The Estate Planner

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An important estate planning goal is to have some say in how your hard-earned wealth will be used after you've parted with it. Gifts in trust, for example, may be conditioned on your beneficiary going to college, staying gainfully employed or reaching a certain age. There are many ways you can use a well-designed estate plan to shape the behavior of your heirs.

The same goes for charitable giving. By imposing restrictions or conditions on your contributions, you can help ensure that the recipients use your money as you intended. It's important to plan these contributions carefully, however, so you don't endanger your charitable deduction.

Give and take

Subject to certain Internal Revenue Code limitations, you're permitted to deduct, for both income and estate tax purposes, contributions of money or property made "to or for the use of " a qualified charitable organization. You can restrict the use of your contribution, so long as the restriction doesn't prevent the charity from freely and effectively using the property (or the income it generates) to advance its exempt purposes.

One way to ensure that your wishes are honored is to include a reverter clause in the contribution agreement or other documentation. This clause provides that, if the charity stops using your contribution in the manner prescribed, ownership of the assets reverts to you or your family.

Handle reverter clauses with care, however. Under IRS regulations, a contribution subject to such a clause isn't deductible unless the chances of reversion are "so remote as to be negligible." Suppose, for example, you transfer land to your hometown for use as a public park. If, at the time of your contribution, the city plans to use the land as a park and the possibility that it will use the land for another purpose is so remote as to be negligible, you're entitled to claim a charitable deduction.

Suppose, instead, you donate property to a not-for-profit organization on the condition that the current executive director remain with the organization for at least 10 years. The IRS likely would find that there's a more-than-negligible possibility the executive director will leave the organization within that time and disallow the deduction.

A less risky alternative to a reverter clause is to provide for alternate uses in the event the charity cannot or will not use your contribution as you originally intended. For example, list one or more specific alternatives that meet your criteria or give the charity the flexibility to use your contribution in a manner that is as similar as possible to your original purpose. Another approach is to name one or more other charities as contingent beneficiaries in the event the first charity can't satisfy your conditions.

Valuation issues

Before placing restrictions or conditions on a charitable contribution, consider their potential impact on the value of your donation. Suppose, for example, you donate undeveloped land to a local university but prohibit the school from developing the property for five years. This restriction reduces the fair market value of the property and, therefore, reduces the amount of your charitable deduction for either income or estate tax purposes, depending on when you make the contribution.

A reduced deduction is never a good result, but it's particularly undesirable for charitable bequests. That's because the property will have one value for estate tax purposes (its fair market value on the date of death) and another, lower value for purposes of the estate tax charitable deduction. In other words, the deduction won't be large enough to offset the estate taxes on the donated property.

Private foundations and DAFs offer greater control

Perhaps the most effective tool for maintaining control over your charitable contributions is creating a private foundation — a tax-exempt entity you establish to accept charitable contributions, manage charitable assets and make grants to other charities.

Contributions to a foundation are deductible immediately — generally up to 30% of your adjusted gross income for cash contributions, 20% for noncash contributions — and you and your family retain control of the foundation's charitable activities and can even change the focus of those activities in the future.

But despite their many benefits, foundations are subject to a number of strict rules and regulations, so they're expensive to set up and administer. A less costly alternative is a donor-advised fund (DAF). A DAF is an investment account that you name. You make tax-deductible donations of cash or securities to the fund, which uses your contributions and earnings to make grants to various qualified charities. Although you can't direct the fund to benefit certain charities, you can make recommendations.

Bear in mind that the Pension Protection Act of 2006 (PPA) casts a cloud on the DAF's future. PPA imposes rigorous new restrictions on the deductibility of DAF contributions, the types of organizations that can own or sponsor these funds, the types of grants they can make, and the ways their assets can be invested. The act also imposes severe penalty taxes on transactions or activities that violate these rules.

