

The ESTATE PLANNER

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A FRESH LOOK AT CHARITABLE REMAINDER TRUSTS

In today's uncertain economic environment, even those with philanthropic intentions may be reluctant to pull the trigger on charitable gifts. What if you make a substantial donation to charity and then run into cash-flow problems down the road? The soft economy, volatile stock market and unsettled tax laws are enough to make anyone a bit leery of giving assets away today. Yet many charities are also facing financial challenges and need support from their donors more than ever.

If you're charitably inclined but concerned about having sufficient income to meet your needs, a charitable remainder trust (CRT) may be the answer.

CRT BASICS

A CRT allows you to support a favorite charity while potentially boosting your cash flow, shrinking the size of your taxable estate, reducing or deferring income taxes, and providing investment planning advantages.

How does a CRT work? You contribute stock or other assets to an irrevocable trust that provides you — and, if you desire, your spouse — with an income stream for life or for a term of up to 20 years.

(You can name a noncharitable beneficiary other than yourself or your spouse, but there may be gift tax implications.) At the end of the trust term, the remaining trust assets are distributed to one or more charities you've selected.

A CRT is particularly effective for selling highly appreciated assets that would otherwise generate substantial immediate capital gains.

When you fund the trust, you're entitled to claim a charitable income tax deduction equal to the present value of the remainder interest (subject to applicable limits on charitable deductions). Your annual payouts from the trust can be based on a fixed percentage of the trust's initial value — known as a charitable remainder *annuity* trust (CRAT). Or they can be based on a fixed percentage of the trust's value recalculated annually — known as a charitable remainder *unitrust* (CRUT).



Generally, CRUTs are preferable for two reasons. First, the annual revaluation of the trust assets allows payouts to increase if the trust assets grow, which can allow your income stream to keep up with inflation. Second, donors can make additional contributions to CRUTs, but not to CRATs.

The fixed percentage — called the unitrust amount — can range from 5% to 50%. A higher rate increases the income stream, but it also reduces the value of the remainder interest and, therefore, the charitable deduction. Also, to pass muster with the

IRS, the present value of the remainder interest must be at least 10% of the initial value of the trust assets.

The determination of whether the remainder interest meets the 10% requirement is made at the time the assets are transferred — it's an actuarial calculation based on the terms of the trust. If the ultimate distribution to charity is less than 10% of the amount transferred, there is no adverse tax impact related to the contribution.

INVESTMENT ADVANTAGES

CRTs facilitate tax-efficient investment strategies. To manage investment risk, diversification is critical. Ordinarily, to diversify your portfolio, you liquidate more concentrated holdings and reallocate the proceeds to a broader range of investments. But rebalancing your portfolio often generates taxable income. By contributing assets to a tax-exempt CRT, however, you're essentially free to reallocate the assets to achieve your investment objectives without undue concern about immediate tax consequences.

A CRT is particularly effective for selling highly appreciated assets that would otherwise generate substantial immediate capital gains. Instead of selling those assets outright, you contribute them to a CRT. The trustee then sells them, unburdened by capital gains taxes, and reinvests the proceeds in more diversified assets that provide greater returns.

Annual payouts from a CRT are taxable — generally as a combination of ordinary income, capital gains and tax-exempt income (if any), and tax-free return of principal. But because you pay tax only as you receive the annual payouts, you can defer much of the tax on a large capital gain for a potentially significant period of time (depending on the trust's term).

Controlling the flow of income

A charitable remainder trust (CRT) gives you the ability to control the income flow to suit your needs, which can be helpful in retirement planning. By designing a charitable remainder unitrust (CRUT) with a “net income with makeup” feature — known as a NIMCRUT — you can reduce or even eliminate payouts early in the trust term and enjoy larger payouts in later years when you're retired or otherwise need an income boost.

Here's how it works. Each year, a NIMCRUT distributes the *lesser* of the unitrust amount (say, 5%) or the trust's net income. The trustee can invest the trust assets in growth investments that produce little or no income, allowing the trust to grow tax-free and deferring distributions to later years. The deferred payouts accumulate in a “makeup account.”

When you're ready to begin receiving an income, the trustee shifts the assets into income-producing investments. You can use the funds in the makeup account to increase your distributions beyond the unitrust amount (up to the amount of net income).

