

PROFESSIONAL TAX & ESTATE PLANNING NOTES

March 2006

Estate Planning ¹ for Married Couples

This issue of *Professional Notes* highlights income tax and estate planning approaches that may be of special interest to married couples who have charitable interests. In a later issue, we will discuss charitable gift planning ideas that may be useful for single people, unmarried couples, and same-sex married couples.

Introduction

Tax planning by married couples typically begins with the assumption that each spouse wants to provide for the survivor. The current tax laws encourage this thinking by providing for the unlimited marital deduction, which allows an individual to transfer all of his or her

property—if appropriately structured—to a spouse either during the individual’s lifetime or by will, free of gift or estate tax. (Under the 1996 Defense of Marriage Act, commonly known as “DOMA,” Federal tax law recognizes the marital deduction only for lawfully married, opposite-sex couples. Accordingly, the terms “spouse” and “married couple” are used in this issue to refer to situations in which the marital deduction is available.) All too often, married couples plan jointly for each other, then leave the *charitable* tax planning to the surviving spouse. There are a number of planning ideas that couples should consider while *both* spouses are still living to better pro-

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By Jane L. Wilton, general counsel, The New York Community Trust, with thanks to Patterson Belknap Webb & Tyler’s Personal Planning Group for its assistance.

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vide for the survivor and to share the satisfaction of planning for charity.

Inter Vivos or Testamentary Charitable Remainder Trust (“CRT”)

An *inter vivos* CRT can be created to provide income payments to named individuals (here, the spouses) and then to the survivor for his or her life (known as a “right of survivorship”), with the remainder to be distributed to a charity, such as The New York Community Trust. A CRT generally takes one of two forms. A *charitable remainder annuity trust* provides for annual payments of an annuity, set as a fixed dollar amount or a percentage of the initial trust value. A *charitable remainder unitrust* (“CRUT”) provides for annual payments that are a percentage of the annual value of the fund. This unitrust amount will increase or decrease from one year to the next with the market value of the trust’s assets.

Although a two-life CRT generally does not afford a significant charitable deduction unless both income beneficiaries are quite elderly, it offers an excellent opportunity to convert holdings of highly appreciated, low-basis, low-dividend stock into higher-yielding securities without having to pay capital gains tax on the appreciation. A CRT may be especially appealing for couples with a large concentration in a single stock who are seeking a tax-efficient way to diversify their holdings. Not only does the grantor avoid tax on the gain realized when the trust sells the con-

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tributed assets, but as a general rule, CRTs are exempt from income tax. As a result, to the extent that the trust earns income (including capital gain) in excess of the amounts currently payable to the individual beneficiaries, a tax-free or tax-deferred accumulation of income occurs.

For donors who are not in need of current income, the CRT can also be structured with an income deferral feature. One income deferral technique is commonly referred to

as a Flip CRUT or the “combination of methods” CRUT. The Flip CRUT pays out the lesser of net accounting income or the unitrust amount during an initial period of years, and when a “triggering event” occurs—such as a date certain or an event of independent significance such as marriage, divorce, death, or birth—the trust “flips” and begins paying out the unitrust amount only. During the period prior to the “flip,” the trust can be invested for growth rather than for trust accounting income, which allows for tax-free compounding on the trust’s realized gain during this period. By the time the “flip” occurs, the assets in the CRT have had an opportunity to grow tax-free, and the unitrust amount could be larger than it would have been if the trust had been paying out the full unitrust amount all along. High-earning donors can view the Flip CRUT as a retirement planning vehicle with many of the same benefits of an IRA or 401(k) plan, but without the annual limitations on how much can be contributed.

The income deferral characteristics of the Flip CRUT also may be appealing to donors who wish to create a charitable remainder trust using an asset that produces little or no income and may be difficult to liquidate, such as undeveloped real estate, a work of art, or interests in a closely held business. In cases involving illiquid assets, the “triggering event” can be the sale of the illiquid assets.

A CRT can be established with a contribution by either or both spouses. The unlimited marital deduction should eliminate concerns about gift or estate taxes, so long as the sole individual beneficiaries are a married couple.

