ESTATE PLANNING GOALS AND TOOLS

THE BASICS AND BEYOND

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INTRODUCTION

WHAT MAKES AN "EFFECTIVE" ESTATE PLAN?

Estate planning is the arrangements of one's financial affairs through asset ownership and legal documents to provide for one's goals related to the management and disposition of one's estate[2]. Your estate planning goals might involve the desire to:

- Provide for your own care and benefit anytime you are incapacitated, without the need for guardianship or conservatorship proceedings;
- Protect assets against lawsuits and other claims;
- Make sure that assets are transferred after your death to your intended beneficiaries;
- Reduce income taxes and reduce or eliminate gift, estate, and generation-skipping transfer taxes;
- Reduce or eliminate the need for probate proceedings at death in order to reduce or eliminate the related fees, costs, and delays;
- Coordinate business and retirement planning with other planning;
- Protect beneficiaries from mismanagement and from the claims of creditors and ex-spouses; and/or
- Discourage or encourage certain types of conduct for family members.

This memo outlines some of the tools that are available to accomplish your estate planning goals. Unfortunately, the accomplishment of some goals may make it more difficult to accomplish others. For example, sometimes the best planning for one's family objectives may actually increase transfer taxes or income taxes. Also, some of the best planning techniques can be complicated and even expensive to set up. Thus, estate planning is the art of balancing of competing objectives and the selection of estate planning tools that most effectively accomplish those goals.

1. BASIC ESTATE PLANNING GOALS AND TOOLS

1.1 <u>**Nontax Goals**</u>: A will or a living trust can accomplish many of your nontax objectives. First, you want to make sure that your assets are administered and distributed as you want. Second, you want to

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[2]"Estate", "assets", and "property" are used interchangeably to refer to everything a person owns. Of course, the term "estate" can be modified to refer to only part of one's entire estate. For example, "probate estate" refers to the property subject to administration in probate proceedings, and "taxable estate" usually refers to the property that is subject to the federal estate tax.

minimize the expenses and complications that can come with the administration of your estate.

(a) Will: A "last will and testament" is the document most frequently used to direct the disposition of one's estate at death. It is also used to designate a conservator or guardian for the testator (or person making the will) and for the testator's spouse and children. In most states, a will requires probate proceedings to be effective, and a will does little to provide for the management of one's estate during life. A will affects assets owned in the testator's name alone, and has no effect on property held in joint tenancy or on property for which there is a designated beneficiary.

(b) Living Trust: The primary tool for most people with substantial estates is the revocable inter vivos trust, most commonly called the "living trust". The revocable trust can work in place of a will to provide for the management and disposition of your estate both during life and after death. You are the settlor (or creator) of the trust[3]. Initially, you are also the trustee (or asset manager) and the beneficiary.

(1) A living trust that owns all of your assets can avoid the need to have a conservator or guardian of the estate appointed to manage your financial affairs if you ever become unable to do it yourself.

(2) Assets owned by the trustee of a living trust are not subject to probate proceedings at the time of the settlor's death.

(c) Estate-Succession Planning: The revocable trust is an excellent tool to accomplish the nontax objectives of estate planning, but the same thing can be accomplished in a will. It is in your will or living trust that you can protect assets from a beneficiaries' creditors and ex-spouses, provide for the management of assets, encourage or discourage specific conduct, and make sure that your family's needs are provided for in accordance with your wishes.

(d) Asset Protection: In our litigious society, there is an increasing concern about losing one's estate in a frivolous lawsuit or because of an unforeseen catastrophe. While the law does not permit one to defraud existing creditors, a living trust can be designed to protect assets against future potential creditors.[4]

1.2 Transfer Taxes: Under current federal law, there are three taxes that can be imposed on the transfer of assets: the gift tax, the estate tax, and the generation-skipping transfer tax ("GSTT"). In addition to the transfer taxes that may apply, income tax can also reduce transfers. The gift tax applies to transfers made during life, the estate tax applies to transfers at death, and the generation-skipping transfer tax applies to transfers during life or at death that skip the children's generation and pass to "skip persons", who are generally grandchildren and those in lower generations. In 2011 and 2012, the federal transfer tax law provides for a $5 million exclusion (exemption), but unless Congress takes action, in 2013, the law will revert to pre-2001 exclusion amounts, including a $1 million exclusion for the gift and estate taxes.

(a) Gift Tax: A donor can give assets with unlimited values to spouses who are U.S.

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[3]"Settlor", "trustor", and "grantor" are frequently used terms that refer to the creator of a trust.

[4]Asset protection is discussed in section 8 of this memo, which begins on page 13.

citizens and to qualified charities. In 2011, gifts totaling up to $13,000 can be made to any number of individuals in each calendar year. Taxable gifts are gifts that do not qualify for the marital deduction, charitable deduction, or $13,000 annual gift tax exclusion. Because of the "applicable exclusion" that available to each person, no gift tax has to be paid until after the donor has made lifetime gifts in excess of that exclusion, which is $5,000,000 in 2011[5]. After the exclusion amount has been exceeded, the federal gift tax is imposed at 35% in 2011 and 2012. In 2013, the transfer-tax rates range from 41% to 55%. The gift tax is paid by the donor out of assets remaining after the gift, so the tax itself is not included in the computation of the tax.

