

# PROFESSIONAL TAX & ESTATE PLANNING NOTES

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## Estate Planning for Individuals and Non-Traditional Families

Estate planning for single people, unmarried couples (same sex or heterosexual), and other non-traditional families is frequently more complex than planning for married couples. In New York, if an unmarried person with no children dies without a will, his or her assets will go to his or her parents or, if they are no longer living, to siblings. Because this may not be what the person wants, it is critical that single people and domestic partners have wills.

Common estate planning tools are not available to unmarried people—the marital deduction being the most important example. This column will address some of the estate planning pitfalls and opportunities that exist because of the disparity in the treatment of married and unmarried couples. It also will consider some concerns of members of non-

traditional families in planning for the possibility of becoming incapacitated.

### Joint Ownership

It is not uncommon for family members to challenge the will of an unmarried relative, even when that relative has a long-term domestic partner. To avoid the possibility of contentious litigation, it may be desirable to minimize the assets that go through probate.

Joint ownership of assets with the right of survivorship—particularly for real estate—is one way to avoid probate. Jointly held property passes automatically to the survivor upon the death of the other owner.

While this technique may avoid probate, there may be gift and estate tax consequences to joint ownership. For example, if a person owns property outright and transfers a

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joint interest to his or her partner, child, niece, or nephew, the transfer may be a taxable gift. For this reason, it may be preferable to acquire property jointly by making equal contributions if feasible. If the joint owners make unequal contributions to buy or maintain property, there also may be gift tax consequences: the larger contribution may constitute a gift to the person making the smaller contribution. In fact, even if the contributions are equal, there may be a gift to the joint tenant with the longer life expectancy. It is advisable to document joint contributions for the acquisition and maintenance of jointly owned property.

Despite the fact that the creation of a joint tenancy may have constituted a taxable gift, the entire value of the property held in joint tenancy may still be included in the estate of the first partner to die. Code Section 2040(a)<sup>1</sup> provides that a decedent's gross estate includes the value "of all property to the extent of the interest therein held as joint tenants with right of survivorship by the decedent and any other person . . . except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than an adequate and full consideration in money or money's worth." When the surviving partner has contributed to the acquisition or maintenance of the property, the portion of the property attributable to that contribution will be excluded from the decedent's estate, provided the contribution was not made with money or property acquired by the surviving joint owner as a gift from the decedent. This is another case where the tax law treats married co-owners differently from unmarried co-owners. When the co-owners are married, the first spouse to die is considered to have owned one-half of the jointly owned property without tracing the relative contributions of each co-owner.

No taxable gift occurs when most types of joint bank accounts or security accounts are created, but there

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<sup>1</sup> All "Code Section" references are to the Internal Revenue Code of 1986, as amended.

may be a taxable gift when the non-contributing partner makes a withdrawal from the account. In addition, assets held in a "payable-on-death" bank account, or so-called Totten Trust, also pass directly to named beneficiaries outside of probate. Under a new New York law effective January 1, 2007, such payable-on-death accounts include individual securities (such as stocks and bonds) and securities accounts, as well as bank accounts. However, as with Totten Trust bank accounts, these assets will be included in the decedent's gross estate.

## Retirement Assets

Assets in an IRA or other retirement account will pass directly—outside the probate process—to a person named as a beneficiary. Rather than naming the estate as a beneficiary, an individual should consider naming the desired beneficiaries so these assets do not pass through the probate estate. Although these assets will avoid estate tax if passing to a spouse, as noted previously, that benefit is not available for non-spouse beneficiaries.

Under changes included in the Pension Protection Act of 2006, effective in 2007, the income tax benefit previously available to a surviving spouse who rolls the deceased spouse's IRA or other retirement plan into the surviving spouse's IRA has been extended to other individuals. As a result, a partner or child named as beneficiary may roll the deceased spouse's retirement assets into his or her own IRA, postponing income taxes until the amounts are distributed out of the beneficiary's IRA. Because estate tax will be payable on these assets, it may be desirable to provide for the payment of the estate tax out of other assets. Otherwise, income tax will be payable on the amount distributed from the IRA to pay estate tax.

