ESTATE PLANNING DEVICES IN DIVORCE

ATTACKING, DEFENDING AND USING TRUSTS, ESTATES, FAMILY PARTNERSHIPS AND OTHER ESTATE PLANNING DEVICES

Richard R. Orsinger
San Antonio

Barbara McComas Anderson
Dallas

Patrice L. Ferguson
Houston

Donn Fullenweider
Houston

NEW FRONTIERS IN MARITAL PROPERTY LAW

State Bar of Texas Professional Development Program
October 10-11, 1996

Disclaimer by the Panel

The purpose of this presentation is to acquaint you with various estate planning devices currently being used throughout Texas, to explain in general the whys and hows of them, to analyze how existing devices might be attacked or defended in a divorce case, and to discuss how these techniques can be used creatively in settling a divorce.

What follows, therefore, are very brief, summary sketches of a sampling of gift and estate planning devices. They were selected to stimulate discussion. This is by no means an exhaustive catalog, and each of the devices listed can have infinite variations. You will note that references to applicable sections and regulations of the Internal Revenue Code are non-existent. These materials are not intended to instruct you on how to draft and utilize these techniques; the technical requirements and planning considerations for each device are themselves the subjects of many detailed articles and outlines. Rather, these sketches are meant to serve as overviews of what the device is and why it might have been included in an estate plan.

LOANS FORGIVEN IN INSTALLMENTS

WHAT?

Father and mother make a loan to their son to enable him to purchase a home, start a business, or whatever. If the annual payment is $20,000 or less, each year when the loan payment is due from son, father and mother forgive that year's payment. If the annual payment due exceeds $20,000, father and mother forgive up to $20,000 of the payment. If father and mother include their daughter-in-law in this transaction, they can forgive up to $40,000 each year. The pattern of annually forgiving the son's obligation is expected to continue throughout the term of the note.

HOW?

The loan is documented with a written note, perhaps also a mortgage, and is amortized over a period of years at a fair rate of interest so as to give the appearance of an arm's length debt obligation that is intended to be repaid. The loan is carried on the parents' financial statements as a note receivable and on the son's financial statement as a note payable.

WHY?

If father and mother were simply to give the amount of the "loan" to their son at the outset, the transfer would be a taxable gift to the extent it exceeded their annual gift tax exclusions ($20,000 from them to their son per year). The parents would be required to file a gift tax return, and the gift would be applied against the parents' lifetime unified credit amount ($600,000 each; $1.2 million for the couple). If the gift, when added to prior taxable gifts, exceeded the unified credit amount, gift tax would be due.

By creating the fiction of a loan rather than a gift and then forgiving the loan in $20,000 annual increments, the parents have managed to transfer the full amount to their son at the outset without paying gift taxes, without using any portion of their unified credit, and without having to file a gift tax return. The structure is not without tax risk, however, for the IRS can be expected to attack it as a sham loan/true gift if the IRS discovers it. But if the annual loan forgiveness amount is within the parents' annual exclusion and the loan is totally forgiven before the death of any of the parties, it is unlikely that it will come to the attention of the Service.

INTEREST HELD IN A DECEDENT'S ESTATE

WHAT?

Under Section 37 of the Texas Probate Code, the interests of heirs of an estate vest immediately upon the death of the decedent, subject to the rights and powers of the executor or administrator to administer the estate, pay debts, expenses and taxes, and otherwise wind up the affairs of the decedent. There is no deadline under Texas law for the distribution of an estate. Taxable estates (those requiring the filing of a federal estate tax return) are seldom distributed within 2 years of the decedent's death, for it takes at least 15 months, and often much longer, for the IRS's examination of the estate tax return to be concluded. It is not uncommon for Texas estates to be undistributed 10 or more years after the death, especially if the estate owns real property or mineral interests, the division and distribution of which might be difficult, expensive or controversial.

HOW?

If the executor is an Independent Executor who is a family member and not in a particular rush to distribute, the executor may simply continue to hold title to assets and administer them on behalf of the heirs indefinitely. An heir can force a distribution after all estate matters have been concluded, but it may be in the heir's personal best interest for estate assets <u>not</u> to be in his name.

WHY?

An amazing number of creditors (probably including soon to be ex-spouses) are unaware of vested inheritance rights or never ask the right questions to determine if such interests exist. Vested but undistributed interests give rise to a number of issues, among them:

- Although the inherited asset is separate property, what of the income generated by it after death and before distribution? Is it community or separate?

- If post-death income is used to pay administration costs and taxes, does a community claim for reimbursement arise?

- Does the non-heir spouse have any claim or complaint if the spouse who is an heir disclaims his or her inheritance?

