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TRUSTS 101

TRUSTS USED FOR TAX REDUCTION

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CHARITABLE REMAINDER TRUSTS (CRAT/CRUT)

A Charitable Remainder Trust ("CRAT" or "CRUT") (IRC §§664(d)(1) and (2) or (3) and New York Estates, Powers and Trusts Law ("EPTL") §8-1.8) is an irrevocable trust designed to convert highly appreciated assets into a lifetime income stream without generating estate and capital gains taxes. The donor, trustee, and income beneficiary can be the same person. The only restriction is that at least one income beneficiary is not a charity. The CRT pays the donor (additional beneficiaries, if desired) an annuity for life or for a period of time not to exceed 20 years or the donor can receive a percentage of the value of the assets re-calculated each year. There can be more than one income beneficiary. To avoid making a taxable gift to the surviving beneficiary upon the death of the co-income beneficiary, the donor can keep the right exercisable by his or Will to revoke the survivor's payments. However, if the donor is not one of the income beneficiaries, then retaining this right will include the trust in his or her estate. Also, if the other income beneficiary is the donor's spouse, then a marital deduction is available and the gift will not be subject to gift tax.

When the amount paid to the income beneficiary is a fixed amount, the trust is called a Charitable Remainder Annuity Trust, or CRAT and when the amount is a fixed percentage of the trust's assets revalued annually, it is called a Charitable Remainder Unitrust, or CRUT. CRATs are commonly used when the income beneficiaries are not concerned that inflation will reduce the spending power of their other assets and therefore, the annuity payments. On the other hand, CRUTs provide a hedge against inflation but can prove costly if unmarketable assets are held in the trust which need appraisals each year. Under Treas. Reg. §1.664-1(a)(7), the trustee can value the unmarketable assets can be determined by either an independent trustee or a current qualified appraiser.

There are four types of CRUTS:

- Standard Charitable Remainder Unitrust (STAN-CRUT or SCRUT) - pays a fixed percentage of the trust's assets revalued annually causing the amount paid to the income beneficiary to increase or decrease each year.

• Net Income Charitable Remainder Unitrust (NI-CRUT). The unitrust amount is the lesser of the fixed percentage of the trust's assets valued annually or the annual trust income.

• Net-Income with Make-up Charitable Remainder Unitrust (NIMCRUT). The trustee compares the fixed percentage unitrust amount to the trust's accounting income and pays the lesser of these two amounts to the income beneficiary. When the trust's accounting income is less than the unitrust amount, the difference is "made up" in the future when the accounting income exceeds the unitrust amount.

• Flip Charitable Remainder Unitrust (FLIP-CRUT). Treas. Reg. §1.664-3(a)(1)(i)(c). Initially, the trust resembles a NIMCRUT and only distributes the trust's accounting income to the income beneficiaries. Then, following a predetermined event, the trust "flips" to a STAN-CRUT and pays out a fixed percentage as a unitrust amount beginning the following tax year. The trustee has only until the end of the tax year in which the triggering event occurs to make up any payments. Permissible triggering events include:

1. The sale of an unmarketable asset see, Treas. Reg. §1.664-3(a)(1)(i)(d);
2. The marriage of any person see, Treas. Reg. §1.664-3(a)(1)(i)(d);
3. The divorce of any person see, Treas. Reg. §1.664-3(a)(1)(i)(d);
4. The death of any person see, Treas. Reg. §1.664-3(a)(1)(i)(d);
5. The birth of a child see, Treas. Reg. §1.664-3(a)(1)(i)(d);
2. A date certain see, Treas. Reg. §1.664-3(a)(1)(i)(c)(1), or
7. An event outside the control of the trustees or any other persons see, Treas. Reg. §1.664-3(a)(1)(i)(c)(1).

For either the CRAT or CRUT, the annual payments cannot be less than 5% of the initial fair market value of the trust and cannot be more than 50%. Additionally, the annual payments must pass the test that there is not more than a 5% probability that trust assets will be exhausted to pay the annual payments. Also, the value of the remainder interest passing to charity must be at least 10% of the value of the contributed assets on

the date of creation of the trust. When a testamentary CRT is created, this rule can be violated because there is no way to predict that the bequest will satisfy this test. Therefore, under the Code, a CRT can be amended to satisfy this test. When drafting, the trust should provide that the trustee has the power to either amend the trust or void the trust to provide for flexibility when unforeseen circumstances arise.

The annual payments can be used all or in part to pay for life insurance policy premiums owned by an insurance trust in order to pass additional assets to children and/or grandchildren (wealth replacement trust). Upon the end of the Trust term, the assets pass to one or more charities which qualify under Code §§170(c), 2055(a) and 2522(a). The donor can retain the right to change the charitable beneficiary. The trustee can have discretion to select a charity that satisfies this criteria or the grantor can name a specific charitable entity. The trust can also provide that the grantor's spouse or another family member has the power to pick the charity so long as such person did not contribute any assets to the trust. The trustee must have the ability to pick an alternate organization in the event the named charity ceases to qualify.

