

# THE BERNSTEIN REPORT

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Dear Reader,

There is a significant amount of tax reform discussed in the President's 2012 Budget. I would not recommend getting too alarmed by individual items that are reported when the Budget is discussed. The proposals contained in the Budget are often just suggestions by the Treasury for raising revenue for the purposes of deficit reduction. Many fundamental tax reform proposals presented in the Budgets of President Bush were never adopted or even given serious consideration by Congress. It will probably be no different this time

The President's Budget reiterated the intention to increase taxes on high income and/or wealthier Americans. These increases would come from increased income tax rates, reductions in the benefits of itemized deductions, and increased estate taxes. It seems doubtful that the votes would be available in Congress to address this again anytime soon. There are some suggested changes to the estate tax rules that might be considered for revenue-reason purposes. First, the use of family limited partnerships (FLPs) or limited liability companies (LLCs) would be restricted to active businesses if valuation discounts are to be effective. Second, the proposal to establish the minimum term of grantor-retained annuity trusts (GRATs) to 10 years was again included in the discussion. Finally, the use of the generation-skipping transfer tax exemption to generation-skipping (dynasty) trusts would be limited to a maximum term of 90 years.

One component of the discussion concerning fundamental tax reform is the corporate tax rate in the United States. There is some bipartisan agreement that the corporate rate is too high within the United States for the purposes of global competitiveness. It was reported recently by the Tax Foundation that the combined federal and state corporate tax rate (39.2 percent) in the United States is second only to Japan in the Organization for Economic Cooperation and Development (OECD) member nations. Japan is currently scheduled to reduce its rates to leave the U.S. with the highest tax rates in this ranking. It seems likely that this issue will receive serious attention from Congress in the near future.

Cordially,

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

## **WHO DO YOU TRUST?**

### **A DISCUSSION OF GRANTORS, TRUSTEES, BENEFICIARIES AND PERMISSIBLE POWERS**

Trusts and similar arrangements are often used as part of the estate plan. The purposes for the trusts vary, but generally, control of the trust principal by a selected trustee is a major goal. A difficult choice must be made between the grantor, a family member, and a completely independent trustee (such as a corporate trust department). The dispositive goals of the grantor of the trust and the accomplishment of tax objectives often limit the possibilities. The following discussion is intended to provide an overview of the choices and limitations for some common estate planning techniques.

#### **REVOCABLE LIVING TRUSTS**

The goal of most living trusts is to transfer trust property outside of probate, not to provide current tax savings. The grantor is generally the initial trustee of his or her revocable living trust unless the grantor has the need or desire to have immediate assistance in managing the trust funds. Because a revocable trust is not intended to be a completed gift, no adverse estate or gift tax consequences are associated with the grantor serving as trustee.

Most revocable trusts have provisions for successor trustees in the event of the grantor's disability. The successor could be a family member or a professional trustee. Of course, the revocable trust becomes irrevocable at the grantor's death and a successor trustee will be named at this contingency. We'll discuss the possibilities for successor trustees in the event of the grantor's death when we discuss testamentary marital and family trusts below.

#### **IRREVOCABLE LIVING TRUSTS**

Most irrevocable trusts are intended to result in current completed gifts. The goal of these trusts is to remove the trust property from the grantor's taxable estate. Generally, the grantor cannot serve as trustee because most discretionary powers held by a trustee would render the gift incomplete for gift and/or estate tax purposes. For example, a gift will be incomplete if the grantor has the power to change beneficiaries or determine the shares distributed to individual beneficiaries of the trust. The grantor's estate will also include all property in which the grantor retains the right to use trust funds to satisfy his or her legal support obligations.

If the grantor insists on serving as trustee, adverse estate and gift tax consequences will be avoided only if the grantor's powers are restricted. Court cases have concluded that a grantor-controlled trust will be excluded from the grantor's estate only if the grantor's power to determine the shares provided to beneficiaries is limited by a "fixed or ascertainable" standard. The reasoning is that the grantor cannot affect beneficial enjoyment if the power to determine shares is based on a standard that could be measurable in the applicable state court.

For example, “support in the beneficiary’s accustomed standard of living” should be an acceptable ascertainable standard. However, the benefits of the trust should not be used to satisfy a legal support obligation of the grantor. Quite often, naming a co-trustee to serve with the grantor and vesting the distribution decisions in the co-trustee answers these concerns. A grantor-controlled irrevocable trust requires careful drafting and strict adherence to the ascertainable standards.