GENERATION-SKIPPING DYNASTY TRUST

WHAT?

A generation-skipping dynasty trust (a GST trust) is created by the senior generation for the benefit of their children, grandchildren and perhaps even great-grandchildren. The trust property is intended to remain in trust throughout the lives of as many younger generations as possible, often until the Rule against Perpetuities requires that the trust interests must vest.

HOW?

The grantors execute the trust agreement creating an irrevocable, spendthrift trust for the benefit of multiple, successive generations. The basic terms of the trust are such that the trust assets will not be included in the taxable estates of trust beneficiaries upon the beneficiaries' deaths, although the beneficiaries may have limited powers of appointment that will allow them to control to some extent to whom and how the assets will pass among the next generation. It is not uncommon for a trust beneficiary to also be a trustee or co-trustee. The dispositive provisions of a GST trust are influenced by a variety of elements, not the least of which are tax consequences. Income and corpus distributions are seldom mandatory and may restrict discretionary distributions to only one generation at a time or allow distributions to be sprinkled among several generations.

WHY?

Under current law, each taxpayer may transfer no more than $1 million during his lifetime or at death in such a way that the transferred property will not be taxed in the estate of the next, younger generation. A generation-skipping transfer may take the form of a trust for children and grandchildren, in which multiple generations benefit simultaneously or successively without estate tax being due at the death of any beneficiary. A generation-skipping transfer may also be a direct gift to a grandchild which bypasses the child entirely. Generation-skipping transfers that exceed $1 million per transferor are subject to a flat tax of 55% <u>in addition to</u> the gift or estate tax that is also applicable.

If the grantors of the GST trust also want to take advantage of the annual gift tax exclusion for their gifts to the trust, the GST trust may give to the beneficiaries an annual <u>Crummey</u> withdrawal right equal to the amount of each year's gift or perhaps limited to no more than 5% or $5,000 per year.

Optimizing the GST $1 million exemption means making generation-skipping gifts early and, if possible, leveraging the value of the gift. GST trusts are often the owners of life insurance policies on senior generation members or the donees of limited partnership interests or other discounted assets.

QUALIFIED PERSONAL RESIDENCE TRUST

WHAT?

A qualified personal residence trust (QPRT) is an irrevocable trust established by homeowners to which they convey their principal residence or a vacation or seasonal home, retaining the right to live in the residence, rent-free, for a specified term of years which they hope to outlive. The grantors have the right to direct the trustees to sell the home and reinvest in another home of the grantors' choosing. If the home is sold during the trust term and another residence is not purchased, the purchase price funds an annuity which is paid to the grantors for the duration of the term. At the end of the specified trust term, the residence (or remaining proceeds, if it has been sold) belongs to the remaindermen named in the trust, who typically are children or a trust for children.

HOW?

A written trust agreement establishes the QPRT and sets out all of the related tax requirements. If the residence is owned as community property, the property may first be partitioned, with each spouse conveying his/her half to a separate QPRT, or the couple may join in one QPRT, both conveying their community interest to it. The property is transferred to the trust via a recorded deed. Because the grantors of the trust have retained their right to use the residence, if the property was their principal residence the homestead exemption and ad valorem tax deductions remain unaffected during the term of the trust.

WHY?

<u>To save gift and estate taxes</u>. Because the grantors have given away the residence but have retained a free tenancy for a period of years, the value of the gift is reduced by the retained value of the tenancy. Thus, the residence is transferred to a younger generation at a fraction of its fair market value.

For example, in September 1996 husband and wife (both aged 50) give their home (valued at $1.5 million) to a QPRT and retain the right to live in the home for 15 years (which they both are likely to outlive, given their current health, family histories, etc.). The gift to the trust is valued at $398,370 ($199,185 by each of them, if the home is community property). If the couple outlive the 15 year term of the trust, they will have removed the residence from their taxable estates at 26% of its value! The tax savings are further increased if the residence appreciates significantly in value during the 15 year term, which in all likelihood it will.

At the end of the trust term, ownership of the residence passes to the children. If the original homeowners wish to remain, they can rent the residence from their children for a fair market rental, thus moving more cash (the rental payments) to the younger generation without gift tax consequences.

FAMILY LIMITED PARTNERSHIP

WHAT?

A family limited partnership (FLP) is the current vehicle of choice for parents (or grandparents) who want to begin reducing the value of their taxable estates but cannot bear to part with control of the assets or are not yet willing to turn over control to the next generation.

HOW?

