

# *The* ESTATE PLANNER

MARCH/APRIL 2008

## CASH FLOW CONTROL

Design a CRT as a “spigot trust”  
to manage income stream

## GOING OFFSHORE

Do your assets need an extra layer of protection?

## LIFE INSURANCE PLANNING: AVOIDING THE 3-YEAR RULE

### ESTATE PLANNING RED FLAG

Your assets haven’t been valued  
by an independent appraiser

**selznick**  
COMPANY, LLP

*Certified Public Accountants*

145 Bedford Road • Suite 201 • Armonk, New York 10504  
914.273.3700 • Fax 914.273.9331 • [www.dselznick.com](http://www.dselznick.com)

**selznick**  
ASSOCIATES, LLC

*Attorneys at Law*

# CASH FLOW CONTROL

## DESIGN A CRT AS A “SPIGOT TRUST” TO MANAGE INCOME STREAM

A charitable remainder trust (CRT) is a flexible tool that can facilitate a variety of estate and financial planning strategies. In addition to benefiting a charity, it allows you to shelter assets from estate taxes, generate an immediate charitable income tax deduction, and retain an income stream for life or for a term of years. A CRT also allows you to avoid or defer capital gains taxes on highly appreciated assets.

If you don't need the income from a CRT right away, you can design it as a “spigot” trust, which allows the assets to grow tax-deferred until you're ready to turn on the income flow, such as when you retire.

### TAPPING THE BENEFITS

A CRT allows you to provide for yourself and your family today while preserving benefits for your favorite charities down the road. You contribute assets — such as cash, stock or real estate — to an irrevocable trust. You or your beneficiaries receive annual distributions from the trust for life or for a term of up to 20 years. When the term ends, the remaining assets are distributed to one or more charitable beneficiaries.

*CRTs are ideal for converting highly appreciated, low-yielding assets into a source of income without triggering capital gains tax.*

Payouts to you or your beneficiaries can be:

- ◆ A fixed percentage of the trust assets' initial value, if you choose a charitable remainder *annuity* trust (CRAT), or
- ◆ A fixed percentage of their value recalculated annually, if you choose a charitable remainder *unitrust* (CRUT).

The percentage must be at least 5%, but no more than 50%.

Keep in mind that, all else being equal, the higher the income interest, the lower your charitable deduction.



Also, if you name noncharitable beneficiaries other than yourself, there may be gift tax implications.

When you fund the trust, you receive an immediate income tax deduction for the value of the charitable remainder interest. That value is computed by subtracting the actuarial value of the income interest (based on IRS tables) from the value of the assets you transfer to the trust.

CRTs are ideal for converting highly appreciated, low-yielding assets into a source of income without triggering capital gains tax. You transfer the assets to the trust, which sells them and reinvests the proceeds in income-producing assets. Because CRTs are tax-exempt entities, the trust pays no tax on the gain.

The taxability of distributions to you or other noncharitable beneficiaries depends on the makeup of the trust's portfolio. It may be subject to ordinary income tax, but a portion of each distribution may be treated more favorably as, for instance, capital gains, tax-exempt income or tax-free return of principal.

### GOING WITH THE FLOW

You can use a well-planned CRUT as a supplemental retirement plan. Ordinarily, a CRUT is required to distribute at least 5% of the trust assets' value annually

(the “unitrust amount”). But there’s an exception that allows you to set up a CRUT that distributes the lesser of the unitrust amount or the trust’s net income for the year. You also can provide that any unpaid unitrust amounts be made up in future years if the trust earns income in excess of the normal unitrust payment.

A net income with makeup CRUT (NIMCRUT) allows you to control the flow of distributions from the trust, letting you defer the income until your retirement or some other time in the future (hence the nickname “spigot trust”). Initially, the trust assets are invested in non-income-producing investments, such as zero coupon bonds, growth-oriented stocks or mutual funds. The assets grow on a tax-deferred basis until it’s time to turn the tap back on, at which time the trustee shifts the trust’s investments to income-producing assets.

For example, Max, age 55, owns a rental apartment building that he originally purchased for \$200,000 and that is now worth \$500,000. He’d like to sell the building but doesn’t want to pay \$45,000 in capital gains tax. He transfers the property to a 5% NIMCRUT, naming his alma mater as the charitable remainder beneficiary. The trust sells the property and reinvests the proceeds in a diversified portfolio of growth stocks that generate little or no current income, but enjoy 8% annual growth.