***Trusts for Minors and Custodial Accounts.*** One commonly used irrevocable trust is a Section 2503(c) minor’s trust. This trust permits the grantor to shelter a gift to an accumulation trust with the \$13,000 annual gift tax exclusion. The remaining trust principal must be payable or made available to the beneficiary at age 21. The grantor cannot be the trustee of a Sec. 2503(c) trust without adverse estate tax consequences. In addition, the parent obligated to support the minor should not serve as trustee if the parent’s estate taxes are a concern. The right to distribute trust funds to satisfy a support obligation is a general power of appointment. Property subject to a general power of appointment will be included in the gross estate of powerholder. Thus, a grandparent should not make a gift to a Sec. 2503(c) trust and name the minor beneficiary’s parent the trustee unless the parent’s estate and gift taxes are not a major concern. If a gift is made to a uniform gift (transfer) to minor’s account (UGMA/UTMA), similar reasoning should apply to naming a custodian for such account.

***Irrevocable Life Insurance Trusts (ILITs).*** ILITs are often used to transfer life insurance benefits free of estate taxes. The insured should not serve as trustee under an ILIT to avoid inclusion of the proceeds in the insured’s gross estate. If a husband and wife are joint-insureds in a survivorship (second-to-die) life insurance policy owned by an ILIT, neither spouse should serve as trustee.

Can the noninsured spouse serve as trustee of an ILIT created by the insured spouse? The answer is yes, with caution. Generally speaking, the surviving spouse will receive significant benefits from an ILIT created by the insured spouse. To avoid inclusion of the ILIT in the noninsured spouse's estate, access to the funds must be limited. The surviving spouse can be provided with all trust income plus the ability to have principal distributed to him or her under a limited (nongeneral) power of appointment. A limited power of appointment includes the ability to invade principal subject to an ascertainable standard. The power of appointment regulations provide that ascertainable standards include the power to appoint for "support in reasonable comfort or support in his or her accustomed manner of living, etc." Thus, the surviving spouse should be able to serve as sole trustee of an ILIT created by the insured spouse if the power to invade principal is limited to a standard based on support, health, and education of the surviving spouse. However, the surviving spouse should not be permitted to invade trust funds to satisfy his or her legal support obligations. Again, if there is concern that the actions of the spouse-trustee will exceed the limits of the ascertainable standards provided by the trust terms, perhaps a co-trustee could be named to determine distributions to the surviving spouse.

## TESTAMENTARY TRUSTS

**Marital Trusts.** A will of a married individual often creates testamentary trusts, normally a marital trust and a family trust. The living revocable trusts that we discussed earlier often provide for distributions to a marital and/or family trust at the grantor's death. An estate tax marital deduction is available for property that passes to a surviving spouse in a qualifying manner. Several types of trusts will qualify for the marital deduction. Generally, the surviving spouse can serve as sole trustee or co-trustee of the marital trust. Unlimited invasion rights or a general power of appointment ensures qualification for the marital deduction. If the ability of the surviving spouse to manage the trust funds is a concern, a professional trustee could be named to serve as co-trustee. If the testator wishes to limit the powers or access of the surviving spouse over the trust principal, an independent trustee should be named. If the surviving spouse is limited to the marital trust's income without current invasion rights to principal, the surviving spouse must be provided with the ability to compel the independent trustee to sell unproductive property and invest in income-producing property.

**Non-Marital Family Trusts.** The family trust was traditionally designed to be sheltered from estate taxes by the decedent's applicable credit amount. Currently, this tax credit will shield \$5 million from estate taxes (in 2011 and 2012 with inflation-indexing in 2012). The portability of the exemption amount may indicate the revision of estate planning documents to adapt to this important change of recent legislation. However, family trusts and the use of the exemption amount at the first death remain important for many reasons. To avoid having the family trust treated as a marital trust, the surviving spouse should not hold an unlimited power to invade principal during lifetime and should not have a general power of appointment with death. The key design component of the family trust is to provide the surviving spouse with limited access. If the surviving spouse will not benefit from the family trust, an independent trustee should be selected. If the surviving spouse will have benefits, such benefit should be limited to income and income and principal as necessary for support, health, and education. If the rights to principal are limited to such an ascertainable standard, the surviving spouse is able to serve as sole trustee of the family trust. The surviving spouse, however, should not be permitted to invade to satisfy a legal support obligation. Again, the terminology of the family trust should be carefully drafted and the surviving spouse should not exceed the ascertainable limited powers of invasion. If this is a concern, a co-trustee could be appointed to determine distributions of principal to the surviving spouse.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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