

the Estate PLANNER

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Sizing up a FIT

Tailor a family incentive trust to meet your needs

As baby boomers grow older in the coming decades, enormous amounts of wealth will pass from one generation to the next. In fact, a 1999 (and reexamined in 2003) report published by the Boston College Center on Wealth and Philanthropy estimates that between \$41 trillion and \$136 trillion will be transferred by 2052.

Despite the vast sums at stake, surveys show that affluent baby boomers are less concerned about sharing money with the younger generation than with sharing values, a sense of responsibility, a strong work ethic and a commitment to education. To achieve this goal, an increasing number of people are using family incentive trusts (FITs) to shape their legacies by shaping the character of their heirs.

Dangers of unrestricted wealth

There's a popular misconception that many of the richest Americans inherited their wealth. In fact, the vast majority of today's millionaires are self-made, and they recognize the importance of earning one's keep. Many believe that inherited wealth can have a corrupting influence.

And you don't have to be on the Forbes 400 list to share these concerns. A \$2 million bequest that earns a modest 6% return will generate an annual income of \$120,000 — more than enough for a child to live off his or her inheritance.

A FIT can serve many important estate planning goals, such as providing financial incentives to lead responsible, productive lives.

One way to protect your heirs from the temptations of easy money is to limit their inheritance or even to disinherit them altogether. A less harsh approach, however, is to use a FIT to share your wealth with some strings attached.

A FIT can serve many important estate planning goals, such as providing a safety net so your heirs will never end up homeless, providing financial incentives to lead responsible, productive lives, and creating opportunities by lending to or investing in a family business.



Structuring a FIT

You can designate most estate planning trusts — including living trusts, asset protection trusts, insurance trusts and certain charitable trusts — as FITs. Typically, FITs are structured as spendthrift trusts, meaning beneficiaries can't assign their interests (such as collateral for a loan), and the assets enjoy some protection against creditors' claims and divorcing spouses. FITs often are set up as dynasty trusts, which allow you to have an impact not only on your children,

Creating a FIT dynasty

If you want your family incentive trust (FIT) to influence many generations to come, consider setting it up as a dynasty trust. A number of states have relaxed or eliminated restrictions on the longevity of trusts, allowing you to create a trust that, in theory, can last forever.

If you establish a dynasty trust, plan carefully to avoid the generation-skipping transfer (GST) tax. The GST tax was intended to prevent families from avoiding estate taxes in one generation by transferring assets directly to the following generation. It's a flat tax — on top of any other gift and estate taxes — imposed at the highest marginal estate tax rate (currently 46%) on gifts, bequests or trust distributions made directly to a "skip person." A skip person is a grandchild or other person more than one generation below you, or a nonfamily member who's at least 37½ years younger than you.

To avoid GST tax, allocate some or all of your GST exemption (currently \$2 million) to trusts you intend or expect to benefit your grandchildren or other skip persons. One of the most powerful tools for leveraging the GST exemption is an irrevocable life insurance trust (ILIT). You can create millions of dollars in tax-free benefits for future generations, but you use only the GST exemption amounts needed to cover contributions for insurance premiums.

Dynasty trusts are complex and require careful planning. Be sure to consult an expert to design a trust that achieves your goals in the most tax-efficient manner.

but also on your grandchildren and later generations. (See "Creating a FIT dynasty" above.)

You may base distributions from a FIT on virtually any criteria, from obtaining a college or graduate degree to maintaining gainful employment to reaching a certain age. Whatever the criteria, however, you likely want to design the FIT so your heirs can't live off the trust funds while doing nothing.

You can limit distributions to the trust's income or provide for distributions of both income and principal. If your children are responsible adults, you can give them unrestricted access to trust funds and provide for the trust to convert into a FIT for your grandchildren.

Typically, a FIT's income or principal is applied first toward providing a safety net so heirs never will be destitute and next toward incentives to encourage desired behavior. You may use leftover funds to establish a "family investment bank" to invest in family businesses or other worthwhile endeavors.

FIT flexibility

Designing a FIT requires intense planning to ensure that it accomplishes your goals while

being flexible enough to avoid unintended consequences and adapt to changing circumstances.

You might provide an incentive to work, for example, by linking trust payouts to a beneficiary's earnings. But what if success in a beneficiary's chosen career requires that he or she start with a low-paying or unpaid internship? What if a beneficiary becomes disabled and can't work? A well-designed FIT should accommodate these circumstances.

You also should consider the fact that living responsibly can mean different things for different people. A FIT that requires beneficiaries to work, for example, may penalize a stay-at-home parent committed to raising his or her children.

A good way to ensure a FIT is sufficiently flexible is to establish general principles for distributing trust funds but to give the trustees broad discretion to apply these principles depending on the facts and circumstances. For a multigenerational FIT, another effective approach is to give beneficiaries a special power of appointment they can use to adapt the FIT to meet the needs and circumstances of their children.

