

# LEGAL ALERT

March 2003

## BUSINESS AND PROPERTY LAW UPDATE

### CHARITABLE LEAD TRUSTS: TIME TO TAKE A LOOK

*By: George F. Bearup*

With the weakened stock market and extremely low interest rates, now is a good time to dust off an old estate planning tool that seldom gets much exposure. A Charitable Lead Trust (CLT) is particularly effective at a time when there is considerable uncertainty surrounds federal transfer taxes, what the laws will be, whether there will even be an estate tax, or whether the estate tax will be restored to its pre-2001 rates. In concept, the Charitable Lead Trust is often described as a "temporary gift" to charity.

A Charitable Lead Trust usually creates income tax benefits to the donor that enable assets to be passed to children or grandchildren several years later at virtually no transfer tax cost. For example, say you have \$1 million of marketable securities. You transfer them to a CLT. The CLT will pay \$70,000 a year for 18 years to a charity of your choice. At the end of 18 years, your children receive the CLT's assets. If the

CLT investments follow historic patterns, more than \$1 million will be in the CLT in 18 years, even after the \$70,000 a year pay out to the charity. While there would be a gift tax return to be filed, you would not owe any gift tax, because of the use of your \$1 million federal gift tax exemption. The gifted stock would be removed from your taxable estate in the event of your death, including any future stock appreciation. Thus, your children would ultimately receive \$1 million, gift tax "free" and estate tax "free." If a CLT unitrust was used and your grandchildren were the "end" beneficiaries, your \$1 million generation skipping transfer tax exemption could also be applied to this gift and there would be no generation skipping transfer tax at the time that the CLT terminated.

The income tax benefits to a CLT depend on the form of a type of CLT Trust. The CLT can either be established as what is known as a non-grantor CLT or a grantor CLT for income tax reporting

purposes. In a non-grantor CLT, the Trust pays income to the charity either in annuity or unitrust (fixed percentage) amount from the CLT. In a non-grantor CLT you will receive a gift tax charitable deduction for the value of the charity's interest in the CLT, but you will not receive any income tax deduction. Income tax savings occur indirectly, however, because you are no longer taxed on the income that is produced by the gifted assets. The primary advantage to you is that a significant reduction in the transfer tax occurs due to the gift tax charitable deduction and the avoidance of the transfer tax on any future appreciation in the value of the CLT's assets.

If a grantor CLT is used, you are treated as the owner of the CLT under the grantor trust income tax rules. A grantor trust usually results if you hold a reversionary interest in the CLT of more than 5%, or you retain the right to substitute assets for equivalent value in the CLT, or you empower the CLT's Trustee to add one or

more charitable beneficiaries. You receive both the gift tax and the income tax charitable deduction, but then you are taxed on all CLT income, even the amounts that are paid to the charity. The income tax that you face as the donor can be minimized if the CLT is funded with municipal bonds that produce tax exempt income or appreciated stocks that can be sold off each year to make the required "pay out" to the charity. However, if the stocks pay dividends, any income to you will be taxed. Generally, however, most of the tax will be in the form of long term capital gains.

To the extent that a charitable income tax deduction is created, a CLT is considered "for the use of" the charity, which means that the donor's contributions are deductible to 30% of the donor's adjusted gross income, with any excess "carried over" for five (5) following calendar years.

Consider a CLT established in March 2003. The applicable federal interest rate for March of 2003 is 3.8%. If the CLT is directed to pay a charity 3.8% of its assets for the duration of the CLT, the gift to the remainder holders can be easily computed. What is significant,

however, is that if the actual assets held in the CLT grow at a rate of more than 3.8% a year; all of that excess growth will be transferred to your children (or grandchildren) gift and estate free, estate tax free, and potentially generation skipping transfer tax free. So now, when interest rates are historically low, and many people are optimistic that the stock prices will "rebound" in the future, strong consideration should be given to a CLT to shift wealth to younger generations at virtually no transfer tax cost.

