Insight on Estate Planning

April/May 2009

Looking for a stimulus package for your estate plan?

Know the basics of basis

A matter of principle

A principle trust can help achieve your estate planning goals

Estate planning pitfall

You haven't planned for GST tax traps

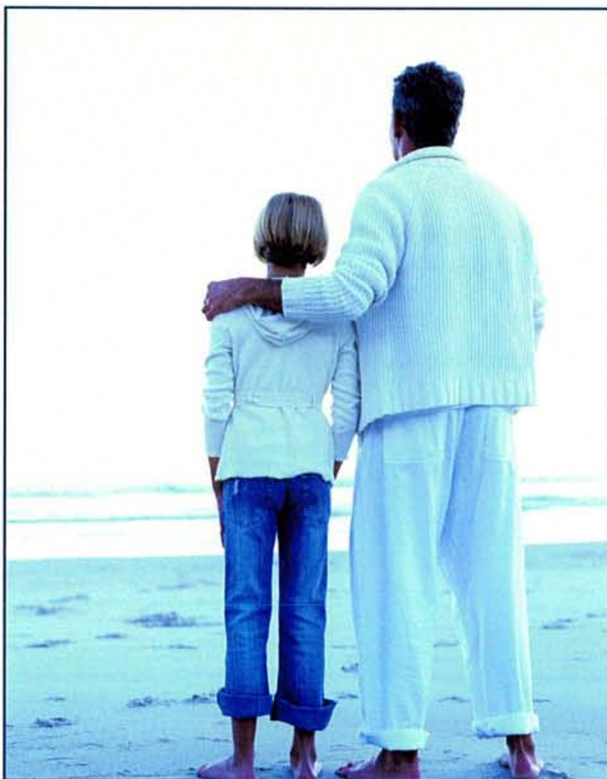
East Office
8621 East 21st Street North
Suite 200
Wichita, KS 67206-2991
(316) 267-2000

Downtown Office
2000 Epic Center
301 North Main Street
Wichita, KS 67202-4820
(316) 267-2000

HINKLE ELKOURI
LAW FIRM L.L.C.

Looking for a stimulus package for your estate plan?

Lately, news about the economy has been downright depressing. But like most problems, the current economic woes also present some extraordinary opportunities. One of these involves estate planning: Low interest rates combined with depressed stock and real estate prices make it an ideal time to transfer wealth to your children or grandchildren.



Hunting for bargains

This year, the federal estate tax exemption is $3.5 million, up from $2 million in 2008, and the lifetime gift tax exemption remains at $1 million. The annual gift tax exclusion is now $13,000 per recipient (up from $12,000 in 2008) or $26,000 for gifts you split with your spouse.

As of this writing, the estate tax is still scheduled for repeal next year. But that's unlikely to happen. Congress is expected to retain the estate tax along with the current (or possibly higher) exemption amounts. Check with your estate planning advisor for the latest information.

The higher exemption and exclusion amounts increase the potential benefits of making gifts to your children and other family members of assets whose values have declined, such as stock or real estate. These gifts allow you to maximize the amount of wealth you can transfer tax free while minimizing the value of taxable gifts. Plus, any future appreciation that these assets will enjoy when the economy rebounds will go to your beneficiaries free of gift and estate taxes.

Gifting now can pay off later

Outright gifts aren't always the most effective way to transfer your wealth. If your net worth is large enough, direct gifts may trigger an enormous gift tax bill, even if asset values are depressed. And regardless of the tax implications, you may not be ready to relinquish control over your wealth.

Outright gifts aren't always the most effective way to transfer your wealth.

Under these circumstances, you may wish to use trusts, family loans, installment sales or other arrangements that provide your children or other beneficiaries with future benefits. And with interest rates at their lowest levels in years, *now* is the time to take advantage of these techniques.

Consider the family loan, for example. To avoid gift taxes on a loan to your child or another family member, you need to charge interest at or above the applicable federal rate (AFR). Recently, the AFR has been as low as under 2% for midterm loans (three to nine years) and just below 3% for long-term loans (more than nine years). Check with your estate planning advisor for the current rates.

Will Congress slash valuation discounts?

Looking for another reason to transfer wealth to your beneficiaries sooner rather than later? (See main article.) Congress is considering legislation that would limit the availability of certain valuation discounts for gift and estate tax purposes when intrafamily transfers are involved.

