the Estate PLANNER

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Can a private annuity benefit your family?

Under the right circumstances, a private annuity can provide significant estate planning benefits. Simply put, a private annuity involves transferring property — such as securities, real estate, a family business or almost any other asset — to a family member or other heir in exchange for a promise to make periodic payments, typically for the rest of your life.

The private annuity pays off

Private annuities can be effective in many different situations, but you're most likely to benefit from one if you want to:

- Freeze future growth in your estate and shift future appreciation of a business interest or other assets to your children or grandchildren,
- Dispose of appreciated assets and spread the capital gains over many years,
- Create an income stream that you can't outlive,
- Convert unmarketable, nonincome-producing property into an income stream for life,
- Reduce income taxes by trading income-producing property for partially taxable annuity income, or
- Diversify family-held investments.

To take advantage of this technique, transfer assets to a child or other family member who promises to pay you a specified amount each year, quarter or month (or some other period) for the rest of your life. After you make the transfer, the assets — as well as any future appreciation in their value — are removed from your taxable estate. And as long as the present value of the annuity is roughly equal to the assets' current fair market value, there's no gift tax on the transaction.

The state of your estate

Using IRS tables, annuity payments are calculated so the present value of annuity payments during your life expectancy is equal to the property's fair market value at the time of the transfer. As you receive the annuity payments, some of the value you transferred to your family is restored to your estate.

What if you don't reach your actuarial life expectancy? To answer this question, let's look at an example.

Tess, age 65, transfers $5 million in assets to her daughter, Anna, in exchange for a private annuity. At the time of the transfer, the applicable federal interest rate (the Section 7520 rate) is 6%. Based on IRS tables, the annuity payments are set at $514,663 per year during Tess's 20-year life expectancy. If Tess dies in two years, she'll have received annuity payments totaling $1,029,326. Thus, she'll have transferred almost $4 million in assets, plus the earnings and appreciation on those assets, free of gift and estate taxes.

Keep in mind, however, that private annuities cannot be deathbed transactions. If your chances of surviving at least one year are less than 50%, the IRS actuarial tables don't apply and the transfer instead will be treated as a taxable gift. If there is going to be any question about the validity of the transaction, it might be better to forgo the private annuity.

The taxing side of annuity payments

Another advantage of a private annuity is that the resulting income stream is only partially taxable, and a significant portion of that income stream is taxable at favorable capital gains tax rates. Assuming you transfer appreciated long-term capital assets, a portion of each annuity payment will be treated as a tax-free return of capital, a portion as capital gains and the remainder as ordinary interest income. Bear in mind, however, that the payor of the annuity doesn't receive an income tax deduction for the portion of each payment that represents interest, thus rendering the technique somewhat expensive from an income tax standpoint.

Using the previous example, suppose the assets are long-term capital assets and Tess's tax basis in the assets is $1 million. When Tess transfers the assets to Anna in exchange for a private annuity, she recognizes $4 million in capital gains. Both the gain and Tess's basis are spread out over her 20-year life expectancy, so that each annuity payment consists of approximately $51,000 in tax-free return of capital and $205,000 in capital gains (currently taxed at a 15% rate). The remaining approximately $258,000 of each annuity payment is interest taxable at ordinary income tax rates.

Be aware that the IRS recently proposed new regulations which seek to disallow the ability to defer the recognition of gain. Instead, the regulations would require that the long-term gain portion of the transaction be immediately taxable.

The downside

Private annuities offer some attractive benefits, but they also present some disadvantages. Unlike many estate planning techniques, which can unravel if you die too soon, private annuities involve reverse mortality risk. In other words, their benefits disappear if you live too *long*. That's because the longer you live, the greater the amount of assets that are returned to your taxable estate in the form of annuity payments.

Another disadvantage of private annuities is that your child or other recipient must have sufficient resources to make the annuity payments without relying too heavily on the transferred assets themselves. Otherwise, the IRS may characterize the transaction as a disguised gift subject to gift or estate taxes.

Similarly, there's also the risk that your child will be unable or unwilling to make the annuity payments. For this technique to work, the annuity obligation must be unsecured. If the recipient defaults, not only will you lose your income stream, but the IRS may challenge the transaction as a disguised gift.

Private annuities offer some attractive benefits, but they also present some disadvantages.

Finally, it's important to consider the potential income tax consequences for your family. When you die, the recipient's basis in the transferred assets is reduced to the amount of annuity payments actually made. Going back to the previous example, when Tess dies, Anna's basis in the assets is $1,029,326. If she sells the assets for $5 million, she'll recognize almost $4 million in capital gains. In many cases, of course, the estate tax savings may outweigh the income tax consequences.

The risk may be worth taking

A private annuity is a valuable planning tool that may provide benefits that few other tools can offer. Although it involves some risk, if you believe the odds are in your favor, this strategy may be worth a look. ▮

A motivating force

Incentive trusts pass on wealth while preserving values

You've worked hard to amass an estate of which you can be proud. And nothing would give you greater pleasure than to pass the wealth on to your adult child with the confidence that he or she will manage the inheritance with responsibility and care.

