

The ESTATE PLANNER

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IS NOW A GOOD TIME FOR A QPRT?

Transferring the family business
USING A CLAT CAN BENEFIT CHARITY AND YOUR FAMILY

TRUST YOUR TRUSTEE

Choosing a trustee who will carry out your final wishes

Estate Planning Red Flag

A MINOR IS A BENEFICIARY OF YOUR LIFE INSURANCE POLICY

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IS NOW A GOOD TIME FOR A QPRT?

A qualified personal residence trust (QPRT) allows you to transfer a home to your children or other family members at a deeply discounted value for gift tax purposes, while retaining the right to live in the home for a set number of years.

As a rule of thumb, QPRTs, unlike many estate planning techniques, are generally most effective when interest rates are *high*. Although interest rates have been low in recent months, the timing may still be right for a QPRT because real estate values are depressed.

QPRTS IN ACTION

To take advantage of a QPRT, you transfer a personal residence — which may be your primary residence or a qualifying vacation home — to an irrevocable trust that meets the requirements of the QPRT regulations. You retain the right to live in the home during the trust term, after which ownership is transferred to your children or other beneficiaries. You may, however, continue to live in the home by renting it from the beneficiaries at the fair market rate.



When you establish a QPRT, you make a taxable gift to your beneficiaries, but the value for gift tax purposes is substantially less than the home's fair market value. Only the value of your beneficiaries' remainder interest in the home is subject to gift tax. To determine the value of the remainder interest, the present value (based on the IRS's Sec. 7520 rate, the current fair market value of the home and the term of the trust) of your retained interest in the home is subtracted from your home's fair market value.

The longer the term, the larger your retained interest and the lower the gift tax cost. But, for a QPRT to be effective, you must survive the trust term. If you don't, the home's full fair market value will be pulled back into your taxable estate. So you need to balance the potential tax savings of a longer term with the mortality risk.

Also consider retaining a contingent reversionary interest in the home, which dictates that, if you die during the trust term, ownership will revert to your estate. Whether or not you retain the reversionary interest, the home will be subject to estate tax if you die before the end of the term. But by retaining such an interest, you increase the value of your interest, which reduces the gift tax value when you establish the trust.

TIMING CONSIDERATIONS

Even though interest rates are low, depressed real estate values may make it an ideal time for a QPRT. Consider this example: Marge, age 60, owns a home that was worth \$1 million — before the real estate bubble burst — but whose value has declined to \$800,000. If she transfers

the home to a 10-year QPRT (retaining a reversionary interest) during a month when the Sec. 7520 rate is 2.8%, the value of the gift to her beneficiaries is \$518,256.

Suppose, instead, that Marge waits for two years and sets up a 10-year QPRT when the home's value has bounced back to \$1 million and the Sec. 7520 rate has increased to 4%. In this case, the value of the gift would be \$560,470.

In this example, Marge is better off establishing a QPRT today, when her home's value is depressed, even though interest rates are low. If she waits, the advantages of a higher interest rate are offset by the home's higher value. Plus the mortality risk might be greater if she waits, perhaps causing her to select a



When you establish a QPRT, you make a taxable gift, but the value for gift tax purposes is substantially less than the home's fair market value.

shorter trust term, which also would reduce the gift tax savings.

ASSESS YOUR SITUATION

Bear in mind that the numbers used in the previous example are for illustration purposes only. If you're contemplating a QPRT, you need to consider the current value of your home and the current Sec. 7520 rate, as well as your life expectancy. The right timing for a QPRT depends on how you think those numbers will change in the coming months or years. ❖

TRANSFERRING THE FAMILY BUSINESS

USING A CLAT CAN BENEFIT CHARITY AND YOUR FAMILY

If you're a family business owner with philanthropic aspirations, estate planning presents unique challenges. Much of your wealth probably is tied up in the business, so it may be difficult to give to charity without tapping those assets. At the same time, you likely want to retain control of the business during your life and to keep the business in the family after your death while minimizing estate taxes.

