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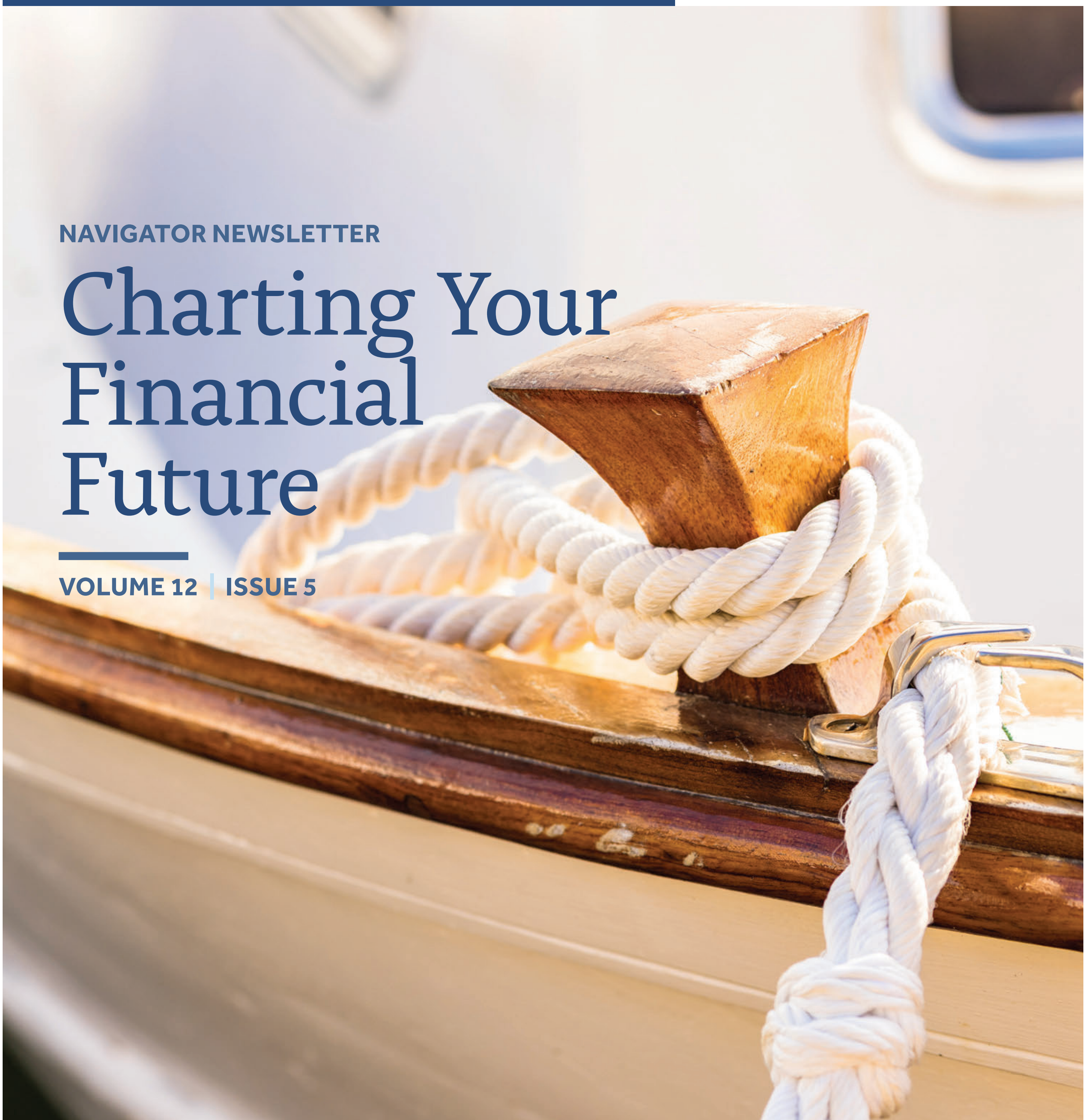

NAVIGATOR NEWSLETTER

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Asset Protection

Regular review of asset titling is important step for protection, distribution to heirs.

The manner in which an asset is titled controls how ownership passes upon the death of the asset's owner. 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.

In addition, asset titling can impact the level of protection afforded to an asset. For these reasons, reviewing how assets of an estate are owned is an important part of any estate planning process. The following describes the operation of various forms of asset ownership.

Joint Ownership

When two or more people own property, generally the title is held as joint tenants in common, joint tenants with rights of survivorship, or tenants by the entirety.

Joint Tenants in Common (JTIC)

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/her 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 jointly owned property is owned JTIC.