But one of your children's recent spending habits has you worried and wondering if he or she will be mentally and emotionally ready when the time comes for you to hand over the keys to the storehouse. What can you do? To prevent your child from potentially squandering away the fruits of your labor — along with their financial security — consider creating an incentive trust.

Help me, help you

An incentive trust sets guidelines with respect to how the beneficiary becomes eligible to benefit from the trust. These trusts go beyond the basic "at age 30, distribute ⅓ of the trust" language. You can use the trust's provisions to reward the beneficiary for achieving a particular set of goals or behaving in a desired manner.

An incentive trust sets guidelines with respect to how the beneficiary becomes eligible to benefit from the trust.

The trust also can stipulate requirements for how the money should be distributed to help ensure your beneficiary's lifelong financial well-being. Incentive trusts can:

Motivate beneficiaries to pursue educational goals. Incentive trust distributions can be contingent on a beneficiary graduating from high school, earning certain grades, or enrolling in or graduating from college.

Encourage healthy lifestyles. You may structure an incentive trust to disallow payouts if the beneficiary indulges in harmful or illegal behavior such as abusing alcohol or using illegal drugs.

Promote personal and professional development. An incentive trust can include provisions that reward your beneficiary for becoming involved in the family business or mapping out a career path of his or her own. With matching charitable donations built into an incentive trust, you also can help a beneficiary develop an appreciation for community service and volunteerism.

Teach money management. You can set up an incentive trust to stagger inheritance

Using honey instead of vinegar

Even if you have the best intentions for employing the use of an incentive trust, it can still backfire. What if resentment builds because your beneficiary thinks you're trying to control his or her life? What if he or she doesn't meet the requirements of the trust?

To avoid these mishaps, carefully evaluate the terms you're considering to ensure they're attainable, they're in line with your beneficiary's goals and interests, and they don't compromise his or her individuality.

After all, encouraging business and academic achievements may be appropriate for some beneficiaries but unsuitable for others. The bottom line is to consider whether you want to provide sufficient flexibility so that the struggling but dedicated and talented artist has as much opportunity to benefit as does the CEO.

distributions, particularly for a younger beneficiary, to allow him or her time to mature and learn how to manage his or her finances.

Communicate what you want, and don't want

Whether you're creating a new incentive trust or, if permitted, adding incentive provisions to an existing trust, be sure to explain the incentives clearly. It's important for a trustee to understand your intentions so they're able to effectively enforce the provisions.

Clearly identified incentives also can allay a trustee's concerns about his or her fiduciary responsibility and liability in a situation where the trust provisions are designed to influence, but could be construed as manipulating or restricting the beneficiary's behavior.

The trust also should provide some flexibility for dealing with a beneficiary who fails to achieve the incentive trust's requirements or whose circumstances change. For example, if a beneficiary becomes disabled and is no longer able to meet the requirements set by the incentive trust, you may want him or her to still enjoy the full benefits of the trust.

In addition, the trust should provide for the disposition of some or all of the funds to a secondary beneficiary, in case the primary beneficiary fails to meet the goals or dies while there are still assets in the trust.

Set it up

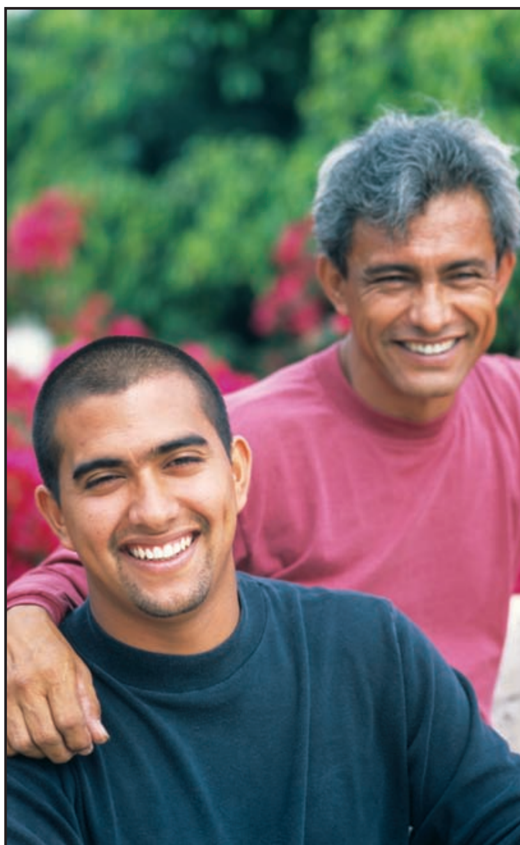
There is no one-size-fits-all approach to setting up an incentive trust. Every family estate is different and comes with its own set of circumstances.

But when implemented with care and sensitivity, an incentive trust can be useful for encouraging your beneficiary's positive behavior and the successful management of his or her inheritance, while preserving your family legacy for future generations. ▮

Estate defective trusts can be highly effective

Tax law changes over the last several years have led to a dramatic shift in the way people approach estate planning. For many years, planning focused almost exclusively on avoiding federal gift and estate taxes. But as tax rates continue to decline and exemption amounts continue to increase, fewer people are exposed to estate taxes and income taxes take on a much more prominent role.

