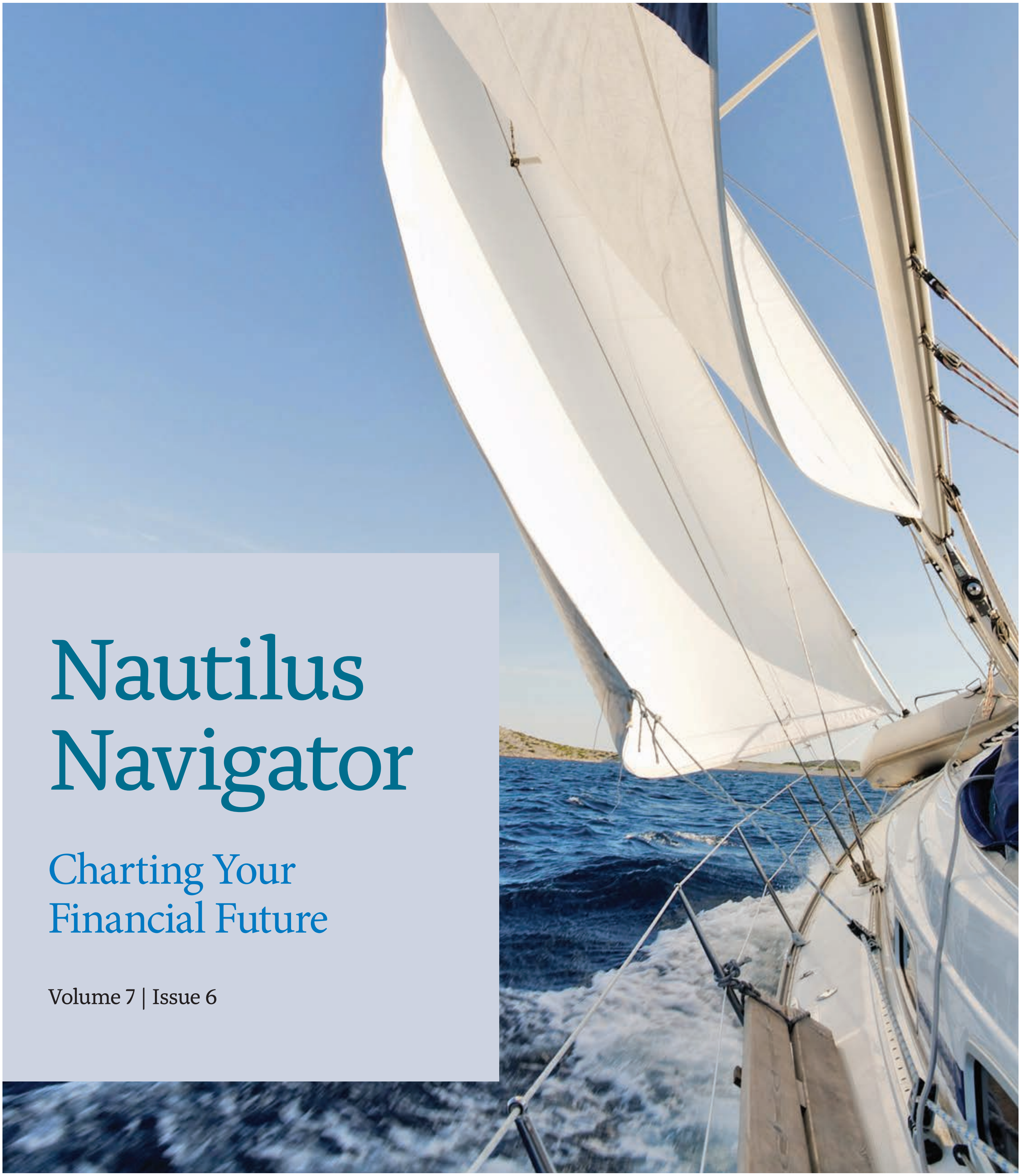

Nautilus Navigator

Charting Your Financial Future

Volume 7 | Issue 6

Asset Protection

Asset titling

Summary.
Even if wills and revocable living trusts are drafted to maximize estate savings, titling and beneficiary designations of property may prevent the documents from operating as intended. Additionally, assets may not pass to the intended beneficiaries if not titled properly.