Absent a pre-nuptial agreement to the contrary, state law in non-community property states typically gives each spouse a right of election over a portion of the property of the first spouse to die. In some cases, the right of election could extend to the assets of a CRT, even if the surviving spouse is a beneficiary of the CRT. Tax practitioners have long been concerned that the spousal right of election, even if it is not exercised, could cause a CRT to fail to qualify under IRC §664(d). In a Revenue Procedure issued in 2005, the IRS reached just this conclusion, and set out a safe harbor that, in effect, required spousal waivers of the right of election in most cases. CRTs created before June 28, 2005, were grandfathered. In early 2006, the IRS announced that it is reconsidering the approach taken in that ruling, and extended the grandfather date indefinitely, so long as the spouse does not exer-

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cise the right of election as to CRT assets. Nonetheless, it may be prudent to have a non-grantor spouse waive the right of election so that he or she cannot subsequently exercise the right of election, creating problems for carefully thought-out estate plans.

If a married couple does not want to commit assets to a CRT during their lifetimes for tax or other reasons, each spouse can provide for a testamentary CRT in his or her will.

The QTIP Trust vs. the Testamentary CRT

No marital deduction is allowed for an interest transferred to or for a spouse’s benefit if the interest terminates after a designated period of time or upon the occurrence or non-occurrence of an event, and the interest then passes to a person other than the spouse or his or her estate. For example, if Mr. Jones bequeaths a lifetime interest in their vacation home to his wife, which then passes to their children at the wife’s death, the gift to the wife does not qualify for the unlimited marital deduction; it is a “nondeductible terminable interest.” The nondeductible terminable interest rule is designed to prevent property that escapes taxation in the first spouse’s estate (because of the unlimited marital deduction) from also escaping taxation in the estate of the second spouse.

Two exceptions to the nondeductible terminable interest rule are the qualified terminable interest trust (“QTIP trust”) and the qualified CRT. As noted

above, with a CRT the payout is defined and limited, either as a fixed annuity or as a stated unitrust percentage.

The rules for establishing a qualified terminable interest subject to the marital deduction and making the QTIP election are detailed and require careful planning and drafting. A QTIP trust is one that holds property for the surviving spouse's lifetime with a right of invasion during the survivor's lifetime. Typically, a QTIP trust provides for the remainder to be distributed to children or trusts for their benefit. However, a QTIP trust may have a charitable remainder beneficiary. The trust will qualify in the first spouse's estate for the marital deduction and for a full charitable deduction in the surviving spouse's estate. The QTIP trust with a charitable remainder beneficiary has one advantage over a testamentary CRT for spouses who are concerned about providing adequate resources to their surviving mate. Under a QTIP trust, unlike the CRT, all of the trust income is payable to the spouse and, more importantly, the corpus may be invaded during the spouse's lifetime. Thus a QTIP trust with a charitable remainder beneficiary is an excellent alternative for the charitably minded testator who also has serious concerns about providing adequately for a spouse.

Qualified domestic trusts (known as "QDOTs") are trusts created to benefit a non-citizen spouse that also will qualify for the marital deduction, and are similar to QTIP trusts with a charitable remainder beneficiary. But unlike a QTIP trust, a QDOT must have at

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least one trustee who is a U.S. citizen or a domestic corporation, and even though the property forming the initial corpus of a QDOT escapes estate tax, any principal distributed to the surviving spouse from the QDOT is subject to estate tax. Therefore, a

QDOT typically distributes only its net income to the surviving spouse.

Gift of a Remainder Interest in a Residence

An individual is allowed an income tax charitable contribution deduction for a gift to charity of the remainder interest in a residence. (This includes vacation homes, primary residences, and remainder interests in farms.) The gift can be structured so that the spouses can live in the residence for their lifetimes, and the interest in the residence passes to the charity after the death of the surviving spouse. The value of the remainder is reduced by the actuarially determined value of the intervening life or lives, as well as a discount for depreciation during the lifetime use, calculated on a straight-line basis. The depreciation deduction only applies to improvements, fixtures, and the residence itself, not to the underlying land. Therefore, the more valuable the land relative to the house, the less the reduction in value attributable to depreciation. It is essential that the gift be structured as the remainder interest in the *residence*, and not a gift of the *proceeds* of the sale of the property following death of either spouse.

