



The Buildup Equity Retirement Trust or BERT! The Wonder Trust™

CECIL SMITH (Memphis, Tennessee) and CAROL GONNELLA (Jackson, Wyoming)



The Buildup Equity Retirement Trust, or BERT! The Wonder Trust™, is becoming one of the most popular trusts in the practices of many estate planning attorneys. This trust is an irrevocable trust, wherein one spouse (the donor-spouse), makes gifts to the trust using the federal annual gift tax exclusion. The beneficiary of the trust is his or her spouse (the donee-spouse).

BERT takes advantage of several sections of the Internal Revenue Code to keep the assets gift tax free during life and estate tax free upon the deaths of both spouses. However, the donee-spouse has access to the assets in the trust for anything he or she needs, based on four standards (the so called ascertainable standards) for the donee-spouse's health, education, maintenance, and support. Based on these standards, the trustee of the trust (who may be the donee-spouse) determines when distributions should be made. This trust can be a haven for retirement savings, without all the onerous requirements imposed upon IRAs and qualified retirement plans, such as 401(k)s.

Generally, the trust is drafted as a "grantor trust." As a grantor trust, the donor-spouse, rather than the trust, is liable for the income tax liability on the income generated by the assets in the trust. Remember, if the trust were not created, the donor-spouse would pay this tax liability anyway. Thus, this is another benefit to the BERT, as the assets within the trust can grow free from income tax.

Because of the flexibility of a BERT, it may hold a multitude of assets, including but not limited to cash, stocks, bonds, real estate, life insurance, annuities, closely held corporate stock, limited partnership units, and limited liability company units. In fact, LLC units are great assets to contribute to a BERT because of the asset protection provided by the LLC and because of the discounts available for gift tax purposes.

Because the income of the BERT is not taxable to the trust, the gifts made into the BERT can grow dramatically over the years. With annual gifting, these trusts can slowly grow to over \$1 million within the spouses' lifetimes. The United States

Congress gives every person an exemption from federal estate tax of \$2 million (in 2008, and \$3.5 million in 2009). This is the amount a person can give away before incurring an estate tax. With a BERT a person can legally create another exemption from estate taxes. However, the assets in the trust are accessible and under the control of the donee-spouse as trustee throughout his or her lifetime.

Husbands and wives (as well as brothers and sisters and domestic partners) can create trusts for one another. Thus, the BERT trusts have the potential to create two additional estate tax exemptions...one for the husband and one for the wife.

With super-funding (gifting more than the annual gift tax exclusion — \$12,000 per donee per year in 2008, and \$13,000 in 2009), the amount that can pass tax-free to one's children or other loved ones can be several million dollars. The sum of \$440,000 is the magic number for superfunding, as 5% of \$440,000 is \$12,000, the annual gift tax exclusion in 2008. (The annual gift tax exclusion is \$13,000 in 2009.) However a donor-spouse may 'superfund' the trust with a lesser amount.

HOW CAN I MAKE GIFTS TO MY SPOUSE DURING MY LIFETIME?

There are several ways to make gifts to your spouse during your lifetime. Most gifting techniques to spouses require that assets be included in the spouse's estate at his or her death. However, there are techniques to keep the gifts free from estate tax liability. Gifts to spouses include the following.

Gifts to spouses who are United States citizens. Gifts to spouses who are United States citizens may be made in unlimited amounts pursuant to the unlimited marital deduction. These gifts may be made outright or in trust. If made in trust, the spouse must receive the income stream from these gifts and the gifts must be included in the donee-spouse's estate.

Gifts to spouses who are not United States citizens. Gifts to spouses who are not United States citizens are limited to \$128,000 (2008 figure, as indexed for inflation) per year. They may be given in the same manner as gifts to citizen spouses.

Annual exclusion gifts. Annual exclusion gifts in the amount of \$12,000 (the 2008 amount, as indexed for inflation) can be given to any number of people free of tax. A gift must be a gift of a present interest to qualify for this exclusion. For citizen spouses, it makes no sense to use this exclusion, as the donor spouse may make unlimited gifts pursuant to the marital deduction, unless they are given to special trusts, as further discussed below. Non-citizen spouses are not entitled to this annual exclusion gifting.

Gifts to irrevocable life insurance trusts. A spouse may be named as a beneficiary of an irrevocable life insurance trust (ILIT). Gifts of either the annual exclusion amount or of a donor's lifetime unified credit exemption equivalent amount may be used in making gifts to the spouse. However, to keep the gifts out of the donee-spouse's estate, a goal we generally wish to accomplish, care must be taken to insure that if the annual exclusion gifting is used, that two rules are followed:

1) the gift is deemed a present interest gift; and 2) the gift does not violate the 5 & 5 rule. These two requirements are further defined in the next gifting strategy.

