Insight on Estate Planning

October/November 2011

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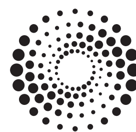

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Keep future options open with powers of appointment

One of the biggest challenges in estate planning is uncertainty over what the future will bring. It's difficult to predict how changes in your family's personal circumstances and financial needs will affect your estate plan. Fortunately, there are several tools that give your plan flexibility to react to changing situations. One of those tools is the power of appointment.

What's a power of appointment?

A power of appointment gives the "holder" of the power — often a beneficiary — the ability to decide how, when and to whom specified assets in a trust or estate will be distributed. Depending on its language, a power of appointment may allow the holder of the power to transfer assets during his or her lifetime (an *inter vivos* power of appointment) or at death through a will or trust (a testamentary power of appointment).

Powers of appointment may be general or limited, a critical distinction that carries significant tax implications.

Powers of appointment may be general or limited, a critical distinction that carries significant tax implications. A general power of appointment gives the holder the right to transfer the assets in any way he or she sees fit. Thus, the holder can decide to keep the assets for him- or herself if so desired.

For this reason, assets subject to a general power of appointment are included in the holder's taxable estate, regardless of whether the holder exercises the power. Consequently, such assets also would normally be subject to the claims of the holder's creditors.

A limited power of appointment doesn't allow the holder to transfer the assets to him- or herself. Typically, a limited power allows the holder to direct the assets to specific people

or classes of people (the holder's children, for example). In some cases, the holder of a limited power may use it to benefit him- or herself, provided distributions are strictly limited based on "ascertainable standards" related to the holder's health, education, maintenance or support.

For estate tax purposes, the holder of the limited power of appointment isn't treated as the owner of the underlying assets. Thus, the assets aren't included in the holder's estate and aren't subject to claims of the holder's creditors.

What are the benefits?

The limited power of appointment is a versatile tool that can be used to accomplish a variety of estate planning goals. Let's look at one scenario. Tom and Mary have two young children. Tom's estate plan calls for his assets to be held in trust for Mary, with the trust income and, as necessary, principal going to Mary for life and the remaining assets divided equally between the children on Mary's death. Tom's plan also gives Mary a limited, testamentary power of appointment.

The power of appointment provides her with some flexibility to alter the distribution of the trust assets on her death depending on the children's circumstances. For example:

- If one of the children is financially independent, she might provide a larger percentage of the assets to the other child,
- If one child lacks the ability to effectively manage his or her finances, she could direct that child's share into a trust that restricts his or her access to the funds, or
- If one child develops serious health problems, she could direct that a portion of the trust assets be placed in a special needs trust, which can be used to enhance the child's quality of life without jeopardizing his or her eligibility for government benefits, such as Medicaid or Supplemental Security Income (SSI).

These are just some of the many ways powers of appointment can be used to make an estate plan more flexible.

Be creative

With a little creativity, you can design powers of appointment to address a variety of estate planning issues. The powers can allow your family to make critical adjustments to your plan to reflect changing circumstances and needs.

A powerful asset protection tool

One of the many benefits of establishing an irrevocable trust for your children or other family members is asset protection. So long as you don't use the trust to defraud creditors, assets you transfer to the trust generally are beyond their reach.

But what if you're concerned that you won't have enough money to live on later in life? You could name yourself as a discretionary beneficiary of the trust, authorizing the trustee to distribute funds for your living expenses. Unfortunately, in most states, such "self-settled" trusts provide little or no asset protection.

A potential solution is the addition of a limited power of appointment. The power can authorize a family member or other trusted person to transfer some or all of the irrevocable trust assets to you as well as to the trust beneficiaries. Because you aren't a trust beneficiary and the power holder has no obligation to make distributions to you, this arrangement should provide full creditor protection (so long as the initial transfer of assets to the trust wasn't fraudulent).

A trust that keeps on giving

Create a dynasty to make the most of today's exemptions

With a properly executed estate plan, your wealth can be enjoyed by your children and even their children. But did you know that by using a dynasty trust you can extend the estate tax benefits for *several* generations, and perhaps indefinitely?

