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CREATING A LEGACY:

WHAT ARE THE ALTERNATIVES TO A LUMP-SUM TRANSFER AND BASICS OF CHARITABLE PLANNING

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CREATING A LEGACY: WHAT ARE THE ALTERNATIVES TO A LUMP-SUM TRANSFER?

In the first part of this article, we discussed the pitfalls of large lump-sum wealth transfers to the next generation, and introduced some of the questions and issues that high net-worth individuals may want to consider in planning their legacies. We suggested that there is good reason to consider alternatives or supplements to large one-time intergenerational transfers – either for the good of the inheritors, or to allow you to pursue other projects that matter to you, or both. But how do you act on that advice? What are the alternatives to consider?

Among the vehicles you can put to use in place of, or in addition to, a traditional bequest, are:

- **Trusts**. One of the most straightforward ways to greatly reduce or eliminate uncertainty, and to help ensure that children use money wisely, with strings attached. The traditional use of trusts is when children are underage – either minors, or simply not yet ready to handle the wealth. Most estate planning attorneys will tell you that leaving money to children at too young an age is inappropriate. Most financial planners agree that it often makes no sense to transfer wealth to children at the simple majority age of 21. It is better to delay control to a later stage in life, perhaps age 30 or 35, and further restrict access to principal to future milestones at age 40 and 45. A trust is the vehicle that allows you to create those restrictions. You will need to take formal steps to establish the trust, identify a trustee and give reasonable instructions so that the trustee knows your desires. You can also include provisions for special circumstances – for example, a child dealing with substance abuse.

  This sort of trust can be set up so the income is taxable to the grantor, further reducing estate assets and allowing the benefit of growth of the assets within the trust.

- **Outright Gifts.** Some parents, by contrast, want to give children a portion of their inheritance when they are younger. That way, the children can be guided on how to handle money while the parents are still around to guide them. An outright gift of a portion of the estate can help children learn the proper management of money and how to use it well.

- **Life insurance**. Among the most useful attributes of life insurance is that it creates flexibility. Among other things, it provides a tool to expand your personal spending options while you also meet specific needs. Life insurance can be looked upon as a "permission slip" – it lets you spend down your wealth because you adequately provide for loved ones with a fully funded insurance policy. The cash value in a fully funded policy will grow and can provide income to the purchaser if needed. In addition, life insurance death benefits are not subject to income and if owned by a third party or trust may be outside of your estate. There are other tax advantages: cash values that accumulate in a life insurance policy are tax free, and you can borrow against them with no tax consequences in many cases. Each policy can be tailored to meet exacting cash flow needs.

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- **Dynasty trust.** A dynasty trust allows parents to leave money to future generations. This gives the grantor maximum control, beyond the grave, through the services of a judicious trustee. The power of the dynasty trust is that the corpus grows to huge balances when undisturbed. Practically speaking, that means that the trust goes on for a very long time, through generations yet unborn, thereby continuing your legacy. Grantors may elect to use their generation-skipping tax exemption, so the trust is GST-exempt. Trusts pay taxes at a typically higher rate than the individual rate, but the dynasty trust avoids estate taxes and grows to perpetuate funds under the protection of the trustee.

- **Restricted trust.** The party that establishes a trust can specify the conditions under which the trustee is authorized to make payments to a beneficiary. The trust can stipulate that the funds in the account are not to be distributed until the beneficiary reaches an appropriate age, or can restrict the funds for specific purposes, such as medical or educational expenses. Unrestricted trusts can be converted into restricted trusts – unless the trust was designated as an irrevocable trust when it was established, the trust terms can be altered while the grantor is still alive. Depending on the state, even an irrevocable trust can be altered with court approval or through decanting.

Charitable vehicles open up a new array of possibilities for effective wealth transfer and healthy family relationships

So far, we've been talking about vehicles for transferring wealth to the next generation. But you may have other considerations in mind – doing good works and teaching life lessons, while still protecting the value of the estate. With that in mind, you may want to think about:

- **Charitable Remainder Trust (CRT).** This is an arrangement that creates many upsides simultaneously. In a CRT, property or money is donated to a charity of your choosing, but you, the grantor, continue to use the property and/or receive income from it while living. The beneficiaries receive the income and the charity receives the principal after a specified period of time. However, the beneficiary is taxed on the income of the trust to the extent a distribution exhausts the ordinary income then they are taxed to the extent there is capital gain income. The Grantor will receive an income tax deduction for the present value of the remainder interest that will ultimately pass to the qualified charity. In addition, the asset is removed from the estate, reducing subsequent estate taxes. While the contribution is irrevocable, the grantor may have some control over the way the assets are invested, and may even switch from one qualified charitable organization to another. CRTs come in several "flavors": charitable remainder annuity trust (which pays a fixed dollar amount annually) and charitable remainder unitrust (which pays a fixed percentage of the trust's value annually) are two of the more common ones. However, there are many permutations.