Joint Ownership.
When two or more people own property, generally the title is either held as joint with rights of survivorship (JWROS) or joint tenants in common (JTIC).

Joint with Rights of Survivorship.
When property is owned as JWROS, if one of the owners dies, the surviving joint owners automatically receive control and ownership of the entire property. The assets do not go through the probate process.

- If Mark and Mary own stock as JWROS and Mary dies, Mark will own the stocks and bonds entirely. Mark will receive the stock even if Mary's will leaves the stock to her son, Manny.

Joint Tenants in Common. When property is owned as JTIC, the deceased owner's fractional share passes by will or revocable living trust. While a JTIC owner has the right to control his share (such as lien, use, sale, partition), in practice, a JTIC may require the consent of the other owners. In the absence of the words, "with rights of survivorship," many states infer that the property is owned JTIC.

- If Mark and Mary own stock as JTIC and Mary's will leaves the stock to her son, Manny, then Manny would receive Mary's share of stock and would become a JTIC with Mark.

Tenancy by the Entirety. Tenancy by the entirety is a statutory form of ownership similar to joint with rights of survivorship that is only available to a husband and wife. Each spouse owns the entire property so he/she cannot convey it independently, and it cannot be partitioned, providing some degree of asset protection. Not all states have tenancy by the entirety.

Community Property. Other common forms of ownership include community property (with or without rights of survivorship) and separate property. Only a limited number of states operate under the community property system.[1] Community property applies to married spouses, and deems property as co-owned regardless of title.

Non-Probate Assets.
Another potential asset titling problem relates to assets that pass by contract or beneficiary designation, e.g., retirement benefits, IRAs, employee benefits, annuities, and life insurance contracts.

- If Mary names Mark on her IRA beneficiary designation, Mark will receive the IRA, even if her will or her revocable living trust states that the IRA should pass to Manny. In some states, even if Mark is an ex-husband he may receive the IRA.
- It is common for bank accounts and investment accounts to be titled as Payable on Death (POD) or Transfer on Death (TOD).

Other Considerations.

- Beneficiary designations and financial accounts should be checked frequently to make certain the beneficiary or the ownership is as the owner intends.
- Non-probate assets cannot fund trusts created in a will or a revocable living trust unless the beneficiary designation specifically states the name of the trust. Additionally, certain requirements must be included in the trust document when retirement plans are made payable to trusts.

Tax Implications.

- Gift Tax - Changes of title may result in gift tax, due to change of ownership.
- Estate Tax - Both probate and non-probate assets owned by the decedent are generally included in the estate.
- When the first owner of community property dies, both the decedent's and the survivor's halves of the community property receive a step up in basis. Therefore, it is important to take care when re-titling community property.
- Change of ownership of a residence may affect homestead exemption and liability insurance.
- FDIC considerations should be considered for bank account changes.

1 Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin

Philanthropic Planning

The charitable opportunity for real estate.

By Bryan K. Clontz, CFP®, CLU®, ChFC®, CAP®, AEP®

Most donors have more of their wealth in real estate than in any other asset type. Despite this, in 2012 (the most recent year for which data is available), the IRS reports that donors gave only $4.5 billion worth of real estate. That may seem significant, but securities donations topped $22.3 billion, while clothing exceeded $9.3 billion. Indeed, real estate gifts were not quite 10% of the fair market value (FMV) of all noncash donations reported on IRS Form 8283—not even including cash contributions.

This may be because the risks and complications that often accompany gifts of real estate require a different expertise to accept, manage, and liquidate—a key aspect as real estate can often be less liquid than other assets.

This article highlights the magnitude of the real estate gift opportunity, reviews types of real estate assets, summarizes key issues organizations and donors face with real estate gifts, and reviews various mechanisms for receiving real estate gifts.

Tax implications of real estate gifts.

Real estate comes in many types, and each type has a number of ownership forms, which can create an array of tax consequences. As the most efficient charitable gift nearly always comes from the lowest adjusted cost basis, highest capital appreciation property held for the long term, real estate is clearly tailor made for charitable giving.