## TENANTS BY THE ENTIRETIES: A NEW LOOK

*By: George F. Bearup*

Recently, Michigan created a new estate planning or more accurate estate preservation opportunity. If you are not married, you can stop reading now. If you are married and are concerned about losing your assets to potential creditor claims, you will be interested in what follows. A part of estate planning is the implementation of asset protection strategies that prevent the loss of assets due to unexpected claims. In our highly litigious society, there is never enough insurance to cover all potential liabilities. As a result, even when individuals are not faced with an imminent liability, they nonetheless want to structure their assets in a manner so as to frustrate potential creditors. One of the most popular ways in which to protect assets from

creditor claims is for spouses to hold their assets as tenants by the entirety.

By owning an assets in an estate by the entireties, a husband and wife take the full title to the asset with full rights of survivorship. An estate by the entireties resembles a joint tenancy in that there is a survivorship interest held by both spouses, but it is distinguishable from a normal joint tenancy estate, because: (i) tenants by the entirety may only be held between a husband and wife; and (ii) a tenants by the entirety property cannot be forcibly partitioned, i.e., divide and sold, in a court action. [Divorce, of course, is a unique form of legal partition of assets between a husband and wife.]

But an estate by the entireties cannot be destroyed voluntarily or by the involuntary act of either spouse; consequently, creditors of one spouse cannot reach any interest in an entireties held asset. Accordingly, an entireties estate is exempt from creditor claims of either spouse. Creditors that hold joint claims against both spouses may continue to force the sale of an entireties held asset.

The common law of Michigan was that the entireties ownership of personal property was not formally recognized. Only real estate owned by a husband and wife could be owned by the entireties. This unique treatment of entireties property is a result of a 1927 Michigan Act that recognized tenants by

the entireties in certain assets besides real estate. Unfortunately, given the antiquity of that 1927 statute, it is not clear that the ownership of all types of property in Michigan can be held by a husband and wife by the entireties. When the 1927 Act was passed, six (6) limited classes of personal property were recognized under that statute to possess the effect of joint ownership as by a husband and wife who own real estate together, meaning by the entireties. While real estate can clearly be owned by spouses as tenants by the entirety, tangible personal property and what is called intangible personal property interest are not so clear. Unfortunately, the 1927 Act has never been amended. Consequently, many modern financial products that are owned by a husband and wife together may not, depending upon a judge's interpretation of this old statute, be considered to be held by them as by the entireties.

Since 1927 the Michigan Supreme Court has had infrequent occasions to comment upon the scope and intent of the statute. The late Theodore Souris, a well known and respected Michigan Supreme Court Justice, pointed out that the 1927 statute does not expressly provide for the creation of entireties ownership in those assets since "the Legislature could have easily used the word entireties as opposed to the concept joint tenancy in the Act. Consequently, courts have not

been inclined to expansively read the statute and the scope of its protection, limiting the statute to a few specifically identified assets, e.g., stock; mortgages; promissory notes; debentures; and evidences of indebtedness.

Why the background discussion on entireties ownership? With modern financial products it is unclear whether such assets can be owned by a husband and wife by the entireties and thus provide to the spouses a cloak from the creditor claims. An example of how the courts struggle with modern investment products is a recent federal court case Shapiro v Nicoloff. The federal judge held that a husband and wife's ownership of stock in a broker investment account, which contain publicly traded stock and money, was not part of the husband's bankruptcy estate, since it was held by them as by the entireties. The judge focused upon the fact that the investment account had required, at all times, that distributions be in the form of a check payable to both husband and wife. From that restriction, the judge concluded that an entireties interest was created. Had that investment account been accessible by either the husband or the wife, a different result would have occurred, and half the investment account would have been lost to the husband's bankruptcy creditors.

However, on December 30, 2002, Michigan amended its Limited Liability Company Act

to permit LL member interests to be held by a husband and wife by the entirety. Consequently, when spouses want to shelter modern investment assets from potential creditor claims, investment that are not clearly described in the 1927 statute, one step that they can take is to create a Limited Liability Company (LLC), transfer their investments to the LLC, and then own their LLC membership units as tenants by the entirety. If assets are held in that fashion, if either the husband or wife subsequently encounter creditor problems, the LLC units cannot be seized and liquidated to satisfy the creditor claims of the one spouse. Consequently, all assets held in the name of the LLC will be removed from the reach of one spouse's creditors. So while the scope of the 1927 statute is narrowly construed by courts to preclude the entireties ownership of modern financial products, the use of an LLC to hold title to those assets can circumvent that limited statute.