(b) Estate Tax: Upon death, the decedent's gross estate includes the then current fair market value of all property interests held by the decedent at the time of his or her death, whether passing by operation of law (such as joint tenancy assets), by operation of contract (such as insurance proceeds), or by operation of probate laws. There are deductions for debts, administrative expenses, qualified transfers to spouses, and transfers to qualified charities. The net amount is the taxable estate. To the extent the applicable exclusion has not been used for lifetime gifts, it will be applied to the taxable estate. After the exclusion amount has been exceeded, the federal estate tax is imposed at 35% (in 2011).[6] The estate tax is paid out of the taxable assets, so the amount of the estate tax itself is included in the computation of the tax.

(c) Generation-Skipping Transfer Tax: The generation-skipping transfer tax (GSTT) is a one-rate tax equal to the highest estate tax bracket, but in 2011 each donor or decedent has a $5,000,000 GST exemption.[7] The generation-skipping transfer-tax applies in addition to any applicable gift or estate tax. Estate taxes paid are deducted before computing the GSTT, but combination of the estate tax and the GSTT can result in a combined rate of close to 60%.

(d) Income Taxes: Income taxes further deplete transfers, especially with respect to assets that are all taxable income, such as retirement plan benefits. The combination of transfer taxes and income taxes can deplete some transfers by more than 75%.

1.3 Tax Reduction: Revocable trusts can be structured to reduce the estate tax and the generation-skipping transfer tax, especially for married couples. In other words, revocable trusts can be used to:

(a) Deferral: Defer estate tax for married couples upon the death of the first spouse to

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[5]Internal Revenue Code § 2010(c) provides for an "applicable exclusion", which is the cumulative amount that can pass free of gift and/or estate tax. This is sometimes called "the exemption equivalent of the Unified Credit". For ESTATE TAX purposes, the applicable exclusion has been, is, and will be: $625,000 in 1998; $650,000 in 1999; $675,000 in 2000; $1,000,000 in 2002 and 2003; $1,500,000 in 2004 and 2005; $2,000,000 in 2006, 2007, and 2008, $3,500,000 in 2009; unlimited in 2010; $5,000,000 in 2011 and 2012; and $1,000,000 in 2013 and beyond. Prior to 2004, the applicable exclusion for GIFT TAX purposes was the same as that for estate tax purposes, but for 2011 and 2012 the applicable exclusion for GIFT TAX is $5,000,000, and it reverts back to $1,000,000 in 2013.

[6]The maximum rate imposed for federal estate tax purposes was, is, and will be: 50% in 2002; 49% in 2003; 48% in 2004; 47% in 2005; 46% in 2006; 45% in 2007, 2008, and 2009; 0% in 2010; 35% in 2011 and 2012; and 55% in 2013 and beyond.

[7]The GST tax is imposed at the highest rate imposed for federal estate tax purposes, which is shown in note 6. The GST exemption was $1,100,000 in 2002 and was $1,120,000 in 1993. In 2011 and 2012, the GST exemption is the same as the applicable exclusion for the estate tax, which is shown in note 5.

die by using marital-deduction trust planning;

(b) Bypass Trust: Reduce or eliminate estate taxes for married couples upon the surviving spouse's death by using a credit-shelter bypass trust; and/or

(c) Generation-skipping Trusts: Reduce or eliminate estate taxes for children and other descendants by using generation-skipping trusts that maximize the GST exemption.

(d) Use of "Subtrusts": In order to minimize the estate tax and the generation-skipping transfer tax, revocable trusts are designed to split into "subtrusts" upon the death of each spouse. *(See **Figure 2.**)*

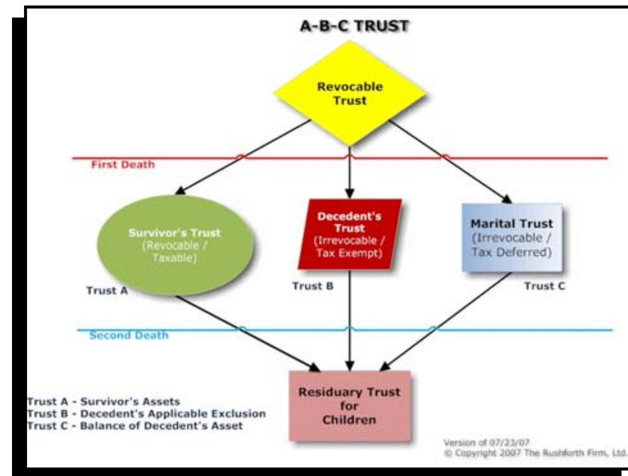

Figure 2: A/B/C Trust

1.4 The Role of Asset Ownership: Estate planning is implemented with legal documents, including change-of-ownership or change-of-beneficiary documents. Asset ownership and beneficiary designations are critical to estate planning.

(a) At death, assets pass by operation of law (such as by right of survivorship under joint tenancy ownership), by operation of contract (such as by beneficiary designation under an insurance contract), or by operation of probate laws (either under the term of a will or under intestate succession laws.

(b) The laws and legal documents that govern an entity (such as a trust, corporation, or partnership) only affect the assets that are owned by that entity. An entity without assets has no meaning.

(c) While selecting the proper estate planning tools is important, it is just as important to make sure those tools are properly used. An effective estate plan requires that ownership and beneficiary-designation documents are consistent with the plan. The transfer of assets to a trust or business entity is referred to as "funding" or "capitalizing" the entity, and that is just as important as the formation of the entity itself.