Gifts to a BERT. In this trust, we use the donor-spouse's annual gifting exclusion to place gifts into an irrevocable trust that he or she has created for his or her spouse. We must carefully follow two rules if we use gifts of the donor's annual exclusion amount — the present interest rule and the 5 & 5 rule. We insure the gift will be one of a present interest by allowing the donee-spouse a temporary withdrawal right over the property contributed to the trust. In essence, the trustee of the trust must notify the donee-spouse that a gift has been made and that the donee-spouse has a certain limited period of time (30 days, for example) within which to withdraw the gift. If the gift is not withdrawn in that time period, the right to withdraw the gift lapses and the trust assets (including the gift) can only be distributed pursuant to the terms of the trust. Compliance with the 5 & 5 rule requires the following: With annual exclusion gifts placed in trust, the Internal Revenue Code causes a portion of the trust assets to be included in the donee-spouse's estate if the annual exclusion amount is greater than \$5,000 per year or 5% of the value of the trust property. So, generally, with a BERT, our goal is to keep all of the trust assets free from estate tax liability upon both the donor-spouse's and donee-spouse's death, and thus if the clients' goal is to avoid any possible gift tax, we take care that the gifts to the trust are no greater than \$5,000 per year or that the gift, up to the maximum annual gifting exclusion for that year, does not exceed 5% of the trust assets.

THE ECONOMIC POWER OF BERT! THE WONDER TRUST™

As previously discussed, the annual exclusion from federal gift taxes is currently \$12,000 (\$13,000 in 2009) per donee. With annual exclusion gifts, if you don't use them, you lose them. In other words, if you do not make an annual exclusion gift to your spouse in any given year, you give it up forever, and you cannot thereafter make that gift without adverse tax consequences. Over time, these annual exclusion gifts can grow remarkably, particularly if the income tax liability of the trust is deflected away from the trust and is instead paid by the donor-spouse, also known as the Grantor. Assume a spouse creates a BERT and funds it initially with some amount between \$5,000 and \$440,000. The gifts do not have to be cash. They can be stocks, bonds, real estate, business interests, limited liability company interests, family limited partnership interests, annuities, life insurance, etc. In a few states (Tennessee being one of them) a gift in excess of the annual exclusion will be subject to a state gift tax. No federal gift tax will be due. There will be no gift tax on the annual gifts after the first year as these annual gifts are kept under maximum amounts allowed under the gift tax rules so as not to have to pay gift tax.

In the tables below we compare 6%, 8% and 10% growth rates.

EXAMPLE 1: INITIAL GIFT OF \$5,000. The tables below reflect the value of the trust assets at the end of various year intervals assuming the BERT is funded initially with \$5,000 and annual gifts between \$5,000 and \$11,000 are made. We didn't use the full \$12,000 annual exclusion

amount available in 2008 in order to have \$1,000 each year for gifts to the spouses for birthday, anniversary, and Christmas presents.

6% GROWTH RATE		8% GROWTH RATE		10% GROWTH RATE	
Year 5	\$ 29,877	Year 5	\$ 31,680	Year 5	\$ 33,526
Year 10	\$ 69,904	Year 10	\$ 78,227	Year 10	\$ 87,656
Year 20	\$221,728	Year 20	\$ 278,774	Year 20	\$ 355,593
Year 30	\$532,119	Year 30	\$ 773,953	Year 30	\$1,115,158
Year 35	\$777,824	Year 35	\$1,206,886	Year 35	\$1,869,845

EXAMPLE 2: INITIAL GIFT OF \$440,000. The tables below reflect the value of the trust assets at the end of various year intervals assuming the BERT is funded initially with \$440,000 worth of ownership interests in an LLC, and annual gifts of LLC interests worth \$22,000 (again, not using the full \$12,000 annual exclusion amounts) are made in 2008. The LLC interests are illustrated here as having a discount for estate and gift tax purposes of 50%. Actual discounts vary.

6% GROWTH RATE		8% GROWTH RATE		10% GROWTH RATE	
Year 5	\$ 690,835	Year 5	\$ 753,570	Year 5	\$ 820,937
Year 10	\$1,055,950	Year 10	\$ 1,246,631	Year 10	\$ 1,469,870
Year 20	\$2,198,423	Year 20	\$ 3,035,584	Year 20	\$ 4,198,150
Year 30	\$4,244,416	Year 30	\$ 6,897,800	Year 30	\$11,274,605
Year 35	\$5,811,433	Year 35	\$10,274,521	Year 35	\$18,305,600

The amounts shown above are protected from lawsuits and creditors of both spouses and will pass free of estate tax to their children when the donee-spouse dies.