In terms of deciding which type of trust to use, consideration should be given to using a NIMCRUT for retirement planning. The assets can be invested for growth until the beneficiary retires and then the investments can change to those that produce more income. By using a combination of the unitrust amount and the makeup payments, the trustee is able to replace the beneficiary's lost income on retirement. To achieve this goal, the trust must include a provision deeming capital gains to be accounting income if permitted under state law. Additionally, the trustee can invest in partnerships, life insurance or deferred annuities which can in some situations cause distributions from these assets to be accounting income.

A NIMCRUT can also be used to leverage the gift to pass out a greater amount to the donor's children but at a small gift tax valuation. This type of trust can also be called a "near zero CRUT." Here too, the NIMCRUT would provide that capital gains are deemed to be accounting income. The donor is the income beneficiary for a term of years. During this time, the trustee invests for growth causing the donor to receive few, if

any, trust distributions. As a result, the makeup account increases. After the donor's term ends, the donor's children become the beneficiaries. At that time, the trustee switches investment strategies from growth to income. While the children are beneficiaries, the trustee distributes both the unitrust amount and the makeup account to the children. The gift to the children is valued at the time of creation based on the assumption that the donor would actually receive the unitrust amount each year.

The IRS dislikes these trusts because of the manipulation of the income streams and is considering whether such behavior constitutes self-dealing subject to excise tax under Code 4941. In PLR 9643014 the IRS refused to determine "whether the trustee's control over the timing and amount of realized income from the sale of trust assets would constitute an act of self-dealing." In that same year, it stated as Topic K in the IRS Training Manual, "1996 Exempt Organizations CPE Technical Instruction Program Textbook" that the use of NIMCRUTs to defer payouts to beneficiaries when such beneficiary is in a lower tax bracket constituted self-dealing under Code §4941. Then, in 1997, the IRS issued Rev. Proc. 97-23 in which it provided that it would not rule on whether a trust qualifies as a CRT in the situation where there is a NIMCRUT with a grantor, trustee, beneficiary or a person related or subordinate to any of those parties who controls the timing of the CRT's receipt of income because it is an area being studied by the IRS. Additionally, the Treasury Regulations provide that pre-contribution gain is allocated to principal upon the sale of the appreciated asset in the trust. Beginning on January 2, 2004, the requirement went into place that sale proceeds from assets purchased by the trust must be allocated to principal to the extent of the purchase price paid by the CRT.

Treas. Reg. §1.664-3(a)(1)(i)(c) applies to FLIP-CRUTs created on or after December 10, 1998. Trusts with defective flip provisions created before that date may be reformed or amended to comply with the new regulations. However, a CRT, regardless of when created, that is reformed or amended to add a flip provision will cease to qualify as a CRT unless an existing trust began the process to do by June 8, 1999. The key to this trust is the conversion from the NIMCRUT or NICRUT to a STAN-CRUT at the

beginning of the first calendar year following the triggering event. After the change in payment method, the trustee must pay at least annually only the unitrust amount and not any makeup amount that accrued while the trust was a NIMCRUT. This condition eliminates the benefit from the makeup feature.

The donor of an inter vivos CRT receives an immediate tax deduction at the time the trust is created or the donor's estate with regard to a testamentary CRT receives an immediate tax deduction at the time of the testator's death based on the remainder interest of the trust. This remainder interest is calculated using the donor's age (or CRT term), the selected payout percentage and the applicable federal (interest) rate. The value of the donor's income tax charitable deduction increases with lower payout amounts, higher interest rates and shorter trust terms. In determining the interest rate used in the calculations, the grantor picks the higher of the 7520 rates for the month of the contribution to the trust or the two immediately preceding months.

The donor realizes an estate tax savings of the value of the assets removed from the donor's taxable estate plus the growth on these assets. However, if the donor retains the income interest, then the principal is includable in the donor's estate. At such time, the estate can claim a charitable deduction for the remainder interest passing to charity. No additional contributions may be made after the trust is created to a CRAT but they can be made to a CRUT if the governing trust authorizes additional contributions. Additional contributions must satisfy the 10% charitable remainder rule discussed above and the trust must contain provisions to recalculate the unitrust amount based on Treas. Reg. §1.664-3(b).

If the donor transfers appreciated assets, the donor incurs no capital gains tax on these assets. However, if there is an understanding between the donor and the trustee to sell the assets, the IRS could impute the gain to the donor. If the donor contributes stock in a closely held business that the donor has held for more than a year, the donor should consider naming a public charity as discussed previously in this article over naming a private foundation. A CRT is not a qualifying S corporation stock holder and therefore cannot hold S corporation stock without terminating the S corporation status of the entity

causing the corporation to be taxed as a C corporation. An alternative would be for the S corporation to create the CRT and fund it with appreciated assets causing the charitable deduction to pass through to the shareholders. Gifts of tangible personal property to a CRT are valued at the basis of the contributed property.

