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# PRACTICAL PLANNER

## WHICH ASSETS TO WHICH TRUST

### Which Assets Go To Which Trusts Under Your Will:

Executors (or trustees of your revocable living trust) have to make decisions as to which assets of your estate should be transferred to which trusts ("funding"). The planning opportunities, traps and complications are far greater than most executors, trustees and heirs realize. Let's take a look at just some of the questions that can come up in a typical estate of a married couple, on the death of the first spouse. There are likely to be at least two trusts (often many more) to which your will provides for distributions:

1. A By Pass trust (also called "credit shelter trust") which can be funded with up to \$2 million in assets to protect the \$2 million current federal exclusion (the amount you can bequeath federal estate tax free). This amount is supposed to increase in future years. The assets in the By Pass trust will be available to the surviving spouse, but not taxed in his or her estate. In many instances a lower amount may be transferred to the By Pass trust (if the will or post-mortem planning permits) to avoid state estate taxes (many states don't follow the federal law and have lower exclusions).

2. A marital bequest which can be outright to the surviving spouse, with no trust; to a marital trust such as **Qualified Terminable Interest Property Trust** ("QTIP"); or a **Qualified Domestic Trust** ("QDOT") if the surviving spouse is a non-citizen. There are other options but the key is that this bequest qualifies for a marital deduction to avoid estate tax on this portion of the estate on the death of the first spouse. Let's assume that the entire amount is to be held in a QTIP – marital trust (trusts provide far more planning flexibility and protection than an outright bequest to the surviving spouse).

Which Document Controls: If your will specifies that a particular asset should be distributed to a designated trust, then that decision probably controls. For example, if you have a family business you want to retain in the family line, you may bequeath it to a QTIP-Business trust with specially selected trustees, principal invasion rights, and eventual distribution to your named heirs. The rest of your assets may then be divided between a By Pass trust and regular QTIP trust (i.e. a QTIP trust intended to hold all assets other than the business). Other docu-

ments may be relevant. For example, if you own stock in a close corporation, the shareholders' agreement may govern where your stock must be distributed.

Who Allocates Assets Between the Trusts: When there is a choice, the decision as to which assets should be transferred to which trust should be a team approach to address the many income tax, estate tax, legal, business and other issues that can be affected. The team could include, depending on the asset and issues: accountant, probate attorney, corpo-

rate counsel, pension consultant, investment adviser, and others. Don't expect your probate attorney to be as sharp on income tax issues as your accountant, and don't expect your accountant to identify the optimal mix of securities with the same skill as your wealth manager.

Factors to Consider: There are a myriad of issues that can be relevant to making the decision as to which assets are best to transfer to which trust under your will. The following is only a partial listing:

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## CHECKLIST: QPRT

A **Qualified Personal Residence Trust** ("QPRT") is an estate planning technique used to leverage a gift of your principal residence or vacation home out of your estate at a significant discount. The technique, when successful (which requires your outliving the term of the trust) can save substantial estate taxes. However, to succeed, you must have all your **QPRT** ducks in a row. Not a simple task considering that many different professionals are involved. Unless you've expressly confirmed that one professional is honcho'ing the plan, make sure you have all the following documents and steps addressed. Too often taxpayers try to address many of

these steps to control professional fees and the steps are ignored or only partially completed, undermining the objectives:

✓Trust Agreement: Be sure you have a signed original of the QPRT agreement. The agreement should be dated (too often trustees fail to fill in the date in the blank provided). Signatures should be witnessed and/or notarized as required in the document. The house to be transferred to the trust should be indicated in the trust or an attached schedule. In many plans there may be two QPRT agreements as 1/2 of the house is

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## ...WHICH ASSETS TO WHICH TRUST

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o How is the funding of the trust structured in the will. For example, if the By Pass trust is funded under a **pecuniary formula**, and assets have appreciated between the date of death and the funding, an income tax cost may be incurred on funding.

o Who are the current beneficiaries of the different trusts? For example, in some plans the surviving spouse is the only current beneficiary of both By Pass and QTIP trusts. In other plans, the surviving spouse, children and others may all be beneficiaries of the By Pass trust. So, for example, if the children are beneficiaries of the By Pass trust, and certain assets should be made available to them or for their benefit, those assets should be used to fund the By Pass trust. Another example, if the family home is in the estate, it might be best to fund it to the QTIP

