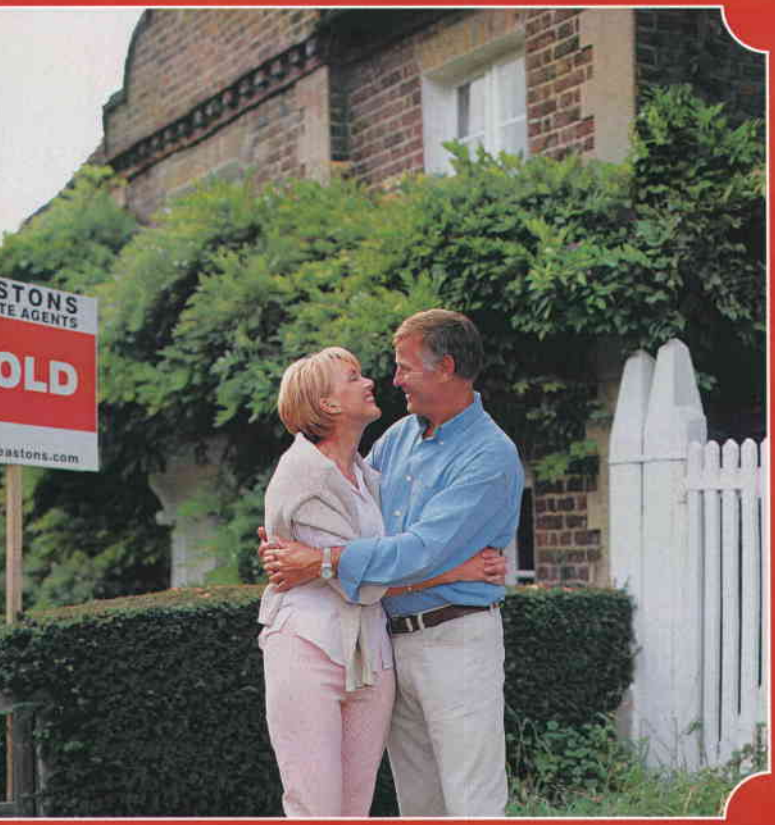
Insight on Estate Planning

February/March 2008



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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.

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A simple strategy offers big estate tax savings

If you're like most people, your home is your most valuable asset. And one of the most effective strategies for passing your home to your children or other loved ones while minimizing gift or estate taxes also is one of the simplest: the joint purchase.

Joint tenancy vs. joint purchase

Don't confuse a joint purchase with joint tenancy. There's a common misconception that owning property with a child or other family member as joint tenants is an effective estate planning strategy.

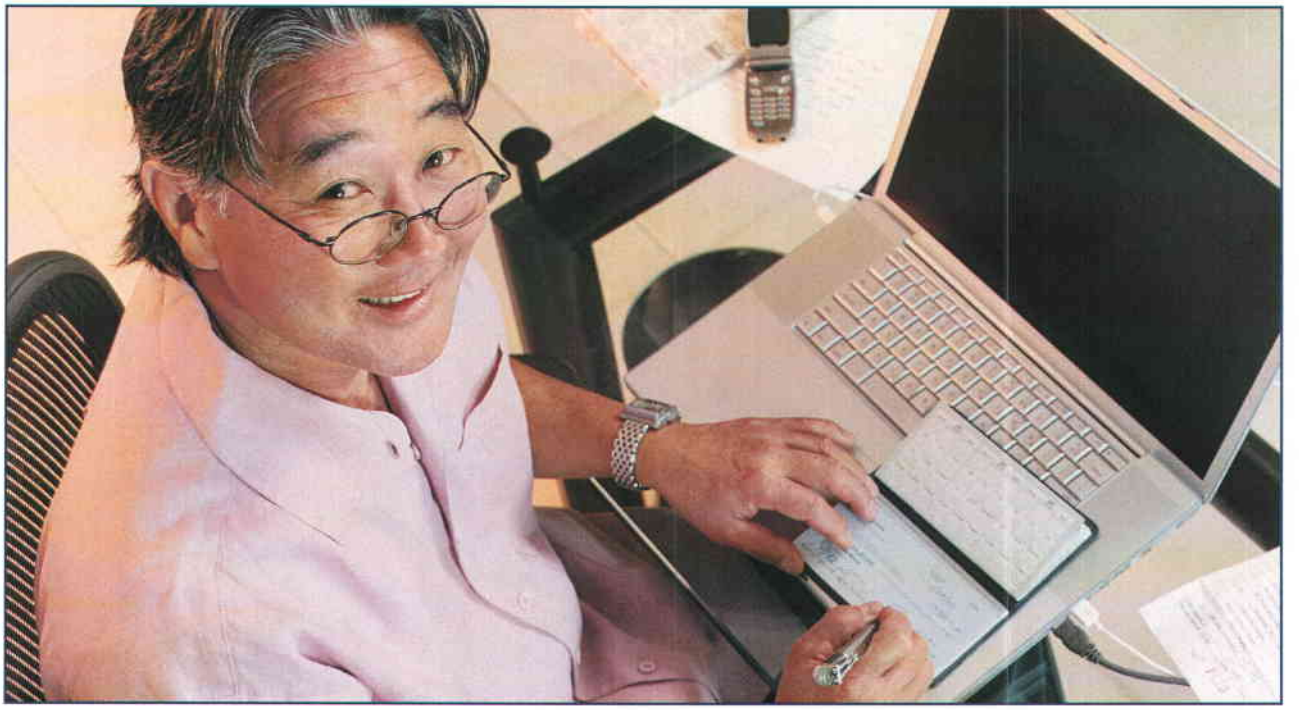
Indeed, joint tenancy offers simplicity: When you die, the title to the entire property automatically passes to the joint owner without the need for probate. But it also has serious drawbacks.

