Solutions

WEALTH AND BUSINESS PLANNING STRATEGIES 1st Quarter 2009

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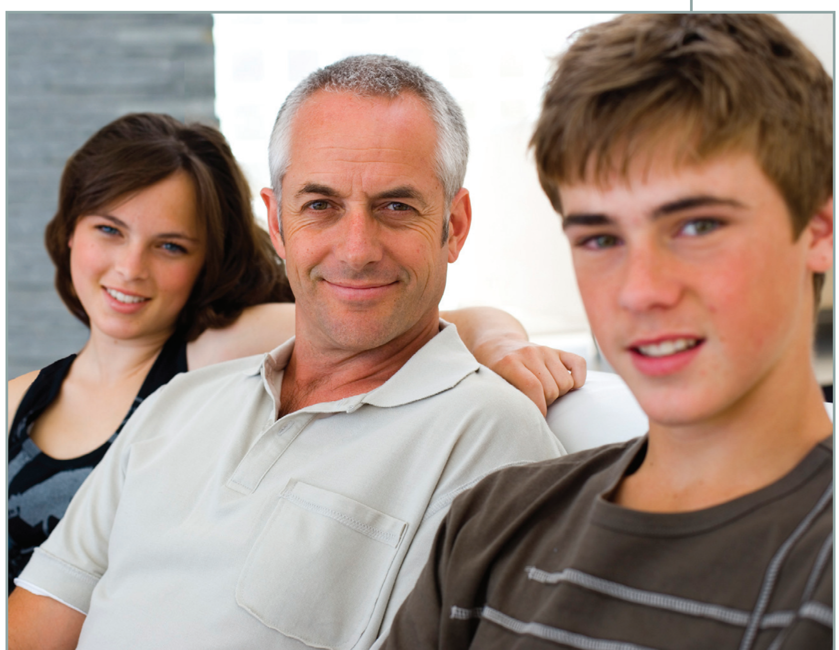
WHERE THERE'S A WILL THERE COULD BE A PROBLEM

A will is a wonderful tool to assist individuals in seeing to it that their assets go to people of their choosing when they die. If people don't create wills, the state in which they live is more than happy to step in and create one for them. The state version rarely is the way most people would elect to distribute their assets. On occasion, a small mistake can be a costly mistake in carrying out a person's goals. This article will discuss one such problem if you have minor children as heirs.

Charles has two children by a previous marriage and he wants to do the best that he can for them and for his new wife of three years. His son is age 16 and his daughter is age 14. He does not want to allow his former wife to have access to any of his assets and does not want any of the money he is giving to the children to be controlled by his former wife while the children are minors. Charles also wants to be sure that his present wife will be properly taken care of and directs that all personal property is to go to her. She also is to receive the residence. Charles has purchased a $1 million life insurance policy and wants half to go to his current wife and the balance to go to a testamentary trust created at his death for the benefit of his children. There are no children of the current marriage. His will calls for the creation of the children's trust with the trustee to have total discretion as to distribution of income to the children or, if retained, to add it to principle. He nominates his current wife to serve as trustee. If she is unable or unwilling to serve, he names his sister who lives in another state to serve as trustee. The trust continues until the children reach age 30. As each child reaches age 30, their portion of the trust is distributed to them.



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Inside: Qualified Personal Residence Trust Gone Wrong

Charles chose not to establish an Irrevocable Life Insurance Trust. His estate is below $7 million dollars. We were asked to review the will and to suggest the best way to word the beneficiary designation on the life insurance policy.

Observations:

Charles' state of residence does not permit the appointment of an out-of-state trustee without an in-state co-trustee. The reason is that the state does not have jurisdiction over an out-of-state trustee. Some jurisdictions will permit an out-of-state trustee who agrees to come under the jurisdiction of the courts of the resident state. Many states do not permit an out-of-state Personal Representative of his estate. The best way to make certain that there will not be additional legal fees is to name only in-state individuals to serve as trustee and as Personal Representative of his estate.

If Charles should die while the children are still minors, and if the trustee should elect to make income distributions to them, they would not be permitted to receive those funds since they are minors. The income would have to be distributed by the trustee to the "guardian of the assets" of each child. If Charles' will is silent, as it is now, the normal guardian of the children and of the assets of the children would be the surviving parent, his former wife. Since he indicated he did not want his former wife to have any access to the children's funds, he will need to make an addition to his will. It will need to say something along the lines of "I hereby appoint __________ to serve as the "guardian of the assets" of any minor child of mine to hold and expend for the benefit of my children such funds as the guardian may receive from my trustee. I specifically request that for the purpose of such distributions that my former spouse not be appointed by the court as the "guardian of the assets" of my children." The former spouse may well be appointed the physical guardian of the children but she does not need to be the guardian of the assets.

Since the will calls for the establishment of a trust for the benefit of the children if they are under the age of 30, the beneficiary designation should name the trust established by the will as the beneficiary of one half of the death benefit with the balance to be paid to Charles' current wife.

All of our clients need to carefully re-read their wills to make certain the will actually carries out exactly what they have intended.

This is an example of how a minor error of not naming a "guardian of the assets" would have resulted in giving Charles' former wife access to assets that he specifically did not want her to have. All of our clients need to carefully re-read their wills to make certain the will actually carries out exactly what they have intended.