2. REDUCING TRANSFER TAXES

2.1 Beyond the Revocable Trust: Revocable trusts cannot eliminate estate taxes for unmarried individuals with an estate exceeding the applicable exclusion ($5,000,000 in 2011 and 2012)[5] or for married couples with a combined estate exceeding twice that amount.[8] When the net taxable estate exceeds the available exclusion, the taxable estate must be reduced, or arrangements must be made to pay the tax. Several estate planning "tools" can supplement your basic will and/or revocable trust. This memo mentions a few of

[8] Under current law, a trust is not required to double the exclusion for married couples, but it is advisable.

those tools.

2.2 Personal Considerations: Most of the estate-tax savings techniques require you to give up at least some control over your own assets and to limit or eliminate the benefits you receive from them. Only you can decide how much benefit and control you are willing to give up to save taxes and other expenses for someone else (your children or other beneficiaries) at a future date.

(a) Some techniques — like life insurance trusts — probably will not have much impact on you or your lifestyle because you are giving up control over and benefits from an asset you probably would not tap into anyway. Of course, if your planning requires significant insurance, it will also require the payment of significant insurance premiums, making cash flow an important factor in your estate plan.

(b) Some estate planning tools seem illogical and can simply make people uncomfortable. For example, irrevocable trusts can be designed so that the grantor[9] does not receive trust income but pays income taxes on trust income to benefit trust beneficiaries indirectly without making taxable gifts. It may be psychologically unpleasant to have to pay taxes on someone else's income, but for persons trying to reduce their taxable estates, it can be an effective tool.

(c) Other techniques — such as a qualified personal residence trust — require you to give away assets earlier than you normally would, assets that you may really want to keep and use for the rest of your life.

(d) Some techniques — such as charitable remainder trusts — not only remove assets from your estate, but also keep those assets from your children or other beneficiaries.

(e) Each person has to decide for himself or herself the combination of estate-planning techniques that balance the desire to save taxes and expenses with the desire to maintain control over and benefits from hard-earned assets.

2.3 Spending: The first estate-reduction technique is to spend and use up your estate for your own benefit. You earned it; you spend it. You do not have to leave it to anyone. You may want to tell your children or other beneficiaries, "If I leave you anything, it is only because I miscalculated." Most clients do not want to be so aggressive in reducing their estates, but you may want to be a bit more generous with yourself, and — using one client's example — "buy a bit of melon in off-season."

2.4 Lifetime Gifts: Most estate-reduction tools involve some sort of gift giving. As you know, each person can give up to $13,000 to each of any number of recipients in each calendar year without having to report a taxable gift or use up the applicable exclusion. To the extent a gift exceeds the annual exclusion ($13,000), the applicable exclusion for gift tax ($5,000,000)[10] eliminates any out-of-pocket payment of gift tax until all lifetime gifts cumulatively exceed that exclusion. From a transfer-tax perspective, making lifetime gifts is much more effective than making after death distributions under a will or trust. Consider the following illustration, which, for simplicity, assumes that prior gifts have used up the applicable exclusion:

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[9]The terms "grantor", "settlor", and "trustor" are used interchangeably to refer to the creator of a trust.

[10]See note 5.

(a) A lifetime gift of $1,000,000 in the 35% tax bracket would generate a gift tax of $350,000, so the combined total of the gift itself AND the tax would be $1,350,000. In this scenario, the recipients receive $1,000,000 or around 74%. Although the stated tax rate is 35%, the effective tax rate is approximately 26% because no tax is imposed on the tax itself.

(b) A death-time transfer of $1,350,000 at the 35% rate results in an estate tax of $472,500, leaving $877,500 for the recipients. The effective tax rate is 35%. The tax is imposed on the full amount without reduction for the tax paid. In other words, the tax is imposed on the net transfer AND the tax itself.

(c) In both examples, the combination of the transfer and the tax totals $1,350,000, but the lifetime gift results in the beneficiaries receiving $122,500 more (and the IRS receiving $122,500 less).

2.5 **Making More Effective Gifts:** Some gifts can be more effective than others at reducing the taxable estate.

(a) People who want to reduce their estates commonly make annual gifts of up to $13,000 cash to children, grandchildren, and other beneficiaries. This reduces the estate by the amount of the cash and by the amount of its potential earnings.

(b) A more effective gifting technique is to give away appreciating property. This type of gift reduces the estate by the current value of the asset given, and by the value of potential appreciation and potential earnings.

(c) The best type of gift is a gift that reflects a small value for gift-tax purposes but reduces the estate by a larger value. For example, if you can give a $13,000 gift and reduce your estate by $15,000, $20,000, or more, you have effectively "leveraged" your gift-tax annual exclusion. Gifts of life insurance, remainder interests, and value-discounted interests are some "gift-leveraging" or "gift-maximizing" techniques mentioned in this memo.

2.6 **Outright Gifts; Gifts in Trust:** Making an outright gift to a beneficiary is common, but making gifts through irrevocable trusts is often more appropriate. Irrevocable trusts are discussed more fully below.

3. IRREVOCABLE TRUSTS

3.1 **Generally:** There are several types of irrevocable trusts that can be used to make gifts to other persons with the assets under the control and management of a trustee.

(a) Gifts to an irrevocable trust are sometimes motivated by a desire to minimize federal transfer taxes or to shelter assets from the claims of future creditors and other claimants (including spouses in divorce cases and plaintiffs in civil lawsuits).

(b) To be effective for estate-reduction purposes, the trust must be irrevocable, and the grantor of the trust cannot be a trustee or a beneficiary of the trust.

(c) To qualify for the $13,000 annual exclusion, irrevocable trusts usually contain a provision giving the trust's beneficiaries a temporary right to withdraw annual contributions, at least in part.