## Life Insurance

Life insurance proceeds generally pass outside of probate and can circumvent potential challenges to a will. Life insurance may be advisable so that the surviving partner can pay off a mortgage or cover

living expenses, or it may be useful to replace assets otherwise needed to pay estate taxes. Generally, state law provides that only a person with a lawful and substantial economic interest in the continued life, health, or bodily safety of the insured has an insurable interest and may purchase an insurance policy. It is not entirely clear under New York law whether an individual has an insurable interest in his or her domestic partner. One way around this potential problem would be for the insured to buy the policy and name his or her domestic partner as beneficiary. The insurance policy proceeds will be paid to the named beneficiary outside the probate process, but if the policy is owned by the decedent and not the surviving partner, the insurance proceeds will be included in the decedent's gross estate.

In that case, it may be advisable to transfer ownership of the policy either directly to the intended beneficiary or to a trust for his or her benefit. The transfer of ownership will be a taxable gift to the extent that the value of the policy exceeds the annual gift exclusion of \$12,000 per donee and the lifetime gift tax exemption amount (currently \$1,000,000), as will the transfer of cash to pay premiums.

It may be preferable to transfer the life insurance policy to a trust, despite the costs of setting up and administering the trust, because it may keep the assets out of the survivor's estate. If an existing policy is transferred to a trust, the grantor must survive for three years to avoid the policy's inclusion in the grantor's gross estate. If the trustees purchase the policy, there is no three-year inclusion rule. A carefully drafted life insurance trust can avoid the risk that contributions to the trust to pay the premiums will not qualify for the annual gift exclusion. This may be accomplished through a so-called Crummey power, which gives the trust beneficiary an annual right to withdraw for a specified time period the lesser of the annual gift exclusion amount or the contribution to the trust. This power to make a withdrawal gives the beneficiary a present interest in the gifted property, so that each transfer of cash to the trustee to pay premiums will qualify for the annual exclusion.

## Wills and Trusts

### *Revocable Living Trusts and Wills*

Although a revocable living trust offers no income or estate tax advantage, assets placed in such a trust usually pass without going through probate, reducing the risk of challenge by relatives. The revocable living trust also should be considered by anyone concerned with keeping his assets or the identity of his beneficiaries out of the public eye. However, because the standard of capacity required to create a living trust is different and, arguably, slightly higher than the standard for executing a will, this may not be a viable planning tool for individuals who are seriously ill or incapacitated.

Even when other estate planning tools are in place—such as joint ownership or trusts—some assets inevitably will not have been included. The will directs to whom these assets pass. The will also should appoint the surviving domestic partner as guardian of any children that have not been legally adopted by the partner.

### *Irrevocable Trusts*

Irrevocable trusts may offer significant income or estate tax advantages but have one serious drawback: the assets irrevocably leave the control of the grantor. There are several types of irrevocable trusts, and each offers specific advantages to a person contemplating a gift to anyone other than a spouse.

A grantor retained annuity trust (“GRAT”) pays an annuity to the grantor for a fixed number of years. When the GRAT terminates, the remaining trust assets pass to the trust remainderman. If properly structured, a GRAT may be used to pass the future appreciation of assets in excess of the IRS rate under Code Section 7520 to a domestic partner or to children, nieces, or nephews with no gift tax.

The transfer of assets to a GRAT is a gift to the remainderman equal to the value of the property transferred to the GRAT less the present value of the grantor's retained interest. For example, if (i) the IRS rate is 6 percent when the trust is established, (ii) the actuarial value of the grantor's annuity is equal to the value of the property contributed plus the 6 percent

rate, and (iii) the trust actually appreciates in excess of the 6 percent rate, then all the appreciation in excess of the 6 percent rate passes to the remainderman gift- and estate-tax free. Short-term GRATs that pay a high annuity rate are often used to virtually eliminate the gift tax. Short-term GRATs also reduce the likelihood that the grantor will fail to outlive the term of the trust, in which event the trust would be included in the grantor's estate. Moreover, the grantor may roll over the annuity payments into a new short-term GRAT to further increase the assets ultimately paid to the remainderman.

