

SPECIAL REPORT

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THE FIVE LEVELS OF ESTATE PLANNING FOR UNMARRIED COUPLES

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Introduction

Whether of same-sex or opposite-sex unions, unmarried couples face many estate planning issues (and opportunities). Although unmarried couples clearly face challenges that married couples do not, most are challenges that can be overcome with planning. However, because many of the issues discussed in this brochure are state-specific, it is important that unmarried couples preparing an estate plan seek the counsel of an attorney familiar with the laws of their state of domicile.

Unmarried couples (whether same-sex or opposite sex) have the same estate planning objectives as do married couples. They want to:

- ◆ avoid the costs, delays and publicity associated with probate;
- ◆ eliminate or minimize estate taxes;
- ◆ make certain their assets will pass to whom they want, when they want, and how they want; and
- ◆ protect their assets from their heirs' disabilities, disabilities, creditors and predators.

Unlike married couples, unmarried couples do not benefit from many of the legal presumptions and default provisions under state and federal law. Unmarried couples:

- ◆ are not entitled to the federal unlimited estate and gift tax marital deductions;
- ◆ cannot utilize the tax-free "rollover" of retirement benefits in the same manner as a surviving spouse;
- ◆ are not covered under most state intestacy laws that determine who receives a decedent's property if there is no Will; and
- ◆ are not permitted, by most state laws, to elect against a partner's Will and thereby receive a portion of the deceased partner's property.

Same-sex couples have made some strides under the law toward qualifying for the same benefits that married couples enjoy. In March 2010, Washington D.C. became the sixth place in the United States where same-sex marriages can take place. Connecticut, Iowa, Massachusetts, New Hampshire and Vermont also issue

marriage licenses to same-sex couples. Rhode Island, New York and Maryland recognize same-sex marriages from other states; and Hawaii, Illinois, and New Jersey allow civil unions, thereby providing state-level spousal rights to same-sex couples. And California, Oregon, Nevada, Washington, Hawaii, Maine, Wisconsin, and Washington D.C. recognize domestic partnerships, which allow some state-level spousal rights to unmarried couples (whether same-sex or opposite sex). Still, 30 states have constitutional language banning the recognition of same-sex marriages, and 39 states have statutes defining marriage as the legal union of two persons of the opposite sex.

Although the U.S. Constitution requires each state to give "full faith and credit" to the laws of other states, the 1996 federal Defense of Marriage Act ("DOMA") expressly undercuts the full faith and credit requirement in the case of same-sex marriage. In July 2010, DOMA was ruled unconstitutional by a federal judge who found that gay and lesbian couples deserve the same federal benefits as heterosexual couples. And in February, 2011, President Obama, in a major legal policy shift, directed the Justice Department to stop defending DOMA against lawsuits challenging it as unconstitutional. Thus, because of the conflict between the U.S. Constitution and DOMA, it may ultimately be left to the Supreme Court of the United States to decide the issue of same-sex marriage.

LEVEL ONE **Avoiding State Default Laws**

Most unmarried couples will want to avoid their state's intestacy laws. These are the laws that determine who receives a decedent's "probate" estate if he or she dies without a Will. Except for a few states, intestacy laws do not recognize "unrelated persons." However, assets passing to a surviving joint tenant, or payable by beneficiary designation to a person or trust, are not part of the decedent's probate estate and, therefore, avoid the intestacy laws. Same-sex couples will also want to avoid most states' default laws on matters such as burial desires and priority among persons to act as guardians, conservators, personal representatives, and patient advocates.

Basic estate planning for an unmarried couple involves

these documents:

1. Wills

A Will directs how assets in the decedent's name alone will pass at death. These assets may include bank accounts, brokerage accounts, and real estate. Without a Will, assets held in the decedent's name alone pass according to state intestacy laws. Since most state intestacy laws do not include unrelated persons, it follows that without a Will an unmarried decedent's partner would be disinherited. Although assets passing through a Will must go through probate, the Will assures that assets will pass according to the testator's wishes and allows the testator to name a personal representative to carry out the terms of the Will.

2. Will Substitutes

Will substitutes are usually revocable and avoid the costs, delays and publicity associated with probate. They include:

- ◆ joint ownership with rights of survivorship;
- ◆ beneficiary designations (for IRAs, annuities, life insurance policies, etc.);
- ◆ transfer on death accounts (for brokerage accounts); and
- ◆ payable on death accounts (for bank accounts).

It is important to understand that assets passing to a third party by a Will substitute are not governed by the decedent's Will.

The rules on joint ownership vary significantly from state to state. They also differ within a state, based on the type of asset being held in joint name; for example, real estate compared to a bank account. While holding property jointly may afford the right of survivorship and can avoid probate, it may produce income, gift and estate tax consequences for unmarried couples. Joint tenancies may also be difficult to sever if the personal relationship between the unmarried partners terminates.

While most state laws provide that estate planning provisions and beneficiary designations for a former spouse are automatically revoked upon divorce, in most states no such provisions exist for unmarried couples. Thus, it is important for unmarried couples to quickly amend their estate planning documents and beneficiary designations when they separate.

3. Revocable Living Trusts

A Revocable Living Trust has many advantages over a Will. While alive and legally competent, the grantor is the trustee and beneficiary of the trust; and retains the right to amend or revoke the trust and the right to add and remove trust property. If the grantor becomes incapacitated, a successor trustee can handle the grantor's financial affairs without a conservatorship proceeding in

probate court. Therefore, the grantor is afforded great privacy and efficiency in managing his or her affairs in the event of incapacity. Upon the grantor's death, the assets in the trust will pass either outright or in further trust to the named beneficiaries without going through probate.

4. Durable Powers of Attorney

A Durable Power of Attorney (DPOA), sometimes referred to as a General Power of Attorney, allows the named agent to handle the financial affairs of the principal. Thus, a conservatorship proceeding in probate court can be avoided. The DPOA may also include the power to make gifts to domestic partners. The DPOA provides that the power of attorney remains effective even though the principal subsequently becomes incapacitated. A DPOA can be drafted to become effective either immediately or upon the principal's incapacity - a so-called Springing Power of Attorney. In either case, DPOAs allow unmarried persons to name partners as their agents. In most states, an unrelated person is not given priority to act as an incapacitated person's guardian or conservator.