Adding your child's name to the title of your home generally is considered a taxable gift of half the property's value. Plus, when you die, some or all of the home's value will be included in your estate and may be subject to estate taxes. You also expose the home to the claims of your child's creditors, and you lose a great deal of the control you have over the property.

In a joint purchase, you (or you and your spouse) purchase a life interest in the home, and your children purchase the remainder interest. As the name implies, a life interest gives you the right to live in the home for your lifetime. You retain complete control over the property, including the right to mortgage or sell it (subject to the remainder interest). After your death (or the deaths of you and your spouse), the home — including any appreciation in value — passes to your children estate tax free.

Structuring a joint purchase

If you structure a joint purchase properly, you also can avoid gift taxes. Ordinarily, a joint purchase with a family member results in gift tax on the property's full purchase price. But the tax code contains an exception for a home, provided you use it as your primary residence.



To escape gift taxes, you and your children must pay adequate consideration for your respective interests in the home. The relative prices of the life and remainder interests are set by IRS tables based on your life expectancy (or the joint life expectancies of you and your spouse) and the applicable federal interest rate at the time of the transaction.

For example, Chris purchases a home for $500,000. When he dies 20 years later, the home, which has increased in value to $1.5 million, goes to his daughter, Tess. Assuming that Chris has exhausted his $2 million estate tax exemption and that his marginal estate tax rate is 45%, his estate is liable for $675,000 in taxes on the home.

Suppose, instead, that Chris and Tess purchase the home jointly, and Chris's life interest and Tess's remainder interest are valued at $375,000 and $125,000, respectively. Provided Tess can afford to purchase her interest with her own funds, a joint purchase generates $675,000 in estate tax savings.

Keep in mind that "family member" means your spouse, your descendants (children or grandchildren, for example) and your descendants' spouses. Further, your ancestors and their spouses are included, as are your siblings and their spouses. If you enter into a joint purchase with your cousin, niece, nephew or anyone else not considered a family member, you're not limited to your primary residence. You can purchase virtually any type of property and enjoy the tax benefits.

Don't overlook income taxes

When property is transferred at death, the recipient's tax basis is generally "stepped up" to the property's value on the date of death. The recipient can turn around and sell the property without triggering any capital gains tax liability. In a joint purchase, however, the property isn't transferred at death. The remainder interest holder's tax basis is the amount he or she paid for the interest.

In the previous example, Tess's tax basis is $125,000. If she sells the home after her father's death, she'll have a capital gain of $1,375,000. Assuming that the federal capital gains tax rate is 15%, as it is now, she'll owe $206,250 in federal taxes on the gain. Even if she also owes state income tax, when netted against the estate tax savings the family comes out ahead.

Another option: The QPRT

A qualified personal residence trust (QPRT) also can shield your home's value from gift and estate taxes. You transfer your home to an irrevocable trust for the benefit of your children or other family members, retaining the right to live in the home for a specified number of years. At the end of the term, the home goes to your beneficiaries, but you may be able to continue living there by paying fair market rent.

Unlike a joint purchase, the initial transfer to a QPRT is a taxable gift. But by retaining an interest in the home, you minimize the property's gift tax value. With careful planning, you may even be able to eliminate the tax by taking advantage of your lifetime gift tax exemption.