One disadvantage of a NIMCRUT is that, even with careful planning and quality investment advice, there's a risk that it will underperform and fail to provide you with income when you need it. A less risky alternative (albeit with less upside potential) is a FLIP-CRUT.

It's a NIMCRUT that converts into an ordinary CRUT on a specified date or at some predetermined event, such as retirement, marriage, divorce, birth of a child or death. This ensures that, when the time comes, a fixed percentage of the trust assets will be distributed regardless of the trust's income.

CRTs offer a great deal of flexibility — they can even provide retirement planning advantages. (See “Controlling the flow of income” above.)

HANDLE WITH CARE

CRTs require careful planning and solid investment guidance to ensure that they meet your needs. But properly structured and funded, they can provide substantial benefits. Discuss your options with your advisor before taking action. ❀

PRENUPS AND ESTATE PLANS: MAKE SURE THEY WORK TOGETHER

If you're getting married, estate planning is probably the last thing you want to think about. But if you and your future spouse plan to sign a prenuptial agreement (commonly referred to as simply a "prenup"), it's a good idea to design the agreement with your estate plan in mind. A well-planned prenup can provide several estate planning benefits; a poorly planned one can trigger unintended tax consequences or hinder achievement of your estate planning goals.



ESTATE PLANNING BENEFITS

Prenups are usually associated with divorce. But they also provide several benefits for successful marriages, including protection from liability for your spouse's separate debts and implementation of estate planning strategies.

Prenups typically preserve a spouse's right to receive a substantial portion of the other spouse's wealth.

Most states give a surviving spouse certain rights to a deceased spouse's property. In community property states, for example, a surviving spouse enjoys a 50% interest in all community property. In most other states, surviving spouses can choose to receive an "elective share" amount — usually between one-third and one-half of the deceased spouse's estate.

These rights supersede the terms of a will, but they can be waived in a prenup, which doesn't necessarily

mean that you'll be disinheriting your spouse. Prenups typically preserve a spouse's right to receive a substantial portion of the other spouse's wealth. But by waiving marital property rights, they allow you to specify the manner in which your assets will be distributed and ensure that your estate plan will operate as intended.

Suppose, for example, that you own a closely held business that you run with your children from a previous marriage. Assume further that the business makes up 75% of your net worth and you want your children to inherit it. A prenup can prevent your spouse from acquiring an interest in the business — either through a divorce or spousal inheritance rights — while preserving his or her right to the other 25% of your estate.

ESTATE PLANNING TRAPS

A prenup should work in concert with your estate plan, rather than against it. Here are a few areas where traps may lurk:

Premarital transfers. For an agreement to be legally enforceable, each party must provide "adequate consideration" — that is, the parties

must exchange items or promises of comparable value to create a binding contract. Typically, prenups transfer property rights from one spouse to the other in exchange for the release of certain marital rights. If the transfer takes place before marriage, however, it can trigger income and gift taxes.

The best strategy is to make the transfer after the wedding, because transfers between spouses generally are exempt from both income and gift taxes. There are exceptions, however, when a non-U.S. citizen spouse is involved.

The estate tax exemption. For couples with larger estates, an important goal of estate planning is to maximize the use of each spouse's estate tax exemption (\$5.12 million for 2012 but, as of this writing, scheduled to drop to \$1 million for 2013 and beyond). Often, this is accomplished by placing assets up to the exemption amount in a credit shelter trust, with the excess distributed to the surviving spouse (either outright or in a marital trust).

If a prenup distributes too much to the surviving spouse, it can leave the credit shelter trust underfunded, triggering unnecessary estate taxes in the surviving spouse's estate. A prenup should have the flexibility to accommodate this estate planning strategy and adapt to future changes in the exemption amount.

The disposition of the family home. Prenups often provide for the sale or other disposition of the family home, or give the surviving spouse the right to continue living there. The prenup should be drafted so that it doesn't impede your ability to execute home-related estate planning strategies, such as transferring the home to a qualified personal residence trust.

PLAN AHEAD

Prenups offer several significant financial and estate planning benefits. To maximize these benefits and avoid tax traps, work with your advisor to ensure that your prenup operates in harmony with your estate plan. ❀

MAKING A DIFFICULT DECISION WHEN IS IT APPROPRIATE TO HAVE YOUR ELDERLY PARENT DECLARED INCAPACITATED?

