TRUSTS, ESTATES, LLCS: HOW BEST TO PROTECT YOUR REAL ESTATE ASSETS
2 CREDIT HOURS

The Pros and Cons of Trusts

- Living Trusts **(10 MINUTES)**
  - A living trust is a legal device—created by a trust document known as a trust agreement—that acts as a holding bin for property and other assets.
  - Typically, the trust takes title to a grantor's property and gives control to a trustee.
  - In many living trusts, the grantor names himself the trustee and the trust agreement also specifies what happens to the assets upon the grantor's death.
  - When property is transferred to heirs using a will, the will is generally subject to probate:
    - Probate is a proceeding in which a judge declares a will to be valid and appoints the individual responsible for handling the administration of the estate.
    - By law, however, certain property, like life insurance with a named beneficiary, is not subject to probate. An asset in a trust is that kind of property.
    - If all of a person's assets are in a living trust, they pass to beneficiaries without being subject to probate.
    - While that might sound good at first, two issues should be considered:
      - First, the individual creating the trust must be diligent in transferring title to all assets to the trust, including those currently owned in his or her name as well as those obtained in the future. Any assets not specifically owned by the trust, could be subject to probate, undermining the reason for creating it in the first place.
      - In the vast majority of cases, probate isn't nearly as expensive, complicated or time-consuming as most people think.
  - Since a living trust is revocable—it can be dissolved at any time by the grantor—its assets receive no special treatment for tax purposes, either while the grantor is alive or after death.
- Irrevocable Trusts **(10 MINUTES)**
  - Irrevocable Trusts are designed to allow a person's estate to continue to be useful long after they pass away.
  - Like all trusts, three parties are involved:
    - The Settlor (person funding the trust)
    - The Trustee (person managing the trust)
    - The beneficiaries (people who will receive the trust property)
  - When you create an irrevocable trust you actually transfer ownership of property from yourself to your trustee(s). The trustee(s) then holds legal title to the property, the beneficiaries hold equitable title, and you, the Settlor, no longer have any title to the property.
    - This is a significant step, especially where the trust is irrevocable. <u>Irrevocable means that once you create the trust, you can't undo the trust and get the property back without the consent of the trustee and the beneficiaries.</u>
- Creating the Trust **(5 MINUTES)**
  - Funding the Property
    - You can place cash, annuities, CDs, stock, real estate or other valuable assets into your trust. You must apply for a tax ID number from the IRS so you can attach these assets to that number. Once you place assets in the trust, they no longer belong to you. They are now under the control of the trustee.

- Disadvantages **(5 MINUTES)**
    - The settlors must realize that they lose direct control over any assets they place into the trust and the annual costs of an independent trustee can be quite high. Many grantors appoint family members to be trustees to cut down on the costs of maintaining the trust.
- Why use a Trust? Why not just give the money away? **(45 MINUTES)**
    - If someone is trying to protect assets and still qualify for long-term care benefits from the government, their strategy could be to gift away their assets to children or other family members. After the transfer, they apply for their veteran's benefits, or in the case of Medicaid, wait five years before applying for benefits.
        - This strategy poses a number of dangerous risks. The person who receives the assets could die, become estranged, get divorced, invest badly, spend the money, or even lose the money to creditors.
    - Consider that a long-term care crisis could bring about the need for assisted living. If the assets have been lost or spent, there may be no way to pay for care.
    - An Irrevocable Trust could have many advantages over an outright gift, including continued control over the assets
        - The Settlor who creates and funds an irrevocable trust can establish the rules and determines the uses of the trust assets. The settlor can name the trustees and beneficiaries and retain the right to change beneficiaries through a power of appointment in the grantor's will.
        - The Settlor can even choose to employ a Trust protector. You can design a trust to have a third party "trust protector" which is a position usually filled by a close relative overseeing the trustee. The protector has the power to change a trustee, remove a beneficiary, eliminate or reduce distributions, or even change the terms of the trust itself.
    - Retained Income
        - The settlor can decide to retain the income produced by the trust, even if there is no access to the trust principal. Receiving income tends to make the grantors feel like the assets still belong to them. This may ease their concerns about funding an irrevocable trust and losing the direct control of their assets.
    - Tax Advantages
        - An irrevocable trust offers many tax advantages over a direct gift, especially on the subject of capital gains taxes. If the trust is structured as a grantor-type trust, all appreciated assets transferred into the trust, such as real estate or a stock portfolio, can still receive a step-up in basis upon the death of the grantor. If these same assets were gifted directly to the beneficiaries, they would retain the same basis as the donor had, and in most cases owe a great deal more in capital gains taxes.
            - This style of trust also provides a tax advantage for a grantor's principal home. The trust retains the grantor's capital gains tax exclusion under 26 U.S.C. § 121, which would not be available if the residence was gifted directly to the beneficiaries during the lifetime of the owner.
        - Settlors can even set up their trusts so all of the trust income is tax deferred until the trustee distributes the income to beneficiaries. This can provide some incredible tax advantages to the grantor's family.
    - Creative Options

