
Safeguarding the Castle: Can a Trust Keep the Dragon from the Gate?

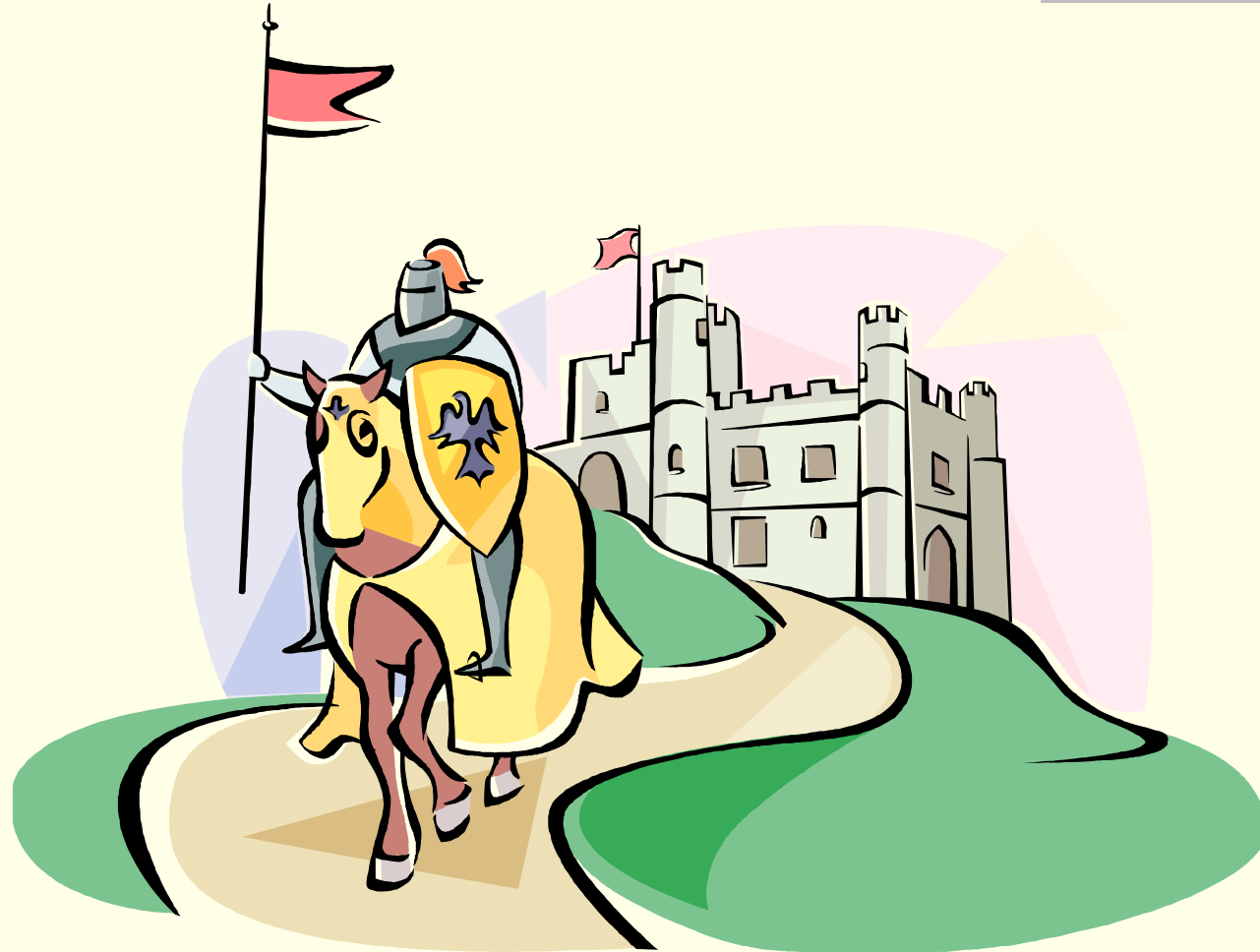
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Yes, if you have a Trusty Knight!



