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Trusts & Estates Newsletter

Estate Planning Focus

College Savings Options

by Karen L. Kayes: **kkayes@wnj.com**

With the cost of college tuition increasing at approximately twice the general rate of inflation, determining the best method to save for college is an important decision for those with young children or grandchildren. There are many options available for creating an account for education expenses.

529 PLANS

In 1996, Congress created the "529 plan" which enjoys many tax and non tax advantages as a college savings vehicle. Michigan's 529 plan is called the "Michigan Education Savings Program." Its specific characteristics include:

Earnings: The account earnings build up income tax-free. Earnings which are used to pay qualified education expenses are also free of federal and state income tax.

Tax Deduction: Michigan taxpayers may be eligible for a Michigan income tax deduction when making contributions to the account. The contribution deadline is December 31.

Gift Tax: Gifts to a 529 account qualify for the $13,000-per-year gift tax exclusion and a donor may elect to treat a contribution of up to $65,000 as being made over 5 years (which requires the filing of a gift tax return). Although the excess amount is subject to gift tax, the Michigan Education Savings Program allows contributions up to $235,000 per beneficiary.

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Although there are a number of options available for funding a college savings account, each has its own unique features to be considered.

Use of Funds: Funds are available for any eligible higher educational institution in the nation, and many abroad. If funds are withdrawn for ineligible expenses, they are subject to income tax and incur a 10% penalty on the earnings portion.

Changing Beneficiary: If the beneficiary does not use all of the funds, another eligible beneficiary (a member of the previous beneficiary's family) may be named for the account with no gift or adverse income tax consequences.

Income Limitations: None.

Estate Tax: Amounts contributed to a 529 are not included in the donor's estate.

These accounts may be set up directly through the state of Michigan or with a financial adviser.

MICHIGAN EDUCATION TRUST

Another savings plan available in Michigan is the "Michigan Education Trust." This is a prepaid tuition plan that allows an individual to pay for future education expenses at discounted rates. Funds withdrawn for qualified higher education expenses are free of federal income tax. Funds can be used only for tuition and fees and may lose some of their value if used for a private or non-Michigan school. The donor may receive an income tax deduction for the amount of his/her contribution. If the funds are not used by the beneficiary before age 30, they can be rolled to another qualified beneficiary.

COVERDELL EDUCATION SAVINGS ACCOUNT (ESA)

A Coverdell ESA allows funds to be set aside for elementary, secondary or higher education tuition and expenses (very broadly defined). Withdrawals are tax-free if used for qualified educational expenses, and if properly coordinated with the use of available federal education tax credits. The contribution amounts are limited to $2,000 per year per child (including contributions from others). The contribution amount is also limited by an individual's income. The funds must be distributed by the time the beneficiary reaches age 30, unless he or she has special needs. A contribution can be made, effective for the prior year, if made by the due date of the donor's income tax return (not including extensions). Unless Congress acts (again), certain ESA benefits expire after 2012. K-12 expenses will no longer qualify, the annual contribution limit will be reduced to $500 and withdrawals will not be tax-free in any year in which a Hope credit, Lifetime credit or Lifetime Learning credit is claimed for the beneficiary.

U.S. SAVINGS BONDS

Under certain conditions, interest is excluded from federal taxes when a U.S. savings bond is redeemed and used to pay college expenses (tuition and fees only). However, this exclusion is designed for parents meeting certain income requirements and purchasing bonds in their own names. Bonds purchased by grandparents hardly ever meet those conditions. The exclusion from income is phased out based on the taxpayer's income.

UTMA or UGMA ACCOUNTS

These assets are typically owned by the child's parent as "custodian" for the benefit of a minor child. The moneys in the account can be used for the benefit of the child, so long as the expenses aren't "parental obligations" or otherwise benefit the custodian. Income from the account is taxable to the child, and may be subject to the "kiddie-tax" rules. When the child reaches age 18 (for UGMA) or 21 (for UTMA), the funds in the account become owned directly by the child.

