisions assuring grantor trust status (income taxed to you) so you can swap assets. The mere right to use trust income to pay insurance premiums may not suffice. ▶ Because of the higher income tax rates ILITs might contain flexibility to turn off grantor trust status. Consider giving a trust protector the power to prohibit the use of trust income to pay insurance premiums. ▶ The biggest change is to refocus estate planning from death planning in your will to planning while you are alive using MILITs to secure asset protection when you need it most, and to provide protection from the challenges of aging in the future. As boomers age this dynamic will provide more non-tax benefits than what typically had been accomplished in the past. PP

Goof up: The Nov/Dec 2013 issue was accidentally labeled Jan/Feb 2013 and this Jan/Feb 2014 issue is late. Sorry. I may have to join e-harmony to get my dating right!

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Review: Andrew Wolfe, CPA, Esq.

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...Checklist: Trust Owned Life Insurance

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ing less might seem "cheaper" but it can over time undermine the policy.

√ 38% of in-force flexible premium non-guaranteed death benefit trust-owned life insurance (TOLI) policies are illustrated to lapse prior to the insured's life expectancy due to inattention of the trustees, or the impact of reduced interest rates over the last 20+ years. TOLI requires TLC!

√ 92% of ILITs have individual trustees. Some refer to these trustees as "accommodation" trustees. They simply accommodate whatever insurance policy the grantor setting up the trust, typically a close friend or family member, selected. The fact that Uncle Joe picked a particular policy doesn't mean you have a "get out of jail free" card when that policy blows up years later on your watch and your formerly cute little cousins sue you.

√ The policy illustration is not a guarantee. Don't use it to compare different types of policies and a layperson should not use it to compare different policies of the same type.

√ Plan your MILIT to include a professional trustee, or an individual trustee that works with insurance professionals. Insist on periodic insurance reviews. Trusts should not buy insurance, but rather "manage" insurance. The distinction is more than semantics. Passive ILITs may prove to be planning time-bombs. Defuse them with proactive professional management.

√ Is there adequate cash to pay premiums? Can the trust borrow from the policy, use other trust assets, or modify the policy?

√ A policy is like any other asset and must be reviewed every few years. Review the policy, insurance company stability, owner and beneficiary designations, and other factors. Different policy types have different risks and these should be assessed by someone with the expertise to do so.

√ Policy exchange may be beneficial. This should be evaluated perhaps every five years. If an exchange is to be undertaken it should benefit the beneficiaries, not the brokers. Before consummating an exchange evaluate whether it would be more prudent to surrender the policy or sell it into life settlement market.

√ Obtain a policy performance monitoring and risk management evaluation report from an independent insurance consultant or TOLI provider who can also assist in the identification and implementation of appropriate policy remediation options and decisions.

√ Draft and implement a TOLI Investment Policy Statement (TIPS) that sets out an annual ILIT administration process intended to safeguard the interests of all affected. While institutional trustees have policies and procedures in place to monitor trusts, including insurance performance, most individual trustees fly by the seat of their pants. Not wise given the risks. In a significant case, In re Stuart Cochran Irrevocable Trust, 901 NE 2d 1128, the trustee was relieved of liability for insurance decisions because it: ▶ Documented the process it used; ▶ Relied on the advice of a delegated agent who did not have a financial incentive; and ▶ Examined both the existing policy and the proposed replacement policy before the exchange. Process is key!

√ Is the trust itself still adequate or can or should it be modified or merged (decanted) into a new trust?

▶ Thanks to Henry Montag of Uniondale NY for his input. PP

Recent Developments

■ Estate tax freeze via a note sale transaction: This has become nearly a ubiquitous planning technique for the wealthy. You sell assets to a grantor trust for a note freezing the value in your estate and avoiding any capital gains tax. This technique results from cobbling together various techniques. The Obama administration has repeatedly tried shutting it down. Now the IRS is trying to whack this technique by claiming that the transaction should be recast as a failed GRAT, subjecting the entire value of the transfer to the trust to gift tax. The Tax Court is considering this in Estate of Donald Woelbing v. Comm'r, Docket No. 30261-13; Estate of Marion Woelbing v. Comm'r, Docket No. 30260-13. A GRAT, in contrast, has statutory authority. In a GRAT you take back a qualifying annuity and the value of the gift is reduced by the value of the annuity. If the transaction doesn't meet the GRAT requirements the annuity is valued at zero so the gift is the entire value of the transfer. The IRS is arguing that the note sale is really a failed GRAT so the full transfer is taxable. While this this position conflicts with Treas. Reg. § 25.2512-8, and the Wandry case indicated a note sale was permissible, consider this a clarion call to exercise diligence in carefully structuring and administering note sale transactions.

■ State Taxation of Trusts: The NJ court reconsidered the landmark Pennoyer and Potter cases. A NJ testamentary trust was created. The sole trustee resided in NY and the trust was administered outside of NJ. The trustee filed and paid NJ tax on S corporation income attributable to income from NJ, but not on non-NJ income. The fact that the tax return showed a NJ address was not significant. The court held that the trust was not administered in NJ, the Trustee was a NY resident, and therefore NJ could only tax the trust's NJ income. Residuary Trust A. v. Director, 27 NJ Tax 68 (2013). Evaluate all trusts to ascertain if there is sufficient basis for state income taxation and if so whether changes can be made (resignation of a current trustee and appointment of a trustee in a more favorable jurisdiction) to minimize state tax. PP