One solution worth considering is a charitable lead annuity trust (CLAT). By using a testamentary CLAT (T-CLAT) to hold business interests and then sell

those interests to your family, you can achieve both your business succession and philanthropic goals.

WHAT IS A CLAT?

A CLAT makes annuity payments to charity during the trust term. At the end of the term, the remaining trust assets are transferred to your children (or other beneficiaries you've named). If interests in your family business are used to fund a CLAT, ideally, the business will generate enough income to cover the annuity payments, and your heirs will own the business at the end of the trust term. If the business

doesn't generate enough income, the trust may have to liquidate business assets to meet its annuity obligations. While the CLAT holds the business the trustee runs the company, but he or she can appoint family members or other beneficiaries as officers or directors of the company.

You can establish a CLAT during your life or at death. The latter, also known as a T-CLAT, offers family business owners a couple of big advantages. First, you control the business during your



life because your ownership interest isn't transferred to the CLAT until your death. Second, your heirs will enjoy a stepped-up tax basis equal to the business's fair market value on the date of your death. This will eliminate or

minimize income taxes in the event your family decides to sell some or all of its interests.

Assets transferred to a T-CLAT are included in your taxable estate, but the taxes will be reduced by an estate tax charitable deduction equal to the present value of the charitable annuity. Present value is calculated using the IRS's modest Sec. 7520 rate, published monthly. If the business outperforms the Sec. 7520 rate, the excess earnings pass to your beneficiaries estate-tax free. (See "A CLAT in action" below.)

CLAT CHALLENGES

Perhaps the biggest challenge in using this strategy to transfer a family business is complying with the private foundation rules, which apply to CLATs. The main obstacles are rules prohibiting self-dealing and excess business holdings. The former

A CLAT in action

Here's an example that illustrates how a charitable lead annuity trust (CLAT) can transfer a substantial amount of wealth at a significantly reduced estate tax cost. Let's suppose that, when Joe dies, his entire estate, \$10 million, is transferred to a 10-year CLAT during a month when the Sec. 7520 rate is 3%. The CLAT pays an annuity of \$762,000 per year to Joe's favorite charity during the trust term, after which the remainder passes to his son, Frank. The present value of the annuity is approximately \$6.5 million, which is deducted from Joe's estate, leaving approximately \$3.5 million.

Assuming a \$3.5 million estate tax exemption amount, Joe's estate tax liability is zero. So long as the trust assets outperform the 3% Sec. 7520 rate, the CLAT will provide a tax advantage. Think of it this way: If the trust earnings match the Sec. 7520 rate, the result will be essentially the same as if Joe had left \$6.5 million to charity and \$3.5 million to Frank. The charity will receive \$7,620,000 over 10 years, and Frank will receive approximately \$4.7 million at the end of the term (\$3.5 million earning a 3% return over 10 years).

But if the trust outperforms the Sec. 7520 rate, the excess goes to Frank without triggering estate taxes. Suppose, for example, that the trust earns a return sufficient to cover the annuity payments (7.62%). Frank will receive the entire \$10 million at the end of the term — about \$5.3 million more than he would have received otherwise — free of estate taxes.

imposes harsh penalties on a CLAT that enters into certain transactions with a “disqualified person,” including family members. The latter generally prohibits a CLAT, together with disqualified persons, from owning more than 20% of a business entity.