A QPRT has some advantages over a joint purchase. Your beneficiaries need not come up with the funds to buy their interests, and the trust offers some protection against claims by your creditors.

There are drawbacks, though. QPRTs don't work well with mortgaged property. Also, you lose control over the property at the end of the term. Perhaps most important, to enjoy a QPRT's tax benefits, you must survive the trust term. If you don't, the property's full value is brought back into your estate.

Bringing tax savings home

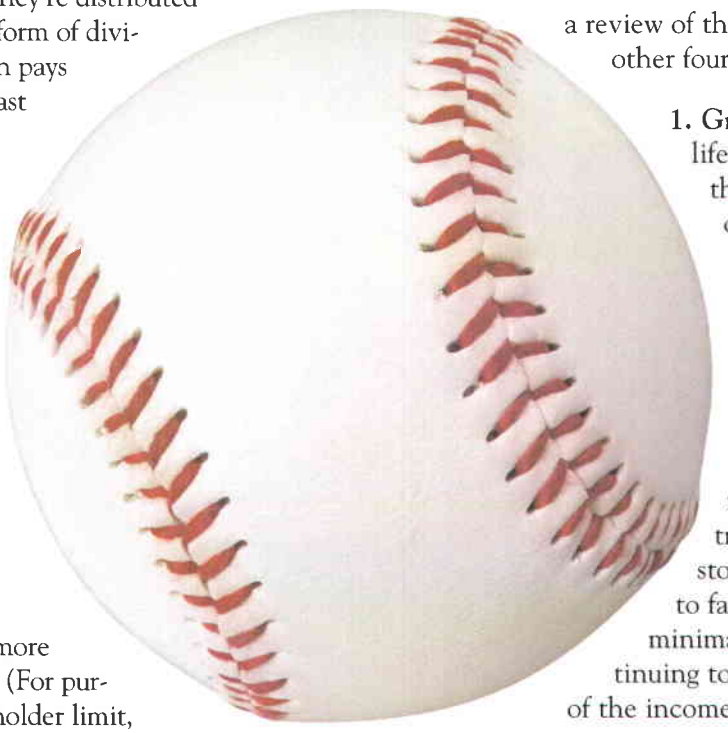
A joint purchase is a simple strategy that allows you to avoid gift and estate taxes on your home (or, if you partner with someone who's not a "family member," other property types). Your estate planning advisor can help you determine whether a joint purchase is right for you, but if your children or other beneficiaries can afford the initial investment, it's worth a look. ▮

Don't let S corporation stock throw you a curve

The S corporation remains one of the most popular entity choices for closely held businesses, combining limited personal liability with the advantages of pass-through tax treatment. From an estate planning perspective, however, S corporation stock can complicate matters.

S corporation restrictions

One of an S corporation's biggest advantages is that it avoids double taxation. Unlike a C corporation, whose earnings are taxed once at the corporate level and again when they're distributed to shareholders in the form of dividends, an S corporation pays no corporate tax (at least at the federal level). Earnings are passed through to the shareholders, who pay tax at their individual rates on their proportionate shares of corporate income.



To qualify for this tax treatment, an S corporation must meet several requirements. It can't have more than one class of stock, for example, or more than 100 shareholders. (For purposes of the 100-shareholder limit, family members — generally defined as descendants of a common ancestor and their spouses — would count as a single shareholder, so long as any one family member so elects.)

Eligible shareholders are limited to individuals who are U.S citizens or residents, estates, certain tax-exempt organizations and certain domestic trusts. If S corporation stock is transferred to an ineligible shareholder, the company risks termination of its S election and loss of the tax benefits that go with it.

