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# Estate Planning

## Spousal Access Trusts — Reciprocal Trust Doctrine

Spousal Access Trusts are irrevocable trusts in which an individual makes lifetime gifts for the benefit of the spouse and typically other family beneficiaries. The assets are removed from the grantor's estate, yet because the spouse is one of the beneficiaries, the grantor can still indirectly benefit from the trust.

Many individuals are using the increased gifting exemption of \$5 million in 2011-2012 as an opportunity to transfer substantial assets. While the primary issue with a single spousal access trust is the selection of trustees and the distribution standard to ensure that the property will not be included in either spouse's estate, when two trusts are created an additional concern is the "Reciprocal Trust Doctrine."

### Trustee: Selection and Distribution Standard

One option to avoid the assets being included in either spouse's estate is to appoint an independent trustee with a discretionary distribution standard. However, many times, it is desirable that the beneficiary-spouse be a trustee, in which case the distributions must be limited to an ascertainable standard. Additionally, it is critical that the trust assets cannot be used to discharge the grantor's support obligation. Attorneys will typically either include a savings clause that prevents the trustee from making a distribution that would discharge the grantor's support obligation, or a clause that requires the trustee to look at the beneficiary's other resources, including the grantor's support obligations, before making a distribution.

### Reciprocal Trust Doctrine

The Reciprocal Trust Doctrine addresses circumstances where parties create two trusts benefitting the same persons, but in the end, each party is in essentially the same situation as if the trusts had not been created. The seminal case is *Estate of Grace*,<sup>1</sup> a U.S. Supreme Court case. The trusts created by Mr. and Mrs. Grace named each other as beneficiaries, contained substantially identical terms, and were created 15 days apart. The court "uncrossed" the trusts and concluded that Mr. Grace's estate should include the value of the trust established by Mrs. Grace in which he was a beneficiary, as if he had established and funded the trust himself. The *Grace* case held that the reciprocal trust doctrine should apply when (1) the trusts are "interrelated" and, (2) the arrangement leaves the two grantors in "approximately the same economic position" as if each had created a trust and named himself or herself as the beneficiary.

1 United States v. Estate of Grace, 395 U.S. 316 (1969).

2 Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977).

3 Exchange Bank & Trust Company of Florida, 694 F.2d 1261 (Fed.Cir. 1982).

4 Estate of Levy, T.C. Memo 1983-453; PLR 200426008; PLR 96403013.

### Working Around the Reciprocal Trust Doctrine

Since *Grace*, no cases have been reported that deal directly with spouses creating trusts for each other, but subsequent cases have interpreted the reciprocal trust doctrine in other situations. Additionally, several Private Letter Rulings (PLRs) have been issued that deal with spousal trusts. PLRs are binding only to the parties involved and cannot be used as precedent, but they can offer valuable insight into what the IRS is willing to accept.

The Tax Court found that trusts were reciprocal when both the husband and wife created trusts for their grandchildren, and appointed each other as trustee with the discretionary right to make distributions.<sup>2</sup> The court said that each spouse had the power to alter distributions and had not given up control. In another case, husband and wife had established two UGMA accounts and named each other as custodians.<sup>3</sup> When the husband died, he was serving as custodian of the trust the wife had created and the court included those assets in his estate.

In reviewing cases and PLRs<sup>4</sup> which have found trusts not to be reciprocal, no "bright lines" have been set as to what differences are sufficient to escape the "uncrossing" of the trusts. However, following is a list of some of differences in the trusts that the courts and the IRS examined.

- Husband was a beneficiary only if Husband's net worth is less than \$xx and only after Wife has been deceased for two years.
- Wife was a beneficiary only if son predeceased her.
- Wife had a \$5,000/5% withdrawal right.
- Wife had a special power to appoint trust assets.
- An independent "distribution trustee" was appointed (each grantor was also trustee of the other's trust).
- One trust benefited the children; whereas, the other benefited the children and the spouse, plus spouse had a special power of appointment.

The options are limitless, but other variances one could consider incorporating in trusts could include:

- Funding the trusts with separate, different assets.
- Varying the duration of the trusts.



# Life Insurance Planning

## Annual Gift Exclusion Allowed for Direct Premium Payment

Irrevocable Life Insurance Trusts are frequently used in family estate planning, and often the trusts are drafted to allow the premium payments to qualify for the annual gift tax exclusion. The U.S. Tax Court recently issued a tax-payer friendly decision in *Estate of Turner*.<sup>1</sup> The Court found that premium payments made by the grantor directly to the life insurance company for trust-owned policies are gifts of present interests for the trust beneficiaries and therefore qualify for the annual exclusion. This article will review *Crummey* withdrawal rights and describe some best practices to use.

### Annual Gift Tax Exclusion

IRC § 2503(b) currently allows an individual to exclude from gift tax each year the first \$13,000 of gifts made to any person “other than gifts of future interests.” In order to qualify a gift to a trust as a present interest gift, the beneficiaries are given a right to withdraw their portion of the gifts. The fact that a beneficiary has the right to demand and receive the property – even for a limited period of time – can allow the gift to qualify. The *Crummey v. Commissioner*<sup>2</sup> case first allowed the use of these withdrawal powers. The IRS acquiesced in the *Crummey* decision in Revenue Ruling 73-405; since then, numerous rulings have been published that focus on the requirements for a valid *Crummey* power.