A dynasty trust can protect your wealth from gift, estate and generation-skipping transfer (GST) taxes and help you leave a lasting legacy. And, with today's higher lifetime gift and GST tax exemptions, a dynasty trust is all the more powerful.

Dynasty trust in action

Transfers that skip a generation — such as gifts or bequests to grandchildren or other individuals two or more generations below you, as well as certain trust distributions — are generally considered to be GSTs and subject to the GST tax (on top of any applicable gift or estate tax). However, you can make GSTs up to the GST exemption amount free of GST tax.

The exemption is $5 million through 2012 but scheduled to drop back to $1 million (indexed for inflation) starting in 2013. So you may want to use as much of your exemption as you can afford to this year and next. Applying it to a dynasty trust can help you make the most of your exemption.

Your contributions to a dynasty trust will be considered taxable gifts, but you can minimize or avoid gift taxes by applying your lifetime gift tax exemption — also $5 million through 2012. (Keep in mind, however, that any gift tax exemption you use will reduce the estate tax exemption available at your death dollar-for-dollar.)

After you fund the trust, the assets can grow and compound indefinitely. The trust should be designed to make distributions to your children, grandchildren and future descendants according to criteria you establish. So long as your beneficiaries don't gain control over the trust, the undistributed assets will bypass their taxable estates.

Enhancing the benefits

To increase the benefit to future generations, you can structure the trust as a grantor trust so that you pay any taxes on the trust's income. The assets will then be free to grow without being eroded by taxes (at least during your lifetime).

Also consider further leveraging your GST tax exemption by funding the dynasty trust with life insurance policies or property that's expected to appreciate significantly in value. So long as your exemption covers the value of your contributions, any future growth will be sheltered from GST tax, as well as gift and estate tax.

Allowing a trust to grow for several generations can produce enormous amounts of wealth. For example, a trust funded with an initial contribution of $5 million and earning an average annual return of 6% will be worth more than $92 million in 50 years and almost $1.7 *billion* in 100 years (assuming no income taxes or distributions).

3 planning scenarios

Even though the long-term tax-saving benefits may be substantial, you may question the reasons to include distant descendants as beneficiaries. Here are three scenarios to consider:

1. If your estate plan already provides for your immediate family with resources to spare, a dynasty trust can be a nice supplement to your plan.

2. You may be reluctant to turn your children into "trust fund babies" by allowing them to live off their inheritances. You can design a dynasty trust to ensure that your children, grandchildren and future generations pursue their own careers while at the same time providing them a safety net in the event they're unable to pay for health insurance, medical care, education, housing or other necessities.

3. A dynasty trust can be a great tool for encouraging charitable giving. For example, you might provide for the trust to make matching distributions to beneficiaries equal to a percentage of the charitable contributions they make each year.

Whatever your reasons for including a dynasty trust in your estate plan, it's important to communicate your intentions to your present *and* future beneficiaries.

Considering state law

If you think a dynasty trust might help you achieve your estate planning goals, talk to your advisor about the state law considerations. Some states apply the rule against perpetuities, which limits a trust's life span, generally to no more than 100 years or so. But many states have extended the limit to several hundred or even 1,000 years or have no rule against perpetuities.

> *The GST exemption is $5 million through 2012 but scheduled to drop back to $1 million (indexed for inflation) starting in 2013.*

You don't have to live in a perpetual trust state to take advantage of this technique; it can be just a matter of specifying the applicable state law in the trust agreement. But additional requirements may include appointing at least one trustee who resides in the state whose laws govern the trust — a bank or other corporate trustee, for example — and locating at least some of the trust assets in that state.

Laws vary from state to state, so choose carefully. Typically, the most attractive states are those that both allow perpetual trusts and have no state income tax.

Is a dynasty trust right for you?