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trust to assure that only the surviving spouse has access to it if other persons, especially children from a prior marriage, are named beneficiaries of the By Pass trust.

o Who are the **remainder beneficiaries** of each trust? If different people are intended to receive assets on the death of the second spouse, than those assets should be distributed into the trust which will be appropriate for them.

o Which assets are most likely to appreciate? Since appreciation in assets in a By Pass trust will be outside of the surviving spouse's estate the assets with the greatest appreciation potential could be funded to the By Pass trust. For marketable securities an investment advisor should be consulted about this decision. The solution may even be to acquire new investments for each trust, in lieu of some of the current investments held in the estate. Since the estate obtains a step up in basis on your death, the executor may just choose to liquidate most marketable assets and have the investment adviser create optimal portfolios in each trust after funding them with cash.

o Who are the trustees of each trust? If different trustees are named there may be an advantage to transferring assets to the trusts so that the trustees best suited to manage those assets have those assets in their trust. In light of recent court cases the likelihood of a trust benefiting from a deduction of investment management fees is looking bleak. If the trustees of one trust have the skills to directly manage investment assets transferring marketable securities to that trust may have a better result than transferring securities to a trust which will have to hire outside money managers whose fees won't be deductible.

o State income taxes may be an issue.

If, for example, your estate owns real estate or business assets that will generate income taxable in a particular state, it might be possible to segregate all of those assets in one trust, and manage the second trust in a manner that avoids state taxation. For example, real estate in State A

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may be put solely into the By Pass trust which will remain taxable in high tax State A. Only securities may be transferred to the QTIP trust. The trustees of the QTIP trust that reside in State A may resign so that there are no longer any connections of the QTIP trust to high tax State A. The savings over time can be significant.

o Discounts on ownership interests in businesses (real estate, family business, investment LLC, etc.) could be an important factor. If your estate owns 60% of a family business, transferring 20% to the By Pass trust and 40% to the QTIP trust will assure that on the death of your surviving spouse each of those interests will have a greater likelihood of qualifying for a **discount for lack of control**, **lack of marketability**, etc. If instead the entire 60% is transferred to only the QTIP trust, there may be a control premium actually increasing taxes on the second death.

There could be a myriad of other factors to consider. When additional trusts are introduced as the complexity of your plan grows, the options also grow. So the best answer is involve all your professional advisers and make the decision carefully. **PP**

## ...CHECKLIST: QUALIFIED PERSONAL RESIDENCE TRUST

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often transferred to a QPRT for the husband, and ½ to a QPRT for the wife. If there are any question contact your estate planning attorney.

✓**Tax Identification Number:** A copy of the IRS documentation assigning the number should be saved. If you cannot find the information, call your accountant.

✓**Deed:** You should have an original deed that reflects the stamp of the local recording office (e.g. the County Clerk) and the book and page number where recorded. The deed should be consistent with the manner in which the QPRT trust agreement was structured. So, if you and your spouse owned the house jointly (which is common) but each transferred ½ the house to your respective QPRT, then you should have a deed from the two of you as husband and wife to the two of you as tenants in common (so that you each own a divisible half interest to transfer). After the date that deed is recorded you should have an original recorded separate deed from each of you to your respective QPRT. The date on the deeds to the QPRT and their recording should be after the dates on the deed changing the title to tenants in common. The deeds transferring the house into the QPRT should ideally be dated the same date as the QPRT. If you're missing any of these items contact your real estate attorney or estate planner (depending on who prepared the deeds).

✓**Appraisal:** An appraisal confirming the value of the house when given to the trust, and any discounts if less than 100% was given, is essential. If you cannot find a copy contact the appraiser used to obtain one.

✓**Gift Tax Return:** A gift tax return should have been filed reporting the gift of the house to the trust. If you have a complete copy of the filed return, it may have many of the other documents and information at-

tached (deed, appraisal, basis calculation, etc.). If a gift tax return was not filed, or if you're not sure, call your accountant or estate planner (whoever prepared the return).

✓**Income Tax Return:** Some accountants file a Form 1041 trust income tax return with an attached statement indicating that the QPRT is a "grantor trust" and that all deductions (there should be no income unless it was converted to a QAT on the sale of the house) are reported on your personal return. If an income tax return was not filed, or if you're not sure, call your accountant.