EXAMPLE: *Mark and Mary own stock as JTIC, and Mary's last will and testament leaves her stock to her son, Manny. Upon Mary's death, Manny would receive Mary's share of stock and become a JTIC with Mark.*

Property held as JTIC provides no creditor protection whatsoever. Creditors of one JTIC can force a sale of the entire property to satisfy a co-owner's personal debts, but the creditor can receive value only to the extent of the co-owner's interest in JTIC property.

Joint Tenants with Rights of Survivorship (JTROS)

If property is owned as JTROS, when one of the owners dies, the surviving joint owner automatically receives control and ownership of the entire property. The assets do not pass through the probate process.

EXAMPLE: *Mark and Mary own stock as JTROS, and Mary's last will and testament leaves her stock to her son, Manny. Upon Mary's death, Mark will own the stock entirely by operation of law even though her will leaves the stock to Manny.*

Generally, JTROS property, whether personal property or real estate, creates the same creditor risks as does JTIC property. Creditors of either joint owner can place liens against the JTROS property, and although the creditors cannot collect on a lien from the non-debtor's share of ownership, the creditors can force the sale of the JTROS property to collect from the debtor owner's share.

Tenancy by the Entirety (TBE)

TBE is a statutory form of ownership like JTROS; however, it is available only to spouses. Each spouse owns the entire property so neither one of them can convey property independently, nor can property be partitioned, providing some degree of asset protection. If a spouse dies, the survivor will become the sole property owner. Not all states have TBE, and in those that do, most require that both spouses must act together to convey, encumber, partition, sell or otherwise transfer TBE property, while some allow a spouse to act alone. In states where the spouses must act together, TBE property is usually exempted from the bankruptcy proceedings if only one spouse is the debtor of a creditor.

The most important right in the context of asset protection with regards to TBE property is the right that creditors do not have, which is the right to force the sale of TBE property. The protection against seizure of assets enjoyed by tenants of TBE property applies to nearly all creditors of an individual spouse. Exceptions include federal tax liens. Other than foreclosure, regulations vary from state to state regarding the degree of asset protection provided under tenancy by the entirety.

As stated, property held under TBE can still be seized as the result of a federal tax lien. The U.S. Supreme court has ruled that TBE property is subject to a federal tax lien against one spouse. This also includes criminal fines and forfeitures resulting from federal criminal cases. Therefore, the federal government (including the IRS) has the right to administratively seize and sell.

Community Property

Other common forms of ownership are community property (with or without rights of survivorship) and separate property. Only a limited number of states operate under the community property system: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Furthermore, Alaska and Tennessee are opt-in community property states which allow both spouses the option to sign an agreement (before and/or during marriage) designating which of their property is to be considered community property. Where a deed for real estate is issued as community property with rights of survivorship, it is not likely to protect the property against one spouse's debts. In community property states, both spouses are equally responsible for debts incurred during the marriage, even if only one spouse contracts for them. Also, residents of community property states may take advantage of an income tax rule (Internal Revenue Code §1014(b)(6)) that provides a full step-up in basis to fair market value on the entire property, not merely the decedent's interest in the property.

Non-Probate Assets

Another potential asset titling problem relates to assets that pass by contract or beneficiary designation. Common assets are individual retirement accounts (IRAs) and other qualified plan accounts, annuities, and life insurance contracts.

EXAMPLE: *Mary names Mark as beneficiary of her IRA (on the appropriate beneficiary designation form), and Mary's last will and testament leaves her IRA to her son, Manny. Upon Mary's death, the IRA will pass to (or may be rolled over by) Mark, even though her will leaves the IRA to Manny. (In some states, Mark will receive the IRA even as an ex-husband.)*

Some accounts also may require naming a successor owner. It is common for bank accounts and investment accounts to be titled as Payable on Death (POD) or Transfer on Death (TOD), which means that an account so designated will pass by operation of law and not through probate to the designated successor.

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.
- 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 the homestead exemption, title insurance, and liability insurance.
- For changes to bank accounts, credit union accounts, and securities accounts, FDIC, NCUA, and SIPC considerations, respectively, should be considered.
- Changes of title may result in gift tax due to change of ownership.
- Both probate and non-probate assets owned by the decedent are generally included in the estate.

Estate Planning

The impact of rising interest rates on estate planning strategies.

By Rebecca J. Solomon, JD, LL.M.

