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Easing Estate Taxes

Guest Speaker: Gideon Rothschild, estate planning attorney with Moses and Singer in New York.
Moderator: Melissa Phipps, community manager of Financial Planning Interactive.

Phipps: Hello everyone, welcome to our Live Forum with Gideon Rothschild, an estate planning attorney with Moses and Singer in New York who will discuss using trusts to lessen estate tax bills for high-net-worth clients. I am your moderator, Melissa Phipps.
Welcome, Gideon. Why don't you begin by telling us a little bit about yourself and your practice?
Rothschild: I'm an attorney and partner with the law firm of Moses and Singer in New York City, co-chairing the wealth preservation practice group. Our firm is a general practice firm of approximately 70 lawyers with various specialties, including new media, health care, corporate securities, banking and real estate. To find more information about our firm, you can visit www.mosessinger.com.
Joe Weiner CLU ChFC: Do you think estate taxes will be reduced or eliminated?
Rothschild: As you know, Congress had a bill that President Clinton vetoed. This bill proposed to repeal the estate and gift tax in 10 years. However, due to budgetary constraints, the year following its repeal it would be re-instituted. So, in essence, there was only a one-year window for clients to die and avoid estate taxes. It is unlikely that the minority of wealthy voters will succeed in convincing Congress to eliminate the tax entirely, which would be viewed by most Americans as pandering to the wealthy. Even if the tax is repealed some day, clients should continue to plan their estates in ways that require minimal outlay in the form of gift taxes. Many possibilities exist to accomplish these goals, including sales to grantor trusts, the use of unified credit exemptions and annual exclusion gifts.
Evan Simonoff (editor in chief and associate publisher of *Financial Planning* magazine): Gideon, I hate to be a party pooper but will folks like you do if we get a Republican president and Congress and the estate tax is abolished? Will you turn your attention more to charitable work and issues like estate equalization?
Rothschild: If the estate tax gets abolished there will still be individuals who need to address the transfer of wealth to the next generation, which requires drafting wills and trusts to accomplish those goals in addition to the charitable objectives that one may have. Query whether there will be as much philanthropy if there is no estate tax.
Nick N: Please comment on "Pure Trusts." My clients are hearing about these wonderful trust to transfer assets, get stepped-up basis, no gift problems, asset protection, no estate taxes, etc, etc. Please give an information source to protect clients from making mistakes.
Rothschild: Recently, the tax court held against a firm by the name of Estate Preservation Services, who were promoting trusts which they represented, would avoid estate taxes, income taxes and creditors. These trusts have been given various names, including "Pure Trusts," constitutional trusts, common-law trusts, etc. The bottom line should be: If it sounds too good to be true, it probably is. The IRS has announced a full-fledged attack against these structures and their promoters, and clients will face substantial adverse consequences, including possible criminal penalties, if they engage in these structures. That is not to say that asset protection trusts, which are tax-neutral, are in the same category as the foregoing.
Frank: What estate tax strategies are effective for S Corps. that hold highly appreciated marketable securities?
Rothschild: S Corporations that hold appreciated securities, as you know, are flow-through entities. Therefore, any gains on the sale of the securities would be reported by the shareholders. When a shareholder dies, there would be no step-up in basis on the underlying securities. However, the deceased shareholder's estate will obtain a step up in basis for the S Corp. stock. When the S Corp. is subsequently liquidated, the loss recognized by the estate will be offset by the gain recognized by the corporation if the transaction occurs in the same year. If the objective is to freeze the value in the shareholder's estate, then the strategy to recommend would be a sale to a grantor trust. A grantor trust is an eligible shareholder of an S Corp.
Phipps: What are dynasty trusts and how are they used within a financial plan?

Rothschild: Dynasty trusts are generally irrevocable trusts established in states which have repealed the rule against perpetuities (currently 12 states), and therefore allow these trusts to last in perpetuity for the benefit of future generations. They take advantage of the available generation-skipping tax exemption and therefore allow the grantor to transfer a substantial amount of wealth, either during lifetime or upon his death.

Milt Colegrove: Have you ever used trusts to protect your clients from tort liabilities by putting apartment buildings, commercial property, etc., in the trust? The trustee of the trust would be a professional trustee and the beneficiary would be another trust, so you have two layers of trusts before you get to the individual?