This withdrawal right is often called a "Crummey power" in reference to a case involving a family with the Crummey surname.

3.2 Irrevocable Life Insurance Trusts: The proceeds of life insurance policies are included in the insured's estate at his or her death if the insured had "an incident of ownership" in the policy within three years of death. Estate taxation can be escaped by having someone other than the deceased own the policy and all of its attendant rights. An irrevocable trust can be made the owner and beneficiary of all life insurance, removing the proceeds from the estate of the insured and the insured's spouse.

(a) The spouse can even be a beneficiary of the trust if contributions to the trust come from the insured's separate property and other strict formalities are followed.

(b) Gifts of cash sufficient to pay policy premiums will usually be covered by the $13,000 annual exclusion if the insurance trust contains the appropriate provision giving the trust's beneficiaries a "Crummey power", which is a temporary right to withdraw trust contributions.

(c) Since the policy will mushroom in value at death, the irrevocable insurance trust will exclude much more value from the taxable estate than the cumulative value of the annual-exclusion gifts.

(d) An irrevocable life insurance trust is better than ownership by a spouse or children because it is shielded from creditors and is more effective at reducing transfer taxes.

(1) Years ago, when the marital deduction was limited, there was some advantage in having the spouse own the policy. This does not accomplish much under current law, and to the extent the spouse is a beneficiary, taxes will be deferred until the spouse's subsequent death. This defers but does not eliminate the estate tax problem.

(2) Ownership by children or other family members can defeat some nontax objectives (such as spendthrift protection) and some tax objectives (such as generation-skipping). The primary problem is loss of control with respect to the use and application of the insurance proceeds. Untimely deaths, lawsuits and other creditors' claims, and even divorces can disturb the insurance plan.

3.3 Minors' Trusts: A trust can be established for younger beneficiaries to provide for education and/or other needs of life. Federal tax law has facilitated the creation of trusts for beneficiaries under the age of 21 years, but trusts can be designed to continue until any age or during a beneficiary's entire lifetime.

3.4 Dynasty Spendthrift Trusts: A "bypass trust" is a trust that benefits one or more beneficiaries without being considered assets of those beneficiaries for estate and gift tax purposes. Under state law, a bypass trust is easily designed to qualify also as a "spendthrift trust", which cannot be attacked by a beneficiary's creditors. In short, this type of trust can reduce the beneficiaries' estate taxes and protect trust assets from creditors' claims at the same time. A “dynasty trust” refers to a bypass trust that is set up to bypass several generations, allowing those generations to avoid both transfer taxes and creditors claims while preserving assets for their enjoyment. Under Nevada law, a dynasty trust can last up to 365 years.

3.5 Supplemental Needs Trusts: If an intended beneficiary is a recipient of Medicaid, SSI, or other governmental assistance programs, an outright gift or a gift in trust may disqualify the beneficiary from continu-

ing to receive such assistance. Trusts can be designed so that distributions are made only to "supplement" the benefits already being received. So long as distributions made by the trustee are discretionary and not mandatory, the trust assets and trust distributions are not, under most programs, considered disqualifying resources.

3.6 **Other Irrevocable Trusts:** This memo cannot possibly discuss all types of irrevocable trusts that exist. Irrevocable trusts can be designed in an infinite number of ways. There are some very special types of irrevocable trusts that have evolved over the years as basic estate planning tools, including life insurance trusts and charitable trusts. Other irrevocable trusts are relatively new, having been developed recently to replace types of trusts that are not longer permitted by law and to maximize the benefits under current transfer-tax laws. Once an estate planning professional becomes aware of a client's specific objectives, specific types of trusts can be discussed in more detail.

4. ESTATE FREEZING TECHNIQUES

4.1 **Appreciation and Inflation:** Appreciation and inflation will increase estate taxes upon death. Years ago, several "estate freezing" techniques were used to shift appreciation to children and younger generations. Even after major "anti-freeze" legislation over the past several years, several effective techniques can be used to shift appreciation and to "freeze" the value of an asset for estate-tax purposes.

4.2 **Installment Sales:** By selling an asset to family members on an installment basis, the potential appreciation on the asset is shifted to the family members. This works only if the purchase price is "full and adequate consideration" and the arrangement is properly documented in order to create a legally enforceable obligation. Upon the death of the payee, the unpaid balance of the note is included in his or her taxable estate for estate tax purposes, but the asset that was sold is out of the estate, including its appreciated value. The installment note can be secured by the property sold. One variation of this type of plan can be a sale of income-producing assets to an irrevocable trust for the benefit of the children. The purchase price can be paid, at least in part from the income produced. If the irrevocable trust is a grantor trust for income tax purposes, the sale will not trigger any immediate tax upon the sale.

4.3 **Self-Cancelling Installment Notes (SCINs):** Another version of the installment sale uses promissory notes that, by their express terms, expire upon the death of the payee. This type of promissory note has the same advantages as any installment note (including the ability to require security), but besides shifting appreciation, the unpaid balance of the note is reduced to zero at death, and there is nothing included in the payee's estate at death. As with any installment note, the purchase price must reflect "full and adequate consideration", but that also means the value of the note must exceed the value of the property being sold. Because the note may expire before the payee receives payments equal to the note's face amount, an additional "premium" must be paid for that feature so that the value of the note is considered adequate to pay for the property. Determining the amount of the "premium" for the death-termination aspect is the primary drawback to this technique. A qualified expert is strongly recommended to make that determination.