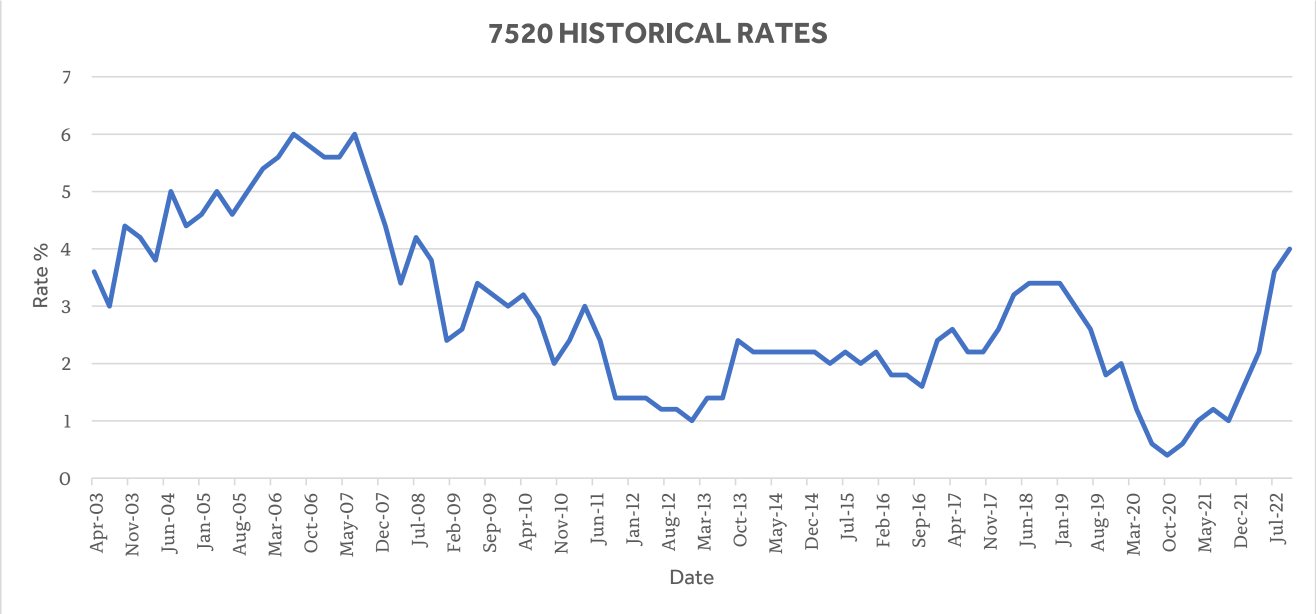
On September 21, the Federal Reserve raised its benchmark Federal Funds Rate for the fifth time in 2022, for a cumulative total of 300 basis points since March 2022. The Fed made these aggressive rate increases to fight inflation, which stood at 8.3% year-over-year at the time of its latest rate hike. These increases in the Federal Funds Rate cascade to all corners of finance, from credit card rates, auto financing, mortgages, and other rate-sensitive loans, to the fixed income (bond) markets.

Rising interest rates also impact the interest rates used in many estate planning strategies. First, rate increases are directly reflected in the Applicable Federal Rates (AFRs), which are published monthly by the IRS for federal income tax purposes. For estate planning purposes, the monthly AFRs establish the minimum rates for loans used in various planning strategies.

Changes in the AFRs also affect the "7520 rate," which is defined as 120% of the mid-term AFR rate (compounded annually) for that month. The 7520 rate is used to determine present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest. Thus, the 7520 rate has arguably the largest impact on estate planning strategies. The 7520 rate stood at 4.00% in October 2022. The chart on the page below shows the 7520 rates over the last 20 years.

Estate planning strategies negatively impacted by higher rates

Intra-family loans will be less effective in a higher interest rate environment. The AFR rate determines the minimum amount of interest that must be charged on such loans. This technique includes loans to family members to finance major purchases, to start a business, or meet other financial obligations. These loans can also be used as an asset shifting strategy, in which a senior family member loans a sum



to a junior family member, and the funds are used to invest in assets expected to have a return greater than the interest rate on the loan. When the loan is paid back, the junior family member keeps the difference between the return on the investment and the interest paid on the loan, effectively shifting the economic benefit from the senior family member without any gift tax consequence. Unfortunately, the higher the interest rate, the fewer assets that can be shifted to the junior family member. It also increases the risk that the investment will not outperform the rate on the loan, leaving the junior family member with a loss. Note that the lending family member will have to recognize the interest income on his/her tax return.