Rothschild: A better approach would be to transfer the real property to a LLC, which insulates the owner from personal liability, and the LLC interest can then be transferred to a trust with a professional trustee.

Phipps: A lot of financial planners will recommend life insurance to cover an estate tax, is this necessary? If so, when?

Rothschild: Life insurance is a useful tool, particularly where there may not be sufficient liquidity in the estate to pay the estate taxes which are due nine months after death. Life insurance can also be utilized to achieve other objectives, such as equalizing an estate between children who receive a family business and those who are not involved in the business. However, when recommending life insurance, it should always be owned by an irrevocable trust to avoid including the proceeds in the insured's estate.

(Question received in advance): What do you see as the downside to the QPRT? My clients who are considering one on their second home have a net worth of $10 million, the majority of which are traded securities.

Rothschild: The downside that concerns most people is the fear of losing control of their home to the children or, perish the thought, their daughter-in-law or son-in-law. The other potential drawback is that the grantor is giving up the use of the equity in the home should he need it at a later date for his own retirement. The first concern can be addressed fairly easily by providing in the trust that at the end of the term the property remains in trust for the benefit of the children, with a reliable trustee controlling the property. This avoids the possibility of the home falling into the hands of an in-law, or conflicts between parents and children.

The other concern can be accomplished by transferring only a fractional interest in the home. So, for example, if the grantor retains 50% and transfers the other half to the trust, upon the sale of the home half the proceeds will go to the grantor for his or her own personal use, while the other half will continue to remain outside the grantor's estate, provided he outlives the term.

By the way, planners should note that the current AFR rate is at a high point (8.2%), and gifts to QPRTs are more advantageous at higher rates.

Jordan: I attended an [International Association for Financial Planning] meeting last fall and a speaker, Alan Eber, JD, was teaching on using life insurance wrappers in offshore trusts that used private annuities and variable life policies. Have you studied this and do you like this approach?

Rothschild: The use of life insurance wrappers is not new and does not accomplish anything that cannot be achieved by using more traditional variable life insurance. However, these life insurance products, which are sold by offshore insurance companies, are basically variable life insurance which allow the insured to select investment advisers to manage the investment portion of the policy. The investment adviser selected can include the insured's exsisting investment adviser. As in all insurance products, the increase in cash value remains tax-free and can be borrowed (provided the policy is not an MEC) tax-free, converting at death to an income-tax-free death benefit.

(Question received in advance): A client is questioning if family limited partnerships are as safe as irrevocable life insurance trusts from the standpoint of the IRS, any chance they may disqualify FLPs?

Rothschild: First, we have to clarify that if life insurance is owned by an FLP, the death benefit can be included in the insured's estate to the extent the insured owns an interest in the FLP. If we are assuming the insured will be gifting the entire FLP interest to his children, then only perhaps 1% of the proceeds will be included in his estate. Since a contribution to an FLP does not require CRUMMEY notices to qualify for the annual exclusion and can be amended easier than a trust, some people have suggested using an FLP to hold insurance. I believe the IRS might take a contrary position if the FLP does not have an independent business purpose. One method I've used is to fund the FLP with income-producing property. An insurance trust can be the owner of the LP