When owners sell real estate, tax rules generally require that any appreciation in value is taxed at capital gains rates—short term for property held less than a year, and long term for over a year. State taxes may apply as well. Additionally, depreciation recapture rules may apply. This means that the proportion of sale proceeds which can be donated to charity is lowered by amounts the donor pays for taxes. Essentially, only after-tax dollars can be donated if the property is sold by the donor.

If the owner donates the real estate directly to the charity, the result can be much more favorable. A direct gift to a public charity means a deduction of fair market value (FMV), limited to 30% of adjusted gross income with a 5-year carry-forward. If the owner instead donates to a private foundation, he or she would receive a deduction based on the lesser of the FMV or the adjusted cost basis. Regulations limit the deduction to 20% of adjusted gross income with a 5-year carry-forward. Note that real estate may be conducive for testamentary funding of a private foundation to the extent the property receives a stepped-up basis. Additionally, the deduction is reduced for any ordinary income elements, and may receive bargain sale treatment if there is debt on the property.

From the charity's perspective, the main tax issue is unrelated business taxable income (UBTI), which gives rise to unrelated business income tax (UBIT). The charity can trigger this treatment if the real estate represents an unrelated business (such as a golf course), or if the property has debt financed income. Charitable remainder trusts are subject to UBTI as well, in the form of a 100% excise tax on the unrelated income.

Risks, challenges, and solutions.

A general risk continuum can be an important starting point for gift acceptance discussions. It can indicate the potential complexity from the donor's perspective—the commitment of dollars, time, and effort. It also may help to identify certain challenges and possible solutions. A common concern is the time needed to explore proposed real estate gifts, especially when the charity may conclude, after many months, that it does not wish to accept the gift.

To avoid this result, the donor's team and the charity should discuss basic and essential information on the gift as early in the process as possible. Similarly, tax and legal questions should be addressed head on, and exposure to potential environmental liability also must be investigated, as it may involve multi-phase assessments.

From a practical perspective, all of the expenses and headaches of real estate ownership—taxes, insurance, utilities, tenant issues, and so on—will simply transfer from the donor to the charity and will continue until the charity can sell the real estate, so lack of marketability can exacerbate or extend these issues.

Ways to donate real estate.

Options abound when it comes to the structure of a real estate gift. There are three general categories that these donations fall into:

- Current gifts,
- Deferred gifts, and
- Life income plans.

Depending on the donor's wishes and needs, some donation structures may be more appropriate, e.g., whether the donor would like income or wants to continue living on the property.

The most intuitive real estate donation is a form of current gift, donating the entirety of the property outright to charity. Donors also can give a smaller proportion of an undivided interest in their land. This means the donor can give some proportion of their interest that is less than 100%—half, a quarter, or any amount that is a "full slice" of the ownership interest. For example, a donor should not donate half of their mineral rights in property they otherwise own outright.

Another current gift is the charitable lead trust, which puts the real estate in a trust with income to be paid to the charity for life or a term of years. At the end of the payment term, the remainder or residual may be paid to the donor or to loved ones chosen by the donor. Inter vivos or lead trusts established during life offer no step-up in basis of the land received for heirs, whereas a testamentary lead trust permits a step-up in basis when the heirs inherit the assets.

Deferred gifts can be intuitive as well, after all, bequests in a will or revocable living trust are the most popular form of planned gift. Of course, prior to acceptance upon the death of the donor, the charity must conduct due diligence pursuant to its policies and procedures as explained above. An alternative to a bequest in a will or trust is a transfer on death (TOD) deed that may be allowed under state law.

Another type of deferred gift of land is the irrevocable gift of a remainder interest in a personal residence or farm with a life estate retained by the donor. This technique is particularly helpful where the donor wants to use the property for life but the charity wants to ultimately use or sell the property. The donor and charity must sign an agreement stipulating respective rights and responsibilities relative to property tax, insurance, and maintenance.

Finally, there are life income options such as charitable remainder trusts and charitable gift annuities. A charitable gift annuity is a contract where the donor contributes assets such as land and the charity provides fixed and guaranteed income for one or two lives. If land is donated, then the charity either may sell the land to fund the annuity or it may draw from its budget or endowment to fund the annuity payments. A deferred payment gift annuity can permit time for the charity to sell the land.