4.4 **Private Annuities:** A private annuity is a contract that provides for specified payments to the named annuitant during the annuitant's lifetime. This is similar to the death-terminating promissory note, but under a private annuity, the payments never cease so long as the annuitant is alive, even if the annuitant outlives his or her life expectancy. The primary advantage of the private annuity is the fact that the annuity amount can be determined from the IRS valuation tables, eliminating the guess work as to the amount of the periodic payments to be made. Unlike promissory notes used with installment sales, private annuities cannot be secured, putting the annuitant at risk that the payor may become bankrupt. Recent tax decisions by the IRS have made

private annuities less attractive.

5. CHARITABLE TRUSTS

5.1 **Charitable Remainder Trusts:** A charitable remainder trust allows one or more individuals to receive designated annual payments during their lifetime or during a set term of years (up to 20 years). The annual payments are usually stated in terms of a percentage (e.g., 8%) of the value of the trust's assets, but they can be stated in terms of a specific dollar amount if the amount is at least 5% of the value of the trust's assets. Upon the death of the life beneficiary or beneficiaries, the remainder of the trust passes to one or more charitable organizations.

(a) Grantors of charitable trusts can be the life or term beneficiaries. If the trust is established during the grantors' lifetime, the grantors are entitled to a charitable deduction for the present value of the remainder interest (which is calculated according to the IRS tables based on the grantors' life expectancies or the term of the trust, current interest rates, and the rate used to calculate annual payments for the life or term beneficiaries).

(b) There are two types of charitable remainder trusts: charitable remainder annuity trusts (CRAT's) and charitable remainder unitrusts (CRUT's). CRAT's provide for fixed payments despite asset valuation fluctuations, and CRUT's allow for payments that can increase with inflation and provide flexibility for the timing of income payments.

(c) Charitable remainder trusts are tax exempt, so the trust itself does not pay any income taxes, even as to retained income. The life or term beneficiary is taxed on income distributed to the beneficiary.

(d) Highly appreciated assets are often contributed to charitable trusts to eliminate potential capital gains tax that will become due when the asset it sold. This can be an "income maximizer trust". For example, rental properties having a current fair market value of $1,000,000 and a cost basis of $50,000 are contributed to a charitable trust. When the properties are subsequently sold, the capital gain tax has been avoided inside the charitable trust, leaving more proceeds available to generate the income necessary to pay the life or term beneficiary.

(e) Charitable remainder unitrusts can serve as a quasi retirement plan. A trustee can defer some annual payments in the early years of the trust by investing in high-growth, low-income assets. When the life beneficiary has a greater need for income, the trustee can invest in assets producing a higher income yield.

5.2 **Combination of the Charitable Remainder Trust and the Insurance Trust:** A charitable trust can provide income distributions to you, but the trust's assets eventually pass to one or more charities, and nothing passes to children or other noncharitable beneficiaries. For many people, the "lost" wealth can be replaced by purchasing life insurance with the savings that result from the income tax deduction and from the additional income that results from a tax-free sale of appreciated assets inside the trust. If the insurance is purchased by the trustee of an irrevocable life insurance trust, the insurance proceeds are not taxable for estate tax purposes. The insurance trust becomes a "wealth replacement trust", allowing the children or other beneficiaries to receive benefits after all.

5.3 **Charitable Lead Trusts:** In very large estates, the estate tax can result in the liquidation of

hard-to-sell assets (such as family businesses), often resulting in "fire-sale" prices that reduce even further the net distribution to the family or other beneficiaries. Estate liquidation can result in losses that make the estate tax seem like 50% to 80% or more.

(a) A charitable lead trust is a trust for a term of years, and during the trust term a specified annual payment (based on a percentage of the trust assets) is paid to one or more designated charitable organizations. Children or other beneficiaries are designated as the remainder beneficiaries who will receive the trust assets at the end of the trust's term.

(b) The creation of a charitable lead trust results in a gift to the noncharitable remainder beneficiaries based on the present value of the remainder interest. That value — which is determined from the IRS tables — depends on the term of the trust and the rate or amount of the specified payment going to the charitable organization(s). It is possible to design a charitable lead trust that provides a small value or even a zero value for the remainder interest.

(c) Although the specified payments are made to one or more charities during the trust's term, the asset itself is preserved for the children. While the children may have to wait 5, 10, 15, or even 20 years to benefit from the trust's assets, it is often the best way to pass some assets to the children without the combined effects of estate taxes and asset liquidation costs. The longer they wait, the lower the value of the remainder interest is for gift tax purposes.

6. RETAINED-INTEREST GIFTS

6.1 Grantor Retained Interest Trusts: Most people would like to "have their cake and eat it, too." If possible, people would retain all control and all benefits from an asset up to their death and then have the value of the asset disappear for estate-tax purposes. Unfortunately, federal gift and estate tax laws do not permit this.

(a) Over the years, various trusts (or trust-like arrangements) have been devised that allow the grantor of the trust to retain benefits for a specified period of years so that the present value of the gift to the children is reduced according to the IRS' own valuation tables. The longer the retained-interest period, the lower the value of the remainder interest is. These trusts used to be called "grantor retained income trusts" or “grantor-retained interest trusts” ("GRITs"). Congress has now limited the use of these techniques to a very few specific types of trusts.

(b) If the grantor of a retained-interest trust dies before his or her benefits are terminated under the trust's terms, the asset is subject to estate taxes in his or her estate (and any gift tax paid is credited toward the estate tax). On the other hand, if the grantor outlives his or benefits under the trust, the trust's assets are excluded, and the only transfer-tax cost is the gift tax paid (or the applicable exclusion applied) on the original value of the remainder interest.