Code §6019 requires the donor to file a Form 709 Gift Tax Return when creating an inter vivos CRT. The benefit to this requirement is that the filing of the Form begins the clock on the statute of limitations as to the value of the contributed assets for gift tax purposes (not for annuity or unitrust valuation purposes). Often, the CRT assets are included in the donor's gross estate under Code §§2036 and 2038 (retaining an income interest, retaining the right to revoke surviving income beneficiary or to designate a beneficiary, or retaining the power to designate a beneficiary). The executor of an estate must file a Form 706, Federal Estate Tax Return, to claim the estate tax charitable deduction for a testamentary CRT. A CRT cannot pay the estate tax or gift tax of the donor (see Revenue Ruling 82-128). Additionally, the grantor's Generation Skipping Transfer ("GST") tax exemption may be applied against a CRT equal to the amount of the taxable gift.

Unlike the Charitable Lead Trust ("CLT"), the CRT is not a tax paying entity and is exempt from income tax. Any income earned in the trust exceeds the amount payable to the income beneficiaries, the trust accumulates the income tax free or tax deferred. Prior to 2007, even $1 of UBTI would cause all of the CRT's income to be taxed. Congress amended Code §664(c) in 2006 to provide that a CRT with UBTI is subject to a 100% excise tax on the UBTI. The trustee must file Form 4720 Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code to report the UBTI. In order to avoid the imposition of the excise tax, the donor should avoid contributing assets which produce UBTI such as an interest in an active trade or business (i.e., sole proprietorship, a general partnership interest, a limited partnership interest, or a limited liability company (LLC) interest), a working interest in an oil and gas well and unrelated debt-financed income from trading on margin or other borrowing.

Even though the trust is exempt from tax, the trustee must still file a Split-Interest Trust Information Return. Form 5227 to report its financial activities and to determine whether the trust is treated as a private foundation subject to excise taxes. Additionally, the trustee must file Form 8283 Noncash Charitable Contributions when the CRT is created by attaching it to the donor's Form 1040 as a means of reporting the charitable deduction claimed for a gift of non-cash property. If a contributed asset is sold within three years of being contributed to the CRT, then within 125 days of the sale the trustee must file Form 8282 Donee Information Return to report the sale price of the asset. The purpose of this form is to provide a vehicle for the IRS to compare the initial value used in claiming the charitable deduction against the sale price.

Like CLTs, CRTs are subject to private foundation rules, including Code §4941, the prohibition on self-dealing which imposes an excise tax on the amount involved in acts of self-dealing between the trust and the disqualified person (i.e., trustees, grantor and family members) discussed above in the section on CLTs. The excise tax is equal to 10% of the amount at issue and is paid by the disqualified person and can also be imposed on the trustees. If the act of self-dealing is not corrected, then a second tax equal to 200% of the amount at issue is imposed. The tax on the trustees is 5% of the amount involved and additional 50% if not corrected up to $20,000. The trustee files Form 4720 to disclose the act, describe the corrective action taken, and compute the excise taxes.

The excise taxes under Code §§4943 (excess business holdings) and 4944 (jeopardy investments) can be avoided by ensuring that the CRT and the disqualified person do not own more than 35% of a business and do not make investments that jeopardize the tax exempt purpose of the CRT. If the value of the charitable income interest is less than or equal to 60% of the assets transferred then these restrictions do not apply (Code §4947(b)(3)(A)).

In Rev. Proc. 2005-24, the IRS stated that the mere existence of a spouse's right of election caused an inter vivos CRT to fail to qualify under Code §664(d) if it was created before June 28, 2005. If the spouse exercised such right, in New York for

example, the spouse would have the right to take back one-third of the gift to the CRT causing the trust to fail to qualify as a split interest trust and be subject to gift tax. The gift would also not qualify for an estate tax charitable deduction. That ruling has since been suspended pending further guidance. The IRS advised in the interim that the spouse should waive the right of election in writing no later than six months from the Form 5227 due date for the later of the year in which

1. the CRT was created,
2. the grantor married the non-grantor spouse,
3. the grantor became a domiciliary of a state with a right of election satisfied with CRT assets (such as New York), or
4. the law creating the right of election was enacted.

On February 3, 2006, the IRS issued Notice 2006-15 to grandfather in all CRTs. Unless the surviving spouse actually exercises the right of election, the CRT will qualify under Code §664(d). Current best practice is to have the spouse waive the right of election as to the CRT when the CRT is created.

