

# Insight on **estate planning**

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## **Give it some thought before giving**

Your options are many when you wish to contribute to a charity

## **New like-kind exchange rules bring new opportunities**

Unmarried couples can smooth  
uneasiness with a GRIT

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Domicile issues: When is a home not a home?



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# Give it some thought before giving

Your options are many when you wish to contribute to a charity

**O**ften, charitable institutions urge you to “give ’til it helps.” But your giving options go beyond cash contributions. In addition to helping your favorite charity, by finding the best one for your situation you may help maximize your tax savings.

## Consider your options

Here’s an overview of several of your giving options:

**Cash.** This is the simplest way to contribute, both from your perspective and that of the recipient organization. Cash bequests, like any other contributions you make at death, are fully deductible for estate tax purposes. For income tax

purposes, the amount you can annually deduct is limited to a percentage of your adjusted gross income (AGI) that varies depending on the type of gift and recipient type. Any gifts in excess of the limit may be deducted in future years, subject to the same AGI limits — for up to five years.

**Marketable securities.** Giving marketable securities isn’t as easy as giving cash, but most charitable organizations are well situated to receive stock and mutual funds that are traded on established markets. Plus, you’ll benefit by avoiding any potential capital gain that you’d realize if you’d sold the

shares to generate the cash needed to make the contribution. If you wish to get a charitable deduction for the entire value transferred, you must donate securities you’ve held for more than a year.

**Other assets.** So long as an asset can be readily valued, it will generally qualify for a charitable deduction in the same fashion as marketable securities. If you don’t need your theater tickets, for instance, you may be able to turn them back to the house, which might, in turn, give them to students. Then you’ll be able to deduct the value of the tickets. But bear in mind that the IRS recently refined the rules for contributing vehicles, so before contributing your car be sure it meets the eligibility requirements.

**Beneficiary designation.** You can make a contribution at death by naming the charitable organization the beneficiary of your 401(k) or IRA. There’s no income tax benefit for designating the charity as beneficiary; the deduction for such a contribution is allowed at death. The contribution, therefore, reduces your taxable estate.

Another reason to gift your retirement funds is because at your death those funds are subject to estate tax and, to the extent that the distribution is considered income, the beneficiary is subject to income tax as distributions are taken. This double taxation leads many to conclude that this is a perfect asset for satisfying a desire to make a charitable contribution.

**Private foundations.** A private foundation is a charitable entity that you create to further your charitable intent. Generally, you start the foundation with a sizable — generally at least \$500,000 is recommended — initial



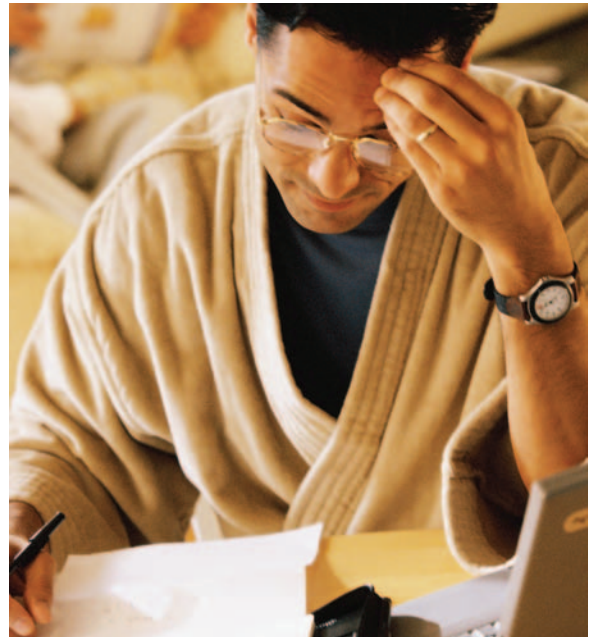
contribution for which you get an immediate income or estate tax deduction, depending on whether you fund the trust during your life or on your death. The administration of a private foundation can be somewhat onerous; one potential burden is that such foundations are required to make a certain amount of charitable donations each year. Nonetheless, a big advantage of a private foundation is that you can front-load your charitable deduction, because you get a deduction in the year you make the contribution to the foundation but the foundation can spread out its donations over many years.