(c) While a GRIT can save transfer taxes, there is at least one disadvantage: the lost of the stepped-up basis for income tax purposes. Assets included in a decedent's estate for estate-tax purpose will (under current law) receive a "stepped up" income tax basis equal to the fair market value of the assets at the time of the decedent's death. In other words, all potential capital gain is reduced to zero. If a retained-interest trust is successful, the asset will not be included in the grantor's estate at the time of the grantor's death, so there will be no stepped-up income tax basis; the recipient will have the grantor's original cost basis.

6.2 **Qualified Personal Residence Trusts (QPRT's):** A "qualified personal residence trust" or QPRT is a type of GRIT that is still permitted under federal law. A grantor can transfer his or her primary residence or even a qualifying vacation home to the trustee of a QPRT that allows the grantor to reside in the home for a designated period. At the end of the designated period, the property passes to (or remains in trust for) designated remainder beneficiaries.

(a) The gift to the trust's remainder beneficiaries is subject to the federal gift tax, but the value of the gift is the present value of the remainder interest, which is determined under the IRS tables after taking into consideration the term of the grantor's retained interest, the grantor's age, and the applicable interest rate published by the IRS monthly. While a longer-term QPRT will result in a lower gift-tax value, even a short-term QPRT can be worthwhile.

(1) Example 1: A home worth $1,000,000 is transferred into a 10-year QPRT for a 58-year-old individual, and the IRS-issued 7520 rate is 6.0 percent. The remainder interest, which is what is being given away, has a present value of $478,594. If the grantor outlives the 10-year term, no estate tax will be imposed on $521,406 plus any appreciation. If the grantor's estate is in the 45% estate-tax bracket, this transaction saved over $234,000 in estate taxes plus the estate tax on any post-transfer appreciation.

(2) Example 2: A home worth $1,000,000 is transferred into a 3-year QPRT for a 70-year-old individual, and the IRS-issued 7520 rate is 6.0 percent. The remainder interest, which is what is being given away, has a present value of $766,632. If the grantor outlives the 3-year term, no estate tax will be imposed on $233,368 plus any appreciation. If the grantor's estate is in the 45% estate-tax bracket, this transaction saved over $100,000 in estate taxes plus the estate tax on any post-transfer appreciation.

(b) If the grantor dies before the retained-interest expires, the home reverts to the grantor and is subject to estate taxes, but since any gift taxes paid are credited, there is no true penalty. The cost of this gamble is the cost of creating and administering the trust.

(c) One psychological drawback to QPRT's is the fact that the grantor no longer has the right to reside in the residence at the end of the term of the grantor's retained interest. To remain in the home, the grantor must make fair-market rental payment according to a lease agreement negotiated *after* the term has expired. Making lease payments is another good way for the grantor to make an estate-reducing transfer to the trust's beneficiaries.

(d) There are several technical rules for QPRT's. For example, there are rules governing the possibility that a residence might be sold and a substitute residence purchased. If a substitute residence is not purchased within a specified time limit, the trust must become a grantor retained annuity trust (which is discussed below) in order to accomplish the objective of reducing transfer taxes.

6.3 **Grantor Retained Annuity Trusts (GRAT's):** Grantor retained annuity trusts (GRAT's) are similar in structure to charitable remainder annuity trusts. GRAT's permit the gift of remainder interests that are discounted for gift-tax purposes under the IRS valuation tables. While longer annuity terms produce lower remainder values, even short-term GRAT's can produce significant transfer-tax savings. Recent court rulings allow one to design a GRAT that has a near-zero value for gift tax purposes if the payments to the grantor can continue to the grantor's estate if the grantor dies before the end of the annuity term. The GRAT is included in the grantor's estate, but only as to the value of the remaining annuity payments at the time of the grantor's

death.

6.4 **Grantor Retained Unitrusts (GRUT's):** Grantor retained unitrusts (GRUT's) are similar in structure to charitable remainder unitrusts. GRUT's are similar to GRAT's in their general purpose, but GRUT's are not considered as effective as GRAT's where the trust's assets are expected to appreciate.

7. BUSINESS ENTITIES

7.1 **Business-Succession Planning:** For those who have interests in one or more operating businesses, estate planning necessarily includes (a) business planning while the business ownership continues, (b) retirement planning, and (c) the planning for the ultimate disposition of that business, whether by sale, by liquidation, by lifetime gifts, or by transfers at death. For those interested in passing the business to the next generation, estate-freezing techniques [discussed in section 4 of this memo] may be appropriate. For those who wish to have the business pass to co-owners or key employees, buy-sell agreements [discussed in subsection 7.2, below] are a great tool, particularly if the those involved qualify for life and/or disability insurance.

7.2 **Buy-Sell Agreements:** Buy-sell agreements can alleviate disputes that can arise between or among other business owners and can provide for payments to the deceased owner's family without disrupting the ongoing business.

(a) If the buy-sell agreement is properly structured, the agreement can determine the value of the business interest for estate-tax purposes. To be binding on the IRS for estate-tax purposes, the agreement must be a fair agreement that has an enforceable buy-out price that is fixed or determined in a way that is reasonably calculated to produce a fair-market price. In other words, a buy-sell agreement cannot be used to create an artificially depressed price just to save estate taxes. An "agreed-upon price" is rarely sufficient for estate tax purposes, so the agreement will usually provide for a price determined by a formula or by formal appraisal.