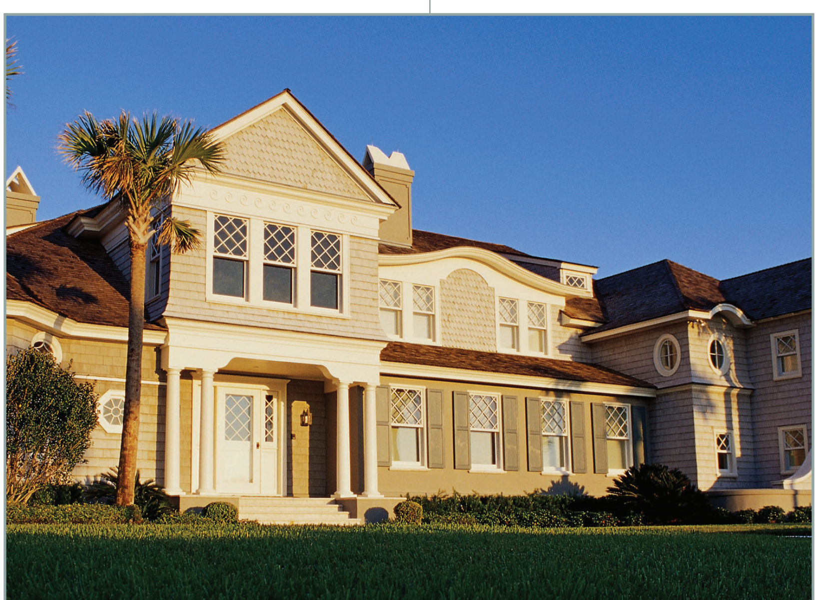
QUALIFIED PERSONAL RESIDENCE TRUST GONE WRONG

The proper way to create a qualified personal residence trust

A qualified personal residence trust (QPRT) is a useful estate planning tool. The major advantage of such a trust is that it permits the transfer of the property out of the estate at a low gift tax value. It also permits the shifting of future appreciation out of the grantor's estate, provided that the grantor lives to the end of the trust term. At the time of the transfer of the residence to the trust, the value of the remainder interest in the residence is calculated using actuarial tables.

Some areas are sufficiently complex that they should not be attempted without the benefit of legal advice.

A taxable gift is made when establishing a qualified personal residence trust. Paying gift taxes can be avoided by utilizing unused unified credit. The grantor may not use the annual exclusion since the gift is of a future interest. The trust is for a specific period of time, typically between 10 and 20 years. At the end of the time period, the residence goes to the remainder person or persons.



Unlike other transfers with a retained interest, the grantor can continue to live in the residence and make use of the residence during the specific period of time. If the grantor lives to the end of the term, the property will be removed from his or her estate. If the grantor dies, before the end of the specific period of time, the full date of death value will be brought back into the grantor's estate. Many estate owners will purchase life insurance to cover the potential estate tax of such a reversion. To minimize any potential estate tax, the trust can give the grantor a contingent reversionary interest which would cause the residence to revert back into the estate in the event of death prior to the end of the time period. The grantor could then utilize the marital deduction to prevent estate tax by passing the residence to the surviving spouse.

If the grantor still wants to live in the residence after the end of the term of years, it is possible for him or her to rent the residence from the remainderperson or persons. The rent must be appropriate.

Now the wrong way to create a qualified personal residence trust

Too often, we become aware of situations where clients have heard about a qualified personal residence trust but are unwilling to retain an attorney to set the trust up correctly, attempt to do it themselves, and fail to comply with IRS requirements. The following case is an actual situation where things went wrong. The residence remained in the estate, and the client created a situation where she would not be eligible for Medicaid assistance—which was her primary motivation in setting up the arrangement in the first place.

The client owned a duplex. She lived in one unit and rented out the second. She transferred ownership of the duplex to a trust that did not meet all the requirements of a qualified personal residence trust. She appointed her daughter as trustee of the trust. The daughter also was the only final beneficiary of the trust. The client did not pay rent for living in the one unit, and she had the right to live in the unit for the rest of her life. Her trustee had total discretion as to distribution of income of the trust to her or to retain in trust and add the income to the principal of the trust. She was a joint tenant on the trust checking account and could withdraw from the account without permission of the trustee. The trustee did not report the rental income from the second unit for income tax purposes nor did the grantor report the income. We were asked to review this arrangement as part of an estate plan review.

Where to go from here

We suggested that the client needed to meet with a qualified personal attorney as soon as possible. We suggested that she would want to discuss with the attorney whether or not the duplex would still be included in her estate under Section 2036 – transfer with a retained life estate. We also suggested that the attorney would need to assist in properly reporting the income of the trust and any income distributed to her. The fact that the grantor had full access to the checking account would also need to be changed as the attorney thought appropriate. We pointed out that based on our understanding of the Medicaid rules, the present arrangement could prevent her from being eligible for benefits and that she should discuss this in depth with her attorney.

Some areas are sufficiently complex that they should not be attempted without the benefit of legal advice. This is a good example of how a qualified attorney could have prevented the estate and income tax problems that resulted by not creating a proper qualified personal residence trust. A QPRT is a useful tool for the right estate situation—when it is properly established.

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First Quarter 2009 • Solutions is published quarterly.

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