The grantor retained interest trust ("GRIT") was a popular planning tool until the tax code was changed in 1996 to make it unavailable to family members. The GRIT remains available for unrelated individuals, including domestic partners, one of the few tax advantages for unmarried couples. The grantor of a GRIT retains an interest in all income of the trust for a term of years, and the remainder is paid to the remainder beneficiary. Like the GRAT, an advantage of the GRIT is that the value of the taxable gift is reduced by the value of the grantor's retained interest, determined using the IRS appreciation rate. Appreciation in excess of the presumed growth rate will pass to the remainderman free of gift tax, and will not be included in the grantor's estate unless the grantor does not survive the trust term. Although a GRIT pays all income to the grantor, the trust assets can be invested to minimize income and maximize appreciation, increasing the value of the assets passing to the remainderman. Alternatively, a GRIT can be used for both current income and as a technique for passing on assets. In this case, the GRIT would produce income to be used by the partners during the trust term, and the remainder would be paid over to the remainderman, usually the younger and less wealthy partner.

A GRIT also may be funded with the grantor's personal residence. Instead of receiving income, the grantor retains the right to use the residence during the term of the trust. The grantor may purchase the residence from the trust just prior to the expiration of

the trust term so that cash or other liquid assets pass to the domestic partner in place of the residence. This technique is no longer available to spouses but can be used by domestic partners to pass appreciated liquid assets free of gift and estate taxes. Moreover, because this sale is a transaction between the grantor and a grantor trust, no gain or loss is recognized by either the grantor or the trust. Alternatively, if the grantor holds the home at his or her death, under current rules the basis will step up to fair market value in the estate.

A grantor retained unitrust ("GRUT") also may be used, but because it pays the grantor a percentage of the trust's fair market value at least annually, appreciation in the trust's value will not pass in its entirety to the remainderman and will not escape gift and estate taxes in the same way as in a GRAT or GRIT.

Because GRATs, GRITs, and GRUTs are grantor trusts, income and gain are taxable to the grantor whether or not distributed.

A charitable remainder trust ("CRT"), which pays income to one or more non-charitable beneficiaries for a period of time with the remainder distributable to charity, is an important gift-, estate-, and income-tax planning tool. A person who creates a charitable remainder trust is usually entitled to an income tax deduction at the time the trust is created (or an estate tax deduction if the trust is created at death) equal to the value, determined using the IRS tables, of the remainder committed to charity. Several factors determine the amount of the deduction, including the value of the property contributed to the trust, the length of time the trust is expected to make payments to non-charitable beneficiaries, and the size of the annual payment. The longer the trust is expected to last and the higher the annual payments, the smaller the deduction. As a general rule, CRTs are exempt from income tax, but the distributions to the non-charitable beneficiaries are subject to tax. A gift or estate tax will be payable on the value of the annuity or unitrust interest payable to a domestic partner or children.

A charitable lead trust ("CLT") also may be an

excellent option. A charitable lead trust pays an annuity or a percentage of its value for a fixed number of years, or for an individual's life, to a charity. At the end of the charitable lead term, the trust will terminate and the remaining property is payable to named individuals. The CLT may be used to minimize gift and estate taxes in providing for a partner or for children. If assets are transferred to a lead trust during the grantor's lifetime and the trust is structured as a grantor trust, an income tax deduction may be available on the trust's annual payments to charity. More typically, charitable lead trusts are structured as non-grantor trusts in order to reduce the value of assets in the estate, and the grantor receives a gift tax deduction at the time of the transfer for the value of the payments to charity during the trust term. The value of the taxable gift or bequest is equal to the present value of the remainder that will pass to non-charitable beneficiaries. If the pay-out rate and the trust term are structured properly, the CLT, like a GRAT or GRIT, can be used to virtually eliminate the gift or estate tax on any post-transfer appreciation in the trust's assets.

The New York Community Trust is an ideal recipient of both CRTs and CLTs. The grantor can establish a fund to perpetuate his or her charitable interests, as well as providing for loved ones.