Now for a bit of bad news. Despite the unity concept upon which entireties ownership is presumed, the United States Supreme Court surprised everyone in 2002 by holding, in United States v Kraft, that a federal tax lien can be filed by the IRS against an entireties interest of only one (1) spouse. As such, one spouse's interest in the entireties property can be encumbered by a federal tax

lien. The Supreme Court did not say, however, how such lien can be enforced leaving us all guessing. As a result of these recent changes, both from Michigan's Legislature and the United States Supreme Court, a couple of conclusions can be drawn. If spouses want to protect their investment assets from the potential

creditor claims of one spouse, the entireties form of ownership is clearly the way to go. If many of their investments are new products that are not clearly identified in the 1927 statute, e.g., CDs; derivatives; mutual funds, it makes sense for the spouses to create a LLC and transfer title to their investments into the

LLC. The spouses can then take title to the LLC units by the entireties. While those steps will go a long way to prevent an attack from the creditor of one spouse, the strategy apparently will not work when the federal government attempts to collect back taxes from one spouse.

### PLEASE WELCOME...

Ann-Mary Petroskey is the newest member of Smith Haughey Rice & Roegge's Business & Property Law Department. Ann-Mary was admitted to the Michigan Bar in 1998 and practices in the areas of business and tax law. She is a member of the State Bar of Michigan Business Law, Taxation, and Probate and Estate Planning sections, the American Bar Association Section of Taxation and is also admitted to practice in the United States Tax Court.

Ann-Mary received her Bachelors Degree from Western Michigan University, her J.D. (cum laude) from Thomas M. Cooley Law School, where she was also an editor for the law review, and a Master of Laws in Taxation from Georgetown University Law Center. A long-term member of the National Ski Patrol, Ann-Mary serves as a regional and local instructor and evaluator in that organization. She currently lives in Farmington Hills where she is renovating a vintage home.

Ann-Mary's arrival strengthens the ability of our BPLD group to address your tax needs. She will be spending time in the next few months in both the Lansing and Traverse City offices before taking up permanent residence in Lansing. Her direct dial is 517.318.5659 and she can also be reached via e-mail at [apetroskey@shrr.com](mailto:apetroskey@shrr.com). We encourage you to contact her with any questions.

The members of the **SMITH HAUGHEY RICE & ROEGGE** Business & Property Law Department are:

Terence J. "T.J." Ackert, Chair	(616) 458-3638	<i>Grand Rapids</i>
George F. Bearup	(231) 486-4510	<i>Traverse City</i>
Thomas F. Blackwell	(616) 458-8426	<i>Grand Rapids</i>
James G. Black	(616) 458-4253	<i>Grand Rapids</i>
Charles B. Judson	(231) 486-4519	<i>Traverse City</i>
Robert C. Stone	(616) 458-3622	<i>Grand Rapids</i>
Richard C. Kraus	(517) 318-5653	<i>Lansing</i>
Robert W. Parker	(231) 486-4504	<i>Traverse City</i>
Jeffrey R. Wonacott	(231) 486-4509	<i>Traverse City</i>
Aileen M. Leipprandt	(616) 458-5298	<i>Grand Rapids</i>
Robert W. Tubbs	(231) 486-4535	<i>Traverse City</i>
Paul T. Jarboe	(231) 486-4538	<i>Traverse City</i>
Randall L. Velzen	(616) 458-3644	<i>Grand Rapids</i>
Rachel Brochert Roe	(231) 486-4503	<i>Traverse City</i>
Eric W. Phelps	(231) 486-4542	<i>Traverse City</i>
Heather R. Blanton-Dykstra	(231) 486-4543	<i>Traverse City</i>
Jeffrey A. VanderLaan	(616) 458-8605	<i>Grand Rapids</i>
Ann-Mary Petroskey	(517) 318-5659	<i>Lansing</i>