Eligible trusts

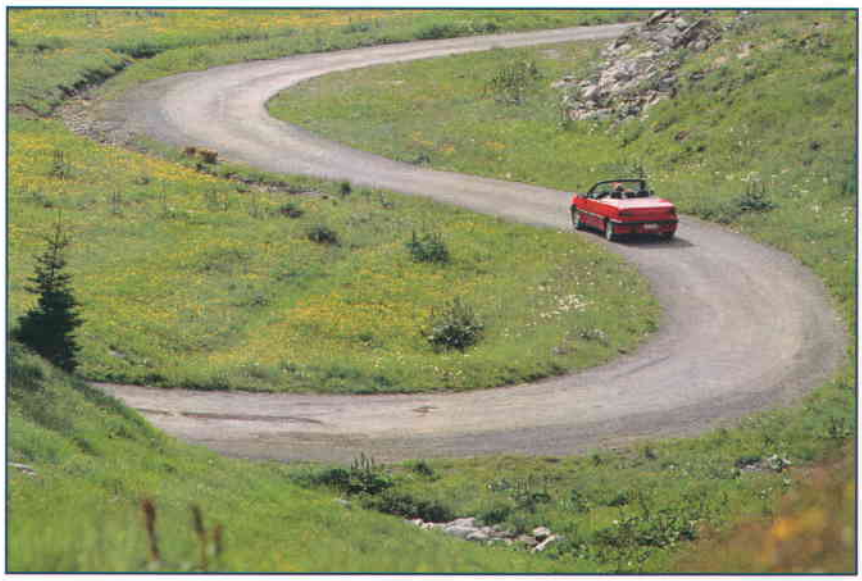
Many people use trusts to build flexibility into their estate plans, preserve their wealth for future generations and remove assets from their taxable estates without relinquishing all control. Five types of domestic trusts (foreign trusts don't qualify) are permitted to hold S corporation stock. Voting trusts are one type, but they have little relevance to estate planning. Here's a review of the pros and cons of the other four:

1. **Grantor trust.** This is a lifetime trust structured so that the grantor is the owner of the trust assets for income tax purposes. Grantor trusts play an important role in many estate plans. A grantor retained annuity trust (GRAT), for example, can transfer S corporation stock and other assets to family members at a minimal tax cost while continuing to receive some or all of the income.

One drawback of a grantor trust is that, to qualify as an S corporation shareholder, it can have only one deemed owner. This may limit the trust's ability to take advantage of techniques such as Crummey withdrawal powers to reduce or eliminate gift taxes on contributions.

When the grantor dies, the trust ceases to be a grantor trust. It will continue to qualify as an S corporation shareholder for two years, however,

providing time to transfer the stock to an eligible shareholder or qualify the trust as a qualified Subchapter S trust (QSST) or an electing small business trust (ESBT).



2. Testamentary trust. A trust established by the terms of your will is eligible to hold S corporation stock for up to two years after the shareowner's death. To continue holding the stock after the two-year period, the trust must qualify as a QSST or ESBT.

3. QSST. To qualify as a QSST, a trust must meet several requirements, including distributing all of its current income to a single beneficiary who is a U.S. citizen or resident. Also, the beneficiary must file a timely QSST election with the IRS.

If S corporation stock is transferred to an ineligible shareholder, the company risks termination of its S election and loss of the tax benefits that go with it.

The primary disadvantage of the QSST is that it can't be used to benefit multiple beneficiaries or allow income to accumulate.

4. ESBT. A trust qualifies as an ESBT if all of its beneficiaries are individuals, estates or certain types of charities; no beneficiary purchases an interest; and the trustee files a timely ESBT election with the IRS.

An ESBT offers estate planning flexibility: The trust income can be accumulated or it can be sprinkled among many beneficiaries. A variety of trusts commonly used in estate planning can qualify, including credit shelter trusts and charitable lead trusts. The main disadvantage is that the trust's income is taxed at the highest marginal rate (currently 35%). (A QSST's income is taxed at the beneficiary's marginal rate, which is often lower.) This is neutralized in a situation where the individual already is paying tax at the highest rate. In such a case, whether the shares were held by the individual or the trust, the tax rate would be the same.

For S corporation purposes, each potential current beneficiary (PCB) is treated as a shareholder. A PCB is anyone who's entitled to distributions from the trust or who, at the discretion of any person, may receive a distribution. Under a 2004 tax law, however, PCBs don't include persons who might receive a distribution under an *unexercised* power of appointment.

It's critical to scrutinize the trust's terms to be sure that its PCBs don't include ineligible shareholders (such as nonresident aliens) or cause the S corporation to exceed the 100-shareholder limit. If that happens, the trust can avoid a termination of the corporation's S election by disposing of all of its S corporation stock within one year.

Review your options

If you own S corporation stock, review your estate plan and take steps to avoid transfers that would endanger the corporation's S status. Trusts such as QSSTs and ESBTs provide estate planning flexibility for S corporation shares, but they have drawbacks. Consult with your estate planning professional to learn more about your options.

A charitable gift annuity can benefit you *and* a charity

There are a variety of strategies you can use to satisfy your philanthropic goals while preserving some tax and financial benefits for yourself. The right strategy depends on your objectives.

Are you looking to create a personal legacy by remembering your favorite charities in your will? Or do you prefer to enjoy the fruits of your generosity during your lifetime? Can you afford to part with assets now by making an outright gift? Or do you need to retain the income from the donated assets?

A charitable gift annuity (CGA) offers an attractive combination of benefits for both you and a charity.