5. Living Wills and Health Care Powers of Attorney

A Living Will states a person's wishes regarding artificial life support if he or she is in a terminal or vegetative state. A Health Care Power of Attorney (HCPA) designates a patient advocate to make medical decisions on the patient's behalf if the patient is unable to do so. As most states do not put unrelated persons first in line for this role, unmarried couples should execute an HCPA so that a partner can have a say in health care matters.

6. Burial Directives

Depending on state law, in the absence of written burial instructions, the decedent's next of kin determines burial arrangements. Therefore, unmarried couples should document in writing the person or persons they want to carry out their burial desires. Moreover, to avoid potential conflicts between the decedent's partner and next of kin, provisions should be made in the Will requiring the personal representative to pay only for funeral expenses that are in accordance with the decedent's written instructions.

7. In Terrorem Clauses

When unmarried couples designate partners as beneficiaries in Wills or Revocable Living Trusts, it is possible that disapproving family members may contest the Will or Trust. Depending on state law, including an "In Terrorem" clause in the Will or Trust Agreement, any person contesting the Will or Trust might receive nothing. Such a clause is intended to discourage persons from challenging a Will or Trust in court since nothing material may be gained by the action.

Qualified Retirement Plans

Although not technically a state default law issue, unmarried couples usually do not fare as well as their married counterparts when it comes to qualified retirement plans. Many 401(k) plans and pension plans provide that, upon a participant's death, his or her retirement account is to be distributed in a lump sum. As such, the distribution is fully taxable (as ordinary income) in the year of the participant's death. However, when the participant's spouse is the named beneficiary, the spouse can roll over the distribution into an IRA. Thus, the income tax on the distribution can be deferred until the surviving spouse attains age 70½, at which time the spouse can "stretch" the distributions over 27.4 years.

Until recently, a non-spousal beneficiary would have been forced to take distributions of the entire qualified retirement plan within five years after the participant's death or, in some plans, immediately following the participant's death. Under the Pension Protection Act of 2006 (PPA), a non-spouse beneficiary of a qualified retirement plan can roll over, via a trustee-to-trustee transfer, the benefits into an "inherited" IRA. The inherited IRA must be titled in the participant's name for the benefit of the non-spousal beneficiary (e.g., "Mary Smith, Deceased IRA f/b/o Alice Jones"). The PPA also permits the post-mortem transfer of qualified retirement plans to inherited IRAs held by trusts for the benefit of non-spousal beneficiaries. Once the benefits are in the inherited IRA, the beneficiary may stretch the benefits over his or her life expectancy.

LEVEL TWO **Domestic Partnership Agreements**

As mentioned in the introduction, a few states have enacted laws allowing domestic partners to register as such. By doing so, unmarried couples in those states will have many of the rights and responsibilities afforded to married couples. However, in the vast majority of states, domestic partners are not recognized. Therefore, it may be beneficial for unmarried couples to define the terms of their relationship in a written Domestic Partnership Agreement (DPA). A DPA works much like a prenuptial agreement for couples planning to marry.

Basically, a DPA is a legally-enforceable contract between two unmarried persons that clarifies the rights and obligations of each person in the relationship. Following are some of the provisions typically found in a DPA:

- ◆ a statement of the relative rights in property acquired before the date of the DPA. For example, such property could belong to the person who earned or acquired it.
- ◆ how income earned by the partners will be divided.
- ◆ how living expenses will be shared.

- ◆ how inherited property will be divided, if at all.
- ◆ whether jointly-titled assets are to be created and, if so, how they are to be divided in case of separation.
- ◆ how assets will be divided in the event of separation, and whether post-separation support will be provided by one partner to the other.
- ◆ how assets will be distributed in the event of death.

Beyond addressing financial concerns, a DPA can help set forth other parameters in the relationship, thereby helping to clarify and strengthen the relationship. A DPA can also help to avoid potential disputes and misunderstandings by specifying a dispute resolution mechanism, such as arbitration. Because some states do not recognize the validity of DPAs, it is important to consult a local attorney.

LEVEL THREE **Providing for Domestic Partners**

Like married couples, unmarried couples may want to make transfers to their partners (either during lifetime or at death) in order to provide for their partner's health, education, maintenance and support. But, unlike married couples (who have an unlimited gift and estate tax exemption for transfers between spouses), transfers between unmarried couples are subject to gift and estate taxes. Fortunately, the Internal Revenue Code offers some tax breaks.

As a result of The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the "Act"), the amount that a person can exempt from federal estate taxes is \$5 million (\$10 million per couple). The exemption is indexed for inflation beginning in 2012. This exemption can be used to make lifetime gifts or testamentary transfers. For example, if a donor makes a \$4 million gift during lifetime, no gift tax will be paid. Instead, the donor will use his/her \$5 million gift/estate tax exemption to offset any gift taxes due, and will have \$1 million of exemption remaining to offset estate taxes at death. Amounts in excess of the exemption are taxed at 35%. For taxpayers who used their \$1 million lifetime gift tax exemption prior to the Act, 2011 and 2012 presents an additional opportunity to gift up to \$4 million (\$8 million for married couples) more without incurring gift tax (although no credit will be given to any previously taxable gifts made prior to 2011).

IMPORTANT NOTE: The \$5M gift and estate tax exemption and 35% rate are only applicable for 2011 and 2012. Without further Congressional action, on January 1, 2013, the \$5M gift and estate tax exemption decreases to \$1M, and the top tax rate increases to 55%!

The donee's basis in property received by gift is the same as the donor's basis (carryover basis). However, the

beneficiary's basis in most property acquired from a decedent is equal to the property's fair market value at the date of death (stepped-up basis). Thus, before making gifts, the donor must consider the impact of capital gain taxes upon the subsequent sale of the gifted property.