Accentuating the positive

Most experts agree that negative reinforcements are counterproductive. Financial incentives that require a beneficiary to refrain from drug use, gambling or other behavior you deem undesirable can send the message that you're "ruling from the grave" and can lead to resentment and conflict. Such incentives also may encourage beneficiaries to conceal their conduct and avoid seeking help.

By stressing positive behavior, such as gainful employment or higher education, the negative behavior tends to take care of itself. After all, it's tough for a substance abuser to hold down a job or stay in school.

It's also important to avoid "buying" desired conduct. If your daughter wants to work but your FIT offers an enormous bonus if she stays home with the kids, she may feel that she has no choice. It's better to offer beneficiaries a variety of positive options that make them feel that they can do anything, so long as they do something productive.

Fitting rewards

A FIT is a flexible estate planning tool that allows you to shape your legacy by encouraging your heirs to lead responsible, productive lives. It also helps preserve your wealth for future generations by preventing your children from getting a free ride. ■

What to do with the collectibles?

Addressing personal property in an estate plan

When planning their estates, many people focus on stocks, bonds and real estate, and pay little attention to personal property. But it's not unusual for collectibles — such as art, jewelry, antiques, automobiles, coins and stamps — to make up a significant portion of one's wealth.

If your estate includes valuable collectibles, there are a number of estate tax planning challenges to be aware of and opportunities to consider.

Determining worth

Whether you give collectibles to family members or donate them to charity, it's critical to obtain a qualified appraisal. The value of property for federal gift, estate and income tax purposes is its fair market value; thus, it's vital to establish this value.

Given the subjective nature of art valuation, and the potential for abuse, IRS auditors are required to refer gifts of art valued at \$20,000 or more to the IRS Art Advisory Panel. The findings of the panel — which includes top curators, dealers and other experts — become the IRS's official position



on the art's value. To obtain the best possible outcome, include a comprehensive appraisal by a qualified expert with your return.

An appraisal also can give you some peace of mind with regard to federal gift taxes. The statute of limitations for gift tax purposes doesn't begin to run until you file a gift tax return that satisfies the IRS's adequate disclosure rules. A qualified appraisal fulfills many of the rules' requirements.

For additional comfort, ask the IRS for an advance ruling on the value of personal property for tax purposes. To obtain such a ruling, you must:

- Make the request *after* you transfer the property,
- Obtain a qualified appraisal,
- Transfer at least one item whose value is \$50,000 or more, and
- Attach copies of Form 8283 and the appraisal to the ruling request.

Bear in mind that there is a fee of \$2,500 for the first three items and \$250 for each additional item.

Making testamentary gifts

If you plan to leave collectibles to your heirs in your living trust or will, it's usually best to make specific bequests. If you transfer collectibles through residual gifts — that is, as part of the property that's left after other beneficiaries receive their bequests — the recipient also may inherit some unwelcome tax liabilities in the form of being responsible to the estate for the share of tax related to the item.

Some people's wills allow their beneficiaries to choose the personal property they'd like to keep and provide for the remainder to be sold. If the beneficiary is a surviving spouse, however, there's a risk the gift won't qualify for the marital deduction. (Ordinarily, the marital deduction defers estate taxes on an unlimited amount of property you transfer to your spouse, as long as he or she is a U.S. citizen.)

There's some authority for the proposition that the marital deduction applies as long as the spouse is required to choose the collectibles he or she wants to keep within the time period for making a qualified disclaimer. (Qualified disclaimers are used to refuse a bequest and allow the property to pass to someone else without adverse tax consequences.) But a safer approach is to bequeath all collectibles to the spouse and allow him or her to disclaim any unwanted items.

You also can make testamentary gifts to charity, but, as discussed below, lifetime charitable gifts

are preferable because they generate significant income tax benefits.

Donating to charity

Art and other collectibles are ideal assets for charitable giving, particularly if they've appreciated significantly in value. When you donate appreciated property to charity, you avoid capital gains taxes — a big advantage for collectibles, which are taxed at a hefty 28% rate. (Long-term gains on most capital assets are currently taxed at 15%.)



If the charity's use of the donated property is related to its tax-exempt purpose, you're also entitled to a charitable income tax deduction equal to the property's fair market value — up to 30% of your adjusted gross income (AGI).

Otherwise, your deduction is limited to your cost basis (up to 50% of AGI). If you donate a painting to a museum for display, for example, or to a university for use in art classes, the use is related to the charity's exempt purpose. If the charity sells the painting and uses the proceeds, however, it's not used for a related purpose.

Keep in mind that, if you donate art or other copyrighted property and you own the copyright, you're entitled to a charitable deduction only if you transfer the copyright along with the work. This rule creates a tax trap for unwary donors. For works created before 1978, purchased art includes the copyright unless the seller specifically reserves it. But under the Copyright Act of 1976, the copyright is presumed to stay with the seller unless it's specifically transferred to the buyer.