To give and to receive

With a CGA, you donate cash, securities or other assets in exchange for a lifetime income stream. The charity receives your gift now and pays you a fixed percentage of the gift annually for the rest of your life. You receive an immediate income tax deduction based on actuarial estimates of the portion of your gift the charity ultimately will keep.

Charities that offer CGAs typically use the annuity rates suggested by the American Council on Gift Annuities (ACGA). The older you are, the higher the rate.

So, for example, if you're 60 years old and purchase a CGA for $1 million, your income interest will be 5.7%, or $57,000 per year under ACGA rates as of this writing. If you're 80 years old, the annuity rate is 8%, or $80,000 per year. You also have the option of purchasing a joint-and-survivor annuity that makes payments for your life or, if longer, for the life of your spouse or another beneficiary.

The ACGA rates generally are lower than those available for commercial annuities because they're designed to preserve a significant portion of your gift for the charity (usually around 50%). For income tax purposes, each annuity payment is treated as part tax-free return of principal, part ordinary income, and — if you donate stock or other property that has appreciated in value — part capital gain.

Saving for retirement

A deferred CGA — where the annuity payments begin at a future date that you specify — is one way to supplement your retirement income or to save for college or other expenses. You still receive an immediate charitable deduction, but you don't pay tax on the distributions until the payouts begin.

One advantage of using a deferred CGA for retirement savings is that you enjoy an income tax deduction now, while your marginal rate is relatively high, but you don't receive the income until after you retire, when you may be in a lower tax bracket. Also, because the annuity payments are delayed, they'll be larger than the payments you would receive from an immediate CGA.

Be aware that a deferred CGA is no substitute for IRAs, 401(k)s or other tax-advantaged retirement plans. But if you've maxed out your contributions

to these accounts, a deferred CGA can be a valuable addition to your financial planning arsenal.

Do your homework

Whether a CGA is a good investment depends on the charitable organization's financial strength. Work with an established charity that you expect will be around for many years to come and will have the financial resources to meet its annuity obligations.

You can evaluate a charity's financial strength and efficiency by examining its financial statements or tax returns (Form 990) or by checking with watchdog groups such as GuideStar (www.guidestar.org), the American Institute of Philanthropy (www.charitywatch.org), Charity Navigator (www.charitynavigator.org) or the Better Business Bureau's Wise Giving Alliance (www.give.org).

A powerful combination

A CGA won't provide the highest return on your investment or generate tax deductions as high as an outright charitable gift. But if you're looking for a combination of current tax benefits, fixed income for life and significant benefits for a charity you care about, a CGA is an option to consider. ▮

Estate Planning Pitfall

You didn't name a guardian for your minor children

No estate planning decision is more important than choosing a guardian to care for your children in the event something happens to you and your spouse. If you don't name a guardian, a court will do it for you. And even though the court is obligated to consider a child's best interests, its choice may not be the one you would make.

Procedures vary from state to state, but typically you're required to name a guardian in your will. Here are several tips to consider in selecting the right person for the job:

- Choose someone who shares your values and parenting style, and who is willing to take the responsibility.
- If you have more than one child, it's usually best to appoint one guardian (or a couple as co-guardians) for all of them. But in some cases — for example, if you have children from different marriages — separate guardians may provide the best care.
- Name at least one alternate guardian in the event your first choice is unavailable or changes his or her mind. Also, if there is anyone you want to *prevent* from raising your children, be sure to say so in your will in case the court is called on to appoint a guardian.
- Be sure that caring for your children won't impose an economic hardship on the person you've selected. Does your estate plan provide sufficient funds to support your children? How long will these funds last?
- Good parents aren't necessarily good money managers, so consider appointing someone other than the guardian to manage your children's assets. Having a separate trustee also avoids conflicts of interest — real or perceived — between the guardian and the children.

A court isn't required to accept the guardian you designate, but courts almost always defer to the parents' wishes unless the person chosen is deemed unfit. Consider leaving a letter of explanation that spells out for the court the reasons you feel your designee is best qualified to raise your children.

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 twelve 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, and post-mortem tax planning. Hugh holds finance, MBA and JD degrees from the University of Kansas.

Donna F. Bohn has over sixteen 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 insurance planning. Donna has an accounting degree from Kansas State University and law degree from Washburn University.

Kari D. Coultis is an attorney and a Certified Public Accountant. She focuses on estate planning design and construction. She supervises drafting assignments with legal assistants and attorneys to ensure errorless document preparation. She also assists with charitable planning, estate tax planning, tax litigation and business valuation matters. 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.

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.

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