interests and thereby receive income distributions from the FLP sufficient to pay the insurance premiums.
M. Nommensen (question received in advance): Last year I missed the opportunity to convert to a Roth IRA, which would enable me to pay the resulting taxes over five years. Would a smaller Roth (funded with $2,500 for example) set-up for an infant be a good way to pay for their college costs 18 years from now?
Rothschild: A Roth IRA can only be used where there is earned income and where the tax payer's AGI is not greater than the allowable limits. Therefore, if the objective is to fund for college education, the only options besides a minor's trust or a UGMA account is an education IRA (maximum $500 per year) or a Section 529 plan. These Section 529 plans have become very popular, and many states provide for these. For example under New York's plan, an individual (who does not have to be a New York resident) can contribute up to $50,000 per child ($100,000 if married). The beneficiary can be changed by the grantor at any time, and should the grantor wish to take the money back he can, subject to a 10% penalty. If the child uses the funds for education-related expenses, the child pays income tax on the income distributed from the account.
Jordan: I understand and agree with your evaluation of the VUL wrapper. However what [Eber] is doing is even more. He would transfer appreciated assets into an offshore private annuity arrangement with an offshore trust. The VUL is then connected with the annuity in a business arrangement.
Rothschild: Frankly, I have participated in seminars with Alan Eber, and am familiar with his structure. However, I have some reservations as to the tax consequences.
Steve Wightman: Pertaining to your Roth IRA answer: If the owner will be at least 59 1/2 when college tuition hits, then a Roth is an excellent choice. Especially for aggressive portfolios because all distributions are tax free to the owner and not included in the financial aid calculation for a non-child student.
Rothschild: Steve, you're right. I was under the impression that the question was referring to a Roth IRA established by the child.
Frank: Are there any planning strategies available for underperforming GRATs that are projected to transfer all FLP units back to the grantor?
Rothschild: The recommendation I would consider is to continue to roll over the FLP units into new GRATs and hope that the future will be brighter.
Barry Kaplan (question received in advance): I am trying to find information about a technique using a limited partnership combined with a sale to a defective trust, but have been unable to. From what I've heard, let's say the grandparents move some (rapidly appreciating) assets into a limited partnership in which they control all the general and limited shares. Then a trust is set up for the kids and grandkids. Grandparents sell the limited partnership shares (at a discount?) to the trust. The grandparents pay the income tax on any gains, because it is defective for income tax, but since its not defective for estate tax reasons, you get an estate freeze.
How can this be funded? A loan for the discounted sales amount funded by assets in the trust? Second-to-die insurance funded by annual gift exclusion money? Will it fly, or is this suspect? Is this done much? Do you do this kind of thing? Where can I find any literature on it?
Thanks for considering my long-winded question.
Rothschild: Barry, the technique you describe is being used extensively by us and many other estate planners. It is perfectly within the confines of the Code, and is not much different from a normal installment sale to a family member. The difference here, of course, is that by selling the partnership to a grantor trust, no gain is recognized and transactions between the trust and the grantor are ignored for income tax purposes. Provided the client expects the appreciation rate to exceed the Section 1274 rate (currently approximately 7%), the excess will remain outside the grandparents' estate. The other advantage of using this technique now is to lock in the discounts available on the valuation of the LP interests in the event Congress were to eliminate such discounts. *The Wall Street Journal* had an article describing this technique on February 28. If you would like a copy, e-mail me at grothschild@mosessinger.com.
The one caution I would make is to ensure the trust has the available cash flow to pay the interest on the note. If the trust does not have such cash flow available, it can pay the interest by using the LP interests in kind, but this would reduce some of the freeze benefits. The trust should also be funded initially with a gift transfer, which some commentators believe should equal 10% of the amount of the sale.
Phipps: Is there any particular estate planning software that you recommend?

Rothschild: There are many software products on the market, including USTrust's E-Plan, ProBate Software, Number Cruncher, among others. The American Bar Association has published a book on software for estate planning, including document drafting software as well as number-crunching software. I generally use a pencil to push my numbers.
Steve Wightman: What five top strategies would you use in estate planning with Roth IRAs? Also, I've lately heard attorneys tout using a trust as beneficiary for IRA assets. Do you think this is a good idea? Why?
Rothschild: I'm not sure I'll have five strategies for you, but we'll give it a try. The key to planning with Roth IRAs is to stretch out the deferral as long as possible. One limitation is, of course, the qualification for using a Roth IRA. Since a taxpayer can not have more than the threshold amount in AGI, it limits the client's ability to use these accounts. Most wealthy clients who have estate tax concerns do not qualify. Where the client does qualify, the key planning strategy would be to spend down all the other assets and allow the Roth IRA to grow. However, if left with a large Roth IRA account at death, there needs to be some consideration on how the beneficiaries will pay the estate tax, and the solution I've found to work best is to have life insurance available for that purpose.
As for using a trust as a beneficiary for IRA accounts, there are numerous types of trusts one might consider using. If a client doesn't have sufficient asset to use their exemption, we might suggest naming the credit shelter trust as a beneficiary. Another example would be where the client wishes to ensure that the IRA would be available for children from a prior marriage, in which event a QTIP trust would be advisable. Other trusts might include GST-exempt trusts and trusts for minors. As long as the trust meets the requirements to be considered a designated beneficiary, it will qualify the deferral over the life expectancy of the eldest beneficiary of the trust.
Phipps: Gideon, thank you very much. And thank you all for participating in our discussion.
Join us next week when our guest will be famed money manager Mario Gabelli, March 16, 5 p.m. to 6 p.m. EST.