(b) A well-designed buy-sell agreement will be "funded" with life and/or disability insurance to the greatest extent possible, but it will also address the payment of the purchase price to the extent not funded by insurance.

7.3 **Formation of New Business Entities:** Sometimes the formation of a corporation, partnership, or limited liability company can help accomplish estate-planning objectives. Business entities require that certain legal formalities be observed and that separate accounting records be meticulously maintained. Creating a business entity is relatively inexpensive, but maintaining it can be expensive. It can be even more expensive if it is not done right.

(a) When a business is formed, it can be a sole proprietorship, a corporation, a limited or general partnership, or a limited-liability company. For estate-planning purposes, it is most common not to use a sole proprietorship or a general partnership.

(1) *Corporations*. Corporations are frequently used to shelter personal assets from the liabilities of a business. Gifting stock in a family corporation is a relatively simple way to make gifts. Gifts of minority interests and non-voting stock are not only entitled to valuation discounts, but they entitle the recipient to retain control of the corporation and its assets. Corporations are separate taxpayers ("C corporations") unless their shareholders elect to be taxed individually on their pro rata share of corporate profits ("S corporations").

(2) *Limited Partnerships*. Limited partnerships can be formed to allow you to make gifts of partnership interests to family members while maintaining control over the underlying assets. Partnerships do not pay taxes and do not have to make special elections in order to be taxed individually on partnership profits. Partnership interests are usually subject to transfer restrictions that can justify even more significant valuation discounts for gift-tax purposes.

(3) *Limited Liability Companies*. Limited liability companies ("LLC's") are relatively new, and combine the best characteristics of corporations (limited liability of all members) and partnerships (pass-through of tax benefits). For most purposes, planning with LLC's is very similar to planning with limited partnerships.

(b) Gift Giving: Gifts of interests in a family business are usually entitled to valuation discounts because of lack of voting control and the lack of marketability. By making lifetime gifts, it is often possible to reduce a person's interest to a minority share (especially for married couples owning equal interest), entitling the estate to a valuation discount for estate-tax purposes.

(1) Gifts of business interests are attractive because the value of such interests for gift-tax purposes is less than the pro-rata value. In other words, a 5% business interest has a fair-market value of less than 5% of the business' assets because of certain valuation "discounts" that apply, including a discount for lack of voting control and a discount for lack of marketability.

(2) A qualified business appraiser is required to determine the extent of the discount applicable in each situation.

8. ASSET PROTECTION

8.1 Generally: "Asset protection" refers to various legal arrangements that make it difficult for creditors[11] to reach certain assets without committing fraud or otherwise violating the law. As a general rule, Nevada law does not permit one to transfer assets to hinder, defraud, delay, or otherwise frustrate the collection of existing obligations[12], but Nevada law does permit one to shield assets from future potential creditors under appropriate circumstances.

8.2 Business Entities: Business entities, such as corporations, limited partnerships, and limited-liability companies, can be used to shield personal assets from business liabilities and business assets from personal liabilities.

(a) Personal Shield from Company Liabilities: Business entities have been traditionally

[11] "Creditor", in this context, refers to any person or entity to whom a person owes a financial obligation, such as a lender, a plaintiff in a lawsuit, a party to a contract, a lessor, a vendor, a service provider, or a governmental entity that is owed taxes, assessments, or fees.

[12] An "existing obligation" includes obligations arising from an event that has already occurred, whether or not a claim or lawsuit relating to that even has been formally asserted or filed. For example, if you were involved in an automobile accident that was your fault, as to any transfer of assets after the accident, all claims resulting from that accident are "existing obligations" even before those injured or harmed in the accident file an insurance claim or a lawsuit.

used to shelter personally-owned assets from the liabilities and obligations of the business entities. With few exceptions, the shareholder of a corporation, a limited partner in a limited partnership, and a member of a limited-liability company cannot be held liable for the obligations of the company.

(b) Shield against Liabilities of Others: Because the law does not want one person's obligations to affect those of an innocent third party, the creditors of a debtor cannot normally force the liquidation of a business entity when the debtor is just one owner among many. Nevada law specifically provides that a creditor of a debtor who is a limited partner or a member in a limited-liability company is entitled to a "charging order" that allows the creditor to collect the debtor's share of the company's income, but nothing more.

8.3 Spendthrift Trusts: A "spendthrift trust" is an irrevocable trust whose assets are protected under state law from the creditors of a beneficiary, and a spendthrift trust can also be written to be exempt from the demands of the beneficiary himself or herself, which precludes the use of the trust assets as collateral on a loan.

(a) Protection of Beneficiaries' Interests: It is common for most irrevocable trusts to be established as a spendthrift trust to protect the beneficiary from his or her creditors and from his or her own imprudence. Until the beneficiary receives actual distribution from the trustee, Nevada law prohibits others from attaching an interest in trust assets.

(b) Self-Settled Spendthrift Trusts: Since October of 1999, Nevada law has permitted a settlor (trust creator) to establish a spendthrift trust for his or her own benefit so long as there is a Nevada trustee and a trustee other than the settlor must approve all distributions to or for the settlor. This type of trust is referred to in technical treatises on trusts as a "self-settled spendthrift trust", but we simply call it a "Nevada asset-protection trust" (or "NAPT") or a Nevada “self-settled spendthrift trust” (“SSST”). A creditor of the settlor can challenge the transfer of assets to a NAPT, but if the creditor's claim arose after the transfer, the creditor must prove that the transfer was fraudulent, and that challenge must be brought within two years of the transfer. A creditor whose claim existed at the time of the transfer can bring the challenge within two years of the transfer or within six months of when the creditor knew (or should have known) of the transfer, whichever is longer.