The income beneficiary of the CRT must pay income tax on the income distributed from the CRT each year. Distributions are taxed on a tier system that takes into account the different tax rates as follows: first from ordinary income, then short term capital gains, then long term capital gains, followed by tax exempt income and then trust principal. Under 2005 regulations, the trustee assigns capital gains and losses to different classes based on the income tax rate applicable to the assets at the end of each year.

Unlike a CLT, a CRT should not be a grantor trust. The trustee should avoid triggering grantor trust status by using the income for the grantor's benefit. Examples are having the trust make the donor's mortgage payments or pay the life insurance premiums on a policy on the life of the donor or donor's spouse.

The IRS has published sample CRATs found at http://www.irs.gov/irb/2003-31_IRB/ar01.html and at Rev. Proc. 2003-53 through 2003-56 (inter vivos) and 2003-57 through 2003-60 (testamentary) and sample forms of CRUTs found at

http://www.irs.gov/irb/2005-34_IRB/ar02.html and at Rev. Proc. 2005-52 through Re. Proc. 2005-55 (inter vivos) and 2005-56 through 2005-59 (testamentary).

QUALIFIED DOMESTIC TRUSTS

A Will also should focus on marital provisions. If there is a prenuptial agreement, it should be reviewed so that the attorney can include any obligations of the testator toward his surviving spouse. An outright bequest to a surviving spouse qualifies for the marital deduction and no federal or state estate tax is owed at the time of the testator's death. A bequest in trust for the surviving spouse, called a qualified terminal interest property ("QTIP") trust, must satisfy the requirements of IRC §2056 in order to qualify for the marital deduction. The assets are not taxed in the Testator's estate due to the unlimited marital deduction but they are taxed in estate of surviving spouse because the assets are includable in the spouse's estate.

The QTIP Trust is a trust which provides that at a minimum all income is given to the surviving spouse, the spouse is the sole beneficiary of the trust, the spouse can direct the Trustee to invest in income producing assets and the trust provides that the Executor must make a QTIP election. The QTIP Trust is used for many reasons including to ensure that assets pass to children (especially in cases where there are children from a prior marriage), prevent assets from passing to new spouse if spouse remarries following Grantor's death and to ease the administration of assets if the spouse is disabled or elderly.

Prior to 1988, assets passing to a non-citizen spopuse were not elligible for the marital deduction. However, the Technical & Miscellaneous Revenue Act of 1988 (TAMRA) created the Qualified Domestic Trusts (“QDOT”), effective for decedents dying after November 10, 1988. The purpose of this new Trust was to provide a method for passing property to the non-ciotizen spouse that would qualify for the unlimited marital deduction. Thereofre, in place of the QTIP Trust, when the Testator is married to a non-citizen spouse, the Will must contain a QDOT to secure marital deduction for assets passing to non-citizen spouse (IRC §2056A and Treas. Reg. §20.2056A). Here

too, the Executor must make election. If the Will does not provide for a QDOT, the executor or the surviving spouse may elect to create a QDOT and transfer the inherited assets to the QDOT before the date on which the estate tax return is due.

There are very stringent restrictions on the QDOT. At least one trustee must be a USA citizen and that trustee has the right to withhold from the distribution the IRC §2056A(b) tax. The Trust must meet the requirements set by regulations to collect tax. In addition, it must satisfy requirements under IRC §2056(b). Distributions of income and hardship distributions of principal (immediate and substantial financial need relating to health, maintenance or support when other funds are not available) are not subject to estate tax. Any other distributions are subject to estate tax and the Trustee must withhold the tax to ensure it is paid. If the QDOT has assets in excess of $2,000,000, the Will must provide for one of the follwong scenarios: (1) the U.S. trustee must be a bank, (2) the individual U.S. trustee must furnish a bond for 65% of the date of death value of the QDOT assets, or (3) the individual U.S. trustee must furnish an irrevocable letter of credit to the U.S. government for 65% of the date of death value of the QDOT assets. Non-probate assets may be transferred to the QDOT at any time before the estate tax return is due to be filed. If these assets are not transferred, then the Testator's applicatle credit amount will be allocated to these non-probate transfers.

In both the QTIP Trust and the QDOT, other provisions that can be included are an exclusive special power of appointment to the surviving spouse to allow for flexibility in distributing assets to surviving issue upon the death of the spouse (EPTL §10-3.2). The Will can alternatively provide for a general power of appointment to the surviving spouse to allow for flexibility in the spouse's estate plan since the trust assets will be includable in spouse's estate upon such spouse's death (EPTL §10-3.2).

QUALIFIED PERSONAL RESIDENCE TRUSTS (QPRTS)

Now that housing prices have fallen, the donor may wish to consider a Qualified Personal Residence Trust (QPRT). The donor transfers a residence to the trust (Treas.

Reg. §25.2702-5) and the value of residence is discounted to account for term of trust and age of grantor. Usually this technique is consider when the §7520 rates are high because high §7520 rates result in lower gift value. However, because a discount is taken on the already depressed value of the home, the donor is able to transfer what would normally be a large asset at a fraction of its worth to children. Additionally, since the house is not liquid, the donor presumably is not relying on the value of the house to meet every day needs. Therefore, this approach should be considered in this time of economic uncertainty.