Types of Castles

- Residences
- Rental Real Estate
- Farms
- Investment Real Estate

Types of Dragons

- Tax Dragons
- Long Term Care Dragons
- Creditor Dragons

Tax Dragons

- **Income Tax**

- Capital Gains Tax

- Sale while living, or
 - By heirs after death

- **Gift Tax**

- After the annual exclusion, and
 - The \$1,000,000 applicable exclusion amount

- **Estate Tax**

- For estates in excess of Federal and State exemptions

Long Term Care Dragons: The Problem

■ **Nursing Homes**

- Cost @ \$9,000/month
- Private Pay or Long Term Care Insurance
- MassHealth will cover if applicant is medically and financially eligible

■ **Assisted Living**

- @ \$4,500+/month
- Private Pay or Long Term Care Insurance

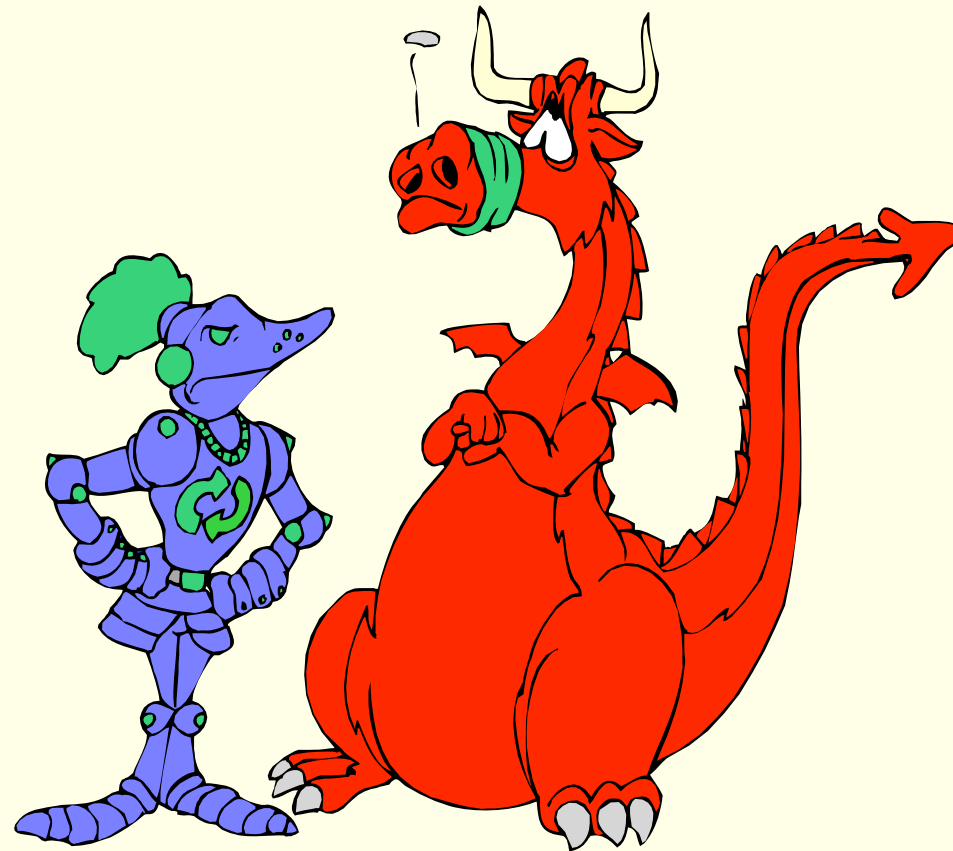
■ **Home Care**

- Private Pay or Long Term Care Insurance

Creditor Dragons

- **Your Creditors**
- **Your Children's if they hold your assets and encounter any of the following:**
 - Divorce
 - Debts
 - Disability
 - Death
 - Disaster

A Trust May Be The Answer



Trusts Which Can Help You Save Gift and Estate Taxes

- **First Line of Defense, Use the Estate Tax Exemptions:**
 - Revocable Living Trusts
- **Second Line of Defense, if insurable:**
 - Irrevocable Life Insurance Trusts

Additional Trust Planning for Real Estate For Larger Estates

- Qualified Personal Residence Trusts (“QPRTs”)
- Grantor Retained Annuity Trusts (“GRATs”)
- Intentionally Defective Grantor Trusts (“IDGTs”)
- Charitable Remainder Trusts (“CRTs”)
- Charitable Lead Annuity Trusts (“CLATs”)
 - Not discussed in detail here as they are not usually funded during lifetime or with real estate

What Do These Trusts Have in Common?