## Generation-Skipping Transfer Taxes

When property skips a generation and passes to the next, the generation-skipping transfer tax ("GST") may be imposed. Although the GST tax is beyond the scope of this article, it is important for an estate planning professional advising a non-traditional family with significant wealth to be aware that the GST tax may apply to transfers to children and even to transfers between partners. A "skip" that is subject to tax occurs when assets pass by gift or bequest to a beneficiary deemed to be in a generation that is two or more generations below that of the transferor. The typical example is a bequest to grandchildren. In the case of unrelated individuals, a single generation is deemed to

be 25 years, and the transferor is deemed to be at the middle of the generation, with 12½ years ahead and behind. This means that the transfer to the children of a domestic partner may be subject to the GST tax, as well as a transfer to a much younger domestic partner.

## Lifetime Transfers and the Applicable Exclusion

The \$12,000 annual exclusion from federal gift taxes offers small relief, but it should not be overlooked. If there is an age disparity making it likely that the wealthier partner will die first, it may be desirable to make annual gifts taking advantage of the annual exclusion amount. Where partners do not share living expenses proportionately, however, any excess paid by a partner may be deemed to be a gift and may use up the annual exclusion. Also exempt from gift tax are payments made for medical expenses and education. There is no limit on the amount of these gifts as long as the payments are made directly to the medical provider or school.

Gifts larger than the annual exclusion amount may be protected from gift taxes by the donor's lifetime credit, which excludes from gift taxes amounts up to a total of \$1,000,000.

In addition, each partner benefits from an estate and GST tax exclusion totaling \$2,000,000 in 2006 through 2008 and \$3,500,000 in 2009. If the estate tax repeal that is scheduled for 2010 occurs, there will be no estate tax for that year.<sup>2</sup> The gift tax exclusion amount will remain in effect for lifetime transfers, and gifts in excess of \$1,000,000 will be subject to gift tax.

State estate tax exemptions may differ considerably from the federal exemption, and planning techniques, such as trusts, that take advantage of the federal exemption may result in estate taxes imposed by a state. Any estate plan for domestic partners should

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<sup>2</sup> Under current law, however, the exemption is scheduled to drop to \$1 million in 2011, although it is widely assumed that Congress will try to maintain the exception, at a minimum, at 2009 levels.

take into account the estate taxes imposed by the partners' state of residence and should be flexible enough to minimize the effect of the differences between federal and state exemption amounts. In addition, an estate plan should be designed to take advantage of any available tax benefits afforded to domestic partners in states that recognize civil unions, such as Connecticut, New Jersey, and Vermont, and in Massachusetts, which recognizes same-sex marriage.

## Power of Attorney

It is also important to consider planning for possible incapacity. A durable power of attorney authorizes the agent—usually the domestic partner or other trusted person—to act on behalf of the principal in financial matters, including during the principal's incapacity. It is also advisable to include in the power of attorney or in a separate document a provision nominating the agent to serve as guardian should one be required. Otherwise, a family member who does not know the principal's wishes may seek to be appointed as guardian.

Alternatively, a springing power of attorney may be used. The springing power is not effective until the principal is found to be disabled or incompetent by a designated third party or physician.

## Health Care Proxy

A health care proxy or its equivalent gives the named agent the authority to make health care decisions on behalf of the principal. This is an important document for any person, but is especially valuable when the agent is not a close relative. The proxy should give the agent the power to consent or withhold consent to treatment, including end-of-life decisions. In addition, it should specify that the agent has the right to visit the principal and, if desired, to restrict visitors. If possible, the proxy should also specify that the agent has full access to the principal's medical information. Under the federal privacy protection regulations known as HIPAA, a health care agent should have access to the principal's medical records, but health care providers

may not always provide access to an agent who is not a family member. It is a good idea to spell this out in the proxy.

In some states (but not New York), a health care proxy may be used to nominate the domestic partner or other close person as guardian, should one be needed. Although not binding, the nomination gives the partner standing in a guardianship proceeding. In New York, it may be advisable to prepare a letter indicating the person desired to have guardianship, should need arise, for probative purposes in a court proceeding.

In addition to or in the absence of a health care proxy designation, a living will may be used to specify an individual's wishes concerning end-of-life treatment and similar matters. It is important, however, that the living will not limit a health care agent's ability to make decisions in situations that the principal did not anticipate. It may be advisable to give a copy of the living will to the agent as documentation of the principal's wishes, but to provide only the proxy form to health care providers.

