



**COX,
HODGMAN &
GIARMARCO, P.C.**

Tenth Floor Columbia Center
101 West Big Beaver Road
Troy, Michigan 48084-5280
(248) 457-7000
Fax (248) 457-7219

*Attorneys and Counselors at Law
Estate Planning Division
www.disinherit-irs.com*

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Editor: Julius H. Giarmarco, J.D., LL.M.
Associate Editor: Robert A. Bryant, J.D., M.B.A.

“Switching” ILITS

By Julius H. Giarmarco, J.D., LL.M.

To avoid having life insurance proceeds taxed in the insured’s estate, practitioners usually recommend that the policy be owned by an irrevocable life insurance trust (“ILIT”). Provided the ILIT is properly designed and administered, upon the grantor-insured’s death, the insurance proceeds will not be includible in his/her gross estate. However, if the policy is not initially purchased by the ILIT, but instead transferred to the ILIT by the grantor-insured, then the full amount of the insurance proceeds will be includible in the grantor-insured’s estate if the grantor-insured dies within three years of transferring the policy to the ILIT. IRC §2035.

What options are available to a grantor of an ILIT that is unhappy with its terms? For example, one of the ILIT’s beneficiaries is no longer in favor with the grantor, or the existing ILIT is not a generation skipping trust and, therefore, the insurance proceeds will be (unnecessarily) taxable in the children’s gross estates.

One solution is for the grantor to create a new ILIT with the desired terms. The new ILIT would then purchase the policy from the old ILIT. For policies on which further premiums are payable, the purchase price should be the policy’s “interpolated terminal reserve” value, plus the unearned premium. Treas. Reg. §25-2512-6(a), Example 4. However, if the insured is uninsurable at the time of the purchase, the interpolated terminal reserve value would not be adequate consideration. See *Est. of Pritchard v. Comm.*, 4 TC 204 (1944) and Treas. Reg. §25.2512-1. In any event, the grantor will have to gift the new ILIT sufficient cash with which to purchase the policy from the old ILIT.

Having one ILIT purchase a life insurance policy from another ILIT will not result in starting a new three-year term under IRC §2035. The reason is that IRC §2035 deals with transfers by gift and not by sale. However, care must be taken not to run afoul of the “transfer-for-value” rule of IRC

§101(a)(2). Under that rule, if a policy is transferred for a valuable consideration, the death proceeds will be taxable as ordinary income – except to the extent of the consideration paid by the transferee. Considering that life insurance proceeds are otherwise income tax-free under IRC §101(a), violating the transfer-for-value rule would obviously be an unwanted result. Specific exceptions to the transfer-for-value rule allow a transfer without jeopardizing the income tax-free nature of the death benefit. Among the exceptions are transfers to the insured and transfers to a partner of the insured.

If the purchasing ILIT is a grantor trust, would this fall under the exception of a transfer to the insured? In PLR 9413045 the IRS implied – but did not state – that the sale of two survivorship policies (wife was the grantor of one trust and husband was the grantor of the other) to a new trust that was intentionally designed as a “grantor trust” would *not* be a transfer-for-value. That ruling – even though private – gives some comfort to using a grantor trust as an exception to the transfer-for-value rule. Another way around the problem is for both ILITS to be grantor trusts. Sales between a grantor and his/her grantor trust are ignored for income tax purposes. Rev. Rul. 85-13. Presumably, the same would hold true for a sale between two grantor trusts. In fact, in PLR 20022819 the IRS held that a transfer of a policy from one grantor trust to another for adequate consideration was a non-event for income tax purposes and, therefore, would not set the transfer-for-value trap.

The problem with relying on PLRs 9413045 and 20022819 is that they are not binding on the IRS, except with respect to the taxpayers requesting the rulings. Moreover, in Rev. Proc. 2002-3 the IRS stated that it will no longer issue an advanced ruling on whether a sale of a policy to a grantor trust qualifies as an exception to the transfer-for-value rule. Finally, when dealing with survivorship policies, it is not altogether clear whether you can have two grantors treated

as the owner of the entire trust. To learn more on how to create a grantor trust, go to our website, www.disinherit-irs.com.

Perhaps, the safest way to avoid the transfer-for-value rule is for the new ILIT to become a partner with the insured(s). As mentioned above, a transfer of a policy to a “partner” of the insured is an exception to the transfer-for-value rule. It should be noted, however, that for purposes of the “partner” exception, members of an LLC are considered partners, whereas co-stockholders in a corporation are *not* considered partners. Accordingly, if a family limited partnership (“FLP”) or family limited liability company (“FLLC”) already exists, an interest in the FLP or FLLC can be gifted or sold by the insured(s) to the new ILIT. If an FLP or FLLC does not already exist, a new FLP or FLLC can be formed with the insured(s) and the new ILIT. This new FLP or FLLC should engage in some meaningful business activity – such as equipment leasing.