If establishing a lasting legacy is an estate planning goal, a dynasty trust may be the right vehicle for you. However, before you take action, consult your estate planning advisor, because a dynasty trust can be complicated to set up.

Charitable IRA rollover: A limited time offer

Last year's tax relief legislation extended several expiring tax breaks, including tax-free treatment of charitable IRA rollovers — formally called "qualified charitable distributions" — by taxpayers age 70½ or older.

If you're eligible, you have until the end of this year to transfer up to $100,000 tax-free directly from an IRA to an eligible charity. (The $100,000 limit is per person. Thus, if your spouse is similarly eligible, he or she can also make a contribution.) You can use a charitable IRA rollover to satisfy your 2011 required minimum distribution (RMD) and enjoy estate planning benefits as well.

Charitable IRA rollover requirements

To qualify for a charitable IRA rollover, in addition to meeting the age requirement, you must:

- Transfer the funds *directly* from the IRA to an eligible charity (donor-advised funds, supporting organizations and private foundations are ineligible), and
- Document the rollover with the same type of written acknowledgment from the charity that you would need to support a charitable deduction on your income tax return.

The distribution to charity must be one that would be *fully* deductible (without regard to percentage-of-income limitations) if you made the donation yourself. In other words, you can't receive something of value in return.

In addition, the distribution must be one that would otherwise be taxable. That rules out most Roth IRAs. A distribution from an IRA that's part of a Simplified Employee Pension plan or a Savings Incentive Match Plan for Employees also won't qualify.

Determining whether you'll benefit

There's little point in going to the trouble of arranging a charitable IRA rollover if it won't provide a tax benefit. You may be able to achieve the same result by taking a taxable distribution from your IRA, donating it to charity and claiming an offsetting charitable deduction on your income tax return. In fact, you can potentially do this even if you haven't reached age 70½.

But a charitable rollover can provide a tax advantage if:

- You'd exceed the annual charitable deduction limit — generally 50% of adjusted gross income (AGI) — if you made the contribution yourself,
- The increased AGI resulting from a taxable IRA distribution would cause adverse tax consequences, such as reduced deductions or exemptions or increased taxes on Social Security benefits, or

- You live in a state that allows tax-free charitable IRA rollovers for state income tax purposes but disallows deductions for charitable donations. (Even if you live in a state that doesn't recognize charitable IRA rollovers, in most cases the federal tax benefits will far outweigh the state tax cost.)

Also consider the potential estate planning benefits: Traditional IRAs can be costly inheritances because the beneficiaries will owe income taxes on the distributions they receive. If you instead donate your traditional IRA assets to charity and bequeath Roth IRAs or investments held in taxable accounts to your loved ones, income taxes will take a smaller bite out of their inheritances.

A valuable opportunity

If you're charitably inclined, over age 70½ and have a significant balance in an IRA, check with your tax advisor to see whether a charitable IRA rollover would be worthwhile. Under the right circumstances, a rollover can produce substantial tax savings. And keep an eye on Congress. Lawmakers have extended the charitable IRA rollover twice before, and they may extend it again.

Estate Planning Pitfall
You have a living trust but no will

Many people mistakenly believe that if they have a living trust — also known as a revocable trust — they don't need a will. After all, a primary purpose of a living trust is to avoid probate and ensure that your wealth is distributed quickly and efficiently after your death.

But even if you have a living trust, a will serves several important purposes. For example, a will generally is the only place you can name a guardian for minor children, if you have them.

In addition, despite your best efforts, some assets may not make it into your trust. For a living trust to be effective, assets must be titled in the name of the trust. Unfortunately, it's easy to acquire assets and forget to transfer title to your trust. A "pour-over" will serves as a safety net to ensure that any assets you neglect to transfer during your lifetime are "poured over" into the trust.

Assets disposed of by a pour-over will must go through the probate process to be transferred to the trust. Still, this result is preferable to having no will. Without a will, any probate assets you own outside your revocable trust will pass to your heirs under state intestacy laws rather than to the beneficiaries of your living trust.

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