Federal estate tax law provides an unlimited marital deduction. Assets left to a surviving spouse through a Will, Trust, or Will substitute are estate and gift tax free (if the surviving spouse is a U.S. citizen). In other words, a married couple can defer the estate tax until the death of the surviving spouse. Because of the Defense of Marriage Act (DOMA), unmarried couples are not afforded this opportunity — even in those states that recognize same-sex marriages, civil unions and domestic partners. Therefore, unmarried couples whose assets exceed the estate tax exemption will incur federal estate taxes upon the first partner's death; and, possibly, state death taxes (depending on the state of domicile).

Following are some tax-saving techniques available to unmarried couples:

1. Annual Gift Tax Exclusion

This exclusion allows the donor to make tax-free gifts of up to \$13,000 per donee per year, with no limit on the number of donees or the donees' relationships to the donor. This exclusion is scheduled to increase in amount, as it is now indexed to the rate of inflation. Lifetime annual gifts under this exclusion do not reduce the donor's \$5 million lifetime gift tax exemption. Moreover, a gift tax return (Form 709) need not be filed for annual exclusion gifts.

In addition, unlimited direct payments of the donee's tuition or medical bills are not subject to gift tax, nor do they count towards the donor's \$5 million lifetime gift tax exemption or to the \$13,000 annual gift tax exclusion. However, the funds must be paid directly to a qualified educational institution or medical provider. Education costs do not include room and board, books or supplies. Medical costs do not include amounts reimbursed by insurance companies.

Unmarried partners may earn substantially different incomes or have accumulated different amounts of wealth. The gift tax annual exclusion and the exclusion for tuition and medical costs allow the wealthier partner to transfer assets to the less wealthy partner during his or her lifetime. This strategy will be particularly beneficial when the wealthier partner's estate is over the \$5 million estate tax exemption, the less wealthy partner's estate is below that amount, and they wish to benefit the same persons at the surviving partner's death.

2. Lifetime Gift Tax Exemption

In addition to the annual gift tax exclusion, a donor can

gift a cumulative total of up to \$5 million to anyone during his or her lifetime without any gift tax. This is the so-called "gift tax exemption." Gifts in excess of the \$13,000 annual gift tax exclusion reduce the gift tax exemption dollar for dollar.

Any gift tax exemption used decreases, dollar for dollar, the estate tax exemption available at the donor's death. However, the income and appreciation on the gifted property is removed from the donor's estate, thereby reducing the estate tax. Thus, an unmarried couple can use the wealthier partner's gift tax exemption to make gifts to the less wealthy partner so that the overall estate tax of both partners is reduced.

3. Gifts to Irrevocable Trusts

Unmarried couples are often reluctant to make outright gifts to partners because the donor loses control over the gifted property. By making gifts to an irrevocable trust, the wealthier partner (grantor) can provide the less wealthy partner (beneficiary) with trust income and/or principal as needed, but can also determine where the remaining trust property will pass upon the beneficiary's death or dissolution of the relationship. Moreover, if it's properly drafted, the assets remaining in the trust can pass, estate tax free, to the "remaindermen" named in the trust agreement upon the beneficiary's death.

To be effective for estate reduction purposes, the trust must be irrevocable and the grantor should not be a trustee or beneficiary of the trust. However, the grantor can, within limits, retain the right to remove and replace trustees and, as noted above, the trust can be designed so that the beneficiary-partner is replaced by another beneficiary already named in the trust if the relationship is terminated.

To qualify for the \$13,000 annual gift tax exclusion, irrevocable trusts usually contain a provision giving the trust's beneficiary a temporary right to withdraw gifts made to the trust, at least in part. This withdrawal right is often called a "Crummey" power, named after the Federal Court case that validated this technique.

4. Irrevocable Life Insurance Trusts

Unmarried couples are advised to purchase life insurance for the benefit of the surviving partner to help supplement the future income lost from the inability to do a spousal rollover, and the inability to receive pension survivor benefits. Life insurance can also be used to create an estate to provide financial security for the surviving partner, or to create the liquidity with which to pay estate taxes. Finally, life insurance can be used as a "hedge" to pay estate taxes if the grantor fails to survive the term of a grantor retained income trust or a qualified personal residence trust, discussed in Level Four.

While life insurance proceeds are generally income tax free to the beneficiary, they are still part of the insured's gross estate and are subject to estate taxes. Accordingly, if the insured has a taxable estate (after including the face amount of life insurance), it may be advisable to transfer his or her life insurance policies to an Irrevocable Life Insurance Trust (ILIT). If the life insurance policy is owned by and payable to an ILIT, the insurance proceeds will be both income and estate tax free. However, if an existing policy is transferred to an ILIT and the grantor-insured dies within three years of the transfer, the death proceeds are brought back into the grantor-insured's estate. This problem can be avoided if the ILIT is the initial owner and beneficiary of a new policy.

Gifts to an ILIT can be made with the grantor-insured's \$13,000 annual gift tax exclusion using "Crummey" powers, and/or with the grantor-insured's \$5 million gift tax exemption. As mentioned above in connection with gifts to irrevocable trusts, the grantor-insured should not be a trustee or beneficiary of the ILIT. Besides keeping the insurance proceeds out of the grantor-insured's estate, the ILIT allows the grantor-insured to set the parameters upon which his or her partner (as the beneficiary of the ILIT) will receive trust income and principal. The ILIT should also be drafted so that, if the beneficiary is no longer in a relationship with the grantor-insured, another person (already named in the ILIT) automatically becomes the new beneficiary.

Before transferring a policy to an ILIT, applicable state law must be examined to determine if the ILIT has an "insurable interest" in the grantor-insured. If not, the insurance company might not be required to pay the death benefit. It may be possible to avoid this problem by having the insured purchase the policy and subsequently assign it to the ILIT. Under most state laws, the insurable interest requirement applies only to the initial owner and not to a subsequent assignee. As mentioned above, however, if a policy is assigned to an ILIT and the insured dies within three years of the assignment, the death proceeds are still includable in the insured's gross estate. One possible technique to avoid the three-year rule would be for the insured to sell the policy to an ILIT that is designed as a grantor trust. (See the discussion of intentionally defective grantor trusts under Level Four.)