Although there are a number of options available for funding a college savings account, each has its own unique features to be considered. For those considering increasing their gifting in this year to take advantage of the $5 million estate and gift tax exclusion, creation of a college savings fund may be an appropriate vehicle. Contact your Warner Norcross estate planning attorney if you would like additional information on these options.

Contingency Planning

Estate Planning in an Uncertain Tax and Low Interest Rate Environment

by Jay A. Kennedy : **jkennedy@wnj.com**

"Every time I find the meaning of life, they change it." - Anonymous

The 2010 Tax Relief Act included a new $5,000,000 exemption for estate, gift and generation-skipping transfer (GST) taxes, together with a maximum 35% estate, gift and GST tax rate. The Act also introduced "portability," which generally permits the estate of a surviving spouse to utilize the unused estate tax exemption of the predeceasing spouse. These changes are scheduled to expire at the end of 2012, which under current law would mean a return to the pre-2001 law including the $1,000,000 estate, gift and GST exemption and 55% top tax rate.

While the 2010 Tax Relief Act created a two-year window to take advantage of the expanded gifting opportunities, recent developments suggest that you may not want to wait until the end of next year to make these gifts. The near record low interest rate environment also creates unique opportunities for certain gifts.

DEFICIT REDUCTION INITIATIVES MAY REDUCE WINDOW FOR EXPANDED GIFTING OPPORTUNITIES

The Budget Control Act of 2011 included the creation of a 12-member Joint Select Committee on Deficit Reduction that is currently reviewing ways to reduce the federal deficit over fiscal years 2012 through 2021. The House Democrats recently released an unofficial summary of revenue-raising provisions that they intend to submit to the Committee. Several of these provisions have been proposed in past tax reform efforts, including new restrictions on valuation discounts and a minimum ten-year term for grantor retained annuity trusts. These proposals also include troubling language regarding the timing of the scheduled change in the estate tax rules after 2012. The proposal states that "Revenue could be raised against a current-law baseline by reverting to 2009 levels one year early (in 2012)." (This language is inaccurate, as the current law will mean a 2013 reversion to the pre-2001, $1,000,000 estate exemption and not the $3.5 million estate tax exemption available in 2009.)

A return to the $1 million gift tax exemption a year early, in 2012, would eliminate a significant opportunity for individuals intending to take advantage of the 2010 Tax Relief Act provisions. While it is too early to tell whether House Democratic proposals will ultimately be adopted by the Joint Select Committee, and it is likely that these proposals will face significant opposition from Republican Committee members, you may want to consider making large gifts before the end of this year to lock in this opportunity. Gifts this year would also remove appreciation on the gifted property from your taxable estate. Today's depressed stock market and real estate values may mean that these gifted assets will realize significant appreciation.

STRATEGIES THAT TAKE ADVANTAGE OF CURRENT LOW INTEREST RATES

The IRS specifies gift tax valuation interest rates each month that rise and fall with market interest rates. Lower interest rates mean that the discount rate used to value a retained annuity is lower, and the value of the retained annuity interest is higher. The October 2011 "section 7520 rate" used to value retained annuities for gift tax purposes dropped to a record low of 1.4%.

A grantor retained annuity trust (GRAT) is an ideal vehicle to take advantage of these low interest rates. These trusts provide that the settlor retains an annuity interest for a fixed number of years, with the remainder passing to named beneficiaries. The amount of the taxable gift is the value of the remainder interest passing to trust beneficiaries. Low interest rates mean that a smaller retained annuity is required to produce a minimal gift to remainder beneficiaries.

For example, if the section 7520 rate is 8%, the annuity needed to "zero out" a ten-year, $1 million GRAT would be $149,029 because the discounted value of this annuity would be approximately $1 million, and the value of the remainder interest is therefore zero. Using the October 2011 rate of 1.4%, the annuity required in this example to "zero out" the GRAT would be only $107,861. The lower annuity amount means that more assets are shifted to the next generation.