For example, many parents establish family limited partnerships (FLPs) to transfer wealth to their children. They transfer assets, such as stock or real estate, to the partnership and then transfer limited partnership interests to their kids.

If an FLP is structured and operated properly, the family can enjoy substantial gift and estate tax savings. Why? Because minority FLP interests generally are entitled to valuation discounts for lack of control and lack of marketability. As a result, a limited partner's interest may be worth significantly less than his or her proportionate share of the partnership's asset values.

In a report published last year by the Joint Committee on Taxation, lawmakers proposed reforms that would limit the ability of families to take advantage of valuation discounts to reduce gift and estate taxes. It's not yet clear what Congress will do, but any reforms it makes will likely apply prospectively only, so it pays to get your estate plan in order now.

If you lend money to your child, who then invests the funds in assets that outperform the AFR, he or she will have a substantial amount of money left over after paying back the loan. In other words, you will have made a sizable tax-free gift.

Using GRATs to your advantage

Another powerful estate planning tool in a low interest rate environment is the grantor retained annuity trust (GRAT). A GRAT is an irrevocable trust that pays you an annuity during the trust term and then distributes any remaining assets to your children or other beneficiaries. Your contributions to the trust are treated as taxable gifts to your beneficiaries, but the value of the gift is limited to the present value of the remainder interest.

To calculate the gift tax value, the present value of the annuity payments is subtracted from the value of the assets you contribute to the GRAT. Present value is based on a conservative, assumed rate of return commonly known as the Section 7520 rate. At the time of this writing, that rate, which is published monthly by the IRS, was at its all-time low of 2.4%.

If you set the annuity payments high enough or the trust term long enough, you can minimize the value of the gift for gift tax purposes or even reduce it to zero. And so long as the trust assets outperform the Sec. 7520 rate (and you survive the trust term), your beneficiaries will receive a substantial amount of wealth at the end of the term, free of gift and estate taxes.

GRATs are an attractive option when interest rates are low because it's easier to outperform the Sec. 7520 rate, maximizing the amount of wealth you can transfer tax free. And if you fund a GRAT with assets whose values are depressed and are expected to appreciate significantly in the future, the benefits a GRAT provides are that much greater.

Act now

These are just a few of the estate planning options available that take advantage of low interest rates and depressed asset values to cost effectively transfer wealth. Other options include installment sales, intentionally defective grantor trusts and charitable lead annuity trusts.

Whichever strategy you choose, it's important to move quickly. Although these estate planning tools are valuable in good times as well as bad, they will lose some of their potency as the economy recovers. ▮

Know the basics of basis

To transfer your wealth in the most cost-effective manner, it's important to understand how an asset's income tax basis affects your estate planning strategies. The basis that your beneficiary receives in an asset depends on how you transfer it, and this can have a large impact on the recipient's income tax bill.

What is basis?

Essentially, basis is the cost associated with an asset. It's used to measure your gain or loss when you dispose of the asset and, if the asset is used in your business, it's used to determine the amount of depreciation, depletion or amortization deductions.

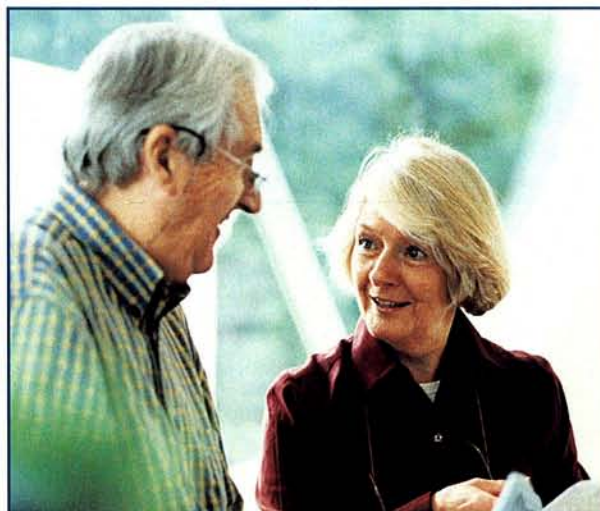
When you sell an asset, your gain or loss is determined by taking the sale proceeds and subtracting your adjusted basis. So, for example, if you purchase stock for $100,000 and sell it for $150,000, you'll recognize a $50,000 gain. On the other hand, if you sell the stock for $75,000, you'll have a $25,000 loss.