Perhaps most significant, PPA instructed the Treasury Department to conduct a study to determine, among other things, whether charitable deductions are appropriate at all for contributions to DAFs and whether a donor's right to advise the fund should affect deductibility. Until these questions are answered, be sure to consult your estate tax advisor before making contributions to a DAF.

Put it in writing

To be effective, you must place restrictions on your charitable contributions at the time you make them. If you retain the right to direct a charity's use of the assets after you make the contribution, you'll lose the tax deduction.

The best way to document conditions or restrictions on a charitable contribution is with a well-designed contribution agreement signed by you and the charitable organization. A written agreement helps ensure that your wishes are communicated clearly, avoids disputes, and allows you and the charity to spell out how your contribution will be used in the event that circumstances change in the future. ✤

Keep your land and give it away, too

A conservation easement preserves the natural beauty of your land for the future and lets you enjoy its tax benefits today. An easement entitles you to a current income tax charitable deduction even though you and your family continue to own and control the land. You can even sell it, subject to the easement.

To take advantage of this technique, grant an easement to a conservation organization — usually a government agency or public charity — in which you agree to permanently restrict some or all of the development rights associated with your land.

Because a conservation easement reduces the land's value, it also reduces your estate's value for estate tax purposes. In addition, you can generally exclude 40% of the land's value (up to $500,000) from your estate.

You also can deduct the value of the easement (usually determined by the difference in the land's value with and without the easement) as a charitable contribution for income tax purposes. Generally, the deduction is limited to 30% of your adjusted gross income (AGI) in the year you grant the easement, with the excess carried forward for up to five years. For easements granted through the end of 2007, however, you can deduct up to 50%, or in limited cases, up to 100%, of AGI and carry forward the excess for up to 15 years.

Stretching your legacy

Dynasty trusts benefit many generations to come

It's said that all good things must come to an end, but a dynasty trust may be an exception. This type of trust allows substantial amounts of wealth to grow free of federal gift, estate and generation-skipping transfer (GST) taxes for many generations — even forever.

Consider this example: A dynasty trust funded with $1 million today will be worth more than $867 million 100 years from now — assuming a 7% growth rate and not taking into account income taxes. In addition, a dynasty trust's benefits go beyond tax savings. Even if Congress repeals the estate tax, you can still use a dynasty trust to provide financial incentives for future generations and to protect assets against the claims of your beneficiaries' creditors or former spouses.

Perpetual movement

Long-term trusts have been used for ages, but until relatively recently they couldn't last forever. Historically, most states applied the rule against perpetuities to limit the life of trusts and other estate planning vehicles. The rule is complex, but in general it requires a property interest to vest no later than 21 years after the death of an identifiable person who was alive at the time the interest was created — typically around 100 years.

In recent years, there's been a movement among the states to abolish the rule against perpetuities or to extend the rule so it allows trusts to last several hundred years. So far, 24 jurisdictions have either abolished or relaxed the rule. (See "Perpetual trust states" on page 5.)

Bear in mind that you don't have to live in a state to take advantage of its trust laws. Generally, in the trust agreement you simply need to specify which state's laws govern the creation and administration of the trust. You'll also need to name at least one trustee who resides in the state and locate some of the trust assets there.

Because a dynasty trust is irrevocable, the assets you contribute are removed from your estate.

Wealth preservation

Because a dynasty trust is irrevocable, the assets you contribute are removed from your estate. You can avoid gift tax on your contributions by taking advantage of your $1 million lifetime gift tax exemption and, if the trust is properly structured, your $12,000 annual exclusion.

Your children, grandchildren and future generations can receive distributions from the trust at the trustee's discretion, but so long as they lack control over the trust, the assets will not be included in their estates.