        - Consider that you could designate your spouse as a "discretionary" beneficiary. The trust could be drafted that a distribution could be made to your spouse when needed.
        - Another option would be for each partner to create a trust for the other. Each trust just has to have enough differences so that they aren't considered reciprocal.
    - Protection from Beneficiary Mistakes
        - Using a trust avoids the risk that a beneficiary could die and that the funds are inherited by the beneficiary's heirs. It also protects the assets if the beneficiary loses money in a divorce.
    - Consider Your Options
        - Whether to create an irrevocable trust in any particular family situation requires a careful assessment of the settlor's objectives, assets, income, health and care needs, family dynamics, and other considerations. For those families that are not rich but wish to leave money to children or charities and still control how that money is used, these valuable trusts can offer a low-cost way for the settlor to indirectly control their assets long after they pass on.
    - Avoiding Taxation Where Possible
        - Surviving Spouse Penalty, ELIMINATED if:
            - The sale occurs no later than two years after the date of death of such spouse, and
            - Immediately before the date of death, either spouse met the 2 out of 5 year ownership requirement, both spouses met the 2 out of 5 year use requirement, and neither spouse was ineligible to claim the exclusion because of another sale or exchange within the prior two years that qualified for the exclusion
            - Thus, for ownership and use, only one spouse must have owned the property for periods aggregating two years or more during the five-year period immediately before the date of death.
            - However, both spouses must have met the use requirement by using the property as a principal residence for periods aggregating two years or more during the five-year period immediately before the date of death.
        - Pre-1977 Joint Tenancies Between Husband & Wife
            - Portion of the property passes to the surviving spouse by operation of law, it is sheltered from estate tax by the unlimited marital deduction.
            - The surviving spouse gets a corresponding step up in basis for the one-half of the property which was included in the deceased spouse's estate.
            - If you are dealing with a pre-1977 spousal joint tenancy, do not sever the joint interest without considering the consequences of receiving only a one-half, rather than a full, step-up in basis when one spouse dies.
            - Joint tenancies between a husband and wife created prior to January 1, 1977 enjoy special treatment for estate tax purposes. The value of the property is included in the estate of the first spouse to die based on the proportionate share of the purchase price furnished by the decedent.
            - If the decedent furnished all the consideration for the property, then the full value of the property will be included in the deceased spouse's estate. The income tax benefit to the surviving spouse is a full step up in basis.

- HOW TO AVOID TAXATION IF GAIN ON SALE OF PROPERTY SUBSTANITIALLY EXCEEDS $250,000 / $500,000
  - Convert to rental property and hold for a sufficient period to qualify for 1031 exchange treatment.
- EXTENSION OF § 121 BENEFIT TO HEIR OR ESTATE
  - The $250,000 exclusion will be available to the heir or estate of such decedent or to a qualified revocable trust left by such decedent.
  - Two-year residency period of decedent applies to heir.
  - A qualified revocable trust may be treated as having been owned by the decedent by virtue of the power to revoke.

Transfer of Wealth Taxes

- Estate Taxes **(10 MINUTES)**
  - The Estate Tax is a tax on your right to transfer property at your death. It consists of an accounting of everything you own or have certain interests in at the date of death.
  - The fair market value of these items is used, not necessarily what you paid for them or what their values were when you acquired them. The total of all of these items is your "Gross Estate." The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets.
  - Once you have accounted for the Gross Estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at your "Taxable Estate."
    - These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities.
    - Value of some business operating interests or farms may be reduced for estate that qualify.
  - After the net amount is computed, the value of lifetime taxable gifts (beginning with gifts made in 1977) is added to this number and the tax is computed. The tax is then reduced by the available unified credit.
  - Most relatively simple estates (cash, publicly traded securities, small amounts of other easily valued assets, and no special deductions or elections, or jointly held property) do not require the filing of an estate tax return.
  - A filing is required for estates with combined gross assets and prior taxable gifts exceeding:
    - $5,120,000 in 2012, $5,250,000 in 2013
    - $5,340,000 in 2014, $5,430,000 in 2015, and
    - $,450,000 in 2016.
  - Beginning January 1, 2011, estates of decedents survived by a spouse may elect to pass any of the decedent's unused exemption to the surviving spouse. This election is made on a timely filed estate tax return for the decedent with a surviving spouse. Note that simplified valuation provisions apply for those estates without a filing requirement absent the portability election.
- Gift Taxes **(10 MINUTES)**
  - The gift tax is a tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not. The gift tax applies to the transfer by gift of any property.
  - Tax rate equals estate tax rate.