Besides avoiding the transfer-for-value rule, other factors must be considered before having a new ILIT purchase a policy from an old ILIT. First, does the old ILIT permit the trustee to sell the policy? Second, if the beneficiaries of the new ILIT are different than the old ILIT, will the trustee of the old ILIT face some challenge if he/

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she sells the policy? If so, this challenge could be minimized if the grantor informs the trustee in writing that he/she will no longer be making gifts to the old ILIT (with which to pay premiums). Third, in valuing the policy, the trustee of the old ILIT should take into account the insured's age and health. In fact, the trustee might be well advised to shop the policy with two or three life settlement companies before agreeing to a sales price. Fourth, the grantor must be willing to fund the new ILIT with sufficient cash to purchase the policy from the old ILIT. Moreover, this gift will use up some of the grantor's gift tax exemption (or will be subject to gift taxes if there is no exemption available). It is not advisable to use *Crummey* powers to fund the new ILIT because upon lapse of their withdrawal right the beneficiaries become "grantors" of the ILIT and, as such, the grantor-insured will no longer be the grantor of the entire trust. Finally, the grantor must understand that the old ILIT continues in existence, with just the sales proceeds as its only asset.

In summary, with careful planning the grantor of an ILIT can "switch" ILITs without estate tax inclusion and without violating the transfer-for-value rule.

For more information regarding this topic, please e-mail your requests to Julius at jhg@disinherit-irs.com or call Julius at (248) 457-7200.

Opportunities Exist in Making Family Loans

By Robert A. Bryant, J.D., M.B.A.

A popular and simple wealth transfer technique is for parents and grandparents to make low interest rate loans to their children and grandchildren or, preferably, to generation skipping trusts for the benefit of their children and grandchildren. The advantage of low interest rate loans to family members is that if the borrower earns more on the borrowed funds than the interest rate paid, the excess passes to the borrower – estate and gift tax free. As long as such loans bear interest at the applicable federal rate ("AFR") under IRC §7872, there will be no imputed gift to the borrower.

The AFR is based on the type and term of the loan and is published monthly by the federal government. Essentially there are three rates:

1. Short-term rate which applies to loans

less than three (3) years;

2. Mid-term rate which applies to loans between three (3) and nine (9) years; and

3. Long-term rate which applies to loans longer than nine (9) years.

Each rate varies slightly depending on whether payments are made annually, semi-annually, quarterly or monthly. For example, the *annual* short-term, mid-term and long-term rates for September, 2004 are 2.34%, 3.84% and 5.03%, respectively. Most family loans are structured as nine-year loans, with interest only (payable annually), and with a balloon payment at the end. Moreover, the promissory note to evidence the loan will provide for no pre-payment penalty.

Besides making low interest rate loans directly to a child or grandchild (or to a trust for their benefit), low interest rate loans are often used in connection with installment sales to grantor trusts. For more details on this technique, go to our website, www.disinherit-irs.com. Low interest rate loans are also common when selling business interests to family members on installments.

Like homeowners who refinance mortgages each time interest rates drop, children and grandchildren (or trusts for their benefit) who borrowed from their parents and grandparents may wish to refinance their family loans to take advantage of the historically low AFRs. The question arises as to whether such refinancing might be treated by the IRS as a gift from the lender to the borrower. Refinancing a family loan at the new AFR should not result in a gift. The reasoning is that IRC §7872, which treats below-market interest rate loans as gift loans, is presumably a "safe harbor" for family loans using the AFR.

Nevertheless, there are three ways cautious practitioners may use to refinance family loans to minimize possible IRS challenges:

1. Default danger. A borrower who risks default because of a high interest rate should allow the lender sufficient consideration to refinance the loan to protect the principal amount owed.

2. New loan. The borrower first refinances with a bank, and then borrows from a family member at the reduced rate. The new family loan is then used to pay off the bank loan.

3. Term adjustment. The borrower pre-pays a portion of the loan and refinances the balance with a family member, using a shorter term than the original note.

In summary, making low interest rate loans to family members is an effective way to transfer wealth with no gift tax. However, given the complexity of the imputed interest rules, care must be taken in structuring (and refinancing) such loans.

For more information regarding this topic, please e-mail your requests to Bob at rbryant@disinherit-irs.com or call Bob at (248) 457-7207.

Time to Revisit Marital Deduction Formulas

By Randall A. Denha, J.D., LL.M.