- **All involve partial interest gifts**
- **Gifts of Remainder interests**
 - QPRTs
 - CRTs
- **Gifts of Appreciation**
 - GRATs
 - IDGTs

Determination of Value

- **FMV determined by**
 - IRS interest rate set monthly under
 - Section 7520 rate for QPRTs, GRATs, CRTs (choice of current, prior 2 mos.), or
 - Section 1274 rate for IDGTs
 - Mortality tables for QPRTs and CRTs
- **GRATs no longer have to take mortality into account**
 - if annuity payments are made to estate after Grantor's death (Walton v. Com.)
 - Proposed Regs., June 7 2007: valuation of retained interest

The Fiction of Fair Market Value

- **Based on false assumptions:**
 - FMV almost never fair,
 - Mortality assumption almost always wrong,
 - FMV assumed constant over life of gift, and
 - IRS rate assumed constant over life of gift.
- If individual results (investment performance and mortality) beat IRS rates, “tax free” gifting is achieved.
- Whether rates are high or low can make the difference to the success of your plan.

Taxable Gift v. Charitable Gift

- If charity begins at home, go with the taxable gift
- If charitable gifting a priority, investigate the options
- Charitable giving with no charitable inclination is generally a disappointment

How to Win the Partial Interest Game for Taxable Gifts

- **Make taxable gifts of remainder interests when IRS interest rate is high**
 - Retained interest in donor high
 - Taxable gift to beneficiaries low
 - QPRTs
- **Make taxable gifts of appreciation when interest rate is low**
 - Easier for performance to beat IRS rate
 - Best when leveraged with discounted interests
 - GRATs, IDGTs

How to Win the Partial Interest Game for Charitable Gifts

■ CRTs

- To minimize capital gain, maximize donor withdrawals, use when interest rates are high.
- To maximize charitable deduction, use when interest rates are low.

■ CRUT v. CRAT

- Optimists go with CRUTs because annual withdrawals are tied to growth (and loss)
 - CRUTs are better in a low interest rate market
- Pessimists go with CRATs for certainty of return.

Qualified Personal Residence Trusts: Taxable Gift of Remainder Interest

- A QPRT holds a personal residence for a term of years for the benefit of the former owner who has created the trust (the Grantor).
- After the term of years, the home is owned by named trust beneficiaries, usually children, who rent the house back to the Grantor.
- The value of the gift to the children is reduced by the value of the Grantor's retained use.

QPRT Example

- Grantor, 70, puts residence, FMV \$500,000, in QPRT
- Keeps use for 10 years
- Value of retained use is subtracted from taxable gift
- Government interest rate determines value of retained use and taxable gift

QPRT Results: The Effect of Interest Rates

- **10 year QPRT, \$500,000 residence, single grantor, 4% after tax growth**
- **Taxable gift:**
 - 5.4% IRS rate: \$202,540
 - 3.2% IRS rate: \$240,775 (May 2008):
- **Potential Death Tax Savings at G's death:**
 - 5.4%: \$268,791
 - 3.2%: \$249,674

Advantages of QPRT

- Substantial estate and gift tax savings if Grantor survives term, no E & G tax risk if she does not,
- Retention of right to use residence or replacement residence,
- After term expires, rent allows additional transfers to children at income rather than gift tax rates, and
- Can use “Drop Down Defective Grantor Trust” to hold children’s beneficial interests
 - Eliminates income taxation of rent, and
 - Allows Section 121 capital gain exemption upon sale of home (but no buyback to G or related party)

Disadvantages of QPRT

- If Grantor survives term, beneficiaries take residence with carry over basis
- If Grantor does not survive the term, residence, residence goes back into Grantor's estate, but
 - Available for Marital Deduction Planning
 - Stepped up basis to heirs, so
 - No substantial downside tax risk
- Creditor issues in re children
- “Skip persons” should not be beneficiaries because GST allocation cannot be made till end of term (“ETIP” rule), i.e., no valuation discount