## Disposition of Bodily Remains

Effective August 2006, a law was enacted in New York concerning the disposition of bodily remains. Before this law was passed, it was unclear who had the authority and responsibility to decide on burial arrangements. The law creates a proxy form for expressing the wishes of the deceased that will now take highest precedence in determining who has the authority to dispose of the deceased's body. Accordingly, the best way for an individual to identify the person who will control his or her bodily remains is to fill out this simple proxy form.

In the absence of a proxy, the law sets forth a priority list to determine authority. The list gives equal standing to spouses and domestic partners above blood relationships like adult children, parents, and adult siblings. In defining a domestic partner, the law provides for three different methods: (1) for same-sex couples who are able to register their partnership with a government entity, the bill recognizes registration as

sufficient proof for control of remains authority; (2) formal recognition as a beneficiary under a partner's employment benefits or health insurance also provides this authority; or (3) if none of these methods is available or has been used, providing documents similar to what the private sector and New York State require for an employee to obtain domestic partner health insurance also is acceptable proof of a partnership.

## Domestic Partnership Agreements

Some domestic partners choose to enter into a domestic partnership agreement in order to define each partner's rights and obligations with respect to property owned separately and jointly. Under New York law, such agreements are not generally enforceable unless both parties enter into the agreement in exchange for "consideration"—that is, something of value. A full discussion of domestic partnership agreements is beyond the scope of this article. However, it should be noted that such agreements play an important role in estate planning, especially for same-sex couples who enter into civil unions in states where domestic partners are granted inheritance rights under state law.

## Conflicts of Interest

Although conflicts of interest may arise in connection

with representing a married couple, practitioners often treat such a couple as a single entity. Representing same-sex couples or unmarried heterosexual couples may give rise to a conflict of interest. A practitioner may want to ask them to sign a written consent to joint representation. Alternatively, it may be preferable for a practitioner to represent only one partner, particularly if the partners' financial situations are very different.

## Conclusion

Estate planning for the non-traditional family is a complex task. It is too soon to predict whether same-sex civil unions in Connecticut, Maine, New Jersey, Vermont, and several other states, or marriages in Massachusetts, will eventually lead to changes in federal gift and estate tax rules. For now, the Defense of Marriage Act, which was enacted in 1996, defines "marriage" for federal purposes as the "legal union between one man and one woman." A similar law defining marriage as between a man and a woman in New York was recently upheld by the New York Court of Appeals. In several other states, including New Jersey, legal challenges are working their way through the system. Despite the absence of the marital deduction, a number of tax-effective opportunities exist to pass assets to domestic partners, children, and others.

**For more information**, call Jane L. Wilton, general counsel, at 212-686-2563.

**For further reference, see:**

Code Section 2036: GRITs  
Code Section 2040: Joint interests  
Code Section 2056: Marital deduction  
Code Section 2601-2664: Generation skipping tax  
Code Section 2702: GRATs and GRUTs  
Treas. Reg. §20.2040-1  
Treas. Reg. §25.2503-3(c), ex.2.  
Treas. Reg. §25.2511-1(h)(5)  
Treas. Reg. §25.2702-3(b)  
NYS Mental Hygiene Law Article 81  
*Crummey v. Comm'r*, 397 F.2d 82 (9<sup>th</sup> Cir. 1968)  
Revenue Ruling 85-13, 1985-1 CB 184

BNA Tax Management Portfolio No. 813-2d, *Estate Planning for the Unmarried Adult*.  
J. Chasen and E. Schwartz, *Estate and Gift Tax Planning for Nontraditional Families*, 15 Probate & Property 6 (2001)  
D. Dorn, *Navigating the Same-Sex Marriage Landscape: A Primer for the New York Private Client Attorney*, 38 NYSBA Trusts and Estates Law Section Newsletter No. 3, 16 (Fall 2005)  
M. Dubois, *Note: Legal Planning for Gay, Lesbian and Non-Traditional Elders*, 63 Albany Law Review 263 (1999)  
L. Katzenstein, *Economic and Valuation Planning Opportunities: GRITs, GRATs, GRUTs and QPRTs*, ALI-ABA Course of Study Materials (1996)  
J. McGrath, *The Ethical Responsibilities of Estate Planning Attorneys in the Representation of Non-Traditional Couples*, 27 Seattle University Law Review 75 (2003)

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