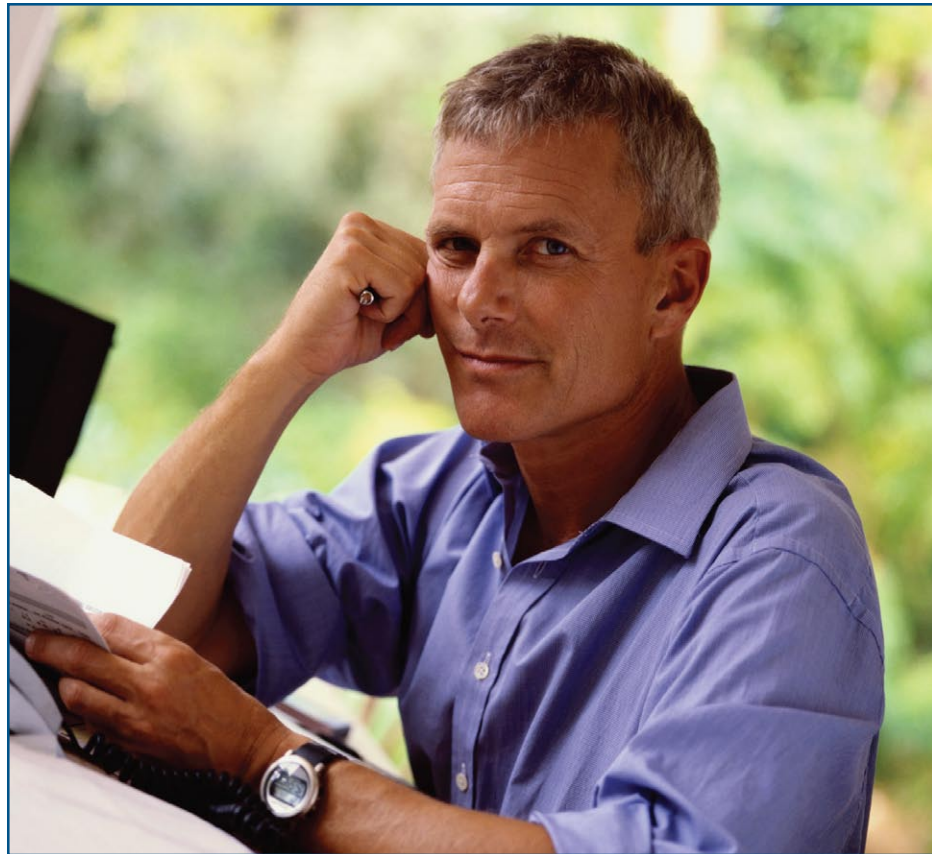
The excess business holdings rule doesn’t apply, however, if the value of the charitable interest (that is, the present value of the annuity payments) is less than 60% of the initial value of the trust assets. But this requirement limits your ability to minimize or eliminate estate taxes with a higher annuity payment. If the trust violates the rule, it must dispose of the excess business holdings.

“LEVERAGED” CLATS

It may be possible to avoid the excess business holdings rules using a leveraged CLAT. This strategy also provides your heirs with immediate access to the business, eliminating another disadvantage of a CLAT — that they must wait until the end of the trust term to enjoy the assets.

A CLAT makes annuity payments to charity during the trust term.

A leveraged CLAT is complex, but essentially it involves granting your children or other family members an option to purchase the family business from the CLAT in exchange for a promissory note.



Your family can then operate the business as they see fit and immediately enjoy the benefits of ownership.

To bypass the self-dealing rules, the transaction must satisfy the “estate administration” exception to those rules. The sale must:

- ◆ Be for fair market value,
- ◆ Be approved by the appropriate court,
- ◆ Occur during the estate administration period, and
- ◆ Meet several other requirements.

The note payments should be sufficient to satisfy the CLAT’s annuity obligations.

KEEPING IT IN THE FAMILY

Using a CLAT to transfer a family business is complicated, but it can pay off. Structured properly, a leveraged CLAT allows you to satisfy your charitable desires while transferring the business to your family at a substantially reduced tax cost. ❁

TRUST YOUR TRUSTEE

CHOOSING A TRUSTEE WHO WILL CARRY OUT YOUR FINAL WISHES

Avoiding probate is a common estate planning objective. One option to help achieve this goal is to establish a living trust, also commonly referred to as a “revocable” or “inter vivos” trust.

With a living trust, you transfer your assets to the trust and provide instructions for the distribution of your assets after your death. You can serve as trustee during your life and manage the assets just as you would if you owned them outright. But you must select a trustee to oversee and administer the trust after your death. Options include a family member or close friend; a professional advisor, such as a financial advisor or attorney; or an institutional trustee, such as a bank or trust company.