Traditionally, a married couple's estate plan establishes a family trust on the death of the first spouse to die. The family trust is funded with the maximum amount that the deceased spouse can pass estate tax free, and the decedent's remaining assets pass either outright to, or in trust for, the surviving spouse – estate tax free because of the unlimited marital deduction. Under the 2001 Tax Act, the amount that can pass estate tax free at the first death is \$1,500,000 in 2004 and 2005; \$2,000,000 in 2006 thru 2008; \$3,500,000 in 2009; unlimited in 2010; and \$1,000,000 in 2011 and thereafter.

On the death of the surviving spouse, the assets in the family trust – also called a residuary trust, bypass trust and credit shelter trust – pass estate tax free to the family trust's beneficiaries (i.e., children and grandchildren). However, for the family trust to pass to the children estate tax free at the surviving spouse's death, the estate tax laws force a married couple to make a difficult decision. If the surviving spouse wishes to be the sole trustee of the family trust – the surviving spouse can only withdraw principal as needed for "health, education, maintenance and support". This is referred to as an "ascertainable standard". Otherwise, the surviving spouse will have a general power of appointment over the family trust thereby causing all of the family trust's assets to be included in the estate of the surviving spouse. IRC §2041(b)(1)(A). However, it is permissible for the surviving spouse to withdraw from the family trust annually (in addition to principal as needed

for health, education, maintenance and support) the greater of \$5,000 or 5% of the trust principal without estate tax inclusion. IRC §2041(b)(2).

In contrast, the surviving spouse can be given unrestricted access to the marital share. Married couples who took comfort knowing the surviving spouse had unrestricted access to the marital share should reassess their comfort level in light of the increasing estate tax exemption. With an increasing family trust and a decreasing marital share, the surviving spouse may no longer be happy with the typical “reduced-to-zero” estate plan design. Also, if the combined estates of both spouses is less than twice the estate tax exemption, fully funding a family trust to save estate taxes will be unnecessary.

One solution to this problem – particularly well suited for first marriages – is the use of a disclaimer trust. With this technique, the entire estate of the first spouse to die is left to the surviving spouse with a provision that creates a family trust for any amount the surviving spouse disclaims. Although the surviving spouse may be the sole trustee and beneficiary of the family trust that receives the disclaimed property, he/she cannot be granted a limited power of appointment to direct who ultimately inherits the family trust at the second death. Although the surviving spouse will still be subject to the ascertainable standard, the surviving spouse at least has some control over whether there will be a marital share that can be freely accessed.

For more information regarding this topic, please e-mail your requests to Randy at rad@disinherit-irs.com or call Randy at (248) 457-7205.

Charities: A Primer, Part II

By Salvatore J. LaMendola, J.D.

In the first installment of this series, some basic terminology was reviewed to clear the way for future installments to focus on 501(c)(3) organizations. This second installment will discuss the process of creating a new 501(c)(3) organization in Michigan.

The first step is to choose a form of organization. The tax law generally doesn't require a specific form of organization. Code Section 501(c)(3) allows for nonprofit cor-

porations, community chests, funds, and foundations. The IRS also allows trusts and unincorporated associations to qualify as 501(c)(3)s. In practice, the choice is generally between a nonprofit corporation or a trust.

The nonprofit corporation is the most common form for organizing a tax-exempt organization (501(c)(3) or otherwise) in Michigan. Nonprofit corporations are governed in Michigan by the Michigan Nonprofit Corporation Act, which provides the usual corporate limitations of liability for members or shareholders. The Act also contains additional limitations on, or elimination of, liability for volunteer directors and officers and other volunteers.

There are many varieties of corporate formats to choose from. Membership corporations, directorships with or without members, and shareholder corporations provide flexible alternatives for handling virtually any governance issue. This flexibility, as well as the statutory limitations on liability mentioned above, are why the nonprofit corporation is the favored format.

Trusts can also be a useful 501(c)(3) format. A trust can be established while the donor is alive, or language establishing a testamentary trust can be built into a living trust agreement. The latter can provide flexibility should the donor's plans change as to how much should pass to the trust and/or as to the purpose of the trust. If control is not a major issue (as discussed below) language establishing a testamentary trust should authorize the trustees to change the trust into a nonprofit corporation should circumstances (such as liability concerns) warrant such a move. Leaving assets to a charitable trust as part of the donor's living trust affords the donor the opportunity to create a 501(c)(3) at death as opposed to incurring the expenses of funding and administering a 501(c)(3) during lifetime.

The trust format's main advantage over the nonprofit corporation lies in its ability to address specific concerns a donor may have. For example, a donor may want to impose the more stringent fiduciary standards of liability over his charitable organization's managers (the trustees), or he may want to assure that after his death such managers do not change the charity's purpose. A trust is better suited than a nonprofit corporation in these cases as it is far more difficult to change the purpose of a trust (generally a court procedure) than a nonprofit corporation (generally a vote of the directors).