The Grantor lives in the residence during the term of the trust and pays ordinary and recurring expenses such as real estate taxes, insurance and minor repairs. The residence then passes to the beneficiaries at the end of the trust term through use of a deed and related transfer documents. This transfer to the beneficiaries avoids having the house pass through probate. By the Grantor surviving the term of the trust, the residence is removed from the Grantor's estate having the added bonus of not being includable in the Grantor's estate for estate tax purposes upon the Grantor's death. Additionally, the transfer removes the appreciation on the value of the residence from the Grantor’s estate. However, if the grantor dies before the trust term expires, the date-of-death value of the QPRT will be included in the grantor’s estate.

At the end of the QPRT term, the Grantor can rent the residence from the beneficiaries at fair market rent. Note that the rental payments the Grantor makes further reduce the value of the Grantor's estate resulting in less estate tax being owed. Additionally, these rental payments pass additional assets to the children without having to use any annual exclusion or lifetime unified credit. The Grantor cannot buy back the residence from the beneficiaries (nor can the Grantor's spouse).

This technique is especially useful with vacation homes so that an Executor can avoid the need for ancillary probate in a second jurisdiction. In such a case, a shorter term which results in a larger gift might make sense since a main goal is to avoid ancillary probate. Ensuring the survival of the Grantor during the term can avoid the added expense and delay of ancillary probate.

When making the gift, the donor applies his available lifetime unified credit against the gift and files a Form 709. If the grantor dies before the trust term expires, the date-of-death value of the QPRT will be included in the grantor's estate. If the individual survives the term of the Trust, then the residence is removed from the grantor's estate and will not be includable for estate tax purposes upon grantor's death.

Real estate is transferred into the QPRT by transferring the real estate with a deed and related transfer documents. Sometimes a nominee agreement is used such as when a co-op board will not approve the transfer. The IRS has approved the use of a nominee agreement which states that the Grantor retains title on behalf of the Trust. (see Private Letter Rulings 9249014, September 4, 1992 and 9433016, May 18, 1994). New York County Surrogate's Court has even held that a transfer of an interest in a residence to the donor's children by delivering the stock certificate to them qualified as a completed gift even though the co-op board did not approve the transfer (Matter of Katz, 142 Misc. 2d 1073, 539 NYS2d 659 (1989); see also Matter of the Accounting by Carniol, 20 Misc. 3d 887, 890, 861 NYS2d 587, 589 (2008) (reiterating the holding in Katz).

DEFECTIVE TRUSTS

Gift planning with an Intentionally Defective Grantor Trust (IDGT) involves several steps. The donor creates a trust for children and then sells assets to the Trust in exchange for an installment promissory note (Self Canceling Installment Note (SCIN)) from the Trustees, calling for periodic interest and a balloon principal payment at maturity. This sale is income and capital gains tax-free under Revenue Ruling 85-13 that holds that gain on the sale by the grantor to a grantor trust is not recognized. However, this unrecognized gain will be recognized at the donor's death (Crane v. C.I.R., 331 U.S. 1 (1947)).

In order for the Note to pass muster, the Trust must have assets with which it can pay off some of the interest payments. Therefore, the donor must make an initial gift to the IDGT of at least approximately 10% of the value transferred to the IDGT (that is, 10% combined purchase price and initial gift). See PLR 9436006 (trust initially funded

with 10% of purchase price of stock was held to be a genuine sale). By gifting seed money to the IDGT, the donor shows that the Trust has economic substance independent of the sale to pay off the SCIN. See PLR 9535026. The term of the SCIN should be so tha it is paid off before the death of the donor. The donor applies his available lifetime unified credit against the gift and files a Form 709. This structure works well when cash or other marketable assets are gifted to the IDGT so as not to raise valuation questions. Additioanlly. the note should bear interest at the rate in effect under Code §1274.

This technique works well with non-controlling interests in business entitites such as LLCs so that the donor can take advantage of valuation discounts. However, since the note must be paid, these intestts myst generate enough cash flow to make the payments. If the income earned by the trust property exceeds the interest payments owed to donor by the IDGT, then the excess income may be used to prepay the notes, or to benefit trust beneficiaries, even though the income is taxed to donor as the grantor of the trust.

Transactions between the donor and trust are ignored. Trust assets are preserved when using this structure because the Trustees will not invade the trust income or principal to pay the income taxes owed on the Trust. By using this technique, the property in the Trust compounds income-tax free which, over a number of years, could greatly increase the value of the property in the Trust (and out of donor's estate). For the IDGT to be effective, the assets must appreciate at a greater rate than the value of the loss of the step up in basis. In other wirds, the estate tax savings gained by moving this asset out of the donor’s estate more than outweigh any capital gains tax owed when the assets are eventually sold. Additionally, there is the added benefit of the donor's personal assets being reduced by the donor's payment of income taxes. This reduction leads to a less estate tax owed upon the donor's death. As an added bonus, the payment of the Trust's income tax is not considered an additional gift to the Trust.

