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## Financial and Tax Planning

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### A Note from Paul

In an effort to further your financial goals; this month I will offer, a free one hour review of your investments, retirement and 529 plans. This offer is good through the end of November. In this issue and next I will be covering estate, retirement and financial planning. Don't forget I am offering 20% off of your next tax return or service for every new client that you refer me. As always, if you have questions, please feel free to call me. - Paul

### Asset Protection using Trusts

Asset protection simply means organizing your business and/or personal affairs in advance so as to reduce or eliminate liability exposure or financial misfortune. It is an extension of and adjunct to traditional forms of protection, such as insurance and incorporation, which have in some cases become inadequate.

While asset protection should be considered for all high-wealth individuals, it is particularly important for professionals who face the possibility of malpractice claims, officers, directors and fiduciaries who face the possibility of claims arising

from their duties, real estate owners who have exposure to possible environmental claims, and individuals exposed to lawsuits arising from claims alleging negligent acts, intentional torts, or contractual claims. It may also be considered as a prenuptial alternative. It is important to note that it is not limited to those currently facing claims -- in fact, asset protection can in most cases offer protection only against future creditors. If a lawsuit is already underway or an accident or other event has already occurred, an asset protection trust will not provide any protection

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### Life Insurance Trusts

Life insurance is usually purchased to accomplish several major objectives. The main reason people purchase insurance is to create an estate that will provide enough cash for their families to sustain an accustomed standard of living should the insured die unexpectedly.

Secondly, wealthy people buy insurance to provide a fund to satisfy their estates' need for liquidity. Less commonly, people may buy life insurance to establish a wealth re-

placement fund to replace property transferred to a charitable remainder trust.

Insurance trusts can be used to help accomplish all these objectives at minimal tax cost.

#### WHY USE AN INSURANCE TRUST

Giving a life insurance policy to a trust has several advantages over direct ownership: the trustee will col-

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## Life Insurance Trusts, Continued

*(Continued from page 1)*

lect the proceeds and disburse them under the terms specified in the trust document, and the trust may provide income tax benefits, in that if the trust's income is spread among several beneficiaries in lower tax brackets than those of the grantor or the trust itself, there is a reduction in total tax liability for the group. In addition, the existence of a trust assures that the insurance proceeds will be available to pay the insured's estate settlement expenses. However, the major purpose of the transfer to the trust is ensure that the insurance proceeds are not included in the insured's estate.

Life insurance held by a trust is generally included in the decedent's estate only if the grantor/decedent had incidents of ownership over the policy, or the proceeds of the policy are required to be used to pay taxes and expenses of the estate of the insured. Thus, the trust must be irrevocable, and the grantor must not be the trustee or beneficiary of the trust. In addition, the transfer to the trust should be carried out while the insured is still in good health, as life insurance transfers made within three years of death cause inclusion of the death proceeds in the grantor's gross estate.

### MINIMIZING GIFT TAXES

The transfer of a life insurance policy to an irrevocable trust is a taxable gift. In general, the gift will not be eligible for the annual exclusion, since it is not a gift of a present interest. In addition, any subsequent payment of premiums by the grantor can result in gift tax liability. However, the transaction, as well as subsequent payments of premiums by the grantor, can be structured so that the annual gift tax exclusion for gifts of present interests will apply.

In the case of the initial trans-

fer, the use of a Crummey power, in which the beneficiary is given the right to withdraw all or a portion of the annual additions to the trust is the best alternative. This allows the transfer to qualify for the gift tax annual exclusion for gifts of present interests, and may allow the avoidance of gift tax on the payment of the premiums, without resulting in any possible estate tax inclusion.

Other alternatives, such as allowing the trust beneficiary to demand the trust's principal, or setting up the trust to qualify as a transfer of a present interest under the rules on gifts to minors, are not recommended, since they will cause the inclusion of the life insurance proceeds in the estate of the beneficiary.

To minimize gift taxes, the Crummey power should limit the right to withdrawal to an amount not more than the greater of \$5,000 or 5 percent of the total value of the assets out of which the power can be exercised. Otherwise, if the beneficiary does not in fact exercise the right of withdrawal, the lapse of the right can be treated as a gift by the beneficiary to the trust. For this reason, many life insurance trusts limit the annual withdrawal power to the lesser of (1) the beneficiary's prorated share of the transferred amount; (2) the annual exclusion of the transferor or transferors (\$ 10,000 or \$20,000); or (3) the \$5,000/5 percent amount.

The use of a Crummey power also allows the grantor to pay the premiums without gift tax consequences, assuming that the premiums amount to less than \$ 10,000 per donee per year (or \$20,000 in the case of a split gift). Alternatively, it may be possible to avoid a gift tax result by having the donor make cash gifts to the beneficiary and having the beneficiary pay the premiums.