The starting point for calculating an asset's basis is the price you pay for it (including the amount of any existing debt you agree to assume in connection with the purchase). But depending on the nature of the asset, your basis may be adjusted to reflect changes that increase or decrease your investment in the asset.

Suppose, for example, that you purchase stock in an S corporation. Your initial basis is the price of the stock plus the adjusted basis of any property you contribute to the corporation.

Over time, your basis is *increased* by your taxable share of the corporation's income, as well as by additional capital contributions or loans you make to the corporation. (Be aware that your basis isn't increased by the fact that you guarantee a loan made by the corporation.) Your basis is *decreased* by items such as your share of distributions and any tax losses that are passed through to you.

Your basis in an asset has significant tax implications, so it's important to track basis carefully and to document any events that increase or decrease it.



Why does basis matter?

From an estate planning perspective, basis is important because it affects the amount of taxable gain your beneficiary will recognize should he or she sell the asset. And your beneficiary's basis in an asset depends on the manner in which you transfer it.

The general rule is that, when you transfer an asset at death, your beneficiary receives a "stepped-up" basis equal to the asset's fair market value on that date. If you transfer an asset by gift, however, your adjusted basis in the asset "carries over" to your beneficiary.

At first glance, it would seem that transfers at death are preferable because a stepped-up basis minimizes the gain on a sale of the asset. But it's not that simple. To determine the best strategy for transferring assets you need to look at the big picture.

First, consider your basis in an asset. If the asset's value hasn't appreciated significantly — so that its fair market value isn't substantially higher than your basis — then the manner in which you transfer the asset won't have a big tax impact on your beneficiary. Also, if your beneficiary plans to hold onto the asset rather than sell it, the income tax implications may not be a significant factor.

Case in point ...

It's important to balance any negative income tax consequences against potential transfer tax

savings. For example, Todd, whose net worth is well above the $3.5 million estate tax exemption, wants to transfer $1 million in publicly traded stock to his daughter, Rebecca. Todd's adjusted basis in the stock is $200,000, and he's already used up his $1 million lifetime gift tax exemption.

If Todd gives the stock to Rebecca, he'll owe $450,000 in gift tax (assuming a 45% rate). His basis carries over to Rebecca, and she also gets to increase her basis by virtue of the fact that he paid gift tax.

The increase is determined by a formula of the gift tax paid and the appreciation gifted. In this instance, she increases the basis by 80% of the $450,000 gift tax paid. Thus, her adjusted basis is $560,000. So if she sells the stock she'll recognize a $440,000 gain, resulting in a $66,000 federal capital gains tax liability (at the current rate of 15%). (For illustrative purposes, it's presumed that Rebecca lives in a state that has no income tax.) The combined tax on the transfer (assuming Rebecca sells the stock immediately) would be $516,000.

It seems that a transfer of the stock at Todd's death is preferable because Rebecca would receive a stepped-up basis and avoid the $440,000 gain. That would be true if Todd were to die tomorrow. But what if he dies 10 years later and the stock's value grows to $2 million? Rebecca wouldn't inherit any built-in capital gains, but Todd's estate would owe $900,000 in estate tax (assuming no change in the estate tax rate).

As you can see, determining the best strategy can be a challenge. Are Todd and his family better off paying $516,000 in taxes now or $900,000 in 10 years? Will the stock's value actually double in 10 years? The answers depend on the time value of money and Todd's best guess of the stock's performance and value in the future.

Bear in mind that, if Todd had not previously used his lifetime gift exemption, there would be no gift tax paid on the gift and, consequently, no adjusted basis for Rebecca. If she were to sell the asset immediately, her gain would be $800,000, and she'd owe a capital gains tax of $120,000.

What does the future hold?

Complicating matters further, as of this writing current law calls for the estate tax to be repealed in 2010 and to be reinstated in 2011. During 2010 only, assets transferred at death won't be entitled to a stepped-up basis, except for a limited amount of property.

It's likely that Congress will pass legislation this year that preserves the estate tax, but it's not yet clear whether such legislation will modify the basis rules. So it's important to keep track of your income tax basis in various assets and to evaluate its potential impact on your estate plan. ■

A matter of principle

A principle trust can help achieve your estate planning goals

For many, an important estate planning goal is to encourage their children or other heirs to lead responsible, productive lives. A popular tool for achieving this goal is the incentive trust, which conditions distributions on certain "acceptable" behaviors. But is this your best option?