The note is includable in the donor’s estate if he dies before it is repaid. However, the remaining assets in the IDGT are not includable in the donor’s estate and will avoid probate. For estate and GST tax purposes, transfers to IDGTs are deemed to

be completed gifts and outside of the donor's estate. Therefore, there is no step-up in basis on the IDGT assets upon the death of the donor. However, for income tax purposes, the existence of the trust is ignored and the donor is treated as the owner of the trust. Despite this fact, the donor is not treated as the owner for legal or equitable ownership purposes. Thereifre, creditors cannot attach this Trust. However, creditors can reach the SCIN. Because of these benefits, the donor cannot be the beneficiary of the IDGT or manage the assets.

If the IDGT is for the lifetime of children (they would have use of the income and principal) and then passes to grandchildren, the donor will keep the trust assets in the hands of descendants and avoid the risk of the assets passing to future spouses-in-laws or other non-family members. Additionally, creditors of the donor's children would not be able to reach these trust assets. As an alternative, these trusts can be created to last for a term of years or until the donor's children reach certain ages. If the IDGT assets will pass to grandchildren, then the donor's Generation Skipping Transfer Tax Exemption should be allocated to the gift.

EDUCATION TRUSTS FOR CHILDREN AND GRANDCHILDREN

One can make gifts while preserving the ability to make annual exclusion gifts and use applicable exclusion amount, by making gifts for tuition expenses (IRC §2503(e)). Gifts for tuition expenses involve an unlimited amount paid to an educational institution on behalf of any person regardless of age or type of school (primary, secondary, vocational, graduate, parochial, etc.). There is no limit on how many people or to whom the donor may benefit. The gift is limited to tuition only, and does not include books, supplies, dormitory fees, etc. The donor does not use annual exclusion or applicable exclusion amount with these tuition gifts.

Another way to benefit a minor is a gift to §529 Qualified Tuition Plan. These plans are regulated by both state and federal law and allow for tax free growth on the contributed assets. The account owner does not make investment decisions, but chooses among alternatives offered by the particular state's plan. The donor has the ability to

provide for a contingent account owner in case of the disability of the donor/account owner.

Some states have contribution limits (New York is $375,000 per beneficiary). Contributions are not deductible under federal tax law. New York does allow deductions up to $5,000 of contributions made to New York Plan ($10,000 for a married couple filing jointly). Earnings of the fund are not taxable and withdrawals from the plan are not taxable if used for qualified educational expenses for the beneficiary. The money in the account can only be used for tuition, room and board, books, supplies, and other qualified higher education expenses at post-secondary school (college, graduate school and vocational school). If the beneficiary does not need the money in the account, then donor can name another eligible family member as beneficiary on the account and use the 529 assets to pay for that person's education or donor can close the account and earnings will be subject to federal income tax and an additional 10% federal income tax, as well as state and local income taxes.

The donor can make five years of annual exclusion gifts at one time for each beneficiary without incurring federal gift tax. At present time that is $70,000 (5 x $14,000 = $70,000) or $140,000 for a married couple filing jointly. The one caveat is that such donor cannot make any other annual exclusion gifts to that child for five years. The plan assets are usually not included in the estate of the contributor. However, if the five year election is made, the payments will be included in the donor's estate if the donor dies before the expiration of the five year period.

When a donor contemplates the gift to be used for expenses in addition to education expenses or wants greater investment options for the gift, instead of making a gift to the §529 Plan (or in addition to), the donor may wish to make a gift to §2503(c) Trust. The Trust is created to receive annual exclusion gifts for a child or grandchild. Upon the beneficiary attaining the age of 21, the beneficiary must be given at least 30 day notice of right to withdraw all trust assets. If beneficiary chooses not to withdraw trust assets, the trust can continue for the benefit of the beneficiary. This trust passes money to the next generation and avoids probating these assets. The beneficiary's enjoyment of the

proceeds is not tied into waiting for the donor to die or for appointment of an Executor or Testamentary Trustee. Additionally, the use of such a trust passes assets outside of the donor's estate before he dies causing there to be less available assets subject to estate taxes and probate upon the donor's eventual death. However, there is a risk inherent with this plan that the beneficiary will take the assets at 21 and not leave them in the trust. Careful guidance must be given to the donor and the beneficiary as to why leaving the assets in the trust is beneficial.

For an older child, the donor may wish to make a gift to a traditional or Roth IRA in the donee's name. The donee must be at least 18 years of age and have earned income. The income tax penalties from early withdraw may discourage such action.