**Donor advised funds.** Perhaps best described as a “light” version of a private foundation, a donor advised fund is created by making a donation to a public charity that segregates your funds and gives you discretion in making contributions to other charities. Though no absolute power is conveyed, the reality is that the charity will give you options in deciding where the funds will be contributed. In addition, most charities allow you to create a donor advised fund with a relatively minor contribution — often as little as \$1,000.

**Charitable trusts.** There are two basic types of charitable trusts: a charitable remainder trust (CRT) and a charitable lead trust (CLT). With a CRT, you, as the grantor, reserve the right to receive payments either for life (yours and others) or for a specified period, limited to no more than 20 years. At your (or the last beneficiary’s) death or when the term ends, any assets that remain in the trust revert to the charity. Thus, there’s an element of risk by creating a trust based on your life, but you may reduce that risk by opting for a CRT for a term instead of life.

A CLT, on the other hand, flips the timing of the charitable and noncharitable beneficiary, so the charity receives the right to payment and the remainder goes to you or your specified beneficiary or beneficiaries.

There are two types of CLTs — a grantor-type CLT is similar to the CRT in that you get an immediate income tax deduction when you create the trust. But, each year, you are taxed



on the income earned by the trust. The other type of CLT, which is more common, doesn’t yield a charitable deduction on creation. Neither, however, are you taxed on the income that goes to the charity each year.

With a CRT or a CLT, you can set up either an annuity trust (the annual payment is based on the value of the assets when you originally transfer them to the trust) or a unitrust (the payment is based on the value of the assets as of a particular date within a specified interval). The choice will affect any charitable deduction for which you may be eligible.

**Charitable gift annuities.** This strategy combines an outright gift with an annuity feature, and is similar to a CRT. You make a gift to the charity and, in turn, the charitable organization guarantees a certain return from the asset for the specified period. Various factors dictate the amount of the charitable deduction and the composition — and tax action — of the annuity payment, such as return of principal, ordinary income and, if applicable, part capital gain.

### Form your plan

The charitable giving option that’s best for you depends on your goals and financial circumstances. Thankfully, you have many options to consider when forming your charitable contribution plan. ■

# New like-kind exchange rules bring new opportunities

**I**n a like-kind exchange, the IRS allows you to defer gain on the sale of your investment property. But earlier this year, the IRS clarified its treatment of gain when there is a like-kind exchange on a property that is — or has been — used for both a principal residence and for business purposes.

## How a like-kind exchange works

Internal Revenue Code (IRC) Section 1031 provides that no gain or loss is recognized on property held either in a trade or for business or investment purposes if you exchange the property solely for other property that is to be held for trade or for business or investment purposes. To the extent, however, that other property is received at sale — typically cash or other non-like-kind property (known as “boot”) — you must recognize a gain.

**With Rev. Proc. 2005-14, you must first own property that you used as both a principal residence and a rental or in your trade or business.**

So, for example, if you have land that you bought for \$10,000 and then sell it for \$100,000, you have realized a gain of \$90,000. That gain is now taxable.

But, if you *exchanged* the parcel for another piece of land worth \$100,000, your \$90,000 gain wouldn't be taxable. Thus, you could defer the \$90,000 gain until you sold the replacement property. But if you hold the

property until your death, your heirs may receive a step-up in basis and, if they sell the property before it appreciates further, they'll recognize no gain on the sale.

## A combination of benefits

Historically, one question has been how to treat property that is part personal and part business. In Rev. Proc. 2005-14, the IRS provides guidance that is rather favorable. The rules allow combining the benefit of a like-kind exchange tax deferral with the Sec. 121 provisions for exclusion of gain on the sale of a principal residence.

Sec. 121 rules allow you to exclude up to \$250,000 (\$500,000 for married couples) of gain on the sale of a principal residence. IRC Sections 1031 and 121 together should provide significant opportunities for reducing taxable gain on the sale of property. And, when combined with the step-up in basis allowed at death, these rules potentially allow you to completely avoid paying capital gains tax that would otherwise be due.