Grantor Retained Annuity Trusts: Taxable Gift of Appreciation

- Grantor transfers property to the trust and takes it back over a period of years in annual payments
- Value of gift is based on assumed growth rate under midterm Section 7520 rate, currently 3.2%
- At the end of the term, if trust outperforms IRS rate, beneficiaries take trust balance essentially gift tax free

Leveraging the GRAT With Discounted Gift

- A owns rental real estate held in LLC, FMV, \$1,000,000
 - Net income and appreciation 10%
- A transfers 30% interest in LLC to GRAT (\$300,000)
- Value of A's gift discounted by 25% to \$225,000
- A gets back @ 22%/yr for 5 yrs
 - Part from rental income on 10% interest
 - Part from return of interest in LLC at discounted value

GRAT Results

- A receives GRAT income, plus % of property necessary to equal 22% of \$225,000
- @ IRS rate of 3.2%, taxable gift: \$.34
- Tax free gift at end of term: \$183,418
- With “Ramped GRAT”: \$190,455
- Note carry over basis to heirs, GST issues

Advantages of GRATs

- Good alternative to QPRT for non residence real estate, particularly if discount available for initial gift, i.e., partial interest in property or entity
- When
 - interest rates low, actual performance beats IRS rate
 - funded with appreciating and income producing assets
- If Grantor survives term, no substantial risk as long as initial taxable gift is minimal.
- Grantor retains control of property (excluding appreciation)

Disadvantages of GRAT

- If Grantor does not survive term, property sufficient to fund the remaining annuity payments is included in Grantor's estate. Proposed Regs, June 7, 2007.
 - Not just remaining annuity payments
- Outright taxable gift may be better.
 - Appreciation on gifted property also excluded from Grantor's estate
 - Gift tax paid is excluded under IRC 2035 if Grantor survives 3 years
 - But Grantor has to be willing to give up property and pay gift tax.

Intentionally Defective Grantor Trusts: Taxable Gift of Appreciation

- Similar to GRAT strategy, good for rental R/E
- Sell property to IDGT
- Take back promissory note @ IRS rate
 - Section 1274(d) rate (not Section 7520 which is 120% of Section 1274(d) midterm rate)
 - May 2008: Section 7520: 3.2%
 Section 1274(d): 2.74%
- At end of term, appreciation goes to IDGT assuming that trust performance exceeds interest on the note

Tax Results of IDGT

- Income Tax:
 - Transactions between Grantor and IDGT ignored for income tax purposes
 - No capital gain tax upon sale of property to IDGT,
 - Income earned by IDGT taxed to Grantor
- Gift Tax
 - Completed gift for gift tax purposes
 - No additional gift when Grantor pays IDGT income taxes (Rev. Rul. 2006-64)
- Estate Tax
 - Trust (hopefully) excluded from Grantor's estate

Structure of IDGT

- Grantor owns rental real estate held in LLC, FMV, \$1,000,000, net income/growth, 10%
- Basis \$100,000
- Grantor sells 30% interest in LLC to GRAT
- Value discounted by 25% to \$225,000
- Grantor paid back via 5 yr installment loan at 3.2%
- At end of term, property remaining in IDGT goes to trust beneficiaries

IDGT Results

- No capital gain on sale to IDGT
- No interest income from installment sale
- Amortized loan payment: \$ 48,766
- Tax free gift after 5 yrs \$190,264
- Very similar to Ramped GRAT \$190,455

Problems With IDGTs

- Possible inclusion in Grantor's estate due to retained interest
 - Grantor should put "seed money" in trust to service loan (some commentators suggest 10%), and/or
 - Trust beneficiaries can to guarantee this amount
 - No authority
- Death of Grantor before term of note
 - Balance on note included in estate
 - Carryover basis for trust assets
- Reevaluation of gift by IRS, ? inclusion in estate

GRAT v. IDGT: Which is Better?

- GRATs: The Beaten Path
 - Creature of statute, more certain results
 - No gift or estate tax risk if gift zeroed out
 - Only partial inclusion of GRAT in estate if Grantor dies during term
- IDGTs: For the More Adventurous Client
 - Many unresolved issues
 - Additional funding to pay note? How much?
 - Additional funding (how much?) = taxable gift
 - Tax consequences on termination of Grantor Trust?
 - Retained interest if note is undervalued?