Rigid distribution rules problematic

An incentive trust attempts to shape your beneficiaries' behavior by conditioning distributions on

specific benchmarks that are readily understandable and achievable. Examples include obtaining a college degree, maintaining gainful employment, or refraining from unacceptable behaviors such as drug or alcohol abuse or gambling.

In an effort to quantify acceptable behavior, some incentive trusts provide for matching distributions based on a beneficiary's salary or charitable donations. Unfortunately, this approach can lead to unintended consequences.

A principle trust guides the trustee's decisions by setting forth the principles and values you hope to instill in your beneficiaries.

For example, if your trust conditions distributions on gainful employment or matches a beneficiary's salary dollar-for-dollar, it may discourage heirs from becoming stay-at-home parents, doing volunteer work or pursuing less lucrative but worthwhile careers, such as teaching or social work. If the benchmark is graduating from college or obtaining a graduate degree, the trust may unfairly penalize family members with disabilities or who simply lack the temperament or capacity for higher education.

One potential solution is to design a detailed trust document that attempts to cover every possible contingency or exception. Not only is this time-consuming and expensive, but, even with the most carefully drafted trust, there's a risk that you'll inadvertently disinherit a beneficiary who's leading a life that you'd be proud of. Or, the trust may reward a beneficiary who meets the conditions set forth in the trust but otherwise leads a life that's inconsistent with the principles and values you wish to promote.

Principles trump incentives

If you're comfortable giving your trustee broader discretion, consider using a principle trust, instead. By providing the trustee with guiding values and principles rather than rigid rules, a principle trust may be a more effective way to accomplish your objectives.

A principle trust guides the trustee's decisions by setting forth the principles and values you hope to instill in your beneficiaries. These principles and values may include virtually anything, from education and gainful employment to charitable endeavors and other "socially valuable" activities.

By providing the trustee with the discretion and flexibility to deal with each beneficiary and each situation on a case-by-case basis, it's more likely that the trust will reward behaviors that are

consistent with your principles and discourage those that are not.

Suppose, for example, that you value a healthy lifestyle free of drug and alcohol abuse. An incentive trust might withhold distributions (beyond the bare necessities) from a beneficiary with a drug or alcohol problem, but this may do very little to change the beneficiary's behavior. The trustee of a principle trust, on the other hand, is free to distribute funds to pay for a rehabilitation program or medical care.

At the same time, the trustee of a principle trust has the flexibility to withhold funds from a beneficiary who appears to meet your requirements "on paper," but otherwise engages in behavior that violates your principles. Another advantage of a principle trust is that it gives the trustee the ability to withhold distributions from beneficiaries who neither need nor want the money, allowing the funds to continue growing and benefit future generations.

Not for everyone

Not everyone is comfortable providing a trustee with the broad discretion a principle trust requires. If it's important for you to prescribe the specific conditions under which trust distributions will be made or withheld, an incentive trust may be appropriate. But keep in mind that even the most carefully drafted incentive trust can sometimes lead to unintended results, and the slightest ambiguity can invite disputes.

On the other hand, if you're comfortable conferring greater power on your trustee, a principle trust can be one way to ensure that your wishes are carried out regardless of how your beneficiaries' circumstances change in the future.

Estate planning pitfall

You haven't planned for GST tax traps

The federal generation-skipping transfer (GST) tax can be hazardous to your tax bill, so it's critical to discuss GST tax issues with your advisors when planning your estate.

The GST tax is a flat tax, in *addition* to the estate tax, imposed at the highest marginal estate tax rate. It applies to certain transfers to "skip persons," which include your grandchildren and other family members who are two or more generations below you, as well as nonfamily members who are more than 37½ years younger than you. The GST tax applies to direct gifts to skip persons as well as to certain trust distributions.

The tax code provides a GST tax exemption — currently $3.5 million — but the rules regarding allocation of that exemption are fraught with pitfalls. Suppose, for example, that at your death you contribute $3 million to a trust for the benefit of your children and grandchildren, allocating $3 million of your GST tax exemption to the trust. The trust assets are protected against GST tax even if their value grows to $5 million by the time they're distributed.