As with any situation, the facts have to fit before you can take advantage of the rules. With the new revenue procedure, you must first own property that you used as both a principal residence and a rental or in your trade or business. Then you have to exchange that property for a like-kind property.

## Home and rental property

Let's look at how you might combine the benefits of a like-kind exchange with those of the home sale exclusion when your home also has been a rental property. Let's say you rent out your principal residence for a period of time after you move out. Sec. 121 rules allow you to exclude gain on the sale of property that was your principal residence for at least two of the five years before the sale.

An example provided by the IRS presumes the exchange of a property that had been rented for the past three years but used as a principal residence for the prior two years. Thus, the Sec. 121 exclusion rules apply. In that example, the property had an original cost of \$210,000 and was subsequently exchanged for a rental property worth \$460,000 plus \$10,000 cash.



Before the sale, there was depreciation in the amount of \$20,000, so the tax basis in the property was \$190,000 (\$210,000 less \$20,000). The gain was \$280,000 (\$470,000 less \$190,000), of which the single taxpayer in the example could exclude \$250,000. The balance, \$30,000, was deferred until the property was subsequently sold. Or, as was pointed out earlier, the gain could have been completely avoided if the property had been held until death. And, although \$10,000 in cash was received, Sec. 1031 rules ignored such “boot” to the extent that it didn’t exceed the gain excluded under Sec. 121.

It logically follows, therefore, that had the exchange been for \$250,000 in cash and a property worth \$220,000 — for the same total of \$470,000 — none of the gain would have been currently taxed. The \$250,000 boot would have been excluded under Sec. 121 and the \$30,000 balance of the gain would have been deferred under Sec. 1031.

### Home and home office

If you exchange your property for another home and office property, you’ll also be able to take advantage of the rules of both Sections 121 and 1031.

Using an example from Rev. Proc. 2005-14, let’s say the property purchased for \$210,000 was used as a principal residence but the owner had used one-third of the home as an office. Also, depreciation of \$30,000 had been taken and the property was subsequently exchanged for a property valued at

\$360,000, which also was to be used as the owner’s principal residence and office.

The total gain on the exchange was \$180,000 (\$360,000 less basis of \$180,000). Because gain attributable to the depreciation couldn’t be excluded, only \$150,000 would be excluded, and the balance would be deferred.

Had the property been exchanged for something worth \$460,000, the total gain would be \$280,000. Only \$250,000 could be excluded under Sec. 121 for the single taxpayer in the example, so \$30,000 was deferred. Note that, the way the rules work, the Sec. 121 exclusion could be used for the business portion, but the Sec. 1031 deferral couldn’t be used on the personal portion.

So, if the property had been exchanged for \$750,000, the total gain would be \$570,000 but only \$250,000 would have been excluded under Sec. 121. Gain attributable to the rental portion would have been deferred, but the balance of the gain attributable to the personal portion would have been currently taxable. Thus, gain of \$210,000 would have been deferred under Sec. 1031 and \$110,000 would have been taxed.

### When two IRC sections interact

Rev. Proc. 2005-14 provides guidance with respect to the interaction between Sections 1031 and 121. Before attempting to take advantage of the rules, be sure you fully understand how they may be applicable to your situation. ■

# Unmarried couples can smooth uneasiness with a GRIT

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here are many people in committed, though not legally binding, relationships. Estate planning rules heavily favor married couples, but unmarried couples can financially provide for each other in many of the same ways.

One strategy, a grantor retained income trust (GRIT), is available only to unmarried couples, at least with respect to providing the means to support each other. Interestingly, it works for precisely the reason that most of the other estate planning strategies don't

work for unmarried couples: It works because the couple isn't married.

## The gritty details

A GRIT is similar to a grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT), but there are a few significant differences. With a GRIT, you retain the right to the *income* generated by a pool of assets, while with a GRAT or GRUT you retain an *annuity* that's secured by the trust's assets. A GRIT, therefore, provides you the opportunity to leverage your gift.

Ultimately, you may be able to transfer significantly more than if you had simply made an outright gift.