As estate taxes become less of a factor, estate planning priorities naturally shift. For years, planners have taken advantage of intentionally "defective" trusts to potentially achieve significant tax benefits. Historically, the focus was on income defective trusts (IDTs). By reserving certain powers to the grantor, a trust could be designed that was defective for *income* tax purposes but constituted a completed gift for gift and estate tax purposes.



Defective, how?

Why would you intentionally create a defective trust? Although your initial contribution is subject to gift tax, the assets transferred to an IDT, together with any future appreciation in their value, are removed from your estate. But because the trust is defective for income tax purposes, you pay the tax on trust income. As the following example illustrates, designing the trust this way allows you to leverage your gift, increasing the amount that goes to your beneficiaries without adverse gift or estate tax consequences.

Suppose you transfer $1 million for your children's benefit to an irrevocable trust that generates an 8% return and pays federal and state income tax at an effective rate of 40%. In 20 years, the trust will grow to more than $2.5 million.

If you structure the trust as an IDT, however, you pay the taxes on the trust's income, allowing the assets in the trust to not be determined by taxes. In 20 years, the assets are worth more than $4.6 million, providing your children with an additional $2.1 million without triggering gift or estate tax or using any of your exemption. As long as the trust is designed properly, your payments of the trust's income tax are essentially additional tax-free gifts to your children.

Of course, this strategy is beneficial only if the additional amounts transferred to your beneficiaries would otherwise have been subject to gift or estate tax. With a current estate tax exemption of $2 million ($4 million per married couple), increasing to $3.5 million in 2009 ($7 million per married couple), the IDT may have lost some of its appeal.

If estate tax avoidance is no longer an issue for you, however, an *estate* defective trust (EDT) may offer significant *income* tax benefits.

The estate defective trust

An EDT is the opposite of an IDT: It's designed to keep assets in your estate and to shift the income tax to your beneficiaries. As long as estate taxes aren't a concern, an EDT may provide income tax benefits.

By shifting income taxes to your children in a lower tax bracket, you may reduce the current income tax burden on your family. But by

retaining the assets in your estate, you also provide your children with significant tax savings down the road. One of the advantages of transferring assets at death is that they enjoy a stepped-up basis in the hands of your beneficiaries. For highly appreciated assets, this dramatically reduces the amount of capital gains your children will recognize if they sell the assets.

For example, Allan, who is in the 35% federal tax bracket, owns property that generates income of $50,000 per year. His tax basis is $200,000, but the property's fair market value has grown to $1 million. Allan transfers the property to an EDT for the benefit of his daughter, Lauren, who's in the 25% bracket. Because the income is shifted to Lauren, the family enjoys an income tax savings of $5,000 per year. Plus, because the property remains in Allan's estate, when he dies, Lauren's tax basis is stepped up to its fair market value, eliminating $800,000 (or more) in taxable capital gains when Lauren sells the asset. Keep in mind that in 2010 there will be only limited step-up in basis.

Proceed with caution

In today's shifting estate planning environment, an EDT has the potential to generate significant income tax savings. But EDTs also present significant risks. This strategy is based on the assumption that you won't be liable for federal estate taxes. But if a large inheritance, unexpected growth in asset values or future reductions of the estate tax exemption expose you to estate taxes, the strategy could backfire.

With these caveats in mind, an EDT is an exciting new estate planning tool that's worth considering under the right circumstances.

Estate planning red flag

Your estate plan leaves everything to your spouse

There's a common misconception that leaving all of your wealth to your surviving spouse is a good strategy because the unlimited marital deduction (UMD) protects you from federal estate tax. (Your surviving spouse must be a U.S. citizen.) Unfortunately, this can be a costly mistake – as much as a $900,000 mistake, or even more if you're forgoing the possibility of creating a generation-skipping or dynasty trust.

Here's the problem: You're entitled to an estate tax exemption that shields $2 million from estate tax. But when you leave everything to your spouse, the UMD doesn't really eliminate the tax; it just defers it until your spouse dies, and you've wasted your estate tax exemption.

For example, Steve and his wife, Elise, have three children. Steve dies in 2007, leaving his entire $4 million estate to Elise. Although there's no immediate estate tax by virtue of the UMD, the tax is merely deferred until Elise dies in 2008. Assuming she hasn't spent any of her inheritance, Elise also dies with a $4 million estate. Her exemption shields $2 million from estate taxes, but the remaining $2 million is subject to $900,000 in estate taxes, leaving $3.1 million for their children.

What would be a better strategy? Instead of leaving everything to Elise outright, Steve should take advantage of his exemption by leaving $2 million federal-estate-tax free to a bypass trust that pays income to Elise for life and then distributes the principal to the children. The remaining $2 million would go to Elise, protected from estate tax by the UMD. When Elise dies, her estate can use her exemption to transfer the $2 million to the children federal-estate-tax free.

The bottom line? By using a bypass trust to make the most of Steve's exemption, the couple transfers the entire $4 million estate to the children and saves $900,000 in estate taxes.

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