Installment sales to an intentionally defective grantor trust (IDGT) will also be adversely affected. This strategy involves an individual (the grantor) who “sells” property to a grantor trust created by him/her in exchange for a promissory note. The goal is that the property sold to the trust will have a total return greater than the interest rate on the loan, so that the net return after interest is retained in the IDGT, with no gift or estate tax consequence. Since the sale is to a grantor trust, the lender does not recognize any interest income for tax purposes, and the assets can grow income tax-free in the IDGT while the grantor is alive. However, as with intra-family loans, a higher interest rate will result in fewer net assets retained by the IDGT, and there is a similar risk that the total return on the asset sold will not outperform the rate on the loan. The hurdle to clear in order for this strategy to make economic sense gets higher as interest rates rise.

Similar to the sale to an IDGT strategy, the use of a grantor retained annuity trust (GRAT) will also be negatively affected by higher rates. The GRAT strategy involves a “split-interest” trust, in which the trust’s grantor transfers assets to the GRAT, and the GRAT pays back to the grantor a fixed annuity for a term of years. After that term is up, the remainder interest then stays in trust or is paid out to the remainder beneficiaries. Since the IRS’s 7520 rate determines the value of the annuity retained by the grantor, the goal is that the total return on the assets in the GRAT outperforms the 7520 rate, so after the annuity term the assets go to the remainder beneficiaries without gift or estate tax consequences. In this case, the 7520 rate is the hurdle that must be cleared, and a higher 7520 rate results in a larger annuity payment back to the grantor and fewer assets for the remainder beneficiary.

A charitable lead annuity trust (CLAT) is another type of split-interest trust, except the annuity payments for a term of years are made to a charity and the grantor is entitled to a charitable deduction for the amounts passing to charity. Only the assets calculated to remain at the end of the term are subject to gift tax. As with the GRAT strategy, a higher 7520 rate increases the charitable annuity and decreases the remainder for the grantor’s family (assuming all other factors remain the same).

Estate planning strategies that benefit from higher interest rates

A charitable remainder annuity trust (CRAT) is essentially the reverse of a CLAT—the non-charitable beneficiary receives an annuity for a term of years or for life (or two people can have a joint and survivor annuity for life), and the remainder goes to a named charity. In this case, higher 7520 rates will result in higher annuity payments to the family, assuming all other factors remain the same. The only caveat is that Treasury regulations require a minimum of 10% of the initial trust value must go to the charity in order for a CRAT to be valid. The IRS has also ruled that a CRAT is not valid if there is a greater than 5% chance that the trust fund will be exhausted before the trust ends. So, there is an upper limit as to how much a CRAT can pay out to the non-charitable beneficiaries. Nevertheless, higher 7520 rates make CRATs more attractive as an estate planning strategy.

The other strategy that benefits from higher 7520 rates is the qualified personal residence trust (QPRT), a split-interest trust used to transfer a residence or vacation home to children or other family members at a discounted value for gift tax purposes. The grantor(s) transfer the home to the trust and retain the right to use/occupy the home for a period of years. At the end of the term, the home is retained in trust or transferred to the children or others. As above, higher 7520 rates increase the value of the retained interest and decrease the value of the remainder interest—the amount subject to gift tax. The relationship between the 7520 rate and the amount of the taxable gift is illustrated in the table below, showing the taxable gift for the same QPRT terms over the last five years.

Qualified Personal Residence Trust
20-Year Term
$1,000,000 FMV Real Property

Date	7520 Rate	Taxable Gift
Oct 2022	4.0	$364,230
Oct 2021	1.0	$654,050
Oct 2020	0.4	$736,820
Oct 2019	1.8	$558,580
Oct 2018	3.4	$408,910

Final Thoughts

While interest rates impact these estate planning strategies in substantial ways, one should be careful not to let the "interest tail" wag the dog. While interest rates are relatively high now, they still remain within reasonable levels compared to historical patterns. Even if the hurdle to break even on an estate planning strategy is now around 4%, it will still make economic sense if the underlying asset is expected to have a total return substantially greater than 4%. Waiting for rates to decrease also may not be wise. Even if a strategy does not yield as much benefit as before, any amount that can be transferred out of one's taxable estate now is better than none.

In the meantime, work with your professional advisors to take advantage of the opportunities that higher rates bring to estate planning by considering the benefits of a CRAT or a QPRT.

Rebecca Solomon, JD, LL.M., joined The Nautilus Group in 2020 as a member of the case development team, bringing more than 25 years of experience in the areas of estate planning, estate and gift tax compliance, business planning, and philanthropic services in both private law practice and public accounting. She has been a frequent speaker at national conferences on estates and trusts, and she is a past instructor in the Certified Financial Planner™ education programs at two universities. Rebecca earned her B.A. in political science from the University of Michigan, her J.D. from Michigan State University College of Law, and her LL.M. in tax from Wayne State University Law School.