Ten years later, when Max is ready to retire, the value of the trust assets has grown to about \$1.08 million. The trustee moves the investments into fixed-income securities that yield a 6% annual return. Because of the net income makeup feature, Max receives all of the trust income — almost \$65,000 per year — for about six years. Each year that Max’s payments exceed the 5% unitrust amount, he’s depleting the reserve that had been built up. After he’s been paid all of the amounts he “missed” in the prior years, the payout drops to the 5% unitrust amount, which in this example is approximately \$54,000.

## FLIPPING OUT

NIMCRUTs require careful planning and involve some risk. To accomplish your goals, you need solid investment advice and a trustee who’s qualified to manage the trust’s portfolio to achieve the spigot effect. Still, even a well-planned and well-managed

NIMCRUT can fall short if its returns are less than those generated at the unitrust rate. If the trust doesn’t produce enough income, you may be unable to access the funds when you need them most.

To avoid this predicament, under certain circumstances you can design the trust to convert from a NIMCRUT to a standard CRUT. This type of trust, called a flip CRUT, provides for the trust to convert and begin making standard unitrust payments in the future. The trust can convert on a date you specify or when a triggering event occurs that’s outside your control or the control of the trustee or other unitrust payment recipients.

Permissible triggering events include marriage, divorce, death, reaching a certain age, the birth of a child or a sale by the trust of an unmarketable asset, such as real estate or closely held stock. Examples of impermissible triggering events include the trust’s sale of marketable assets and a request by the recipient of the unitrust payments or his or her financial advisor.

## A VERSATILE TOOL

If you’re interested in supplementing your retirement savings while benefiting a favorite charity, a spigot trust is worth a closer look. But because of its complexity, make sure you consult an estate planning professional. ❁



# GOING OFFSHORE

## DO YOUR ASSETS NEED AN EXTRA LAYER OF PROTECTION?

Offshore financial planning may evoke images of international spies wiring funds into secret, numbered bank accounts, but the reality is far more mundane. Still, if your wealth is substantial and your business exposes you to the risk of frivolous lawsuits, an offshore trust can provide an extra layer of protection.

### DISPELLING THE MYTHS

Contrary to popular belief, an offshore trust won't allow you to avoid taxes or hide your assets. In most cases, they're "tax neutral," meaning you'll pay income taxes on the trust earnings, and the assets transferred to the trust will be subject to gift or estate taxes.



In the past, many affluent people used offshore trusts and other accounts to keep their financial affairs private. In today's world, though, that's an increasingly elusive goal. The threat of terrorism and concerns about money laundering have inspired the international community to promote transparency in the banking industry.

Bear in mind that an offshore trust isn't for everyone. It's expensive, it requires you to relinquish control over your assets for a long time and, for many people, it isn't necessary. The benefits may justify the costs, however, for wealthy entrepreneurs, physicians and other high-income professionals whose business activities expose them to a heightened risk of spurious claims and litigation.

*Offshore trusts are similar to domestic trusts, except they're located in a foreign country with more favorable asset protection laws.*

### INSULATING YOUR ASSETS

Offshore trusts are similar to domestic trusts, except they're located in a foreign country with more favorable asset protection laws. The assets you're protecting don't necessarily have to be located in the country where you establish the trust, but moving the assets outside the United States generally offers greater protection. That's why offshore trusts are usually funded with cash or securities that are readily moved, rather than real estate or other property that could be seized by a U.S. court.

How do offshore trusts insulate wealth from attack by unscrupulous creditors? They're established in foreign countries that generally don't recognize judgments from U.S. courts and whose procedural rules make it difficult and costly for a U.S. creditor to collect there.

Typically, a creditor must relitigate its claim in the jurisdiction where the trust is located. To do so, however, the creditor must jump through several challenging hoops,

## It pays to start planning early

The sooner you start asset protection planning, the more effective it will be. Most states have fraudulent transfer laws that allow creditors to go after assets you've transferred to a trust or to another person.

Generally, to succeed, a creditor must establish either that 1) you made the transfer with the actual intent to defraud creditors, or 2) you made the transfer without receiving reasonably equivalent value in exchange and you were (or became) insolvent.

Planning early pays off for two reasons: First, most fraudulent transfer laws contain a statute of limitations that prevents creditors from challenging a transfer after a specified amount of time has passed (four years, for example). Second, intent to defraud is a subjective standard that's difficult to defend against. But the longer the period between the time assets are transferred and the time a creditor's claim arises, the more difficult it is for a creditor to prove that you intended to defraud that creditor.

starting with the statute of limitations. Foreign jurisdictions often impose tight time requirements on lawsuits — often one to two years after the trust is created.