But you aren't permitted to use a GRIT if your beneficiary is related to you — with one specific exception dealing with personal residences. Thus, the GRIT serves unmarried couples well.

To set up a GRIT, you, as grantor, create a trust in which you retain the income interest for a specified term and you name your partner as beneficiary. At the trust's creation, you have made a taxable gift to the beneficiary. The gift is determined by factors such as the duration of the trust, your age and the Internal Revenue Code (IRC) Sec. 7520 rate. (See "The nitty gritty: Gift taxes and GRITs," at left.)

The Sec. 7520 rate is a presumed return that the assets will earn during the life of the GRIT. You, as grantor, have flexibility with respect to the trust terms, so it's relatively easy to structure a GRIT to meet your needs.

Should you die during the trust term, the trust's assets are included in your

## The nitty gritty: Gift taxes and GRITs

When creating a grantor retained income trust (GRIT), it's important to consider the gift tax consequences. For gift tax purposes, it's irrelevant whether your actual results are better or worse than the Internal Revenue Code (IRC) Sec. 7520 rate. During the trust term, all income is taxed to you. Any income that the trust earns, and on which you are taxed, is payable to you.

Bear in mind that appreciation isn't considered income and stays in the trust. You can augment the estate planning effectiveness of a GRIT by transferring securities that are more growth oriented than income oriented.

One caveat: The IRS has successfully challenged a GRIT where the grantor was required to hold certain assets that were paying a dividend well below the Sec. 7520 rate. So long as the grantor has discretion with respect to investing the trust assets, such a challenge should be unsuccessful.



estate as if you'd never created it. If you survive to the end of the term, the assets are no longer included in your estate and are distributed according to the trust's provisions. The trust may require, for example, that all assets be distributed outright to your beneficiary or it may retain the assets in trust for his or her benefit.

Is a GRIT right for you?

Unmarried couples face unique challenges with respect to estate planning. As with married couples, though, there are several possible strategies to employ. It's vital to

carefully plan for which ones are going to be most beneficial. It may be worth your while to learn more about the benefits of a GRIT. ■

## Domicile issues: When is a home not a home?

Your domicile — your home or permanent residence state — will control where your estate is probated and which state's rules apply at your death. State estate tax rates can vary significantly. So your domicile can dramatically affect how much of your estate goes to taxes vs. your heirs. Your domicile also may have other important ramifications during your life, such as determining how (and if) your income will be taxed. State income tax rates vary widely.

As a result, it's important that it's as obvious as possible and not overly subject to interpretation. If you have homes in multiple states, you may be inadvertently adding confusion to your eventual estate administration. Why? Because more than one state may lay claim to your estate and the accompanying tax.

Even though your intent with respect to domicile is important, your actions are more important. To demonstrate that you consider a particular place to be your domicile:

- Use the address for correspondence, particularly with respect to the IRS or state tax authorities with whom you may have to argue your position,
- Register to vote there,
- Register and insure your vehicles there,
- Have your driver's license and, if relevant, other licenses issued there, and
- License or register your pets there.

If you change your domicile, be sure to update your estate plan to reflect your new state as your state of domicile and, as appropriate, as the controlling law.

Regardless of the steps you take, more than the intended state may try to claim that you are domiciled there. Determine where you want your domicile to be and take as many steps as necessary to strengthen your argument. After all, just because you have a home in a state, it doesn't necessarily mean that the state is your home state.

# A message to our clients and friends:



Hall Render is excited to provide you with this issue of *Insight on Estate Planning*. Should you have any questions regarding the articles in this newsletter, please feel free to contact one of the attorneys listed below.

**We are experienced in assisting clients in implementing a wide range of estate planning and tax strategies, including the use of:**

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- Qualified Personal Residence Trusts (QPRT)
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  - Limited Liability Companies
  - General and Limited Partnerships
  - Family Limited Partnerships
  - Limited Liability Partnerships
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  - Family Business Planning
  
- Charitable Trusts & Foundations
  - Gift Annuities
  - Charitable Lead Trusts
  - Outright Gift Planning
  - Private Family Foundations
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  - Public Charities

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