✓**Insurance:** Your property and casualty insurance, and title insurance, should have been updated to reflect the QPRT as owner, and it should also list the trustees as in-

sured. If you're not certain, call your insurance agent.

✓**Mortgage:** If there is, or was, a mortgage or home equity line, a copy of the mortgage or line, and the documents and steps taken to address it in the context of the QPRT should be saved. Payment of principal on your home mortgage would constitute additional gifts to the QPRT each time you made a payment. Different estate planners address this issue in different ways (the simplest being having you pay off any mortgages before the transfer to the QPRT). The documents confirming how you implemented this plan should be saved. If you're not clear and had a mortgage, contact your accountant and estate planner. **PP**

## RECENT DEVELOPMENTS

**S Corporation Basis:** If you're an S corporation shareholder you should plan to be able to utilize tax losses that pass through from the corporation to your personal return. To deduct losses you must have "basis" (investment) in the S corporation to support the loss. If the S corporation borrows money, it won't increase your basis (but in a partnership or LLC it could). So borrowing has to be carefully planned. In a recent case the taxpayer was entitled to increase his basis for a \$6 million bank loan he took to fund S corporation transactions. The IRS argued that because the loan repayments were sourced from the corporation, the corporation and not the shareholder was the borrower. That would have undermined the taxpayer's deductions. The court, however, held for the taxpayer finding that the loan was really between the bank and the shareholder, and not between the bank and the S corporation. The IRS argument was refuted because the shareholder was listed as sole borrower on the loan and letter of credit. Further, the lender intended to treat the shareholder as the borrower. The taxpayer lost the arguments on other loan transactions. *Thomas Gleason, et ux. v. Commissioner*, (2006) TC Memo 2006-191. The moral is simple, have your tax adviser, not just corporate counsel, review all S corporation related borrowing and capital infusions in advance.

**Private Annuity:** Selling a business to your heirs in an exchange for a private annuity has been a popular estate and retirement planning technique. You could freeze the value of your business, sell it to an heir active in the business, have an annuity for the rest of your life, report income as you received the annuity rather than immediately, and more. The IRS proposed new regulations *Reg-141901-05 10/18/06* ruining the party by requiring you to recognize the gain immediately. These rules are only proposed, and they provide a slight window of opportunity. If you're contemplating such a sale, you'd better move quick. **PP**

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## PLANNING POTPOURRI

◦ **Banks and Powers of Attorney:** If you're an agent under someone's power, say your mom, don't be surprised if banks and brokerage firms give you a hard time trying to manage mom's assets. They may send the power to their legal department for "review" (read languish). Tips for before: While mom is well, see if the bank has their own standard form power of attorney. Mom might sign it. Take the power into the bank in advance and have it approved. In addition to a lawyer prepared form, have mom sign a standard form commonly used in your state. Tips for after: If the power is springing (only effective if mom is disabled) provide the bank with corroboration proving disability (otherwise your power to act is not triggered). Some state laws mandate that if certain statutory language is included in the power banks in that state must accept the power. If your pointing that out to the bank doesn't

solve the log jam, have your attorney do it. If you're in a branch, transfer to their private bank where the service and sophistication are greater. If all else fails, switch banks to one that is more cooperative. There is no shortage of great banks and trust companies that understand how to provide service. Have the new institution "pull" the assets in from the old institution, rather than fighting with the old institution to transfer assets.

◦ **Traveling While Ill/Disabled:** TSA may give you a tough time going through airport security with needles and other essential medical paraphernalia. Take along several sets of all physician letters, prescriptions, and other relevant documents. Have your estate planner scan these documents, along with your living will and health care proxy. In the event of an emergency they can be emailed to you. Copies can be printed in your hotel in an emergency or for your return trip.

◦ **Asset Allocation and REITs:** If your financial planner recommends real estate as part of your overall investment allocation model and suggests real estate investment trusts (REITs) as the vehicle, dig deeper. **REIT** is almost as generic a term as stocks. Shopping center REITs may perform vary differently than apartment REITs, etc. REITs can vary geographically. If you want to diversify, all these variables should be evaluated. Be wary of advisers who recommend index funds on the basis that stock pickers can't beat the market, then use private real estate deals for your real estate allocation. There is an inherent inconsistency in these positions. Ask why. **PP**



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