The typical FLP is structured so that control and management is retained by the general partner(s), which may be the individuals of the senior generation, a corporate general partner owned by the senior generation, a trust controlled by the senior generation, or perhaps a combination of the above. Children and perhaps grandchildren (or trusts for any or all of them) purchase or are given limited partnership interests, allowing them to share in the value and growth of the partnership without having any control.

WHY?

The FLP can accomplish many estate planning goals:

- Control. It allows several generations of a family to share in the appreciation and income of the partnership enterprise while the senior generation retains management control. Perhaps the senior generation is not yet ready to step aside; perhaps the younger generation is not yet old enough or experienced enough to take over the controls.

- Asset Protection. The partnership agreement typically provides for a long partnership term (perhaps 40-50 years) and restrictions on the transferability of partnership interests. If partnership interests pass into the hands of non-permitted transferees (e.g. a creditor or a soon to be ex-spouse), those transferees become merely assignees of the partnership interests. Assignees are taxed as partners but have absolutely no role in management or liquidation decisions.

- Valuation Discounts. Limited partnership interests lack marketability, for they are units of a closely held enterprise with no recognized market and no means of forcing a buy-out or liquidation. They are also minority interests which do not represent control. As a result, the value of a limited partnership interest for gift and estate tax purposes is discounted from the fair market value of the partnership assets for (i) lack of marketability and (ii) minority interest. These factors can result in discounts ranging from 25% to 60% of the value of the partnership assets.

CHARITABLE REMAINDER TRUST

WHAT?

A charitable remainder trust (CRT) is an irrevocable trust that provides for a specified annual payment to one or more non-charitable beneficiaries for each beneficiary's life or for a prescribed number of years. A charitable remainder unitrust (CRUT) requires the payment, each year, of at least 5% of the value of the trust assets, which are revalued annually. A charitable remainder annuity trust (CRAT) requires an annual payment of an amount that is determined only once, at the creation of the trust (e.g., 7% of the value of the trust assets at the time of trust creation). When the required payments to the non-charitable beneficiaries come to an end, the trust property is distributed to one or more charitable organizations.

HOW?

The grantors establish an irrevocable charitable trust by signing a trust agreement that contains the requisite provisions chosen by the grantors and those required by the Internal Revenue Service, and by transferring assets into the name of the trust. A CRAT can be funded only once, at its inception. The grantors of a CRUT can make additional contributions to it over time.

WHY?

For donors who are charitably inclined, a CRT allows them the best of both worlds by satisfying their charitable goals while retaining an absolute stream of income from the gifted assets.

For donors who are less charitably inclined but who own assets of high value with low basis and low rates of return, a CRT provides a means of increasing the cash flow from their assets without first recognizing substantial capital gains. When highly appreciated assets are given to the CRT and subsequently sold by the CRT, recognition of the gain is avoided.

Depending upon the structure of the CRT, the donors will receive either an income tax charitable deduction or a gift tax charitable deduction. In either case, the CRT assets are also removed from the donors' estates at death.

If there is a disadvantage to a CRT, it is that the gifted assets are removed from the donors' estate and thus cannot be left to younger generations. Planners therefore often suggest pairing a CRT with an irrevocable life insurance trust which replaces the "lost" assets for the benefit of younger generations.

GRANTOR RETAINED INCOME TRUST

WHAT?

Grantor retained income trusts generally fall into two categories, much like charitable remainder trusts. Grantor retained annuity trusts (GRATs) reserve to the grantor an annual payment of a fixed amount, determined by a percentage of the value of the trust assets upon initial funding of the trust. Grantor retained unitrusts (GRUTs) reserve to the grantor an annual payment of a fixed percentage of the value of the trust assets, redetermined annually. At the expiration of the trust term, the trust assets typically belong to the grantor's children.

HOW?

The grantor establishes an irrevocable trust by signing a trust agreement that contains the requisite provisions chosen by the grantor and those required by the Internal Revenue Service, and by transferring assets into the name of the trust. A GRAT can be funded only once, at its inception. The grantor of a GRUT can make additional contributions to it over time.

WHY?

The purpose of a GRAT or GRUT is to remove assets from the estate of the grantor at a fraction of the assets' value while retaining a finite stream of payments. As with the QPRT, the value of the transferred assets are discounted for gift tax purposes by the value of the interest retained by the grantor. The amount of the discount depends upon a number of interrelated factors, including the amount of the retained payout, the term of the trust, and the applicable interest rate at the time of the trust's creation.

The use of a GRAT or GRUT is particularly appealing if the assets transferred are expected to appreciate rapidly in the foreseeable future or if the income generated by the assets will reliably exceed the amount of the required payout. In that case, the excess, undistributed income is additional value transferred to the remaindermen without additional gift tax.