Alternatively, the donor may wish to make a gift to a custodial account for the benefit of a minor (person under the age of 21) pursuant to the Uniform Transfer to Minors Act in New York (UTMA). If the donor names someone other than self as custodian, then the account will not be includable in donor's estate if the donor dies before the minor attains the age of 21.

GENERATION SKIPPING TRUSTS

The GST tax was originally enacted in 1976 in an effort to prevent passing assets to grandchildren to escape estate tax owed at the child level. Under the current law, each person has a GST tax exemption amount which can be used during lifetime or upon death to avoid payment of federal GST tax (current rate is 40% and is usually paid by donor). Currently, up to $5,250,000 can be gifted during lifetime to a grandchild or more remote descendant, or to an individual 37 1/2 years younger than the donor who is not a family member. Upon death, the rules provide that up to $5,250,000 can be transferred to a grandchild or more remote descendant, or to an individual 37 1/2 years younger than the donor who is not a family member. However, this amount will be reduced by any amount used to shelter lifetime gifts from federal GST tax.

In planning for use of a donor's GST tax exemption during lifetime, the attorney should inform the donor that assets can be transferred during lifetime to a trust and still

qualify for the exemption. Therefore, the donor has more gifting options available than simply outright gifts to grandchildren.

During the current economic conditions, many assets are undervalued. By gifting them in today's market at the lower values, the donor is able to transfer what would otherwise be highly valued assets at reported values well under expected future worth. The donor will use less of his or her annual exclusion, lifetime gift tax exclusion and GST tax exemption on the gift. The donor can minimize gift and GST taxes by taking advantage of these lower values. Additionally, the donor can give away a larger percentage of that asset or additional assets by gifting the asset at its depressed value.

- GST Tax planning using GST Tax exemption amount which is the same as the available unified credit which is $5,250,000, subject to change by future legislation (less any amount used by testator to shelter lifetime gifts from federal generational skipping transfer tax). (IRC §2631).
  - GST Tax exemption placed in Trust for spouse and issue or spouse then issue.
  - Outright bequest of GST Tax exemption to issue.
  - Can be applied against Credit Shelter Trust.
  - Issue can be given general power of appointment in Descendant's Trust in case of death before trust terminates to avoid application of GST tax.

By using the GST Trust as part of the plan, the testator can protect grandchildren from creditors, preserve assets in the case of divorce, shield assets in the event of a business failure and assist the grandchildren in asset management. The GST Trust also preserves assets and prevents grandchildren from rushing to sell them upon inheritance. The GST Trust also enables the testator to ensure that there are sufficient funds availbel for education if the grandparent dies before the grandchild’s education is completed.

FUNDING THE TRUST

Each person has an applicable exclusion amount (unified credit) ($5,250,000) which can be gifted during lifetime without paying a federal gift tax (current rate is 40% and is usually paid by donor). The available applicable exclusion upon death is currently

$5,250,000 and will be reduced by amount used to shelter lifetime gifts from federal gift tax. Additionally, as discussed, each person has a GST tax exemption amount which can be used during lifetime or upon death to avoid payment of federal GST tax.

To fund both revocable and irrevocable trusts, a new bank account is created for the trust in the name of this trust typically under the employer identification number assigned to the trust. However, Revocable Trusts and some irrevocable Grantor trusts use the tax identification number of the Grantor. The assets are transferred from one bank account to the other to fund the trust. To the extent that partnership interests or share in a corporation or limited liability company are transferred, assignment and assumption agreements are also signed. Real estate is transferred into a trust by transferring the real estate with a deed and related transfer documents. Sometimes a nominee agreement is used such as when a co-op board will not approve the transfer. The IRS has approved the use of a nominee agreement which states that the Grantor retains title on behalf of the Trust. (see Private Letter Rulings 9249014, September 4, 1992 and 9433016, May 18, 1994). New York County Surrogate's Court has even held that a transfer of an interest in a residence to the donor's children by delivering the stock certificate to them qualified as a completed gift even though the co-op board did not approve the transfer (Matter of Katz, 142 Misc. 2d 1073, 539 NYS2d 659 (1989); see also Matter of the Accounting by Carniol, 20 Misc. 3d 887, 890, 861 NYS2d 587, 589 (2008) (reiterating the holding in Katz).

Assets do not receive a step-up in basis on the date of the gift but do receive a step-up in basis if transferred upon death. Therefore, the donor must weigh benefit of giving away highly appreciated assets during lifetime to reduce potential estate tax against the loss of the step-up in basis the donee would have received had the donor passed the same asset to the donee upon death (IRC §1014). In general, the capital gains tax the donee will have to pay upon sale of the asset will be less than the estate tax owed on the same asset if the donor's estate will be subject to estate tax. This analysis becomes very important when planning with a Qualified Personal Residence Trust. Therefore, the attorney should be sure to ascertain the basis of the house when discussing the transaction

with the client. Assets transferred to a Revocable Trust retain the Grantor's basis since these assets are not removed from the Grantor's taxable estate.