LEVEL FOUR **Reducing Estate Taxes**

For unmarried couples with very large estates, fully utilizing the \$13,000 annual gift tax exclusion and \$5 million gift tax exemption may not be enough to significantly reduce the overall estate tax. Gifts in excess of the \$5 million gift tax exemption are taxed at the same rates as estate transfers (35% in 2011 and 2012). Because of the uncertainty in the estate and gift tax laws,

many people are reluctant to make taxable gifts to reduce estate taxes. Therefore, effective estate planning for persons with large estates must involve strategies that help freeze or reduce the value of assets at minimal gift tax cost. Following are some strategies the wealthier partner can use to shift future appreciation to the less wealthy partner while minimizing taxable gifts:

1. Low Interest Rate Loans

One simple way to shift potential appreciation from the wealthier partner to the less wealthy partner, without incurring a gift tax, is to make an interest-only loan. The loan must bear interest at the Applicable Federal Rate (AFR) published monthly by the IRS. The less wealthy partner reinvests the loan proceeds, and the appreciation in excess of the AFR will pass to the borrower free of gift tax and will also be excluded from the lender's estate. For the last several years, the AFR has been at all-time lows, making this strategy particularly beneficial. The loan should be documented with a promissory note.

2. Family Limited Partnerships or FLLCs

A Family Limited Partnership (FLP) or Family Limited Liability Company (FLLC) might allow the wealthier partner to make gifts to the less wealthy partner on a "discounted" basis while retaining some measure of control over the gifted partnership/membership interests. For example, the wealthier partner could transfer property to an FLLC in exchange for a 1% voting membership interest and a 99% non-voting membership interest. The non-voting membership interests are then gifted to the less wealthy partner (either outright or in trust). The wealthier partner maintains control over the FLLC's assets through the voting membership interests by naming himself or herself as the manager of the FLLC. Moreover, the gift tax value of the non-voting membership interests may qualify for valuation discounts because they lack control and marketability.

Besides the tax reasons for creating an FLP or FLLC (i.e., discounting the value of the property for gift tax purposes and removing the income and appreciation on the gifted property from the donor's estate), there is also a variety of non-tax reasons for using an FLP or FLLC. As mentioned above, the donor can retain control over the management of the entity's property and the distribution of its profits. Assets in an FLP or FLLC are protected (to a degree) from creditors, and FLPs and FLLCs facilitate the making of gifts in much more efficient ways than direct gifts of property, particularly when real estate is involved.

The substantial benefits of using FLPs and FLLCs have subjected their use to increased scrutiny and challenge by the IRS. A recent line of case law has complicated the task of estate planners in advising clients on the use of FLPs

and FLLCs. Thus, the proper structuring, administering and defending of the FLP or FLLC must be placed in the hands of a knowledgeable attorney.

3. Private Annuities

When properly structured, a private annuity can provide income, gift and estate tax benefits. In its most basic form, the wealthier partner (the annuitant) sells assets to a trust (the obligor) for the benefit of the less wealthy partner in exchange for the obligor's unsecured promise to make scheduled payments (the annuity). Once in the trust, the assets must be managed to produce the annual annuity obligation. Upon the beneficiary's death, or if the relationship between the beneficiary and the annuitant terminates, another person already named in the trust agreement becomes the new beneficiary.

Private annuities are typically structured so that the value of the annuity retained equals the value of the property transferred (as determined under IRS actuarial tables). Thus, no taxable gift occurs when the private annuity is acquired. Moreover, when the annuitant dies, nothing is included in his or her estate for federal estate tax purposes (because the payments cease). A private annuity works particularly well as a wealth transfer technique where the annuitant is in poor health but has at least a 50% chance of surviving one year. However, if the annuitant outlives his or her life expectancy, the obligor could find himself/herself paying more than the assets are worth.

Previously, the IRS took the position that gain would be recognized gradually from a portion of each annuity payment, allowing favorable income tax deferral in private annuity transactions. In Revenue Ruling 69-74, the IRS ruled that, in the exchange of property with a family member for an annuity, gain is recognized ratably from the annual payments received over the period of years measured by the annuitant's life expectancy. The payor of the annuity would ultimately take a basis in the property equal to the annuity payments actually made. However, in 2006, the IRS issued proposed regulations altering the treatment of gain recognition in private annuity transactions. The proposed regulations provide that the entire amount of the gain in a private annuity transaction is recognized immediately at the time of the exchange. Prop. Reg. 1.1001-1(j)(1). Although the regulations have not yet been finalized, they are proposed to be effective for annuity transactions after October 18, 2006. Therefore, income tax deferral in private annuity transactions may no longer be available, making private annuities a somewhat less desirable planning vehicle for appreciated assets.

The obligor cannot deduct any part of the payments, but each payment is added to the obligor's basis in the assets purchased. Therefore, double taxation occurs: the obligor

is taxed on the trust's income and the annuitant is taxed on the payment. If the trust is designed as an Intentionally Defective Irrevocable Trust (IDGT), discussed below, this double taxation problem would be eliminated.

4. Grantor Retained Income Trusts

A Grantor Retained Income Trust (GRIT) is an estate planning tool that has been around for many years. However, the Revenue Reconciliation Act of 1990 effectively eliminated the GRIT as a wealth transfer technique among "family" members. But GRITs are still a viable tool for unmarried couples — one of the few areas of the tax laws where an unmarried couple has an advantage over a married couple.

A GRIT is an irrevocable trust whereby the grantor (the wealthier partner) transfers assets to a trust while retaining the right to receive all of the net income from the trust assets for a fixed term of years. The net income must be paid at least as frequently as annually. At the expiration of the fixed term of years, the remaining trust principal is either distributed to the remainder beneficiary (the less wealthy partner) or held in further trust for his or her benefit. However, if the grantor does not survive the fixed term, the assets in the GRIT are included in his or her estate, but any gift tax exemption used in establishing the GRIT is restored. Thus, the grantor is no worse off than if the GRIT had not been created. In many cases, it might be advisable for the grantor to create an Irrevocable Life Insurance Trust to own a policy on his or her life to provide the liquidity — both income and estate tax free — to pay the increased estate tax that will be owed if the grantor fails to survive the GRIT's term.