The GST tax exemption

An important consideration when designing a dynasty trust

Perpetual trust states

Jurisdictions that either have abolished the rule against perpetuities or allow you to opt out of the rule under certain circumstances	Alaska, Arizona, Delaware, District of Columbia, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, South Dakota, Virginia and Wisconsin.
Jurisdictions that have extended the otherwise applicable period	Colorado (1,000 years), Florida (360 years), Nevada (365 years), Utah (1,000 years), Washington (150 years), Wyoming (1,000 years).

is avoiding the GST tax. The tax is the federal government's way of recovering transfer tax revenues lost when property skips a generation. This flat tax is imposed — at the highest estate tax rate of 45% — on transfers to a grandchild or other "skip person" more than a generation below you. For nonrelatives, a skip person is someone more than 37 years younger than you.

GST tax is *in addition to* regular estate tax, so it can quickly devour a substantial portion of your estate. The tax can be triggered by a "direct skip" — that is, an outright gift to a skip person.

Leveraging your exemption

The key to maximizing the value of a dynasty trust is to leverage your GST tax exemption. Currently, the exemption is $2 million, increasing to $3.5 million in 2009. By allocating your GST exemption to a dynasty trust, you can insulate the trust assets — including any future growth — from GST tax.

By contributing property expected to appreciate significantly in value, or by having the trustee use your contributions to purchase an insurance policy on your life, you can build a substantial amount of wealth — well beyond the exemption amount — free of GST tax.

Under current law, the estate and GST taxes will be repealed in 2010, only to be revived in 2011. During the year of repeal, there's no limit on the amount you can contribute to a dynasty trust without triggering GST tax. But remember that the gift tax isn't scheduled to be repealed, so gifts in excess of your $1 million gift tax exemption will be taxable. Still, the opportunity to shield a substantial amount of wealth from GST tax may be worth taking a gift tax hit.

Value-added taxes

By structuring a dynasty trust as a grantor trust, you can leverage your gift even more. A grantor trust requires you to pay the taxes on the trust's income. At first glance, that may seem like a drawback. But by paying the income taxes yourself, the trust essentially grows income-tax free, preserving even more wealth for your beneficiaries while removing additional assets from your estate. In effect, your income tax payments become additional tax-free gifts.

Do your homework

If you're interested in using a dynasty trust to stretch your legacy decades or even centuries into the future, work closely with your estate planning advisor to design a strategy that meets your needs. The laws related to dynasty trusts vary dramatically from state to state, so select a state that offers the right combination of tax advantages, asset protection and flexibility. ✤

Don't underestimate the power of Crummey trusts

Named after the taxpayer who first used the strategy successfully, a Crummey trust isn't a specific type of trust. Rather, it refers to withdrawal powers granted to beneficiaries of various trust types to qualify contributions for the annual gift tax exclusion.

Small gifts make a big difference

Don't underestimate the significance of the annual gift tax exclusion, which currently stands at $12,000 per recipient. Thus, you can gift $12,000 per year gift-tax free to as many beneficiaries as you want. Also, if you're married and split gifts with your spouse, the exclusion doubles to $24,000.

Perhaps most important, annual exclusion gifts don't use any of your $1 million lifetime gift tax exemption. It's advantageous to preserve as much of your lifetime exemption as possible because using it reduces your available $2 million estate tax exemption dollar-for-dollar.

Well-planned lifetime gifts can protect large amounts of wealth from gift and estate taxes. For example, Brian and Carla have three children. Each year they contribute $24,000 per child to a trust for the children's benefit, or a total annual contribution of $72,000. These amounts are removed from Brian and Carla's estate and are shielded from gift taxes by the annual exclusion. In 10 years, they'll have transferred $720,000 — plus the appreciation thereon — in trust for their children estate-tax free without tapping their lifetime gift tax exemptions.

One of the most effective uses of Crummey powers is to establish an irrevocable life insurance trust designed as a Crummey trust.

No time like the present

Here's where Crummey powers come into play. The annual exclusion applies only to gifts of *present* interests. But if you want to restrict your beneficiaries' access to assets by placing them in a trust, that's considered a *future* interest, which doesn't qualify for the annual exclusion.