### Turner Case

While the *Turner* court’s decision is welcome news to many ILIT trustees, two caveats are important to consider: (1) The court carefully looked at the trust language, and (2) the IRS continues to skeptically view certain *Crummey* rights. The court reviewed the *Turner* trust agreement, and found the following language gave the beneficiaries the legal right to receive the contributions.

- Each direct and indirect transfer to the trust was to be treated as a gift.
- The beneficiaries had the “absolute right and power to withdraw” each transfer to the trust up to the gift tax exclusion within 30 days of the transfer.
- The trustee was required to satisfy any withdrawal request made by a beneficiary.
- The trustee could satisfy the withdrawal right by distributing cash, other trust property, or borrowing against any life insurance cash value against any life insurance cash value.

The *Turner* court liberally construed the withdrawal rights in allowing the gifts to qualify for the annual gift exclusion. However, each case is strongly dependent on the facts, and in the *Turner* case the court held against the family on the family limited partnership issue and included millions of property value in the estate. Additionally, the IRS tends to be more restrictive than the Tax Court in the use of the “present interest” exclusion for trusts; therefore, prudence would dictate carefully drafting and managing *Crummey* withdrawal powers.

### *Crummey* “Best Practices”

- Beneficiary must have the **immediate right to receive** something of value at the time of the gift.
- **Property must exist** in the trust that can be used to fulfill the withdrawal right.
- Provision should be included to allow someone, other than a grantor/parent, to act on behalf of a **minor**.
- Trustee should provide **notice** in accordance with the trust agreement.<sup>3</sup> Written notice is recommended, but not required. Despite the fact that in *Turner* no notice was given, some type of notice would be prudent.
- Beneficiary must have a **reasonable time to exercise** the withdrawal power. Three days has been held too short; 30 days is often used.
- **A waiver of notice should not be executed.** A waiver is considered a release which would lead to unintended gift tax results. The beneficiaries could sign a receipt acknowledgement if desired.

1 Estate of Turner v. Comm’r, T.C. Memo 2011-209, (U.S. Tax Court) August 30, 2011.

2 Crummey v. Comm’r, 397 F.2d 82 (9th Cir. 1968), *aff’d* in part and *rev’d* in part T.C. Memo 1966-144.

3 Rev. Rul. 81-7 is often cited as requiring notice; however, no notice was merely one of the factors in that ruling where the IRS held that “the donor’s

# Executive Benefits

## Executive Bonus Arrangements

A perpetual challenge to any business is how to attract and motivate valuable key employees and executives. Traditionally, some type of qualified retirement plan (and possibly a non-qualified deferred compensation plan for the executives) has been used. However, in light of current economic conditions and recent changes in the laws, these traditional forms of executive retention may not be the optimum choice. Another consideration for rewarding valuable personnel is the “executive bonus arrangement” also referred to as a “Section 162 plan.”

### Issues with Qualified Plans and Deferred Comp Plans

For many closely-held businesses, qualified plans are simply too expensive because they must be made available to all employees. Additionally, because of the discrimination testing, oftentimes executives and other key employees must refund a portion of the executive’s deferrals, resulting in the inability to fully utilize the plan.

Before 2005, deferred compensation plans were widely used by businesses because the employer could select certain key employees to benefit and meaningful amounts could be provided at retirement or another designated event. However, since the enactment of IRC § 409A, the law now requires that the agreement is in writing, distributions are limited to certain events, deferrals are limited, and an annual report is filed with the IRS. The penalties for non-compliance are quite severe. Consequently, the cost of establishing and maintaining such a plan has increased and has become untenable for many businesses.

With both types of plans, 100% of the distributions are subject to income tax when received. Historically, it was presumed income taxes would be lower at retirement; however, particularly for higher net worth taxpayers, that may well no longer be the case.

### Executive Bonus Arrangement

An executive bonus arrangement is an insurance funded non-qualified benefit that offers immediate and long-term benefits to the employee. The employer awards a compensation bonus to the employee and uses the funds to purchase a permanent life insurance policy owned by the employee on the employee’s life. The employer selects both the persons who will receive the benefit, and the amounts to be received by each participant. No reporting to the IRS is required.

The premium paid is deductible to the company, provided the total compensation paid to that employee is reasonable. Because the employee must take the bonus amount into income, some businesses choose to “gross up” the amount to the employee to provide an amount necessary to pay the income taxes.

The employee has all ownership rights to the policy, including the right to name beneficiaries and access cash in the policy through withdrawals and policy loans.<sup>1</sup> The premiums paid and any cash bonuses appear on the employee’s W-2 in the year received. At death, the proceeds are received income-tax free.

