The Estate Planner

November/December 2007

A well-defined strategy
Use a defined-value clause to limit gift tax exposure

Take the lead
Minimize or even eliminate
estate taxes with a T-CLAT

Super trustee to the rescue
Gain flexibility in your irrevocable
trust with a trust protector

Estate Planning Red Flag
Your required IRA distributions
are more than you need

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

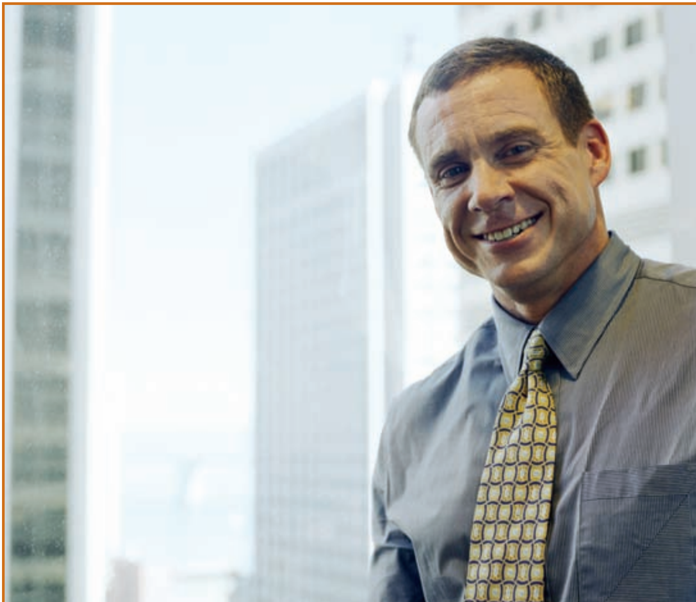
selznick & ASSOCIATES, LLC
Attorneys at Law

A well-defined strategy

Use a defined-value clause to limit gift tax exposure

Accurate asset valuations are critical to an effective estate plan. Unfortunately, valuation is an inexact science. A determination by the IRS or a court that certain assets are undervalued can throw a monkey wrench into your plans and result in unexpected gift or estate tax liabilities.

One way to cap your gift tax exposure and add some certainty to your estate plan is to use defined-value gifts. Instead of transferring a percentage interest in a business, family limited partnership (FLP) or other assets to your beneficiaries, a defined-value gift transfers a specific dollar amount.



If the IRS or a court assigns a higher value than the one reported on your gift tax return, a portion of the gift goes to a nontaxable "excess beneficiary," such as your spouse or a charitable organization.

Valuation matters

Here's an example that illustrates the risk to your estate plan if the IRS or a court revalues an asset:

Toby is the sole owner of a successful manufacturing business. He transfers his company stock to an FLP and gives limited partnership interests to each of his four children. He wants to structure the transaction so that it falls within his $1 million lifetime gift tax exemption.

Toby hires a professional business valuator, who determines that the company's fair market value is $2 million. The appraiser also advises Toby that minority interests in the FLP are entitled to a 35% valuation discount.

Based on this valuation, Toby transfers 19% limited partnership interests to each of his children and retains a 24% general partnership interest. After applying the valuation discount, Toby values each child's interest at $247,000, for a total of $988,000.

After an audit of Toby's gift tax return, the IRS determines that the company's fair market value is $2.3 million and that an appropriate minority interest discount is 30% rather than 35%. As a result, the IRS increases the value of the limited partnership interests from $247,000 to $305,900, for a total gift of $1,223,600.

Assume that, because Toby has already made other gifts to his children, his annual gift tax exclusion is unavailable. Toby is left with a gift of $223,600 in excess of the $1 million gift tax exemption. Applying the current gift tax rate of 45%, revaluation of the limited partnership interests results in a $100,620 gift tax liability.

Placing a cap on gift taxes

Toby may have avoided this unpleasant tax surprise by using a defined-value clause. Instead of transferring 19% limited partnership interests to his children, he could have transferred interests valued at $247,000, with any excess value going to charity.

Using a defined-value clause, when the IRS revalues the business, each child's interest will be reduced to approximately 15.34%, and the excess will be donated to charity without triggering any gift tax liability. It might even be possible for the FLP to buy back the donated interests at fair market value.