Avoid this problem by granting your beneficiaries Crummey powers — that is, the right to withdraw trust contributions for a limited period of time after they're made (30 days, for example). To qualify, the trust document must contain the proper language, and your trustee must provide beneficiaries with written notice of their withdrawal rights each time you make a contribution.

Be aware that the IRS may challenge your entitlement to the annual exclusion if it believes there was an "implied understanding" among family members that they won't exercise their withdrawal powers. Discuss with your beneficiaries the benefits of allowing assets to continue growing in the trust, but take care not to give the impression that withdrawals are prohibited.

A Crummey trust and an ILIT

One of the most effective uses of Crummey powers is to establish an irrevocable life insurance trust (ILIT) designed as a Crummey trust. By contributing assets to a properly structured ILIT and having the trustee use the funds to purchase and hold an insurance policy on your life, the proceeds bypass your estate, passing to your beneficiaries tax-free.

To avoid gift tax, fund an ILIT with annual exclusion gifts combined with Crummey withdrawal powers. If the trustee immediately uses contributions to pay premiums, however, the IRS may claim this reflects an implied understanding that withdrawal powers won't be exercised. After all, the IRS might argue, if the only asset held by the trust is the insurance policy, it's unlikely a beneficiary would demand that the trustee cash in the policy so he or she could withdraw $12,000.

To insulate an ILIT against this sort of attack, the trustee should consider holding enough cash in the trust to satisfy potential Crummey withdrawals until the withdrawal period has expired.

Seek help

ILITs and other Crummey trusts are subject to many complex requirements. To take advantage of their remarkable benefits, have your estate planning professional create all trust documents. ✤

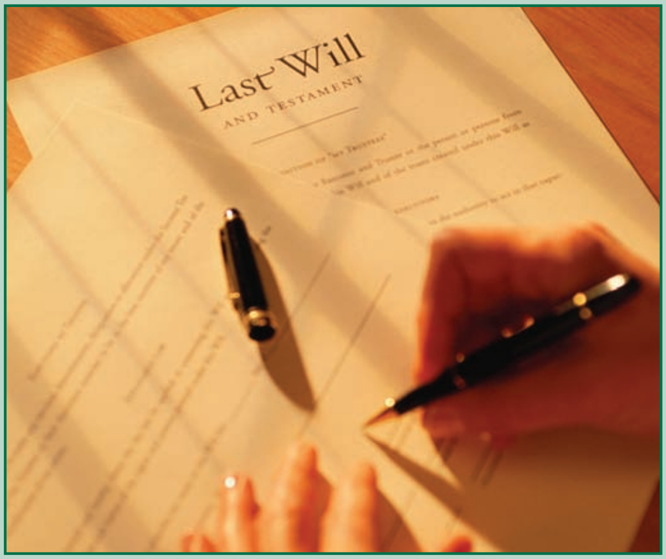
Estate Planning Red Flag

You don't have an advance medical directive

A critical part of estate planning is to make arrangements for health care decisions in the event you're unable to do so. Even if you've expressed your wishes in your will, your family will not be able to carry them out unless you have an advance medical directive. Why? A will generally doesn't take effect until it's filed with and accepted by the probate court, and by then it will be too late.

An advance medical directive allows you to express your preferences for medical treatment in the event you become incapacitated prior to the time such treatment is needed. Although the precise terminology may vary from state to state, medical directives generally include living wills and health care powers of attorney.

A living will states your preferences for life-sustaining medical procedures. It can specify the situations in which procedures, such as artificial nutrition, invasive diagnostic tests and pain medication, should be used or withheld.



A health care power of attorney (sometimes called a durable medical power of attorney or health care proxy) authorizes your spouse or another representative to make health care decisions for you in the event you're unable to do so. It can cover terminal illness as well as medical emergencies in which you're unable to consent to treatment.

Many people use both documents: a living will to express their health care preferences in advance and a health care power of attorney to provide for situations not expressly covered in the living will.