The success of a GRAT is generally tied to the spread between the total return on GRAT assets and the section 7520 interest rate. The extremely low section 7520 rate increases the likelihood that this spread will be substantial.

The extremely low interest rates favor other planning strategies tied to the value of retained annuities.

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Non-Probate Transfers: Good Intentions, Unintended Results?

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Probate can be a real hassle – it is expensive, time-consuming and public. However, probate proceedings are not required for every estate and, when possible, successfully avoiding probate can save money, minimize administrative burdens, avoid delay and protect the privacy of your estate and your family.

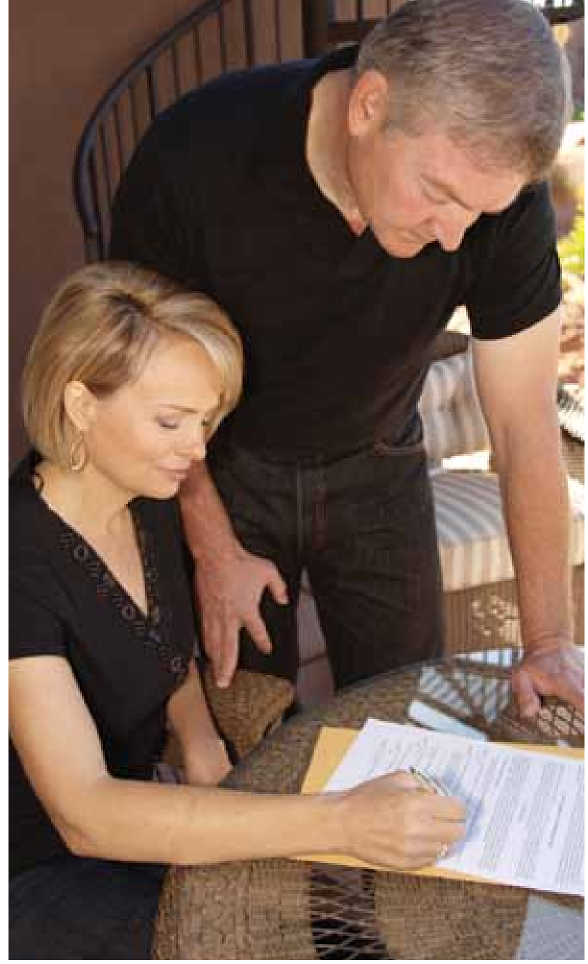
The key to avoiding probate is ensuring that, at your death, no assets are titled in your name alone which do not pass by beneficiary designation. There are three basic forms of non-probate transfers: (1) revocable trusts, (2) joint ownership and (3) beneficiary designations. You should carefully consider the advantages and disadvantages of each before pursuing any of these transfers – specifically, be aware that, although your intentions were good in trying to avoid probate, the action (or inaction) of you or your family members can nonetheless lead to unintended and undesirable results.

Oftentimes, an individual seeks to avoid the pitfalls of probate by creating a revocable trust and re-titling assets in the trust's name. This method is an especially popular choice due to the degree of control and flexibility you retain over the trust and its assets. While you are able, you may serve as trustee and continue to control the assets as though you own them outright. You have access to use trust assets for your own benefit or for the benefit of your loved ones. Once you become incapacitated or pass away, the successor trustee is bound by a duty to continue to manage the assets for your benefit and according to your desires. However, for your trust to be an effective probate avoidance tool, it is critical that you perform the necessary exercises to have each of your assets re-titled in the name of or payable to the trust.

While a revocable trust is an attractive option for avoiding probate, the creation and maintenance of such a trust does not make sense for everyone. Revocable trusts may be more expensive to draft and administer, and may provide no tax savings to those individuals who will not otherwise face an estate tax liability at death.