Once the choice of format has been made, the next step is to make the requisite filings with the IRS and the State of Michigan. This will be addressed in our Winter (January, 2005) newsletter.

For more information regarding this topic, please e-mail your requests to Sal at sjl@disinherit-irs.com or call Sal at (248) 457-7204.

Is the Death Tax Really Dead?

The U.S. estate tax has had a long history:

1797 - First estate tax.

1802 - Estate tax repealed.

1862 - Estate tax reenacted.

1870 - Estate tax repealed.

1898 - Estate tax reenacted

1902 - Estate tax repealed.

1916 - Predecessor of today's estate tax passed with top rate of 10% on estates worth more than \$10 million.

1932 - The Revenue Act reduces estates exempt from estate taxes from \$100,000 to \$50,000, reinstated the gift tax and established the top estate tax rate of 45% for estates worth more than \$10 million.

1940 - The Revenue Act increases top rate to 77% for estates worth more than \$50 million.

1981 - The Economic Property Tax Act established an unlimited marital deduction, provided for the phased in reduction of top rates to 50% by 1985 and phased in an increase to the unified credit equivalent to \$600,000 by 1987.

1984 - The Deficit Reduction Act delayed the reduction of the top estate tax rates.

1993 - The Omnibus Budget Reconciliation Act reinstated top estate tax rate of 55%.

1997 - The Taxpayer Relief Act phased in an increase in the unified credit equivalent available for gift and estate tax transfers to \$1,000,000 by 2006. The Act also indexed for inflation the general-skipping tax exemp-

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tion and the annual exclusion from gift tax.

2001 - The 2001 Act passed purporting to ultimately eliminate the estate and GST taxes. The 2001 Act sunsets in 2011.

As a general summary, the 2001 Act: (a) increases the applicable exclusion amount; (b) reduces the estate tax rates; (c) repeals the estate tax for decedents dying after 2009; and (d) phases out the estate death tax credit. The new legislation also repeals the generation-skipping transfer ("GST") tax effective after 2009. It is important to note that the 2001 Act did **not** repeal the gift tax! Moreover, it eliminates the "step-up" in basis for income tax purposes for those dying after 2009. In effect, the 2001 Act transforms the estate tax to an income tax.

Because of the "Byrd Amendment", all of the changes from the 2001 Act will terminate on December 31, 2010. The repeal of the estate and GST taxes could be extended, but it will take an act of Congress. It should be noted that we, like many other estate

planning attorneys, do not believe that the ultimate total repeal of the estate and GST tax is likely. In fact, since the gift tax was left in place, and the repeal is only slated for one year (i.e., 2010), it appears unlikely that the repeal will ever take place. Moreover, even if there is a "repeal" it is truly not a repeal, since the repeal also includes the repeal of the "step-up" in basis rule. Since the existing tax has been with us since 1916, and there have been death taxes in one form or another going back to the earliest days of the republic, don't hold your breath expecting premanent relief anytime soon.

As with all changes to the law, what Congress purported to do was give taxpayers a tax break. For some this may be the case. But for others, what they have done is make the planning more difficult. The result is that it will require many to revisit their estate plans since the "rules of the game" have changed, and will likely change again.

What does this mean to persons with large estates concerned about practical applications? It means there will be more uncer-

tainty and more expense since any strategy will have to reflect the concerns of either owing no estate taxes or having to plan for estate taxes. Beside the classic timing problem of death, which should never be influenced by tax savings, this new law may also affect planning by discouraging transfers to surviving spouses, it may negatively affect the use of some charitable trusts and it provides a disincentive to make gifts to family members.

We'd Like To Hear From You!

If there are any estate planning, retirement planning or business succession planning topics or techniques that you would like to learn more about, please contact Julius H. Giarmarco at jhg@disinherit-irs.com and let us know. If there is great interest in a particular topic, we will cover it in an upcoming edition of this newsletter, on our E Monthly Update (see back page), or at one of our future seminars. If there is only nominal interest in the topic, then we'll host a private study group at our office and invite all interested parties. We look forward to hearing from you.

This newsletter is designed to provide accurate (at the time of printing) and authoritative information with regard to the subject matter covered. It must not be used as the basis for legal or tax advice. In specific cases, the parties involved must always seek out and rely on the counsel of their own advisors. Thus, responsibility for modifying and guiding any party's action with respect to legal and tax matters is placed where it belongs - with his or her own advisors.

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For a referral to one of our attorneys, please call **Julius H. Giarmarco** at (248) 457-7200



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101 West Big Beaver Rd. • Suite 1000 • Troy, MI 48084-5280 • Phone (248) 457-7000 • Fax: (248) 457-7219 • www.disinherit-irs.com