Offering fractional gifts

Fractional giving is a great way to generate income tax savings while continuing to enjoy your art — at least for part of the year. Say you donate a 25% interest in your art collection to a local museum. The museum gains the right to display the collection for three months each year.

You deduct 25% of the collection's fair market value immediately, while continuing to display the art in your home for the remaining nine months. Most museums will accept fractional gifts only if you agree that the work eventually will become the museum's exclusive property.

If the art continues to appreciate, your deductions will grow with each donation. Giving art away gradually also can help you avoid losing deductions that exceed the 30%-of-AGI limit. Although excess deductions can be carried forward for up to five years, the deductions may be lost permanently if a work or collection is extremely valuable.

Collecting your thoughts

These are just a few of the many strategies you can use to transfer art and other collectibles in a tax-efficient manner. Other options for charitable giving include charitable trusts, artwork loans and bargain sales. Techniques for sharing collectibles with your family include trusts, family limited partnerships and family limited liability companies.

Whichever strategies you choose, if you own valuable collectibles it's important to include them in your estate plan. ■

An air of uncertainty

The Roth 401(k) may be good for your estate plan, but will it last?

Beginning this year, businesses can establish a Roth 401(k) plan or add a Roth contribution option to an existing 401(k) plan. Yes, these plans offer attractive retirement benefits, but the estate planning benefits may be their biggest draw. You must, however, bear in mind that the Roth 401(k) plan provisions expire at the end of 2010 unless Congress acts to extend them.

Tax-free retirement income benefits

Like a Roth IRA, contributions to a Roth 401(k) aren't tax deductible, but earnings accumulate tax-free and can be withdrawn tax-free in retirement. This can be a big advantage, particularly if you expect your income tax bracket to increase after you retire.

High income taxpayers, however, haven't been able to take advantage of the Roth IRA. (Under the Tax Increase Prevention and Reconciliation Act of 2005, beginning in 2010 there will no longer be any income limitation on converting a traditional IRA to a Roth IRA.) Eligibility for contributing to a



Roth IRA is phased out beginning at \$95,000 of modified adjusted gross income (AGI) — \$150,000 AGI for joint filers. The Roth 401(k) provides you an opportunity to enjoy the Roth benefits, because there are no AGI limits for contributing.

Contribution limits for Roth 401(k) plans are the same as for traditional 401(k) plans: In 2006, the maximum contribution to all 401(k) accounts is \$15,000, plus a \$5,000 "catch-up" contribution if you're 50 or older by the end of the year. If no AGI phaseout applies, Roth IRA contributions are limited to \$4,000 plus a \$1,000 catch-up contribution.

Stretch out estate planning benefits

It's often said that traditional IRA and 401(k) accounts are the worst assets to leave to your heirs. Why? Because the combination of income and estate taxes can shrink these accounts to a fraction of their original value. But Roth accounts don't have this drawback because qualified distributions aren't subject to income taxes.

Contributions to a Roth 401(k) aren't tax deductible, but earnings accumulate tax-free and can be withdrawn tax-free in retirement.

With careful planning, assets in a Roth 401(k) account can continue growing tax-free throughout your lifetime and beyond — provided you have other sources of retirement income. Although a Roth 401(k), like a traditional 401(k), is required to begin mandatory distributions when you reach age 70½, IRS rules allow you to roll the funds

over into a Roth IRA, which isn't subject to mandatory distribution requirements until the death of the Roth owner.

This technique allows you to stretch out the account's tax-free benefits, providing a valuable nest egg for your children and even your grandchildren. Heirs are required to take distributions, but the distributions can be spread out over their lifetimes. Depending on the size and growth rate of the account, this means there may even be more left in the account for the grandchildren's benefit.

Too good to last?

If Congress doesn't act to extend the Roth 401(k) provisions, you'll have to stop contributing to the account after 2010. But you should be able to leave your previous contributions in the account or roll them over into a Roth IRA.

If you feel a Roth 401(k) is right for you, and your employer offers it, at the very least you'll have a little over four years to take advantage of its retirement and estate planning benefits. ■

Estate planning red flag

Most of your wealth will pass through beneficiary designations

No matter how long you agonize over who gets what in your will or living trust, your wishes may not be carried out if the bulk of your estate will be transferred through beneficiary designations.

Many types of assets pass to your heirs on the basis of beneficiary designations, including life insurance, brokerage accounts, IRAs and 401(k) accounts. It's not unusual for these assets to make up most of a person's wealth. And the beneficiary designation controls their disposition, regardless of the terms of your will or trust.

Suppose, for example, your living trust provides for all of your assets to benefit your children. If the bulk of your estate is in an IRA, and your spouse is the designated beneficiary, your estate plan may not be what you think it is.

To avoid this result, you might consider designating the living trust as the beneficiary of your IRA. However, if you do so, it's critical that the trust be designed as a qualified beneficiary so as not to accelerate the income tax on the IRA assets.

To ensure that your wishes are carried out, review all of your beneficiary designations periodically and confirm that they're consistent with the terms of your estate plan.



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