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- **Charitable Foundation.** Foundations are usually associated with the very rich (think: Rockefeller Foundation), but in fact can be created by those of only moderate wealth. A foundation is a nonprofit organization that donates funds or otherwise provides support to other organizations. A personal or private foundation is typically endowed or otherwise funded by an individual or family for its own charitable purposes. Creating a personal foundation can be a wonderful opportunity to support causes you believe in and realize a tax deduction. The foundation is required to make minimum distributions. How much money do you need to donate for it to be worth the effort to start and maintain a foundation? There is no hard-and-fast rule. But according to the Council on Foundations, most family foundations have assets of at least a few hundred thousand dollars. Some foundations have more than a billion dollars in assets, but 60% have fewer than $1 million.

- **Donor Advised Fund (DAF)**. This platform has the potential to unite your family, share your values with the next generation and make the world a better place. As described by the donor-advised fund Donors Trust, a donor-advised fund begins with a donor contributing cash or assets to a public charity, which in turn creates a separate account for the donor. The donor may then recommend disbursements from the fund to other public charities. The contribution is a current tax deduction. Technically, the charity that sponsors the fund has final say on the disbursements, and is legally required to ensure they go only to charitable purposes, but in normal circumstances the original donor's requests will be followed.

  As a component fund of a public charity, a DAF features tax deductibility limits that are higher than those available for gifts to a private charity (such as a private foundation or private charitable trust). There are no excise taxes on investment income in a Donor Advised Fund, nor are there annual minimum distribution requirements. The DAF is not required to file separate tax returns, and is not subject to restrictive private foundation rules.

  I can speak from personal experience about the value of a Donor Advised Fund. My wife and I established our DAF at a Community Foundation where we live. We, like others, have found that a DAF can help your family develop or strengthen your values – a natural result as you and your children learn about the world around you, work and make decisions. You determine how your fund's money will be managed, and come to understand how processes such as spending, saving, and giving function together. Devoting even a small amount of time at family events or holidays to a DAF allows a family to enjoy working together and enjoy the results of giving.

- **Family Philanthropic Fund.** Less structured and restricted than a Charitable Foundation, it is usually created as a sub foundation of a public charity. More flexible than a DAF, a Family Philanthropic Fund is yet another useful vehicle for teaching children a healthy balance between

their needs and the needs of others, and introducing them to the concept of making the world a better place. It also allows them to make mistakes while under proper guidance.

There are many benefits of family philanthropy. It allows you to:

- **Teach your children responsibility for the greater good.** Engagement in family philanthropy means you will be discussing social problems such as the environment and poverty at dinnertime. This can encourage your children to think about and talk about how they can make a difference.

- **Put words into actions.** Family philanthropy is a practical lesson – it shows your children how money can improve the community.

- **Develop shared values and let children "earn" their inheritance**. Once children come to share your values and make them your own – that's when you can consider trusting them with your fortune. Children who grow up with parents who are engaged in charity will understand the power and the gift of philanthropy. They might not think of philanthropy as an albatross – they can surprise parents by thinking of it as an opportunity to carry on philanthropic values.

- **Have your children teach you new ways to make a difference**. Children can and will surprise you. They may come up with an entirely new way of doing good work and benefitting more people than you ever imagined was possible.

Finding the right advisors is the first and most important step toward a carefully planned legacy

These ideas are about philanthropy – and more broadly, about managing your legacy – are thought starters. They are intended to stimulate your ideas, passions and interests, and perhaps move you to action. But any action you take should be deliberate and well considered. As with any major, far-reaching financial decision, the best course is to proceed slowly and carefully, and to take advantage of good counsel. A series of discussions with financial advisors, legal advisor and tax professionals will help you navigate the "traps." Ideally, one or more of those advisors knows the family well, and can help guide you on a course that preserves your legacy in a manner that follows your wishes and desires for your family, others and your community as a whole.

SIDEBAR: TAX INFORMATION FOR LEGACY PLANNING

Federal estate tax rules

Today, the Federal estate tax exemption in 2016 is $5.45 million. The estate tax rate for estates valued over this amount is **40%**. The lifetime gift tax exemption and the generation skipping tax exemption is

also currently **$5.45 million** and the maximum tax rates are also **40%.** The annual exclusion from gift taxes is $14,000 for 2016.

"Portability" of the federal estate tax exemption between married couples has become permanent. In short, married couples can add any unused portion of the estate tax exemption of the first spouse to die to the surviving spouse's estate tax exemption, referred to as "portability of the estate tax exemption." This means that **in 2015, a married couple can pass on up to $10.86 million to their heirs free from federal estate taxes** with absolutely no planning at all. Note, however, that even if the deceased spouse's estate will not be taxable (less than $5.43 million in 2015), the surviving spouse must properly file a UNITED STATES ESTATE (AND GENERATION-SKIPPING TRANSFER) TAX RETURN, in order to take advantage of the deceased spouse's unused estate tax exemption, otherwise the deceased spouse's exemption will be lost.

The generation skipping transfer tax applies to the amount that can be directly transferred to grandchildren or into a generation skipping trust for the benefit of children without incurring a federal generation skipping transfer tax. The tax also applies to transfers to an unrelated person who is 37 1/2 years or younger than the transferor.

State taxes vary considerably and require careful consideration when planning gifts and estates.