Retirement Planning

IRA distributions to a CRT can provide asset protection and retirement income.

By Robert Ahearn, JD, LL.M., CFP®, CLU®, ChFC®, CRPC®, CTEP®

The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) that took effect in January of 2022 was designed to prevent older taxpayers from outliving their assets by increasing access to certain tax-advantaged accounts. A consequential part of the SECURE Act eliminated an estate planning tool designed to stretch individual retirement account (IRA) payments over the lifetime of the IRA beneficiary, replacing it with the requirement of full distribution of an IRA to its beneficiary (or beneficiaries) within 10 years following the year of the IRA owner's death.

A noteworthy estate planning technique has arisen in response to this new 10-year distribution requirement that attempts to recreate a "stretch IRA" by using a charitable remainder trust (CRT). Utilizing a CRT can lengthen (or stretch) the time for payments to the beneficiary and provides income tax advantages also. The payment made from the CRT (referred to generically as the "payout") is made instead to the CRT lifetime beneficiary, replacing the distribution that would have been made from the IRA.

There are two basic types of CRTs:

- A charitable remainder annuity trust, or CRAT; and
- A charitable remainder unitrust, or CRUT.

Payments can be structured as either a fixed percentage of the value of the CRT assets at inception (an annuity trust, or CRAT), or a fixed percentage of the value of the CRT assets on an annual basis (a unitrust, or CRUT). A CRUT is the preferred type of trust due to its innate flexibility regarding both design and payout options.

IRA owners can fund a CRT by distributing either their entire IRA balance at one time or, alternatively, over several years (not to exceed 10). A CRUT is preferred because it allows the owner to make additional contributions following the initial year and the beneficiary is not required to make withdrawals. While the IRA distribution to fund a CRUT is considered taxable income, the IRA owner can offset a portion of the income with a charitable income tax deduction. The proceeds of the trust can be used to pay income to the IRA owner's beneficiaries.

The CRT beneficiary receives a payout over his/her lifetime with the remainder passing to a charity of the original IRA owner's choice, including a donor advised fund established by the original IRA owner.

Payments made to the CRT lifetime beneficiary are considered taxable income, and furthermore, are subject to the "tiering" rules set forth at Internal Revenue Code §664(b). These rules determine how distributions to the beneficiary are taxed since a CRT will often have a mixture of various types of taxable income.

For example, assume that a CRT has investments that generate ordinary income, capital gains, and tax-free interest income. The tiering rules determine how the distribution is taxed to the CRT's lifetime beneficiary:

- First, ordinary income;
- Then, income from capital gains;
- Next, tax-free interest income; and
- Last, any tax-free return of basis.

As an enhancement to this plan, two basic strategies using life insurance that can augment CRT assets are available.

First, if all IRA assets are subject to tax, then IRA proceeds (typically, a post-tax amount) can be used to purchase a life insurance policy within the CRT. Life insurance inside of a CRT will boost the assets available to a successor lifetime beneficiary and/or the charitable remainder beneficiary.

Second, payouts to the CRT's lifetime beneficiary can be redirected to a wealth replacement trust (WRT), which is merely another name for an irrevocable life insurance trust. At the death of the lifetime beneficiary, the remainder of the CRT passes to the charity named in the CRT, but since a life insurance policy was funded with part of the CRT distributions (typically, the post-tax amount), the WRT has essentially replaced assets contributed initially to the CRT for the benefit of family members. The life insurance policy distributions will be income tax-free.

By designating a CRT as recipient of IRA distributions, the SECURE Act's 10-year payout can be altered effectively for asset protection, estate planning, retirement income, and charitable planning purposes.

Robert Ahearn, JD, LL.M., CFP®, CLU®, ChFC®, CRPC®, CTEP®, has been with The Nautilus Group since 2016, applying his substantial business, legal, and tax experience to support Nautilus member agents with the development of advanced planning strategies for their clients. As an estate and business planning attorney, Robert worked extensively with high net worth individuals, closely held businesses, farmers and ranchers, private foundations, and public charities. He earned a B.S. in Business Administration from the Boston University School of Management, a J.D. from the Suffolk University Law School, and a LL.M. in Taxation from the Boston University School of Law. Robert is a member of the state bars of Arizona, California, and Massachusetts and the Estate Planning Council of North Texas. He holds FINRA Series 7 and 66 licenses.