In planning for a gift of an appreciated asset to an irrevocable trust, the donor should obtain an appraisal of the asset. Appraisals are essential for hard to value assets such as real estate, art, collectibles and closely held business interests. These appraisals will be the basis for determining the fair market value of the gift and can be challenged by the IRS. Therefore, the donor should work with the attorney to consult a valuation expert knowledgeable about the specific asset to be gifted.

Gifting highly appreciated assets makes sense when the donor is in a higher tax bracket than the donee. By doing so, the donee can sell the asset and be taxed in a lower tax bracket than the donor. Conversely, when an asset depreciates, the donor should first sell the asset if the donor can take advantage of the capital loss on his own return. Following the sale, the donor then gifts the sale proceeds to the donee.

Since the gift is valued as of the date of the gift for gift tax purposes, any post-gift increase in the value of the property escapes the donor's estate which will reduce estate tax owed upon the donor's death. Therefore, in deciding which assets to gift, consideration should be given to how much the asset is expected to appreciate in the future in addition to the present value of the gift and its appreciation to date.

During the current depressed economic conditions, many assets are undervalued. By gifting them in today's market at the lower values, the donor is able to transfer what would otherwise be highly valued assets at reported values well under expected future worth. The donor will use less of his or her annual exclusion, lifetime gift tax exclusion and GST tax exemption on the gift. The donor can minimize gift and GST taxes by taking advantage of these lower values. Additionally, the donor can give away a larger percentage of that asset or additional assets by gifting the asset at its depressed value.

When a donor gives away a partial interest in an asset such as real estate, a partnership or a limited liability company, the donor is able to take a discount for lack of marketability and/or control. This gift of this minority interest allows the donor to give

away more of the asset without having to use more of his or her annual exclusion, lifetime gift tax exclusion and GST tax exemption. For example:

> Partnership is valued at $1,000,000. Donor wishes to give trusts for his three children and five grandchildren annual exclusion gifts of his interest in the partnership. Therefore, the donor can give this class of beneficiaries a total of $112,000 in annual exclusion gifts ($14,000 x 8). He can split this gift with his wife and give away a total of $224,000.
>
> However, if the donor has the partnership appraised and the appraisal values the effect of the lack of marketability and the lack of control present in the gifted interests to the trusts for the donor's children and grandchildren, then the appraisal will show that the donor is entitled to take as much as a 35% discount with respect to the transfer. The donor can now give away an interest valued at $172,308 (before the discount is applied) to this class of beneficiaries and for split gift purposes he and his wife can give away $344,616. By utilizing this discount technique, the donor and his wife are able to gift an additional $120,616 to their children and grandchildren without having to use any of their lifetime gift tax exemption or lifetime GST tax exemption.

The Form 709 must be filed in April of the year following the date of the gift if more than the annual exclusion is gifted or if a discount was taken when valuing annual exclusion gifts. On the Form 709, the donor reports the fair market value of the gift on the date of the transfer, the tax basis (as donor) and the identity of the recipient. The donor must attach supplemental documents to support the valuation of the gift, such as financial statements and appraisals.

Treas. Regulation §20.2031-1 defines fair market value as:

> The fair market value is the price at which the property would change hands between a willing buyer and a willing

> seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

There is no joint gift tax form. If a husband and a wife each make a taxable gift, each spouse must file a Form 709. If husband and wife are splitting an annual exclusion gift, then each of them must file a Form 709 to reflect the split gift.

The gift tax is a tax on the transfer of any type of property by one individual to another while receiving nothing, or less than full value, in return. The taxable transfer includes a gift of the use of or income from property, the sale of an asset for less than its full value and an interest-free or reduced-interest loan. The tax applies once the donor has exhausted his lifetime applicable credit amount.

By filing the Form 709, the three year statute of limitations begins to run on the transaction. If the donor chooses not to file a gift tax return, the IRS can question the valuation of the transferred property at any time in the future. Therefore, even in the case of a transfer limited to the annual exclusion or sale of property for full fair market value, the transferor may still wish to file a Form 709 if the value of the transfer could be contested in the future (such as in the case of hard to value assets like heirlooms, business interests and artwork).

The Form 709 should be prepared by the donor's attorney or by the donor's accountant with review by his attorney. A copy of the Form 709 should be keep in the donor's file at the attorney's office since copies will be needed upon the death of the donor and in the event the donor intends to make future gifts.

This presentation is for informational purposes only and is not intended as a substitute for legal, accounting or financial counsel with respect to your individual circumstances.

Under IRS regulations we are required to add the following IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding any penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction(s) or tax-related matter(s) addressed herein. This communication may not be forwarded (other than within the recipient to which it has been sent) without our express written consent.