(1) Since we have started preparing these trusts, the most popular format of a NAPT is one that mirrors the appearance of a revocable trust (including tax-planning provisions to optimize the use of the applicable exclusion for gift and estate tax, the marital deduction, and the allocation of the GST exemption to reduce the generation-skipping transfer tax). The settlor can have full control over investments and trust administration, excluding, of course, the power to make distributions without the consent of a Distribution Trustee. Transfers to this type of spendthrift trust is not a completed gift for federal gift tax purposes, and the assets will be included in the Settlor’s estate.

(2) An NAPT/SSST can be designed so that transfers are completed gifts and assets in the trust will not be included in the settlor’s estate for federal estate tax purposes. For example, an irrevocable life insurance trust can be created as a self-settled spendthrift trust with the settlor as a permissive beneficiary. In this type of trust, the trustee would only make a distribution to or for the settlor if the settlor’s other assets were insufficient to provide for his or her needs. This can provide a financial “safety net” to the settlor.

9. CONCLUSION

9.1 Goals: Estate planning has competing goals. For example, saving transfer taxes on your assets will often reduce your lifetime control and benefit over those assets. The best estate plan for you is one that balances your objectives according to your own priorities. It is up to you "how hard you want to play the game."

9.2 Going Beyond the Basics: The basic estate plan begins with a will or revocable trust. This memo has discussed advanced estate planning techniques and tools that go beyond the basics. Some of these tools can be combined to become even more effective.

(a) For example, the best asset for a "GRAT" (grantor retained annuity trust) may be an interest in a limited partnership. The limited partnership interest is entitled to a valuation discount, and the gift tax value of the GRAT's remainder interest is also discounted based on the IRS's valuation tables.

(b) Another example is a QPRT (qualified personal residence trust) that pours into an ILIT (irrevocable life insurance trust) after the settlor's term has expired. If the settlor of the QPRT pays rent to continue to use the residence, the rent can be used to pay insurance premiums on the insurance owned by the ILIT, thus reducing the taxable gifts needed to fund the insurance.

9.3 Additional Options: Although this memo is far too long, it does not begin to cover all of the estate planning techniques that are available, and it would be impossible to outline all possible combination of estate planning tools. Just as each person's estate, each person's family, each person's goals, and each person's abilities are unique, each person's ideal estate plan will be unique.

9.4 Costs: Each estate planning "tool" has its price. Before using a tool, you must be committed to paying all of the costs.

(a) Legal fees, accountants' fees, and other expenses are part of the cost of establishing and maintaining trusts and business entities. Advisors' fees are paying for expertise, not just the documentation they produce.[13]

(b) The most sophisticated estate planning techniques often require expert appraisers who can determine valuation discounts for transfer-tax purposes.

(c) Insurance trusts and buy-sell agreements also require a commitment to paying insurance premiums to provide the cash necessary to meet liquidity needs for taxes and business buy-outs.

(d) Do not be penny wise and pound foolish. It may be tempting to cut costs by: hiring inexperienced appraisers; refusing to employ qualified tax accountants; avoiding the use of corporate trustees; purchasing cheap insurance products; and even trying do-it-yourself documents for business

[13] Keep in mind that the person who hires a tailor to produce custom-designed clothing is going to pay a lot more than the mere cost of the cloth and more than one-size-fits-all clothing. In that same vein, a person who wants an estate plan that is tailored to their specific objectives, is going to pay his or her advisors substantially more than someone who is willing to use an estate plan taken from a generic form book.

and trusts. This is a false economy for most estate planning, especially where federal transfer-taxes are involved. For example, with respect to a multi-million dollar family partnership, an appraisal done by a qualified appraiser can save you hundreds of thousands of dollars in estate taxes. Properly documented valuation discounts may even discourage the IRS from disputing the discount in the first place. It would be foolish, then, to refuse to spend several thousand dollars for an appraiser who is an expert in valuation discounts.

9.5 Going Forward: We suggest that you:

(a) Make or update your estate inventory, making sure that you have a good understanding of your assets (including the cost basis and current value of investments), your liabilities, your cash flow, and your tax liabilities;

(b) Make or update your prioritized list of your estate planning goals and objectives;

(c) Have existing documents and plans reviewed in light of your current goals and objectives;

(d) Build an estate planning team that can coordinate their efforts for your benefit, which may include your accountant, your insurance advisor, your investment advisor, business advisors, and estate-planning attorney;

(e) Select a "captain" of your estate-planning team[14], and let each member of the team know that member's role in your planning so that the team can work together to analyze your estate planning options, to make recommendations, and to implement the plan you ultimately decide upon.

NOTE: This memo provides general information only and does not contain legal, accounting, or tax advice. For brevity, this memo is oversimplified and should not be relied on for any particular situation. Although this memo may discuss tax issues, this is not a "covered opinion" as defined in Circular 230 issued by the U. S. Treasury Department, and nothing in this memo can be relied upon to avoid any tax penalties.

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[14]The "captain" of the estate planning team is usually the person who is most familiar with your financial affairs and who is proactive in his or her approach to financial, tax, and estate planning. For most people, this is unlikely to be the estate-planning attorney and is more likely to be the certified public accountant or the primary investment advisor.