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*Disclosure: The information provided in this newsletter is of a general nature and isn't intended to address the circumstances of any particular individual, business or other entity. Please consult your CPA or Attorney if you have questions or concerns.*

*\*Securities offered through H.D. Vest Investment Services, a non-bank subsidiary of Wells Fargo & Company, Mem-*

## Asset Protection Using Trusts, Continued

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against those claims.

Although there is no single formula, the basic features of asset protection include:

(1) Limiting directly-owned assets to those that cannot be reached in bankruptcy or under the laws relating to creditors' rights.

(2) Using family limited partnerships to take title to business and investment assets, with the person seeking asset protection holding the general partnership interests and the other family members holding the limited partnership interests.

(3) Making systematic gifts to relatives of family partnership interests.

(4) Using domestic or foreign trusts to hold assets.

This article will focus on using trusts for asset protection.

### TRUSTS IN GENERAL

Trusts separate legal ownership from beneficial ownership. Since a trust beneficiary does not generally have legal ownership of trust property until distributions are made, the property is free from the beneficiary's creditors' claims (although in some cases, this may not be true if the beneficiary is also the settlor, as discussed below). Thus, trusts can be an important part of asset protection planning.

One important function a trust can serve is to separate ownership of "dangerous" assets -- assets that tend to produce liability, such as real estate -- from other assets. In addition, it may be appropriate to consider partitioning and dividing assets into groups and placing them in different trusts, as follows:

(1) exempt assets (such as the taxpayer's personal residence, if it qualifies for the homestead exemption) are placed in trust for the benefit of the spouse who faces the greater exposure to being sued (the exempt-assets trust);

(2) another trust takes income-producing assets for the benefit of

the non-exposed spouse;

(3) a living trust takes other non-income producing assets, so as to avoid probate;

(4) another trust takes the stock of a corporate general partner in the limited partnership;

(5) finally, other assets will go to trusts for children.

### USING DOMESTIC TRUSTS

In most states, domestic trusts can offer only limited protection to the person who transfers assets into them. In general, the creditors of the person who creates a trust (the settlor) can recover against trust assets if the trust was funded as a result of a fraudulent conveyance, the settlor retained control, such as the power to revoke or appoint property, the settlor retained a beneficiary interest, or the trust is a sham. However, beneficiaries other than the settlor, such as the settlor's spouse and children, may receive considerable protection. In addition, since most states recognize the validity of spendthrift trusts when not established by the beneficiary (at least against most creditors), protection can be obtained for the owner of the property by having newly acquired property, such as gifts or inheritances, transferred directly into a spendthrift trust.

The protection available to the beneficiary of a domestic trust is dependent on three factors: the degree of control retained by the settlor, whether beneficiaries have a power of appointment over the trust, and the withdrawal or invasion rights provided to the beneficiaries. Maximum protection is available if the trust provides for an independent trustee, the beneficiary has the right to receive income or principal distributions only at the trustee's discretion, the trustee has the power to hold back distributions if they are adverse to the beneficiary's interest, the trustee has the power to make payment on behalf of beneficiaries, rather than directly to them, the trustee is authorized to ac-

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quire assets for the use of the beneficiaries, the power of appointment given to beneficiaries is limited, the trust includes spendthrift provisions, and the trustee has the power to create separate trusts and entities to isolate dangerous property, as discussed above. Examples of commonly used trusts that provide some asset protection include:

- (1) discretionary trusts;
  - (2) support trusts, under which the distributions are limited to health, support, and maintenance;
  - (3) credit-shelter discretionary trusts;
  - (4) marital trusts that limit principal invasions;
- and
- (5) split interest trusts such as charitable remainder trusts, grantor retained annuity trusts, and qualified personal residence trusts.

In addition, a settlor can obtain some protection by retaining an income-only interest, which protects the principal, or giving the trustee limited discretion to distribute principal to the settlor only for emergency needs or where the settlor has insufficient resources for support and maintenance.

Asset protection is not primarily a tax reduction strategy (although it may be combined with estate planning). However, it is intended to be tax-neutral -- that is, it should not place the you in a worse position than if the asset protection plan had not been undertaken. Therefore, it is important to look at the tax consequences of the transfers to the trust. Since the settlor of a domestic trust must

keep to a minimum his or her control over the trust, the trust should not be a grantor trust. Thus, the transfer to the trust will in most cases be a taxable gift to beneficiaries of the value of the their beneficial interest. In addition, the income from the assets will be taxed to the trust (and to the beneficiaries as distributed), under the rules on the taxation of trusts. The trust may or may not remove the assets from the settlor's estate, as the assets will be included in the estate to the maximum extent that the trustees can distribute the property to the settlor. However, the transferor will at worst be no worse off than if the asset protection strategy were not put in place.

I have just touched the subject of using trusts for asset protection, if you would like more information, give me a call or email.

### **In Closing.....**

If you have a question as to how to save more on your taxes, give me a call to set up a meeting to review your situation. I am currently setting up appointments for review and planning for businesses and individuals. There are still things we all can do to save on taxes. Remember, It's not too late to make a difference for 2003...as long as you act before January 1, 2004!