    - Every donor has aggregate lifetime exemption of$5,340,000 (“2014 gift tax applicable exclusion amount”).
    - What can be excluded from gifts:
        - The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts.
        - Gifts that are not more than the annual exclusion for the calendar year.
        - Tuition or medical expenses you pay for someone (the educational and medical exclusions).
        - Gifts to your spouse.
        - Gifts to a political organization for its use.
        - In addition to this, gifts to qualifying charities are deductible from the value of the gift(s) made.
- Generation Skipping Tax **(10 MINUTES)**
    - Tax imposed (in addition to estate and gift tax) on transfers to grandchildren and other persons who are treated by statute as the functional equivalent of grandchildren (“skip persons”) (37.5 years older)
    - Generation skipping tax equals estate tax rate.
    - For example, property is placed in a trust for the donor's child and grandchildren. The income may be distributed among the child and grandchildren in accordance with their needs and the principal of the trust will be distributed outright to the grandchildren following the child's death.
    - If the trust property is not subject to estate tax at the child's death, a generation-skipping tax will be imposed when the child dies.
    - In 2010, like the Federal Estate Tax, the generation-skipping transfer tax was repealed. In some ways, it could be viewed that the exemption is essentially unlimited in 2010 for transfers that would otherwise be subject to the tax. However, the law that created the increases and ultimate repeal of the GST Tax Exemption expired on December 31, 2010. Now, the exemption is 5.43 million dollars.
    - For generation-skipping trusts created in the years of 2011 and 2012 and for outright gifts to skip-persons, taxpayers are entitled to a $5 million GST tax exemption.
- New York State Specific Estate Taxes and Details **(5 MINUTES)**
    - NYS Estate Tax Exemption is $1,000,000
    - Tax Rates:
        - New York estate tax rates range from 5.6% for estates just over $1,000,000 to 16% for estates over $10,000,000.
        - For an estate valued at $2,000,000 the New York estate tax is approximately $100,000.00.
- Estate Planning **(10 MINUTES)**
    - Goal: Make maximum use of the ability to make gifts that do not require payment of gift tax.
    - Making Most of Non-Taxable Transfers
        - Low tech estate planning techniques that permit wealth transfer without triggering gift tax
        - Lifetime gift tax exclusion
            - Every taxpayer can give an aggregate of$5,340,000 of taxable lifetime gifts without paying gift tax
        - Annual exclusion gifts

            - §2503(b) allows $14,000 to be transferred each year to an unlimited number of persons free of gift tax (gift tax annual exclusion)
            - Annual exclusion gifts do not use any of donor's lifetime gift tax exclusion amount
            - Annual exclusion gifts are also exempt from the GST without using any of the donor's GST exemption amount
        - GST annual exclusion gifts
            - Gifts in trust must meet special criteria to be GST exempt
    - Transfer Property with Potential Appreciation
        - Transferring property (such as real estate) with appreciation potential reduces transfer taxes because the appreciation on the gifted property escapes transfer taxation.
    - Transfer property that can be valued with substantial discounts
        - Gifts of discounted assets produce transfer tax savings because the value of the discount escapes transfer taxation
    - QPRT (Qualified Personal Residence Trust) for primary residence and vacation home
        - Transferring a residence to a qualified personal residence trust (QPRT) is a popular estate planning technique that can help reduce the size of the grantor's estate. If structured properly, the QPRT will freeze the value of the taxpayer's residence at the time he or she creates the trust and result in significant estate tax savings.
        - A QPRT is an irrevocable trust created pursuant to Section 2702(a)(3) to hold a personal residence.
        - The federal interest rate under IRC section 7520 is one of the main factors that drive the favorable tax outcome of valuing the gift of a residence.
        - The higher the federal rate, the lower the gift value and the lower the potential gift tax. Conversely, a low federal interest rate usually translates into lower estate tax savings.
        - A QPRT is a grantor trust for income tax purposes. As a result, during the trust term the grantor can claim an income tax deduction for any real estate taxes he or she pays.
    - GRAT (Grantor Retained Annuity Trust) for income producing asset (not necessarily real estate)
        - An irrevocable trust that lasts for a fixed term of years and pays the person who created it (the "Grantor") an annuity that is fixed or increases up to 20% per year.
        - Offers opportunity to make transfer with reduced or no gift tax
        - Should be funded with assets that either (i) generate substantial income or (ii) are expected to appreciate substantially in value