Defined-value vs. price-adjustment

The IRS and the courts have consistently condemned price-adjustment clauses as a violation of public policy. These clauses provide that, in the event a portion of a transfer is deemed to be subject to gift tax, the transaction

Court guidance for defined-value gifts

Last year, a federal appeals court offered some hope for defined-value gifts. In *Succession of McCord, et al. v. Commissioner*, the Fifth Circuit Court of Appeals gave full effect to a defined-value clause.

Unfortunately, the court didn't address the public policy issue because the IRS didn't raise that argument on appeal. Instead, the IRS relied on an alternative valuation method applied by the Tax Court.

Nevertheless, *McCord* may be good news for estate planners. Some commentators believe that the Fifth Circuit would not have endorsed the taxpayer's defined-value arrangement if the court felt it violated public policy, even though the issue wasn't argued on appeal. And the IRS's decision not to pursue the public policy argument may signal that it is abandoning its position on the issue.

will be adjusted to eliminate the tax by either transferring the excess back to the donor or requiring the donee to pay fair market value for the excess.

Price-adjustment clauses raise several public policy concerns. For example, they violate the long-standing rule prohibiting modification of a gift by a "condition subsequent." The clauses also discourage the IRS from attempting to collect taxes because challenging a valuation only serves to defeat the gift.

Arguably, a properly structured defined-value clause avoids these problems. Because the dollar amount of the gift is fixed upfront, it can't be adjusted based on *subsequent conditions*. And the IRS still has an interest in ensuring that assets aren't undervalued.

If the excess value goes to a charitable organization, for example, it furthers the government's interest in supporting charities. And if the excess goes to your spouse, it ultimately will be taxed as part of his or her estate.

It's a good idea to avoid a clause that provides for the excess to revert to you or requires the beneficiary to pay for it. The IRS likely will view it as suspiciously similar to a price-adjustment clause.

Another good strategy may be to place the assets in an escrow trust that will distribute them to your primary and excess beneficiaries after the assets' value has been determined. A final determination occurs when the statute of limitations for challenging the gift expires or an IRS challenge is resolved through negotiation or litigation.

If the assets are held in trust, the gift isn't "complete" until their value is finally determined, making it difficult for the IRS to argue that the gift's value is being adjusted after the fact.

In recent years, the IRS has challenged defined-value clauses on public policy grounds, equating these provisions with price-adjustment clauses. As previously noted, however, there are some strong arguments for distinguishing between the two.

Defined-value gifts should be designed carefully so that they're readily distinguishable from price-adjustment clauses.

In addition, defined-value clauses are routinely used in other areas of estate planning. For example, it's common for a will or living trust to transfer assets to a bypass trust up to the amount of the applicable estate tax exemption, with the excess going to a marital trust.

Seek professional help

Pending further guidance on the subject, defined-value gifts should be designed carefully so that they're readily distinguishable from price-adjustment clauses. The IRS isn't a fan of defined-value clauses, but many estate planning professionals believe that a properly structured defined-value gift should withstand a challenge in court. ✤

Take the Lead

Minimize or even eliminate estate taxes with a T-CLAT

Affluent people typically use a combination of sophisticated estate planning strategies to provide for their families, pass their businesses on to the next generation and satisfy their philanthropic goals, all while minimizing estate, gift and income taxes.

But even with a comprehensive plan, you may find yourself with a significant tax exposure if your estate is large enough. By adding a properly designed testamentary charitable lead annuity trust (T-CLAT) — which is a type of charitable lead trust (CLT) — to your estate planning arsenal, you can minimize estate taxes on assets placed in the trust or even eliminate them altogether.

Insight on CLTs

CLTs sometimes are described as the opposite of charitable remainder trusts (CRTs). A CRT provides an income stream to your family members or other beneficiaries during the trust term, after which the remaining assets pass to one or more qualified charities. A CLT reverses the process: It makes regular payments to a charity or charities during the trust term, and the remainder passes to your family.

> *A well-designed T-CLAT can satisfy your philanthropic goals while providing remarkable estate planning benefits for your family.*

A CLT can be a powerful estate planning tool, especially if your heirs are financially independent and can wait a period of years before receiving their inheritance. The charity's interest in the trust substantially reduces the value of the trust for gift and estate tax purposes. And, if the trust is structured properly, it can grow income-tax free.

CLTs come in two flavors:

1. **A charitable lead annuity trust.** A CLAT makes payments to the charitable beneficiaries, at least annually, of a fixed dollar amount or a percentage of the initial value of the assets placed in the trust.