If the company’s objective is to create some type of “handcuff” to entice the employee to remain, a restricted access bonus plan could be considered. At the time the policy is issued, an endorsement is attached to the policy. Typically the endorsement prevents the key employee-policy owner from accessing benefits of the policy such as taking loans, assigning the policy, or removing cash value prior to retirement or other stated event without the consent of the employer.

| Benefit to Business                | Benefit to Employee                              |
|------------------------------------|--|
| Simple                             | Immediate income-tax free death benefit          |
| Can select participants            | Possess all ownership benefits                   |
| Premium is deductible <sup>2</sup> | Can access cash value or take loans <sup>1</sup> |
| Can determine amount paid          | Can retain policy after departure                |
| Not subject to business creditors  | Creditor protected (state specific)              |

### In Summary

An executive bonus arrangement is a simple way to attract, motivate, retain, and reward key employees for their valuable contributions.

1 Loans accrued interest at the current policy rate. Loans and withdrawals will decrease the cash surrender value and death benefit. If the policy is surrendered or lapses for nonpayment of premium, any gains in the policy are subject to income tax. If a policy loan is outstanding when the policy is surrendered or lapses, the amount of the loan and any accrued interest is included in the total proceeds for calculating gain.  
2 To be deductible, total annual compensation must be reasonable.



# Asset Protection

## Domestic Asset Protection Trust Available in

Individuals and businesses are continuing to face heightened liability risks. According to a survey of corporate legal departments in the United States and the United Kingdom, 93% of the U.S. respondents expect legal disputes to continue the upward trend which began in 2008.<sup>1</sup> The primary reasons cited in the study are the lagging economy and the increase in regulatory investigations. State and federal laws provide some asset protection for certain assets, including retirement plans, life insurance and annuities, and homesteads. However, a higher degree of protection may often be necessary. Asset protection strategies can range from simple to very complex; therefore, it is important to determine exactly what level of risk one faces, the property one wants to protect, the available legal tools, and the most appropriate strategy.

**What is a DAPT?** A relative newcomer to the asset protection toolbox is the Domestic Asset Protection Trust (DAPT). A DAPT is an irrevocable trust in which the grantor is a permissible beneficiary. Normally, when a trust is “self-settled,” the grantor’s creditors are able to access trust assets. Only since 1997 has it been possible for a person to create a domestic trust and receive benefits from the trust without the property being available to creditors. Alaska was the first state to adopt a law permitting a U.S. domiciled self-settled trust. Twelve (12) other states have enacted laws that allow a grantor to be a beneficiary of a discretionary trust he or she creates, and to varying degrees, the assets are protected from creditors: CO, DE, HI, MO, NV, NH, OK, RI, SD, TN, UT, and WY. Each state’s law varies broadly; however, the primary differences are: (1) the limitation period – the time within which a creditor can make a claim; (2) exempt creditors such as divorcing spouses; and (3) what constitutes a fraudulent conveyance.

**Benefits.** Transferred assets should be protected from future creditors after the limitations period, which varies from 2 to 4 years. Distributions to the grantor and other beneficiaries can be made by an independent trustee. Additionally, if estate tax exclusion is desired, some states’ statutes allow the grantor to make a completed gift to a trust. The transfer would be subject to gift tax, but the grantor could use his or her available gift tax exclusions. Thereafter, the assets would be creditor protected *and* excluded from the grantor’s taxable estate.<sup>3</sup> (Currently estate exclusion may apply only to grantors that are in-state residents.)



### General Requirements

- The trust must contain a spendthrift provision, preventing the beneficiary from transferring his or her interest to other parties.
- The transfer of assets to the trust cannot defraud any existing creditor.
- The grantor must confirm his or her solvency before and after creation of the trust.
- Typically, some of the trust assets must be located in the governing state.
- Typically, at least one trustee should reside in the state.
- The distribution trustee should be an independent party, i.e. one not related to the grantor.
- Distributions to the grantor can only be made at the trustee’s discretion.
- No express or implied arrangement can exist between the grantor and trustee regarding distributions.

To achieve the intended DAPT benefits, it may also be prudent to: establish and document a reasonable estate planning or business purpose for making the asset transfer to the DAPT, such as investment purposes, estate planning purposes, or personal and/or family planning purposes; name additional beneficiaries, such as the spouse and children; and maintain sufficient assets outside the DAPT for all living expenses.

**Potential Issues.** Because DAPTs are relatively new, many of the possible issues have yet to be litigated. With a non-resident, could a creditor succeed in applying the law of the grantor’s residence? Could the transfer be proven to be a fraudulent conveyance? Could a pattern of distributions to the grantor show an implied agreement between the grantor and trustee?

**In Summary.** Asset protection is about protecting assets before the need arises. It is important to work with qualified and experienced counsel to determine the proper strategy for

<sup>1</sup> Fulbright’s 7<sup>th</sup> Annual Litigation Trends Survey Report, Fulbright & Jaworski L.L.P., October 2010.

<sup>2</sup> Oklahoma permits revocable asset protection trusts. Okla. Stat. Title 31, Sec. 13.

<sup>3</sup> Private Letter Ruling 200944002, September 30, 2009, which is binding only to the parties involved, found that an Alaskan DAPT created by an Alaskan resident was a completed gift and would not be included in the grantor’s estate at death.

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