In addition, many jurisdictions prohibit contingent-fee arrangements, which means the plaintiff will have to pay a retainer to a local lawyer. On top of that, foreign courts often require plaintiffs to post a bond to cover the defendant's legal fees and court costs in the event the defendant prevails. Finally, even if a plaintiff overcomes all of these obstacles, the trustee may be able to relocate the trust to another jurisdiction, requiring the plaintiff to start all over again.

The protection provided by an offshore trust isn't absolute, but the effort and expense required to attack offshore assets often discourages plaintiffs who are looking to exploit the legal system for personal gain.

### PLANNING FOR THE FUTURE

Offshore trusts, like domestic asset protection trusts, shouldn't be viewed as vehicles for evading existing creditors — whether they have legitimate claims or not. The key to making an offshore trust work is to establish it early — at a time when there are no pending or threatened claims against you. If litigation has already commenced or is imminent, moving assets to an offshore trust likely would violate fraudulent transfer laws. (See “It pays to start planning early,” above.)

Planning is also important in the event of bankruptcy. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 allows a bankruptcy trustee to void transfers you made to asset protection trusts in the preceding



10 years if it can be shown that the transfer was made “with actual intent to hinder, delay or defraud creditors.”

### AN INTEGRATED APPROACH

If you'll benefit from offshore planning, it's important to take an integrated approach to estate planning and asset protection. The primary purpose of an offshore trust is to protect your assets from unscrupulous creditors. It's no substitute for estate planning strategies designed to minimize taxes, provide for your family and ensure that your wishes are carried out. ❁

# LIFE INSURANCE PLANNING: AVOIDING THE 3-YEAR RULE

Life insurance is a fundamental component of most estate plans, providing instant liquid assets for your loved ones after you die. In most cases, the insurance proceeds can be received income-tax free. With proper planning, the insurance proceeds also can be exempt from estate taxes.

## KEEPING PROCEEDS OUT OF YOUR ESTATE

The key to keeping life insurance out of your taxable estate is to make sure you don't own the policy or possess any "incidents of ownership" in it, such as the right to change beneficiaries or borrow against its cash surrender value. One way to accomplish this is to have someone other than you or your spouse purchase the policy, such as your adult children or an irrevocable life insurance trust (ILIT). You can still contribute the funds needed to pay the premiums — subject to gift taxes, of course.

But what if you already own an insurance policy on your own life? Can you remove it from your taxable estate by transferring it to a family member or to an ILIT? The answer is "yes," but there's a caveat.

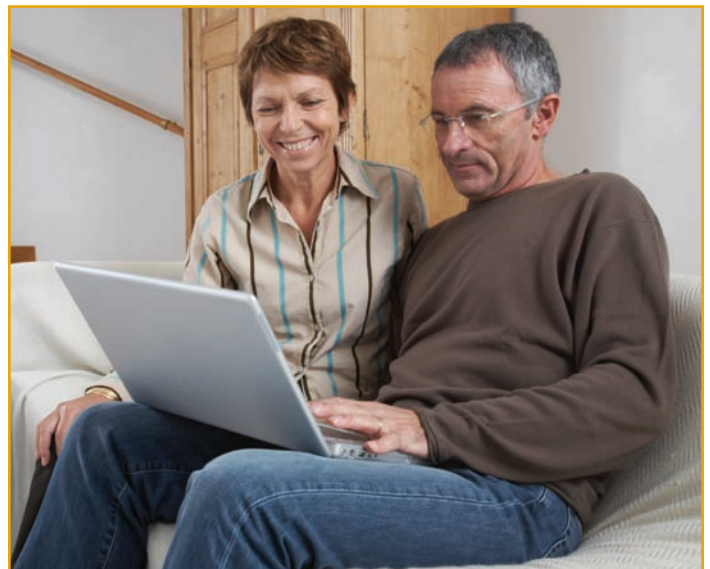
The tax code provides that life insurance you transfer within three years of your death be included in your estate. So, if you transfer a life insurance policy and don't survive for at least three years, the proceeds will be "pulled back" into your estate and subject to estate taxes. With current estate tax rates as high as 45%, that's a pretty expensive caveat.

*The tax code provides that life insurance you transfer within three years of your death be included in your estate.*

## SPECIAL CONSIDERATIONS

Fortunately, there's an exception to the three-year rule for life insurance or other property you transfer as part of a bona fide sale for adequate consideration. Moreover, a recent IRS ruling may open the door to new strategies for avoiding the three-year rule.

The problem with the bona fide sale exception is that, even though it offers relief from the three-year rule, when life insurance is involved it may trigger another, equally devastating, rule: the transfer-for-value rule. This rule provides that a transferee who gives "valuable consideration" for a life insurance policy is subject to ordinary income taxes on the amount by which the proceeds exceed the consideration and premiums the transferee pays.