Another means by which to avoid probate is to title property in joint ownership. When you name another as joint owner with rights of survivorship, you grant that joint owner equal access to the asset during your lifetime and guarantee that the asset will pass automatically to the joint owner at your death. While this method has the benefit of removing the asset from your probate estate, you have given up a considerable amount of control. Suppose, for example, that you name your child as joint owner with rights of survivorship of your checking account, perhaps to assist you with paying bills. You instruct the child to split the balance of the account equally with his or her siblings upon your death. Though you believe he or she will adhere to your requests, our children often have plans that differ from our own. As a joint owner, your child has the right to completely ignore your request and keep the money.

A further method to avoid probate is to transfer property at your death by beneficiary designations. Disposing of assets by beneficiary designation automatically passes title to the designated beneficiary at your death. Beneficiary designations are advantageous because you retain control (you may change beneficiaries whenever you wish) and your child lacks access to the asset during your lifetime. Unfortunately, beneficiary designations are only available for a limited category of assets, including retirement plans, life insurance and certain bank and brokerage accounts. You must take care to ensure that your estate is not depleted by the use of beneficiary designations; there will be expenses that need to be paid upon your death and some funds should be available for this purpose.



The key to avoiding probate is ensuring that, at your death, no assets are titled in your name alone which do not pass by beneficiary designation.

It is also important to remember that the transfer of assets which pass by joint ownership or beneficiary designation are not subject to the terms of your will or trust.

On a steadily increasing basis, individuals are pursuing ways to transfer their property to loved ones without exposing their estates to probate. Though the advantages of probate avoidance are significant, the consequences of poor execution are equally significant – particularly when family feuds or insolvent estates result. Please contact your estate planning attorney at Warner Norcross if you would like to explore these options further.

Managing Vacation Homes...

So They Don't Manage You!

by Susan G. Meyers: **smeyers@wnj.com**

Vacation home planning received a shot in the arm this year thanks to *Klooster v City of Charlevoix.* Planning opportunities to transfer property into joint name with others without uncapping property taxes are available that had not been available previously (see "Keeping the Cap on Property Taxes Through Joint Tenancy," *Estate Planning Focus*, Spring 2011). But perhaps as importantly, *Klooster* has heightened awareness of the importance of advanced planning for a vacation home. Not only can taxes be avoided with proper planning, but also family harmony can be preserved if key decisions about how the property will be managed are decided in advance of a transfer event.

Under *Klooster,* property owners can add another individual as a joint owner with rights of survivorship without uncapping property taxes. In most situations, the death of the original owners also will not result in uncapping. This allows property to be transferred to the next generation without uncapping property taxes. Maintaining the taxable value of the property and keeping property taxes at current levels can be critically important to maintaining the affordability of the property for future generations.

However, despite the many planning opportunities that *Klooster* opens, joint ownership has several drawbacks:

- First, *Klooster* only addressed adding **one** individual as joint owner, leaving open the question of whether multiple persons can be added as joint owners and avoid uncapping.
- Further, careful planning must be undertaken if you desire to have the property continue to be owned by all lines of the family rather than the "last man standing."
- Finally, the property will be taxable in your estate at your death if you remain a joint owner, which is an essential element of *Klooster*.

Other ownership options include using a trust or limited liability company (LLC). While uncapping of property taxes may occur with these forms of ownership, they allow you to gift the property during your lifetime and avoid taxation of the property in your estate at your death. Further, the trust and LLC can provide for centralized management of the property by fewer than all owners, which can be an invaluable tool especially if there will be many owners. Finally, if you want to create a fund to assist with ongoing expenses of the property, the trust and LLC are excellent vehicles to manage the cash gift and ensure the funds will be available to pay those expenses.

Property ownership in any form involves attention and diligence. Decisions concerning property become amplified when the property is owned by multiple people. Having a written agreement addressing management issues can provide certainty, understanding and trust among the owners, allowing the property to be a place of enjoyment rather than a source of friction. A management agreement should address at a minimum issues such as:

- how use of the property will be allocated among the owners;
- how expenses will be shared among the owners;
- penalties for those who don't pay their share of expenses;
- who will be responsible for paying the bills and arranging for repairs when needed; and
- the exit strategy for those who no longer desire or no longer can afford to be an owner.