It may not be difficult to obtain the growth rates shown above as the BERT trusts do not pay income taxes on their earnings. Instead, the Grantor pays the income taxes, thus allowing the trusts to grow more rapidly. The above gifts are illustrations only. Gifts can actually be any amount between \$5,000 and \$440,000, and one does not have to make all of the annual gifts. One can skip years and make no gifts at all.

BERT TRUSTS FOR BENEFIT OF HUSBAND & WIFE

These trusts can be funded with any assets other than qualified plans. We like using LLC units to fund the trusts, because the LLC provides asset protection and discounts for gift tax purposes.

If the trusts are funded with gifts under the annual gift tax exclusion (currently \$12,000) and within the 5 & 5 rule, the two trusts will likely be worth over \$1,500,000 in 30 years, assuming an initial gift of \$5,000 and an 8% growth rate. There will be no gift taxes incurred. See the tables above.

However, if H and W are willing to use some of their federal estate tax exemption amount (currently \$2,000,000 each) and in some cases pay state gift taxes, these trusts can be super-funded with LLC units that will for example grow in value to over \$13,000,000 in 30 years. If the growth rate is 10% the BERTs will likely be worth over \$18,000,000 in 30 years. See the tables above.

Achieving the 8% growth rate should not be so difficult since the BERT Trusts are grantor trusts and don't pay income tax.

The BERT ILIT

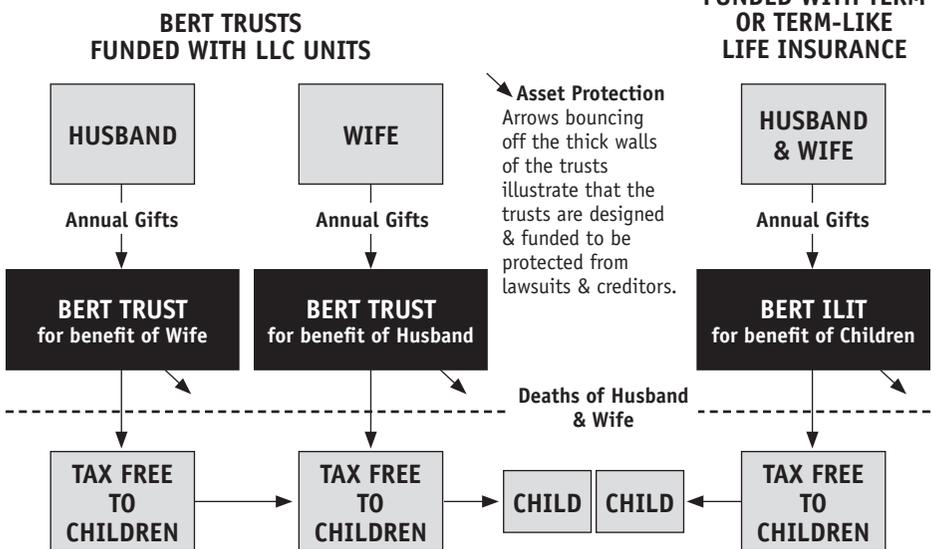
The only risk of the BERT strategy is that H and W may not live the targeted number of years. So, what do wise people do about risks? They insure those risks. The insurance used in this case doesn't have to be the expensive cash-value type. Instead, the insurance can be an inexpensive tax-free second-to-die policy which is designed to terminate when the BERT trusts reach their targeted values. These types of policies have to be carefully crafted by an experienced life insurance professional.

The BERT ILIT is a Second-to-Die Irrevocable Life Insurance Trust.

The annual gifts to the BERT ILIT as well as the annual gifts to the Bert trusts are all subject to the gift tax rules. Thus, if insurance is implemented, the gifts to cover the annual premiums will reduce the amounts that can be gifted tax-free to the children ...birthdays, Christmas presents, anniversary presents, etc.

Note: Some states have a small state gift tax that would be assessed if more than the annual exclusion amount is gifted to the BERT trusts. However, given the growth power of the BERT trusts the state gift tax is pretty cheap insurance.

BERT! The Wonder Trust™ & the BERT ILIT™



Cecil Smith has law offices in Memphis and Nashville, Tennessee. Carol Gonnella has offices in Jackson, Wyoming. Cecil and Carol limit their practices to estate planning, asset protection planning, charitable planning, business planning, and post mortem settlement of trusts and estates.