When spouses own property jointly and want to provide for both of them during their lifetimes, and then for the survivor, the deductible remainder value may

be quite modest. In those cases, donors may prefer to have identical provisions in their wills that provide for a gift of the remainder interest of the residence following the death of the surviving spouse. Gifts of remainder interests in personal residences include gifts of remainder interests in a condominium and the stock in a cooperative corporation.

Use of Disclaimers by the Surviving Spouse

As discussed more fully in our March 2004 issue of *Professional Notes*, the right of disclaimer pursuant to IRC §2518 can provide a useful technique for charitable tax planning. For example, a couple can plan each estate conservatively by establishing a testamentary CRT for the surviving spouse. If it turns out that the surviving spouse does not need the income from the CRT, he or she could disclaim the CRT interest within nine months after the death of the first spouse. In that event, the will should specify that the disclaimed property passes to charity, since the disclaiming spouse may not direct where the disclaimed property will go. (Alternatively, the surviving spouse could accept the CRT initially and decide later to relinquish all or some portion of it, thereby causing a full or partial acceleration of the CRT remainder and generating a charitable deduction for the surviving spouse. If it is anticipated that a surviving spouse might wish to relinquish all or some portion of the CRT, it is advisable that the will make provision for early termination of the CRT.) Similarly, within nine months after the death of the owner of a retirement plan, the surviving spouse or other designated successor beneficiary of the plan can disclaim his or her interest in favor of the designated contingent charitable beneficiary.

Conclusion

Married couples will want to balance providing for charity with providing for the surviving spouse, using any of these methods. The New York Community Trust, the charitable endowment for New York City, may be a remainder beneficiary of a CRT or a QTIP. The remainder may be used to create an unrestricted fund meeting future needs of our City, a field-of-interest fund to address the donor's charitable passions, or an advised fund that may involve children in the grantmaking.

For further reference, please see:

I.R.C. Section 664 and the Regulations thereunder:
Charitable Remainder Trusts.

I.R.C. Section 2512 and Regulations thereunder:
Gift Tax.

I.R.C. Section 2056 and the Regulations thereunder:
Bequests to Spouse.

I.R.C. Section 2056A: Qualified Domestic Trusts.

I.R.C. Section 170(f)(3)(B) and Treas. Reg. Sections 1.170A-7(b)(3) and 1.170A-7(c): Gift of Remainder Interest in a Personal Residence.

I.R.C. Section 2518 and the Regulations thereunder:
Disclaimers.

IRS Rev. Proc. 2005-24, 2005-16 I.R.B. 909.

IRS Notice 2006-15, 2006-8 I.R.B. 1.

N.Y. EPTL Section 5-1.1-A: Spousal Right of Election.

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- 2005 Legislative Proposals to Reform Charity: Chapter I
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Legislative Proposals to Reform Charity: Chapter III

About The Trust

Since 1924, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust, with assets of more than \$1.8 billion, is an aggregate of funds set up by individuals, families, and businesses to support charitable organizations.

A fund in The Trust can help your clients carry out their charitable objectives while qualifying for the maximum tax deduction. Funds can be set up during lifetime or by will and often are an essential part of financial and estate planning. In addition to gifts of cash and publicly traded securities, funds can be established with a wide variety of assets including closely held stock, limited partnerships, mutual funds shares, retirement plan assets, and copyrights.

Because of our administrative efficiency, we are able to offer our services for a very low fee—three-tenths of 1%, i.e., 30 basis points; investment fees are also low. Expert financial management of funds is not tied to any one company or investment vehicle; investments are matched to each donor's grantmaking plans.

Trust staff are always available to advise donors about grantmaking opportunities and ensure that their charity will be carried on beyond their lifetimes. Donors can recommend grants to qualified charities anywhere in the U.S., with assurance that each nonprofit is carefully scrutinized for its fiscal and programmatic soundness.

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