Non-Trust Alternatives

- Private Annuities
 - Great for ill but not terminally ill clients
 - Client has to die prematurely for this to work
 - Gain on sale to be recognized immediately (Prop. Regs Section 1001(b) Oct. 17, 2006) v. possible installment sale (old rule)
 - Grantor trust specifically neutralized under Regs.
 - Nuissance of different interest rate for income (OID) and estate (Section 7520) purposes
 - If Prop. Regs implemented, no different from sale, payment of C/G, purchase of commercial annuity

Non-Trust Alternatives (cont.)

- Self Cancelling Installment Notes (“SCINs”)
 - Also need fairly ill client
 - Increased premium must reflect self cancelling feature (commercial software calc. available)
 - Unlike private annuity, can be secured and interest is deductible
 - Term equal to or less than G’s life expectancy
 - Unrecognized gain at death taxed as IRD

Non-Trust Alternatives (cont.)

- Sale of Remainder Interest
 - Subject to IRC 2702 unless sale is to non-family members
 - May be useful with same sex couples, nieces, nephews
 - Otherwise not effective

Charitable Remainder Trusts

- CRT is a charitable entity
 - Not subject to income taxation
 - Restrictions similar to private foundation rules apply
- Charitable income tax deduction upon lifetime transfer = charitable portion of gift
- Retained interest payment can be made immediately or deferred
- Minimum 5% withdrawal

CRT: How It Works: Grantor Living

- Grantor puts appreciated real estate (farm, rental or investment) in a CRT for life or for a term of up to 20 yrs.
- Trust sells property, pays no capital gain tax currently and reinvests.
- Grantor receives charitable income tax deduction for partial interest in gift.
- Grantor retains annual payout equal to specified percentage of trust fund determined annually.
 - Grantor taxed on payments under WIFO method

CRT at Grantor's Death/ End of Term

- At Grantor's death or end of term, trust balance goes to charity.
- If ending at Grantor's death, trust balance is included in Grantor's taxable estate but qualifies as a charitable deduction.
- Grantor can purchase life insurance owned by an Irrevocable Life Insurance Trust to replace charitable gift.
- Charity can sometimes begin at home.

CRT Example: IRS Rate 5%

- Grantor, age 72, puts farm in CRT
 - FMV \$500,000
 - Income Tax Basis : \$5,000
- Retains income of 5% per year for life
 - CRAT: 5% of initial contribution, \$25,000/ year
 - CRUT: 5% of value of CRT determined annually, adjusted based on annual trust value

CRT: IRS Rate 5.2% v. 3.2%, 5% Withdrawal, Grantor 72

- Charitable Deduction:
 - IRS 5% CRAT: \$282,050 IRS 3.2%: \$253,098
 - IRS 5% CRUT: \$283,335 IRS 3.2%: \$281,760

- Retained benefit to Grantor (before tax), assuming 6% growth
 - IRS 5% CRAT: \$350,000 IRS 3.2%: \$350,000
 - IRS 5% CRUT: \$373,686 IRS 3.2%: \$373,686

Maximum CRT Withdrawal Rates

- Charitable gift must be 10% of original gift.
- CRAT, IRS 3.2%, 5.7% maximum withdrawal rate.
- CRUT, IRS 3.2%, 30% maximum withdrawal rate, greater retained benefit, but more risk if trust assets depreciate.
- May purchase life insurance via ILIT to cover loss to estate from charitable gifts

Charitable Lead Annuity Trusts: Gift of Appreciation

- Grantor creates trust which pays charity annual payment roughly equivalent to value of initial gift for a term of up to 20 years.
- If Grantor receives charitable deduction, will pay income tax on trust income for term.
- At end of term, Grantor's beneficiaries take balance of trust essentially gift and estate tax free.
- Good in low interest climate, best at death (no C/G exclusion) but benefit relinquished for term of trust.

Non-Trust Alternatives (cont.)