Charitable remainder trusts allow the donation of highly appreciated property, such as land, that the trustee may then sell without payment of capital gains tax. The cash proceeds can then be invested to earn income for the named beneficiaries. The trust can either pay a unitrust or annuity trust format. An annuity trust pays a fixed dollar amount; real estate must either produce income or be sold to satisfy the fixed payment amount obligation.

The unitrust format pays a fixed percentage of the trust value, either from income and principal or from the lesser of the fixed percentage amount or net income. The net income format is appealing since this allows time to sell the land to fund the payment obligation. It can even "flip" from a net income type unitrust to a standard unitrust after the land sells.

Summary.

Real estate offers many ways to leave a lasting legacy to a charitable organization. To learn more about the benefits and concerns of gifting real estate, consult with an experienced financial services provider.

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Revoking the irrevocable.

Irrevocable life insurance trusts (ILITs) are useful and powerful tools, and have been a staple of estate and asset protection planning for quite some time; however, as laws and personal circumstances continue to change with each passing decade, those once cutting-edge ILITs drafted in years past may not be serving the objectives that inspired their creation, and clients may want to essentially revoke the irrevocable. Fortunately, there are viable options to do this without triggering adverse tax results.

Reviewing ILIT objectives, purpose.

Ascertain how the ILIT is no longer serving the client's needs, as updated planning may determine the best course of action to effect a modification. The most common reasons for modifying an existing arrangement include:

- Financial wherewithal to maintain policy premiums or long term viability of the policy.
- Diminished perceived benefits due to changes in the transfer tax laws.
- Identity of desired trust beneficiaries due to marital status changes or family strife.
- Concerns over early distributions/ termination to trust beneficiaries.

Potential options to modify.

- **Policy sale.** Because the trustee of the ILIT owes a fiduciary duty to the beneficiaries, a trustee may not generally effect a distribution of a policy directly to the non-beneficiary insured. For a trust that no longer meets the insured's planning objectives, the trustee may generally sell the policy to the insured for the fair market value of the policy.
- **Trustee's discretion to terminate/ distribute.** Often, provisions exist that permit the trustee to terminate a trust based upon its size or the inherent administrative burdens relative to the benefits remaining. Also, depending on the express terms of the document, the trustee may employ liberal discretion to distribute principal or income outright.
- **Powers of appointment.** Conversely, provisions may permit a trustee or beneficiary to employ a limited power of appointment of trust assets, offering a way to direct assets to specific beneficiaries or a trust with more current distribution, tax, and asset protection provisions.
- **Trust protectors.** More recent ILITs may have provisions that permit modification of the trust language based on changed circumstances, tax laws, or a beneficiary's specific situation. For example, a trust protector using his or her appointed power may modify the trust language to include a special needs trust provision in anticipation of distributions for disabled beneficiaries.
- **Trust decanting.** Some states have recently provided a helping hand to modify a trust arrangement in the form of decanting statutes that provide a structure to move assets from older ILITs with insufficient or imperfect language to new trusts with language specifically addressing new tax laws or changed circumstances. Decanting may be especially helpful to address beneficiary distribution issues, such as when an overly strict or liberal ILIT distribution provisions are not appropriate or too restrictive for a given beneficiary.
- **Judicial reformation.** Of course, as a last resort, the ability to petition a court of law to modify or terminate an ILIT may be available under state law; however, depending on the jurisdiction and the sophistication level of the local judges regarding trust matters, the cost and probability of success of doing so vary somewhat. Typically, if all parties to the termination or modification agree, a court may acquiesce to a termination or modification, but a single dissenting voice can increase costs and unpredictability as to the outcome. Additionally, a judicial reformation of a trust can give rise to unintended tax consequences, as the IRS has stated that it will generally not be bound by a reformation for tax purposes.

As in all situations involving a potential modification to an otherwise irrevocable trust, a visit with an experienced estate planning attorney in the applicable jurisdiction to discuss the reasons for seeking to alter an arrangement and review potential planning options is always of paramount importance.

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