The gift tax value with a GRIT will be only the value of the remainder interest (i.e., the difference between the full value of the property transferred to the GRIT and the present value of the grantor's income interest). The plan is to select a term that will give the present value of the grantor's income interest a substantial value (using the IRS's monthly published discount rate), but that the grantor is likely to outlive.

A big advantage of a GRIT is that if the assets transferred to the GRIT generate income at a rate lower than the IRS's discount rate for the month of the transaction, the net effect is to undervalue the gift to the remainder beneficiary. In contrast, where the remainder beneficiary is a family member, the Internal Revenue Code requires the payout to be a fixed annuity, a so-called Grantor Retained Annuity Trust, or GRAT. For example, if a 65 year old grantor transfers property valued at \$1,000,000 into a GRIT with a 15-year term when the IRS discount rate is 3%, the gift tax value of that transfer would be only \$396,710. The grantor could use a portion of his or her \$5,000,000 gift tax exemption to offset that gift. If the

property in the GRIT grows 6% annually, at the end of the 15-year term, \$2,936,558 would pass to the grantor's partner. Assuming a 35% estate tax bracket, the estate tax savings would be \$699,947! **See Diagram on Page 9.**

The gift tax value can be further reduced if the assets transferred to the GRIT qualify for valuation discounts (such as an interest in a family limited partnership). It is possible, with a long enough term and a large enough valuation discount, that the gift tax value will be nominal. Appreciation of the asset's value during the fixed term thus escapes estate taxation. The GRIT should be drafted so that, if the grantor and the beneficiary are no longer in a relationship, another person already named in the GRIT automatically becomes the new beneficiary.

5. Installment Sale to an Intentionally Defective Grantor Trust

The installment sale to an Intentionally Defective Grantor Trust (IDGT) is an alternative to a GRIT. This type of trust is so named because the assets in the trust are removed from the grantor's gross estate but are still considered owned by the grantor for income tax purposes. After funding the IDGT with a small initial gift (typically 10% of the sales price), the grantor (the wealthier partner) sells assets at fair market value to the IDGT. Ideally, the assets sold are expected to appreciate in value, produce income, and qualify for valuation discounts (such as family partnership interests). Usually, the terms of the sale are zero down, interest payable annually at the lowest rate permitted by the IRS (the applicable federal rate), and a balloon payment at the end of the note term. **See Diagram on Page 9.**

The IDGT technique has two major advantages over a GRIT. First, there is no mortality risk with an IDGT. If the grantor dies during the note term, only the value of the note (as opposed to the value of the assets in the IDGT) is included in the grantor's estate. Second, an IDGT can be designed to avoid estate taxes at the beneficiary's death by including generation-skipping provisions in the trust agreement (see below).

Normally, the sale of an appreciated asset to a trust would trigger capital gain. That is not the case with a sale to an IDGT, because transactions between a grantor and his or her grantor trust are disregarded for income tax purposes. For the same reason, the interest payments are not reportable as income to the grantor. Instead, all of the income earned by the IDGT is taxed to the grantor. The grantor's payment of the IDGT's income taxes is essentially a tax-free gift to the beneficiaries (the less wealthy partner) of the trust.

A variation on the sale to a grantor trust is to use a Self-

Canceling Installment Note (SCIN) to evidence the purchase price owing by the IDGT. With a SCIN, upon the death of the grantor, the unpaid balance of the note is cancelled. And the unpaid purchase price is not included in the grantor's estate. Thus, a SCIN would be particularly useful as a wealth transfer technique when the grantor is in poor health. However, to avoid a gift tax upon the sale, the IDGT must pay a premium for the cancellation feature, either by paying a higher interest rate or a larger purchase price. Determining the amount of the premium, especially when the grantor is in poor health, is the primary drawback to this technique and requires the services of a qualified expert. Another variation on this technique is for the IDGT to purchase the assets in exchange for a private annuity discussed above.

The excess income and principal in the IDGT can be used for the beneficiary's health, maintenance, support and general welfare. Oftentimes, some or all of the excess income is used to purchase a life insurance policy on the grantor's life to provide the liquidity to pay estate taxes. All future appreciation of the IDGT's assets in excess of the interest paid to the grantor will pass to the beneficiary (either outright or in trust) free of estate or gift tax. The IDGT, like any other irrevocable trust, should be drafted so that, if the grantor and the beneficiary are no longer in a relationship, another person already named in the trust agreement automatically becomes the new beneficiary.

6. Qualified Personal Residence Trusts

Similar to a GRIT, a Qualified Personal Residence Trust (QPRT) is an irrevocable trust funded with the grantor's personal residence. The grantor (the wealthier partner) can transfer a principal residence or vacation home to a QPRT while retaining the right to continue to use the residence for a fixed term of years. At the termination of the QPRT term, the residence can be distributed to the beneficiary (the less wealthy partner) or remain in further trust for his/her benefit.

The initial transfer to the QPRT is a gift. However, since the grantor retains the right to occupy the residence until the end of the fixed term, the value of the gift is reduced by the present value of the grantor's retained interest (based on the IRS's monthly published discount rate). Similar to a GRIT, the term should be set long enough so that the present value of the grantor's retained interest is substantial but not beyond the grantor's likely life expectancy. For example, if a 65-year-old grantor transfers a \$2,000,000 residence to a QPRT with a term of 15 years when the IRS discount rate was 3%, the gift tax value of that transfer would be only \$793,420. The grantor could use a portion of his or her \$5,000,000 gift tax exemption to offset that gift. If the residence appreciates 5% annually, at the end of the QPRT term, the residence will be valued at \$4,157,553. Assuming a 35% estate tax

bracket, the estate tax savings would be \$1,177,553. Moreover, by transferring only a portion of the residence to the QPRT (i.e., 98%), the gift tax value of that portion may qualify for fractional interest discounts, thereby further reducing the gift tax value of the transfer. **See Diagram on page 9.**

Provided the grantor survives the fixed term, the residence and all future appreciation thereon will be excluded from the grantor's estate. If the grantor dies during the QPRT term, the residence is brought back into the estate for estate tax purposes. However, any gift tax exemption used in establishing the QPRT is restored. Thus, the grantor is no worse off than if the QPRT had not been created. In many cases, it may be advisable for the grantor to create an Irrevocable Life Insurance Trust to own a policy on his or her life to provide the liquidity — both income and estate tax free — to pay the increased estate tax that will be owed if the grantor fails to survive the QPRT's term.