There are several exceptions to the transfer-for-value rule, including transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Under Revenue Ruling 2007-13, it may now be possible to avoid the three-year rule — without running afoul of the transfer-for-value rule — by selling an existing life insurance policy to an irrevocable grantor trust. A grantor trust is a trust structured so that you, the grantor, are the owner for income tax purposes — but not for estate tax purposes.

According to the IRS, the owner of a grantor trust is treated as the owner of a life insurance policy held by the trust. Thus, provided the consideration paid for the policy is adequate, you can avoid the three-year rule. And so long as the trust that is purchasing the policy is treated as a grantor trust for income tax purposes, the transfer-for-value rule doesn't apply because you're essentially transferring the policy to yourself.

Generally, if the insured is in good health, the value of the policy should be its value for gift tax purposes: the policy's terminal reserve value (roughly equal to its cash surrender value) plus any unearned premiums. For an insured who isn't in good health, the IRS will likely take the position that the policy's value is more closely akin to its death benefit, which effectively rules out a sale of the policy to an irrevocable grantor trust.

### FIXING A BROKEN ILIT

The IRS ruling may also make it possible for a trustee to "fix" an existing ILIT with unfavorable terms, without triggering the three-year rule. How? By having it sell the

insurance policy to a new ILIT. According to the ruling, the transfer-for-value rule doesn't apply when a policy is transferred to a grantor trust created by the insured.

### HANDLE WITH CARE

The sale of an insurance policy to an irrevocable grantor trust is a complex transaction, so be sure to consult your estate planning advisor before taking any action. Under the right circumstances, this strategy can allow you to remove life insurance from your estate without the risk of bringing the proceeds back into your estate if you don't survive for three years. ❖

## ESTATE PLANNING RED FLAG

### Your assets haven't been valued by an independent appraiser

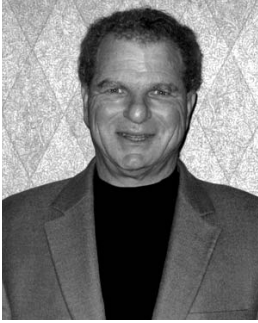
The best way to substantiate asset values reported in gift and estate tax returns is with an independent valuation by a qualified appraiser. In numerous recent matters before the U.S. Tax Court and other federal courts, taxpayers have won or lost their cases based on the qualifications, methods and testimony of their valuation experts.

In *Estate of Thompson*, for example, the Tax Court essentially disregarded the testimony of the estate's two valuation experts, who were inexperienced, noncredentialed and, in the Tax Court's view, "marginally credible." A federal appeals court agreed, despite the fact that the IRS had the burden of proof.

Another reason to obtain qualified appraisals is the risk of monetary penalties for assets found to be undervalued. The Pension Protection Act of 2006 (PPA) made it easier for the IRS to recover these penalties. Previously, penalties for a substantial valuation misstatement were triggered if the reported value was 50% or less than the "correct" value. Under the PPA, for estate and gift tax returns filed after Aug. 17, 2006, these penalties apply to reported values that are 65% or less than the correct value.

The PPA also tightened the determination of the penalty for gross valuation misstatements. These penalties are now triggered when reported values are 40% or less than the correct value (up from 25%). And the act eliminated reasonable cause as a defense to penalties for gross valuation misstatements.





**David R. Selznick**, is an Attorney and CPA specializing in income tax, business succession and estate planning for owners and their closely held businesses. He holds a BS in Accounting from Syracuse University, an MBA in Taxation from Pace University Graduate School of Business and a JD from

Pace University School of Law (*cum laude*). He is formerly the chairman of the Tax Section for the Westchester County Bar Association.



**Sherry L. Bramson, Esq., CPA**

BS Accounting, Wharton School of Business  
JD, New York University  
LLM in Taxation, New York University



**Patricia M. Carroll, Esq.**

BA English, SUNY Stony Brook  
JD, Pace Law School

### **Selznick & Company, LLP offers:**

- Individual, Corporate and Fiduciary Tax Planning
- Tax Return Preparation
- Audited, Reviewed and Compiled Financial Statements
- IRS, State and Local Tax Examinations and Controversies
- Business Valuation



**Marion K. Jablansky, CPA**

BS Accounting, Wharton School of Business

### **Selznick & Associates, LLC, offers:**

- Business Succession and Estate Planning
- Drafting of Wills and Trusts
- Estate Administration
- Preparation of Partnership, LLC and Related Documents



**Laurie A. Urbanowicz, CPA**

BA International Relations, Colgate University  
MBA Accounting, Pace University



145 Bedford Road, Suite 201  
Armonk, New York 10504