We will discuss three states below, but be aware that every state has its own planning issues and needs to be vetted with your advisors. In addition the states may try to draw the estate or gift into multiple jurisdictions which must be carefully managed.

Estate tax rules: Connecticut

Connecticut resident and nonresident estates of decedents are liable for the Connecticut Estate Tax on the amount of their Connecticut taxable estate that exceeds $2 million. A "Connecticut taxable estate" is defined as the sum of the total value of the decedent's federal gross estate, less allowable deductions, plus the aggregate amount of Connecticut taxable gifts made on or after January 1, 2005. A credit is granted for gift taxes previously paid; however, the credit cannot exceed the amount of the Connecticut estate tax.

For Connecticut taxable gifts, a donor must pay Connecticut gift tax if the aggregate amount of Connecticut taxable gifts made on or after January 1, 2005, exceeds $2 million. "Connecticut taxable gifts" are defined as taxable gifts as determined for federal gift tax purposes. They include gifts of Connecticut real property, tangible personal property situated within Connecticut, or intangible personal property made by Connecticut residents.

The Connecticut Gift and Estate tax kicks in on gifts aggregating $2,000,000 or more with graduated rates starting at 7.2% rising as high as 12% for amounts in excess of $10,100,000.

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Estate tax rules: New York

New York residents must file a New York State estate tax returns if the amount of the resident's federal gross estate, plus the amount of any INCLUDIBLE GIFTS, exceeds the BASIC EXCLUSION AMOUNT applicable at the date of death.

An estate of a New York nonresident must file a New York State estate tax return if the estate includes any real or tangible property located in New York State, and the amount of the nonresident's federal gross estate, plus the amount of any INCLUDIBLE GIFTS, exceeds the BASIC EXCLUSION AMOUNT applicable at the date of death.

An includible gift is any taxable gift under the Internal Revenue Code (IRC) that was made during the preceding three year period ending on the decedent's date of death, and is not already included in the decedent's federal gross estate However, a gift is not included if it was made by a resident or nonresident and the gift consists of real or tangible property located outside of New York State, was made while the decedent was a nonresident, or was made before April 1, 2014. Basic exclusion amount is segueing to $5,250 million in 2018 (it is currently $3,125 million increasing annually.)

Estate and inheritance tax rules: New Jersey

New Jersey is one of only a few states that impose both an inheritance tax and a state estate tax.

The inheritance tax is applies when someone who lived in New Jersey, or owned property there, leaves property to someone who isn't a close relative. The tax rate depends on how closely the inheritors and deceased person were related.

New Jersey law puts inheritors into different groups, based on their family relationship to the deceased person.

The following beneficiaries are exempt from the inheritance tax: A spouse, domestic partner, or civil union partner, parent or grandparent a child or stepchild (but not step grandchild or great-step grandchild) and a grandchild or other lineal descendant of a child.

A special class exists for brother or sister, a spouse or civil union partner of the deceased person's child and a surviving spouse or civil union partner of the deceased person's child. The first $25,000 of property inherited by someone in this class is not taxed. On amounts exceeding $25,000, the tax rates range from 11% to 16% (for amounts in excess of $1.7 million.

Everyone else who is not subject to the above special exemption amounts, the applicable tax rates are 15% on the first $700,000 and 16% thereafter.

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Legacies to the State of New Jersey or any of its political subdivisions for public or charitable purposes, an educational institution, church, hospital, orphan asylum, public library, and typically Charitable institutions and nonprofit agencies are exempt from inheritance tax.

The New Jersey Estate Tax is in addition to the New Jersey Inheritance Tax.

A New Jersey estate tax return must be filed if the decedent's Gross Estate plus adjusted taxable gifts amounting a minimum of $675,000 (vs. $5.43 million for federal exclusion) The rates are graduated from 3.7 percent on estates over $675,000 to 16 percent on estates over $10,040,000.

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About Robert G. Kuchner

Robert G. Kuchner, CPA/PFS, is a Partner at Marks Paneth LLP. Mr. Kuchner serves a diverse spectrum of privately owned companies and their owners as well as clients in the theater, media and entertainment industry. He also provides family office and business management services to a varied client base. Mr. Kuchner holds a Bachelor of Business Administration degree in Public Accounting from Hofstra University's Frank G. Zarb School of Business, where he currently serves on its Dean's Advisory Board. He is based in Marks Paneth's midtown Manhattan headquarters.

About Marks Paneth

Marks Paneth LLP is an accounting firm with more than 550 people, including over 70 partners and principals. The firm provides public and private businesses with a full range of auditing, accounting, tax, consulting, trade remediation and valuation services as well as litigation and financial advisory services to domestic and international clients. The firm also specializes in providing tax advisory and consulting for high-net-worth individuals and their families, as well as a wide range of services for international, real estate, hospitality, media, entertainment, nonprofit and government services clients. The firm has a strong track record supporting emerging growth companies, entrepreneurs, business owners and investors as they navigate the business life cycle. Its headquarters are in New York City. Additional offices are in Washington, DC, New Jersey, Long Island and Westchester. For more information, please visit markspaneth.com.

FOR MORE INFORMATION

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