Typically, the terms of the QPRT will permit the grantor to lease the residence at fair market value from the trust at the end of the term, thereby further reducing the grantor's estate by the rent payments. Moreover, if the QPRT is designed as a "grantor" trust after the initial term, such rent payments will not be taxable to the beneficiary of the QPRT and would be the equivalent of making tax-free gifts to the beneficiary. The QPRT should also be drafted so that, if the grantor and the beneficiary are no longer in a relationship, another person already named in the QPRT automatically becomes the new beneficiary of the QPRT.

Treasury Regulations prohibit the grantor from repurchasing the residence prior to the end of the QPRT term when the beneficiaries of the QPRT are "family" members. If permitted, there would be no gain on the sale because the QPRT is a grantor trust. The advantage of purchasing the residence prior to the end of the term is that, by having the residence in the grantor's estate at the time of the grantor's death, the residence would obtain a "step-up" in basis equal to its date of death value. Thus, a subsequent sale of the residence would result in less capital gains taxes. Fortunately for unmarried couples, the prohibition on the grantor purchasing the residence from the QPRT does not apply when the beneficiaries of the QPRT are unrelated. Thus, the grantor can purchase the residence prior to the end of the QPRT term, thereby leaving the beneficiary cash instead of a residence, while obtaining a stepped-up basis for the residence at the time of the grantor's death.

7. Generation-Skipping Trusts

The basic gift and estate tax is designed to tax assets when they pass from one generation to the next, such as

parent to child. The generation-skipping tax (GST) is designed to tax transfers to persons two or more generations below the grantor's generation, such as the grantor's grandchild. But the GST can also apply in non-family situations if the beneficiary of the gift or estate is 37½ years younger than the grantor. Beneficiaries who are two or more generations below that of the grantor's generation, or who are 37½ years younger than the grantor, are referred to as "skip" persons.

Currently, there is a GST exemption equal to the estate tax exemption, which is \$5 million in 2011-2012. On generation-skipping transfers in excess of the GST exemption, a generation-skipping transfer tax is imposed at the then highest estate tax rate. The generation-skipping tax is in addition to any applicable gift or estate tax. Thus, careful planning is necessary to avoid the GST on large transfers.

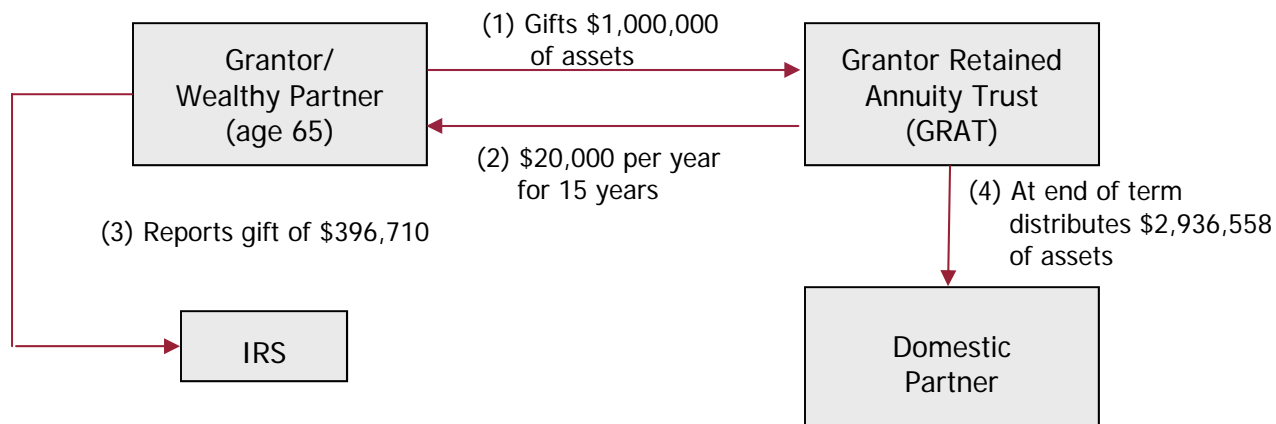
For unmarried couples, a generation-skip could occur when assets are placed in trust (either during lifetime or at death) for the lifetime benefit of the grantor's partner (or until the relationship is terminated). Such an arrangement is typical so that the grantor, as opposed to the beneficiary, controls where the trust assets pass upon the beneficiary's death. If the assets in the trust pass to a skip person upon the death of the beneficiary or upon termination of the beneficiary's interest in the trust because the beneficiary's relationship with the grantor has terminated, a generation-skip will have occurred. Note that, if the unmarried couple is more than 37½ years apart in age, the younger partner would be considered a skip person for GST purposes.

An Irrevocable Life Insurance Trust (ILIT) is a superior vehicle for GST planning. By allocating the grantor's GST exemption to all gifts (of premiums) made to the ILIT, the assets in the ILIT (the life insurance policy or policies on the grantor's life) will be entirely exempt from the GST. Therefore, upon the grantor's death, 100% of the death proceeds will be exempt from the generation-skipping tax, providing great leverage for the GST exemption.