- Charitable Gift Annuities
 - Gift of remainder to charity
 - Retained annuity for life
 - Works well for the healthy
 - Generally marketable securities not real estate
 - No gain on sale by charity
 - Charitable inclination a must
 - Poor man's CRT

How to Choose? Balance the Factors

- IRS Interest Rate:
 - High rate: QPRT or CRAT or CRUT
 - Low rate: GRAT, CLAT at death or (possibly CRUT)

- Type of property to be gifted
 - Residence: QPRT
 - Appreciating, discounted property: GRAT, IDGT
 - Low basis property: CRAT or CRUT

Long Term Care Dragons

- Planning options other than gifting available
 - Long term care insurance
 - Community or Assisted Living
 - Purchase of non-countable assets
 - Purchase of special annuities
- Gifting can still be useful
 - Outright
 - Irrevocable Income Only Trust Agreement (“IOTA”)
- 5 yr MassHealth disqualification on most gifts

Transfer Planning: MassHealth and Creditor Issues

- Outright gifts to children
 - 5 year disqualification for MassHealth
 - Loss of Control
 - Children's creditors (5 D's)

- Transfer of Home to Income Only Trust
 - 5 year disqualification for MassHealth
 - Retained use and control
 - No access by children's creditors

Income Only Trust Agreements (“IOTAs”): Long Term Care and Creditor Protection

- Keeps lifetime benefit of transferred assets for Grantor
- Grantor receives all trust income (not capital gain)
- Grantor retains control over distribution of assets at death
- Stepped up basis at death (Query: 2010 and thereafter)

Best When Nursing Home Care Anticipated in Distant Future

- Nursing home care unlikely in next 5 years, or
- Long term care insurance + private assets available to cover 5 years, or
- Children will and able to cover shortfall
- Standard planning tools must be in place:
 - Financial Power of Attorney
 - Health Care Proxy
 - Will or Will and Revocable Trust

Tax Results

- Income Tax
- Gift Tax (federal only)
- Estate Tax

Structure of IOTA Plan

- Grantor transfers home to Income Only Trust
- Child or other trusted individual as trustee
- Grantor retains income and/or life use of trust property
- Children may be given access to principal
- At Grantor's death, trust assets distributed to designated heirs via trust instrument or Special Power of Appointment in IOTA
- Irrevocable transaction

Grantor's Personal Results

- Retains lifetime right to use home
- If home sold and replaced, retains right to use replacement home or unit in retirement community
- If home not replaced, retains right to income from proceeds

Grantor's Personal Results (cont...)

- Controls distribution to heirs via SPOA
- No exposure to creditors – hers or her children's
- No right to trust principal – but children can have access
- Should not be Trustee but can retain the right to remove and replace Trustee

MassHealth Results Under Current Law

- 5 year disqualification
- Trust reportable on MassHealth application
- Trust income (if any) countable
- Trust principal not countable after 5 years
- No estate recovery

Income Tax Results

- Grantor Trust: Grantor treated as owner for income tax purposes because of retained rights to
 - Income, and
 - Control of distribution of trust principal at death via SPOA. IRC Sections 674, 677
- Income and capital gain/loss taxed to grantor
- No capital gain upon sale of home under IRC Section 121
- Stepped up basis at death (? 2010 and thereafter)

Gift Tax Results

- Incomplete gift due to retained SPOA
- No use of annual exclusion
 - Incomplete gift
 - No present interest
- Federal consideration only
- No Massachusetts gift tax

Estate Tax Results

- Included in Grantor's Federal and Massachusetts estates
- No estate tax inclusion in estate of previously deceased child
- Stepped up basis to heirs subject to changes in 2010 and thereafter

Married Couples

- Option A
 - Transfer to one, add beneficial provisions for survivor, proceed as above
 - Include SNT in IOTA for other if he or she survives grantor

Married Couples...continued

- Option B
 - Create mirror image trusts
 - Each holding one half interest in home
 - SNT provisions in each IOTA
- Note other non trust planning options for married couples, i.e., special kinds of annuities are still very effective for short term planning

Find the Trust Which Fits Your Needs

- Estate Tax Savings – Non-Charitable Planning
 - Revocable Trusts
 - Irrevocable Life Insurance Trusts
 - Qualified Personal Residence Trusts
 - Grantor Retained Annuity Trusts
 - Intentionally Defective Grantor Trusts
- Long Term Care and Creditor Protection
 - Income Only Trusts
- Charitable Planning and Income Tax Savings
 - Charitable Remainder or Lead Trusts



And Then, ...

The Dragon Will Run Away!