A TRUSTEE'S DUTIES

Before you select a trustee, consider the duties associated with managing a living trust. For example, the trustee must manage all trust assets, including securities and business and real estate interests, until

they're distributed; maintain detailed records and prepare transaction statements; handle collections, distributions and payments; prepare and file all tax returns; and, ultimately, settle the trust.

In addition, the trustee must be available to respond to all inquiries from beneficiaries.

2 TRUSTEE TYPES

The two types of trustees are:

1. Individual trustee. This trustee may be a family member or close friend, a business advisor, an attorney, or another professional. A family member or friend may seem like the natural choice because of the trust, common bond and likelihood that he or she understands your wishes for your family's future. It's also likely that he or she will charge little or nothing in trustee fees.

But keep in mind that, ideally, a trustee should have financial knowledge, be familiar with taxes and accounting, and have good business sense. So it's essential that individual trustees without professional expertise in managing trusts consult with accountants, attorneys and investment advisors to help them get the job done effectively.

2. Corporate trustee. This trustee typically is a financial institution, a bank trust department or a trust company. A corporate trustee specializes in managing estates and trusts and generally is free of conflicts of interest, allowing it to carry out its duties impartially.

A corporate trustee usually has direct access to investment advisors, tax planners and other financial experts. Most institutional trustees charge fees based on a percentage of the trust's assets. An institutional trustee also can be beneficial because you don't have to worry about whether the trustee will outlive you.

In some cases, you can create a hybrid trustee by appointing an institution and an individual as co-trustees. The institution provides the professional experience and skills needed to effectively oversee the trust assets, while the individual is someone you can trust to act in your family's best interests.

TRUSTEE GUIDELINES

After choosing a trustee, it's important to determine the amount of control he or she will have over the trust assets and distributions to beneficiaries. Consider giving your beneficiaries the power to remove an institutional trustee and replace it with another that's a better fit as needs change or evolve. This provides an extra layer of protection from a

trustee charging exorbitant fees or mismanaging the trust.

In addition, make your trustee aware of the liabilities involved. For example, the trustee may be held personally liable in instances of poor investment decisions, not exercising discretion or inappropriate allocation of assets.

A CAREFUL SELECTION

When choosing your trustee, remember that he or she must not only be reliable and trustworthy, but also willing and committed to serve. Above all, you need to feel confident that the trustee you select will support your overall estate planning goals. ❖

ESTATE PLANNING RED FLAG

A minor is a beneficiary of your life insurance policy

Most estate plans include one or more life insurance policies as a source of liquid funds and additional wealth. A common, but costly, mistake people make is to name a minor child or grandchild — or a legally incompetent adult — as beneficiary.

Doing so can lead to several problems. For example, insurance companies likely will refuse to pay large death benefits directly to the beneficiary, so the funds would be tied up until a guardian is appointed by a court — at the beneficiary's expense.

More important, though, paying insurance proceeds outright to a minor child or incompetent adult might not be the most effective way to achieve your estate planning goals. A better option is to name an adult as custodian of the funds until the beneficiary turns 18 or 21. An even stronger alternative is to have the proceeds paid to a trust designed to provide the beneficiary with financial security while protecting the funds on their behalf.

Trusts give you broad flexibility to establish the terms under which distributions will be made. You can limit use of the funds to basic necessities or allow the trustee to pay for the beneficiary's education, entertainment, travel and comfort. You can also condition access to the funds on reaching a certain age, completing college or refraining from “bad behavior,” such as substance abuse or gambling.

What if you prefer not to use a trust because the amount of life insurance is small or for some other reason? A cost-effective option is to elect “settlement options” with the insurance company that provide for death benefits to be paid out as a long-term or life annuity in lieu of a lump sum.



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At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

Since 1925, Shumaker has met the expectations of clients that require this level of service. Our firm offers a comprehensive package of quality, experience, value and responsiveness with an uncompromising commitment to servicing the legal needs of every client. That's been our tradition and remains our constant goal. This is what sets us apart.

Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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Shumaker, Loop & Kendrick, LLP

We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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