8. Charitable Remainder Trusts and Charitable Lead Trusts

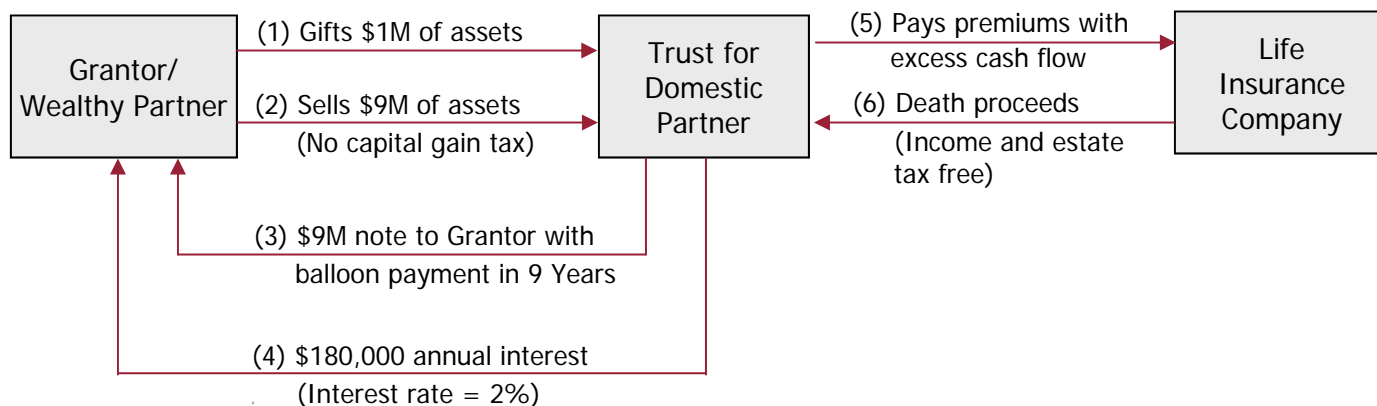
Level Five discusses and offers examples of the ways Charitable Remainder Trusts (CRTs) and Charitable Lead Annuity Trusts (CLATs) created at death can provide an estate tax deduction. If created during lifetime by the wealthier partner for the benefit of the less wealthy partner, CRTs and CLATs can also create gift tax deductions in the manner discussed in Level Five. As such, the less wealthy spouse can benefit from the wealthier spouse's generosity at a reduced gift tax cost, while at the same time benefiting charity.

Grantor Retained Income Trust

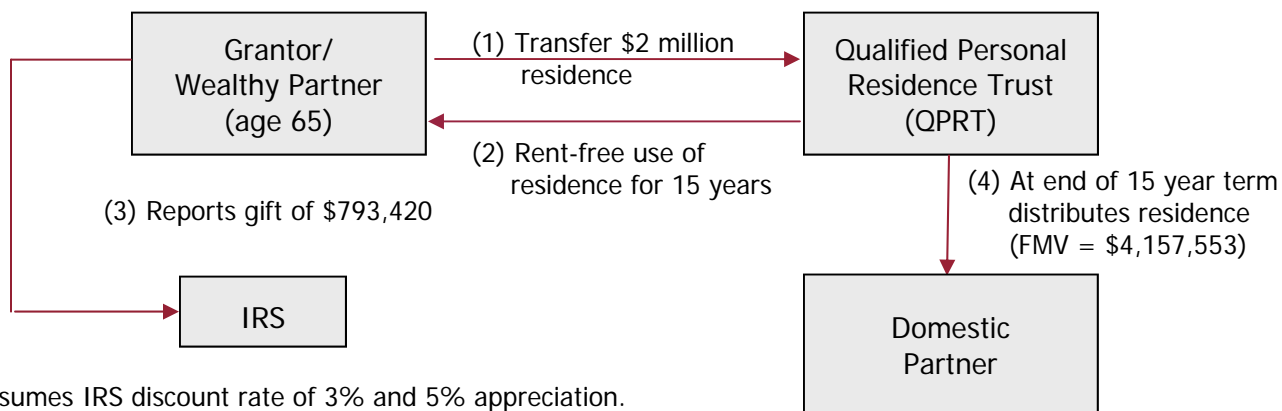


Assumes IRS discount rate of 3%; and 2% income and 6% growth.

Installment Sale to IDGT



Qualified Personal Residence Trust



Assumes IRS discount rate of 3% and 5% appreciation.

LEVEL FIVE

Zero Estate Tax Planning

For married couples with taxable estates, use of a Marital-Family Trust at the first spouse's death can minimize or eliminate federal estate taxes in the estates of both spouses. The estate tax exemption amount is placed in a Family Trust at the first spouse's death. The balance of the trust property is placed in a Marital Trust. The surviving spouse is the beneficiary of both the Marital and Family Trusts. No taxes are due at the first death, because the \$5 million exemption applies to the Family Trust, and the unlimited marital deduction applies to the Marital Trust. Upon the surviving spouse's death, the assets in the Family Trust pass estate tax free to the grantor's heirs under the terms established in the Family Trust. The assets in the Marital Trust are taxable, but only to the extent they exceed the surviving spouse's estate tax exemption. Thus, a married couple can leave \$10 million to their heirs federal estate tax free (in 2011 and 2012).

Prior to the Tax Relief Act of 2010, a married couple had to use Marital-Family Trusts to utilize both spouse's estate tax exemptions. However, for married persons who both die in 2011 or 2012, the executor of the estate of the predeceased spouse can "transfer" any unused estate tax exemption to the surviving spouse (on a timely-filed estate tax return - Form 706). To prevent "serial marriages", only the most recently deceased spouse's unused exemption may be transferred to the surviving spouse. This new law is referred to as a "portability" provision.

Even though unmarried couples do not benefit from the unlimited marital deduction or from portability, certain charitable planning techniques can somewhat replicate the estate tax consequences of a Marital-Family Trust. There are three marital deduction substitutes that an unmarried couple can utilize.

1. Bequest to Charity

Under this technique, the amount in excess of the decedent's estate tax exemption is left to charity or, perhaps, to a private foundation. The portion passing to charity is not subject to estate taxes because of the unlimited estate tax charitable deduction. Retirement benefits should be allocated to the charitable portion since the charity will not have to pay any income taxes on these benefits. The amount passing to the surviving domestic partner is not taxed because of the decedent's estate tax exemption. Thus, the estate tax has been reduced to zero.

The portion passing to the surviving domestic partner can pass either outright or in trust for the health, education, maintenance and support of the surviving partner. If held in trust, upon the surviving partner's death, the assets

remaining in trust can pass, estate tax free, to the "remaindermen."