Whether joint ownership, a trust or LLC is the best form of ownership for you will depend on your facts and circumstances, your goal, and whether avoidance of property taxes or estate taxes is of priority. Regardless of the form of ownership selected, a written agreement outlining the rules, benefits and responsibilities of ownership is essential.

Michigan Implements Estate Recovery

by David E. Waterstradt: **dwaterstradt@wnj.com**

Effective July 1, 2011, the Michigan Department of Human Services finally began to administer Michigan's estate recovery law, which has been on the books since 2007. The state began sending letters to the responsible party of deceased Medicaid long-term care beneficiaries to collect information for a possible claim. Under the estate recovery law, the state may assert a claim to recoup expenses against the probate estate of a decedent who received Medicaid long-term care assistance prior to death. Because most other assets have to be spent down in order to qualify for Medicaid in the first place, recovery would typically come from the only remaining asset most Medicaid beneficiaries have – their residence.

Under the estate recovery law, the state may assert a claim to recoup expenses against the probate estate of a decedent who received Medicaid long-term care assistance prior to death.

The scope of the current estate recovery law is limited. It applies only against the probate estate. There are also a number of exemptions that apply. For example, a claim will not be made if the home continues to be occupied by:

- a surviving spouse;
- a minor or disabled child of the decedent, a relative of the decedent who provided care for the decedent that kept the decedent out of an institution for at least two years; or
- a sibling who is a joint owner and lives in the home.

Additionally, recovery is limited to that portion of the value of the home above 50% of the average price of a home in the county where the home is located. Under Michigan probate law, there are also certain claims against the estate, such as estate administration expenses and funeral and burial expenses, which have priority over an estate recovery claim.

Currently, a Medicaid beneficiary can plan to avoid estate recovery entirely by executing a "ladybird" deed. This is a deed by which the grantor conveys the property to named individuals or a trust but retains a life estate and the power to sell or transfer the property. The retained powers are so great that legally it is treated as if nothing has been transferred. Yet, upon death, if no other transfer has been made, the property will pass to the named beneficiary(ies) outside of probate.

It is possible that a tougher estate recovery program could become law in the future that would not allow a ladybird deed to avoid recovery. If there is no foreseeable need for long-term care currently, an individual could take a more aggressive approach to avoiding estate recovery by creating a joint tenancy with a very small retained interest. The estate recovery law would apply only to those interests that an individual actually owns at the time of death. Therefore, if the individual retained only a small joint tenancy interest, the majority of the property would avoid a recovery claim. This type of planning is somewhat risky because of the five-year look-back rule, which allows the state to disqualify an individual from Medicaid benefits for gifts made within five years of a Medicaid application. Before engaging in such planning, an individual would need to be satisfied that a gift could be reversed if long-term care was unexpectedly needed within five years.

If you or a loved one is concerned about protecting assets in the event long-term nursing home care is needed, contract your estate planning attorney at Warner Norcross.

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These include Charitable Lead Annuity Trusts, where a charity is named as the initial beneficiary of an annuity interest, with the remainder passing to children or other beneficiaries. The annuity interest passing to the charity is eligible for a gift tax charitable deduction. As with the GRAT, the value of the annuity interest passing to the charity will be relatively high, and the value of the remainder passing to family beneficiaries will be relatively low.

Other planning strategies that take advantage of low interest rates include charitable gifts of a remainder interests in a personal residence or farm and sales of assets to defective grantor trusts.

Please contact an estate planning specialist at Warner Norcross if you have any questions regarding current planning opportunities.

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Frank E. Henke is rated a Top Lawyer by *dBusiness*.

Mark K. Harder has been elected Vice-Chair of the Probate and Estate Planning Section of the State Bar of Michigan.

Frank E. Henke was recently elected Chairperson of the Estates and Trusts Committee of the Taxation Section of the State Bar of Michigan.

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