2. **A charitable lead unitrust.** A CLUT pays a percentage of the trust assets' fair market value, recalculated each year.

CLATs usually are the better choice for estate planning. For one thing, to the extent the trust's earnings exceed the annuity payments, your family's remainder interest increases. With a CLUT, on the other hand, the charitable beneficiaries share in this growth. Also, a CLAT (but not a CLUT) can be "zeroed out" — that is, structured in a way that eliminates federal estate taxes on the assets contributed to the trust.

You can set up a CLAT during your life (an "inter vivos" CLAT) or you can provide for one in your will or living trust — the T-CLAT. T-CLATs offer some advantages over inter vivos CLATs, such as the following:

- Because a T-CLAT is established at death, you retain control over the assets (and any income they generate) during your life.
- Assets contributed to a T-CLAT generally enjoy a stepped-up tax basis, minimizing or eliminating income taxes in the event the assets are sold and the proceeds reinvested.

Getting to zero

Assets transferred to a T-CLAT are included in your estate and are subject to estate taxes. But their value is offset by a charitable deduction equal to the present value of the annuity payments that will be made to the charitable beneficiaries. In a zeroed-out T-CLAT, the annuity payments are set high enough so their present value is approximately equal to the initial value of the assets contributed to the trust.

The present value of the annuity payments is based on a conservative assumed rate of return (the Section 7520 rate) published monthly by the IRS.

For example, let's say Lisa's living trust establishes a $10 million, 20-year T-CLAT, with annuity payments going to the Humane Society and the remaining assets going to her son, Zachary. The Sec. 7520 rate for the month the T-CLAT is funded is 6%. According to IRS tables, to zero out the T-CLAT, the annuity payments must be equal to 8.72% of the initial trust value, or $872,000 per year.

To be successful, the T-CLAT must outperform the 6% assumed rate of return. If it doesn't, the trust assets will be depleted by the charitable annuity payments. If the trust earns average returns of at least 8.72%, Lisa's entire $10 million contribution (or more) will be preserved for Zachary.

Hedging your bets

One disadvantage of a T-CLAT is that it's hard to predict what will happen to interest and estate tax rates in the future. So it's a good idea to build some flexibility into your estate plan. For example, the applicable Sec. 7520 rate won't be known until the T-CLAT is funded after your death.

To ensure that the T-CLAT is zeroed out, you may want your will or trust to include a formula that sets the appropriate term and payout rate. The formula can use a fixed term with a payout rate that varies depending on the Sec. 7520 rate. Or it can use a fixed payout rate with a variable term.

You might also consider including a provision that allows your surviving spouse or other designee to reduce the amount of assets used to fund the T-CLAT, or eliminate the trust altogether under certain circumstances. If the estate tax is repealed, for example, or estate tax rates fall below a specified level, the benefits of a T-CLAT will be diminished or eliminated. And if interest rates continue to climb, it will be increasingly difficult for a trust to outperform the Sec. 7520 rate.

Giving doesn't have to hurt

A well-designed T-CLAT can satisfy your philanthropic goals while providing remarkable estate planning benefits for your family. If the trust assets are invested and managed wisely, it's possible to give generously to charity while preserving substantial amounts of tax-free wealth for your heirs.

But bear in mind that a T-CLAT is a complex planning tool. There are several issues you should discuss with your advisors in addition to those outlined above, including income and generation-skipping transfer taxes. ✤

Super trustee to the rescue

Gain flexibility in your irrevocable trust with a trust protector

Many of the most effective estate planning strategies involve the creation of irrevocable trusts. These trusts allow you to remove significant amounts of wealth from your taxable estate while retaining the right to receive an income stream.

Still, you may be hesitant to use an irrevocable trust, especially if you're concerned that changing tax laws or circumstances may affect the trust's ability to achieve your objectives. One way to build flexibility into an irrevocable trust is to appoint a trust protector.

Relinquish control

For an irrevocable trust to be effective, you must relinquish control over the trust assets. This means you can't serve as trustee or retain the power to amend the trust's terms, change beneficiaries, take back the trust property, or otherwise benefit directly from the trust.

Trust protectors are like super trustees. They have the power to amend the trust and take other extraordinary actions to ensure that it continues to fulfill your wishes. You can give a trust protector many of the powers you'd like to retain yourself but can't because they would trigger adverse estate tax consequences if you did so.