By using a private foundation as the charity, the surviving partner (as the director of the foundation) can have absolute control over the foundation's investment policy and of the staffing and selection of charities to benefit, including those charities fostering the rights of unmarried couples. The surviving partner is even entitled to a reasonable salary for these services on behalf of the foundation. Since a private foundation is required to distribute only 5% of its value annually and is subject to an annual excise tax of only 2% on net investment income, it is likely that the value of the foundation will grow after its initial funding. Finally, if properly designed, the surviving partner will be able to select his or her successors to serve on the foundation's board of directors. Thus, a philanthropic training ground can be created for the unmarried couple's families and friends.

2. Testamentary Charitable Remainder Trust

The obvious problem with the technique described in the preceding section is, other than the salary that may be taken from the private foundation, the surviving partner cannot benefit from the amounts passing to charity. If this is a deterrent, then consider a Testamentary Charitable Remainder Uni-Trust (TCRUT) as the charity to receive the amount in excess of the decedent's estate tax exemption. As mentioned above, any retirement benefits should be allocated to the TCRUT to avoid the income taxes on those benefits.

While there are many types of charitable remainder trusts, in the context being referred to here, the TCRUT would be designed so that a fixed percentage (not less than 5%) of the net fair market value of the TCRUT's assets (valued annually) is paid to the surviving partner for a term not exceeding 20 years or for the partner's life. At the end of the term, the property remaining in the TCRUT passes to the named charity.

The decedent's estate tax exemption is the present value of the charity's remainder interest, which must be at least 10% of the fair market value of the TCRUT's initial value. Thus, depending on the age of the surviving partner (or the term of years if a term is being used), the IRS's assumed interest rate, and the set payout percentage, it may be possible to substantially reduce the amount subject to estate taxes while still permitting the surviving partner to receive payments from the TCRUT. For example, if \$1 million were held into a TCRUT for a 70-year-old beneficiary and the payout percentage was 5% for the beneficiary's lifetime, and the IRS's assumed discount rate was 3%, the estate tax deduction would be over 52%. The amount not deductible (approximately

\$480,000) could be offset by a portion of the decedent's estate tax exemption. Moreover, if the TCRUT's principal were to grow by 6% per year, at the death of the beneficiary, there would be \$1,513,875 remaining in the TCRUT to pass to charity.

3. Testamentary Charitable Lead Annuity Trust

A Testamentary Charitable Lead Annuity Trust (TCLAT) can be used in lieu of a TCRUT as the charity to receive the taxable portion of the decedent's estate. A TCLAT, essentially the reverse of a TCRUT, pays an annuity for a set number of years to a charity designated as the income beneficiary. The charity may be the decedent's private foundation. At the end of the term, the remaining trust property reverts, either outright or in further trust, to the surviving partner (or other family members).

The TCLAT provides an estate tax deduction based on the present value of the charity's income interest, which is determined by the payout percentage, the length of the term, and the IRS's published discount rate for the current month. The estate tax is payable based solely on the present value of the heirs' remainder interest. By increasing the term of the trust and payout percentage, it may be possible to reduce the value of the remainder interest to zero, particularly if the property allocated to the TCLAT is eligible to receive valuation discounts, such as family partnership interests. Thus, no estate taxes would be due. For example, assuming the IRS discount rate is 3%, if \$1 million were contributed to a 20-year TCLAT and the charity were to receive 5% in income annually, the estate tax deduction would be 74.39%. The taxable portion could be offset by a portion of the decedent's estate tax exemption. Moreover, if the TCLAT's principal were to grow by 6% per year, in 20 years there would be \$1,367,856 remaining in the TCLAT to pass to the "remaindermen."

CONCLUSION

A TCLAT would be of special appeal to an unmarried couple if the funds protected by the first decedent's estate tax exemption were sufficient to maintain the surviving partner's accustomed standard of living. In that case, the delayed bequest of the TCLAT would not pose a problem for the surviving partner or for other family members.

The laws affecting unmarried couples are changing

rapidly. Certainly more changes are likely, even challenges in the federal courts to the Defense of Marriage Act. The different rules concerning property rights from state to state add complexity to the situation, particularly for same-sex couples who move from a state recognizing civil unions or same-sex marriages to a state that does not. For unmarried couples it is important to have some form of estate planning to prevent state default laws from disinheriting their partners. Finally, because unmarried couples with large estates do not have the benefit of the unlimited marital deduction and other advantages that married persons enjoy, they need to aggressively seek out alternative solutions to maximize assets, reduce estate taxes and make use of powerful techniques not available to married couples.

About the Author

Julius H. Giarmarco, Esq. is a partner and heads up the firm's Trusts and Estates Practice Group. Julius received his law degree (J.D.) from Wayne State University, and his master of laws (LL.M.) from New York University. His primary practice areas include estate planning, business succession planning, wealth transfer planning, and life insurance applications. Julius is a former instructor in both the Chartered Life Underwriter (CLU) and Certified Financial Planner (CFP) programs. He also lectures frequently on a national basis, including speeches before the American Law Institute - American Bar Association (ALI-ABA), the International Forum, the Association for Advanced Life Underwriting (AALU), Million Dollar Round Table (MDRT), the Financial Planning Association, and numerous life insurance companies, brokerage firms and trade associations. Julius has published a number of articles on estate planning appearing in professional journals such as the Estates, Gifts and Trusts Journal (BNA), The Practical Tax Lawyer (ALI-ABA), the Journal of Practical Estate Planning (CCH), the Michigan Bar Journal, and Advisor Today magazine. Julius is also the author of the nationally acclaimed brochure, *The Five Levels of Estate Planning*, and is a featured columnist on estate planning topics for producersweb.com. He is the author of the chapters on succession planning in *Advising Closely Held Businesses in Michigan* and *The Michigan Business Formbook* published by the Institute of Continuing Legal Education (ICLE). Julius has also been selected by his peers as a Michigan "Super Lawyer" in estate planning; as one of the "Best Lawyers in America" in Trusts and Estates; and as a "Top Lawyer" by *dbusiness* magazine.

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