After the death of her husband, Ellen was leading a busy life and staying on top of her financial matters. But then Ellen's daughter, Jackie, noticed that her mother was becoming forgetful and had missed paying a few bills. As Ellen's mental state continued to deteriorate, she became unable to manage her day-to-day activities.

Jackie now faced the difficult decision of whether to try to have her mother declared incapacitated by a judge, who could appoint a guardian or conservator to oversee Ellen's affairs. She had some important questions, which she posed to her estate planning advisor.



WHAT'S THE DIFFERENCE BETWEEN CAPACITY AND INCAPACITY?

The legal definition of “capacity” varies from state to state, but generally it’s the mental ability to adequately function. A person is presumed competent unless an adjudication process determines otherwise. That is, a judge must declare a person incompetent. Factors leading to such a decision will depend on the circumstances.

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One barometer of whether someone is able to adequately function is the person’s ability to understand basic financial matters. Another is whether a person is able to attend to his or her own health needs.

WHAT'S THE ROLE OF A GUARDIAN/CONSERVATOR?

If you make the decision to have an incapacity determination and the judge agrees that your parent is no longer competent, the court will appoint a guardian/conservator. He or she will be responsible for managing your parent’s affairs.

More often than not, an incapacitated person’s child is appointed guardian/conservator, but the guardian/conservator doesn’t have to be a family member. In some states a person

can designate whom he or she wants to act as his or her guardian/conservator.

The guardianship/conservatorship will specify if the guardian/conservator has been appointed for the management of all aspects of your parent’s life or a specific aspect of it, such as for solely financial matters. Whatever the decision, the guardian/conservator will owe a duty of care to your parent and will be held accountable by the court for showing that his or her actions are appropriate.

ARE THERE OTHER OPTIONS?

Sometimes an elderly parent knows he or she needs assistance and asks for it. This is ideal because it avoids the expense and emotional toll of a guardianship/conservatorship proceeding — and your parent will receive the help needed.

For example, perhaps you or a sibling can take care of bill paying. Or, you can retain a professional to handle it — the expense may be worth the increased sense of control your parent may feel from hiring someone rather than depending on a family member.

Another option may be a durable power of attorney for property or a living trust. If your parent executes one of these documents, generally the agent or



trustee named can manage your parent's financial affairs. Similarly, a durable power of attorney for health care, or health care proxy, can allow the agent named to make health care decisions on behalf of your parent. These documents can provide the criteria under which your parent will be considered incapacitated so that a guardianship/conservatorship proceeding isn't necessary.

MAKE THE RIGHT DECISION

After learning the answers to her questions, Jackie concluded that having her mother declared incapacitated was the right decision. If you're facing similar circumstances with an elderly parent, talk to your estate planning advisor to learn more about your options. ❀

ESTATE PLANNING RED FLAG

You and your spouse have similar trusts

If you and your spouse have similar irrevocable trusts for each other's benefit, you could be subject to the "reciprocal trust" doctrine. It prohibits tax avoidance through trusts that 1) are interrelated, and 2) place both grantors in the same economic position as if they'd each created trusts naming themselves as life beneficiaries.

Suppose that you and your spouse's estates will trigger a substantial tax bill when you die. You transfer your assets to an irrevocable trust that provides your spouse with an income interest for life, access to principal at the trustee's discretion and a testamentary, special power of appointment to distribute the trust assets among your children.

Ordinarily, assets transferred to an irrevocable trust are removed from your taxable estate (though there may be gift tax implications). But let's say that two weeks later your spouse establishes a trust with identical provisions, naming you as life beneficiary. This arrangement would violate the reciprocal trust doctrine, the transfers would be undone by the IRS and the value of the assets you transferred would be included in your respective estates.

In this example, the intent to avoid estate tax is clear: Each spouse removes assets from his or her taxable estate but remains in essentially the same economic position by virtue of being named life beneficiary of the other spouse's estate. But the doctrine can also apply in situations where no such intent exists, such as establishing identical irrevocable life insurance trusts as an income replacement strategy.

To avoid unintended tax consequences, trusts should be designed to avoid the reciprocal trust doctrine. There are many ways to accomplish this, but essentially the goal is to vary factors related to each trust, such as the trust assets or terms, trustees, beneficiaries, or creation dates, so that the two trusts aren't deemed "substantially similar" by the IRS.