Grant the power

Perhaps the most important benefit of a trust protector is the ability to adapt the trust to changing circumstances. Suppose your trust provides that your son is to receive a share of the trust assets when he reaches age 30. As that date approaches, however, you worry that he won't be mature enough to handle the money. You explain your concerns to your trust protector, who agrees with you and amends the trust to delay the distribution until your son turns 40.

Trust protectors are like super trustees. They have the power to amend the trust and take other extraordinary actions to ensure that it continues to fulfill your wishes.

You can grant a trust protector a broad range of powers, including the power to:

- Amend the trust to comply with changing tax laws,
- Amend the trust to reflect changing circumstances of the trust or its beneficiaries,
- Remove or replace the trustee,
- Expand or limit the trustee's powers,
- Change the trust's governing law or jurisdiction,
- Direct or veto investment decisions,
- Terminate the trust,
- Consent to the exercise of a power of appointment,
- Change beneficiaries, and
- Modify the trust's provisions regarding disposition of income and principal.

Resist the temptation to give your trust protector every allowable power. Granting him or her too much power can be dangerous, particularly if it involves changing

beneficiaries, modifying dispositive terms or other powers that can alter beneficial interests in the trust. Work with your estate planning advisor to select only those powers you anticipate will be needed to address changing circumstances and further the trust's objectives.

Choose wisely

Technically, you can appoint almost anyone as your trust protector. But to ensure that the trust achieves your estate planning objectives, it's important for the person you choose to be independent. Therefore, avoid naming trustees, beneficiaries, your spouse or other members of your immediate family as your trust protector.

Choose someone you trust who has the skills and judgment needed to carry out your wishes. Possibilities include your lawyer, your accountant, or a business-savvy friend or relative.

Get some protection

Irrevocable trusts have benefits and drawbacks. The benefits include allowing you to remove a substantial amount of assets out of your estate while still receiving an income steam. One drawback is that you must relinquish control of the trust assets. A trust protector allows you to maintain some control without losing the estate planning benefits of the trust. ✤

Estate Planning Red Flag

Your required IRA distributions are more than you need

If you're 70½ or older and own a traditional IRA, you must take required minimum distributions (RMDs) from your account each year. The same goes for 401(k) plans and other employer-provided plans (with certain exceptions). These distributions are taxed at ordinary income tax rates.

But what if you already have sufficient resources to meet your current income needs? Is there an alternative to taking taxable distributions from your IRA or qualified plan? One potential solution — provided you're otherwise charitably inclined — is to make a direct transfer from your IRA to a qualified charity.

A provision of the Pension Protection Act of 2006 allows you to make tax-free qualified charitable distributions (QCDs) of up to $100,000 from an IRA to a charity, and to apply those amounts to your RMDs for the year. This offer expires at the end of 2007. Therefore, unless Congress extends this opportunity, immediate action is required.

To qualify, the following requirements must be met:

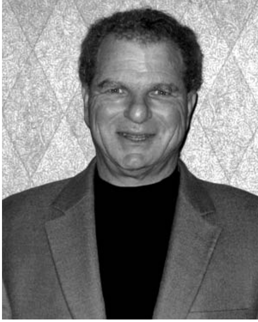
1. You must be 70½ or older when you make the distribution.
2. The distribution must otherwise be taxable.
3. You must make the distribution *directly* to a qualified charity other than a donor-advised fund or supporting organization.

The second requirement eliminates most distributions from Roth IRAs, which generally aren't taxable.

Without this provision, an alternative strategy would be to receive an RMD from your IRA, pay the taxes, donate the money to charity and then claim a charitable deduction on your tax return. But this strategy is ineffective if your charitable deductions are approaching adjusted gross income limits.

The QCD rules are limited to IRAs, but you may be able to take advantage of this option by first rolling over funds from an employer plan to an IRA. In addition, some states don't recognize this federal tax provision and therefore a direct transfer of IRA assets to charity may result in a state income tax liability. Be sure to consult with your estate planning professional.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and accordingly assume no liability whatsoever in connection with its use. ©2007 ESTnd07



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

Marion K. Jablansky, CPA
BS Accounting, Wharton School of Business

Laurie A. Urbanowicz, CPA
BA International Relations, Colgate University
MBA Accounting, Pace University

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

Selznick & Associates, LLC, offers:

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

145 Bedford Road, Suite 201
Armonk, New York 10504