This rule doesn't apply to typical grantor trusts, though. Absent special circumstances, assets held in a grantor trust are included in your estate, and you can't allocate your GST tax exemption to those assets until your death, based on the trust's value at that time. Using the $5 million from the previous example, even if your entire $3.5 million exemption is available, the $1.5 million excess will be subject to GST tax.

Another potential hazard is the IRS's allocation rules, which automatically allocate your exemption to certain "GST tax trusts." The problem is that, in some cases, a trust that's intended to benefit your children may be treated as a GST tax trust if there's a possibility, no matter how remote, that your grandchildren will benefit. Unless you opt out of the automatic allocation rules, your GST tax exemption may be wasted on trust assets that don't really need its protection.

Finally, keep in mind that the GST tax is scheduled to be repealed for 2010 only along with the estate tax. But, as with the estate tax, it's likely that Congress will pass legislation this year reinstating the GST tax. Check with your estate planning advisor for the latest information.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2009 IEPam09

Estate planning counsel you can trust

When you are looking for ways to preserve and protect your wealth, or develop a succession plan for your business, you want cutting edge legal advice that achieves your objectives. In other words, you want the specialized services of the preeminent trusts and estates group at Hinkle Elkouri Law Firm L.L.C.

Since 1987, we have helped individuals and businesses throughout the Midwest with estate planning, business succession planning, tax planning and other wealth management issues. Because our various practice areas compliment each other, the firm's 40+ attorneys have built a reputation for discovering creative solutions to difficult situations, while providing exemplary service with the highest degree of confidentiality.

Our trusts and estates group is ready to serve you in these and other ways:

- Creating and funding revocable and irrevocable trusts
- Preparing wills, powers of attorney and health care directives
- Designing asset protection plans
- Determining the value of business entities
- Designing charitable giving plans
- Planning with life insurance
- Structuring business entities to optimize control and transfer of wealth
- Preparing buy-sell agreements and business succession plans
- Representing clients in probate, tax and trust administration matters
- Preparing pre-marital and post-marital agreements
- Assisting with elder law and medicaid issues

Dan C. Peare chairs Hinkle Elkouri's Trusts and Estates practice. He has extensive experience in high-net worth estate planning, asset protection planning and planning with family businesses. He also assists with business valuations and planning with life insurance. Dan speaks and writes frequently on estate planning and family business planning topics. He received his law degree from the University of Kansas School of Law, and holds a finance and MBA degrees from Wichita State University.

Hugh W. Gill has teamed with Dan Peare for over thirteen years to form one of the best planning groups in Kansas. In addition to estate planning, Hugh manages sub-specialties in probate and trust administration, guardianships and conservatorships, disability planning, marital planning and post-mortem tax planning. Hugh holds finance, MBA and JD degrees from the University of Kansas.

Donna F. Bohn has over eighteen years of legal experience. She handles a variety of transactional matters for the firm's family business clients. Donna also concentrates in medicaid and elder law planning, business entity formation, structuring buy-sell agreements and split dollar life insurance planning. Donna has an accounting degree from Kansas State University and law degree from Washburn University.

Kari D. Coultis is an attorney, Certified Public Accountant and Certified Business Valuation Analyst. She focuses on estate planning and business valuations. Kari supervises drafting assignments with practice group legal assistants and attorneys to ensure errorless document preparation. She also assists with charitable planning and estate and gift tax planning. Kari holds a BS in Accounting and Business Administration, a Master of Accounting and Information Systems, and a JD degree from the University of Kansas.

Ryan D. Farley joined the Trusts and Estates practice group in 2008 after clerking for the Kansas Court of Appeals as a research attorney. Ryan provides depth to the Trusts and Estates practice group with his strong drafting, editing, research and writing skills. Areas of responsibility include estate planning, business planning and estate administration. Ryan has a BA in History from Emporia State University and a law degree from Washburn University.

We welcome the opportunity to discuss your needs and put our extensive knowledge and experience to work for you. Please call us at 316-267-2000 and let us know how we can be of service.

East Office
8621 East 21st Street North
Suite 200
Wichita, KS 67206-2991
(316) 267-2000

Downtown Office
2000 Epic Center
301 North Main Street
Wichita, KS 67202-4820
(316) 267-2000