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ESTATE PLANNING

2006 TEXAS SCHOOL OF TRUST BANKING

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BIOGRAPHICAL INFORMATION

TOP TEN REASONS TO SEND YOUR CUSTOMERS TO QUALIFIED ESTATE PLANNING COUNSEL

1. The customer has no Will.

2. The customer's existing estate plan provides that the "estate tax exemption amount" and the "marital deduction amount" pass to <u>different parties</u> (children from a previous marriage/surviving spouse). **This easily-remedied situation will be what you will most likely encounter from this list, and also provides the most potential for disastrous consequences for the customer's family over the next few years of rising exemption amounts.**

3. The customer has a Will, but has no ancillary documents to provide for control of his or her assets in the event of disability (eg., power of attorney, medical power of attorney).

4. A customer with a high net worth has a Will or Trust that leaves his or her assets outright to his or children, rather than providing for Generation Skipping Trusts.

5. The customer individually has highly appreciated assets that he or she would like to sell.

6. The customer has a reduced life expectancy compared to other people his or her age.

7. The customer is very charitably inclined, but has not created any trusts or a private foundation.

8. The customer owns a business and is paying franchise taxes.

9. The customer owns stock in a closely held C corporation with highly appreciated assets ,and the corporation may want to sell those assets within the next 5 to 10 years.

10. The customer indicates he or she is about to start a new business and has not been counseled on choice of entity considerations.

(Not all of these topics are addressed in the outline - but each of them is a "red flag" indicating your customer needs to be referred to a Board Certified Estate Planning or Tax Attorney)

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ESTATE PLANNING

JOHN HUNTER

I. ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001

The status of the long awaited Estate Tax Repeal continues to be a matter of great uncertainty. Repeal was finally realized in the Economic Growth and Tax Relief Reconciliation Act of 2001, but how the "repeal" will impact your customers currently depends on what year they die, and no one knows how long the repeal in its current form will last. The Act only suspended the estate tax for **one year** – 2010, and the estate tax rules, rates and exemptions which were in effect in 2001 will come back in force in 2011. The estate tax continues through 2009, with the exemption increasing from the current $2,000,000 to $3,500,000 in 2009, before being repealed for the year 2010.

Although everyone could see estate tax reform coming, we all guessed wrong about the exact form it would take. No one predicted the "repeal and reinstatement" approach, and the obvious inequities of the Act's impact on persons near death in the years 2009, 2010, and 2011 cause us to question just how long it will be before the current act is reformed into a more workable system. One thing is certain about the current tax system – it creates the need for complex and highly flexible estate planning tools to accomplish your customers' estate planning goals.

A. HOW WILL YOUR CUSTOMERS' EXISTING ESTATE PLANS BE IMPACTED?

Of course this answer will vary from customer to customer. The *majority* of your customers will have plans which leave the estate tax exemption amount (discussed below) to a family (bypass) trust for their spouse and children, while leaving any amount left over to a marital (QTIP) trust for the benefit of the surviving spouse only. As the exemption increases, these customers will find that a larger and larger portion of their estate will be funded into the family trust, while the marital trust will shrink. This shift will not have a significant impact on customers who have equal dispositive intent towards their spouse and their children, but customers with second spouses, blended families, and those customers who wish to ultimately leave their marital trust assets and their family trust assets to different groups will need to amend their plans. ***Who should be most concerned?*** Anyone whose Will leaves their estate tax exemption amount directly to children (skipping a spouse), on the assumption that the spouse would receive sufficient assets through the marital trust to provide for his or her needs. If a customer comes to you with this kind of existing plan, tell them to run, not walk, to the nearest board certified estate planning attorney for an amendment to the plan. Many of your customers may have put their estate planning concerns on the "back burner" upon hearing of the estate tax repeal, and your goal is to help them avoid the impending family disaster that could occur if their plan relied on the old exemption amount to divide assets between first and second families.

B. IF THE ESTATE TAX IS REPEALED, WHY DO YOUR CUSTOMERS NEED AN ESTATE PLAN AT ALL?

Although tax motivations for estate planning may decrease for some, you should help your customers to realize the other benefits to be gained from estate planning, especially asset protection and separate property segregation. You should ask your customers what they would want to do with their wealth on death if tax were not a consideration, and the answers to these questions will lead them to an estate plan based more on personal values rather than on tax formulas. Many of them will find that protecting their children's inheritance from creditors and divorcing spouses is sufficient incentive to consider trust planning, and many people may be more interested in the ability to control the use of trust funds after their deaths. For example: leaving assets in trust for a surviving spouse protects the assets from the spouse's creditors and gives the assurance that upon the survivor's death, the assets will pass to his or her children. When leaving assets outright to a spouse, there is always a risk that the survivor will be influenced to give the assets to others during life or on death. Likewise, leaving assets in trust for children protects the inheritance in case of divorce or creditor problems.

C. WHAT ARE THE CHANCES THAT THE ESTATE TAX REPEAL OF 2010 WILL BE MADE PERMANENT?

Not likely. When you look at the realities of the system in its current form, you don't know whether to laugh or cry: if a wealthy individual dies in the year 2009, his or her estate will have to pay the government 45% of every dollar over $3,500,000. If he or she happens to die in 2010, however, the beneficiaries have "hit the jackpot:" no tax at all will be owed by the estate. If the elderly benefactor lives until 2011, however, there will be a price to be paid for this longevity: die in the year 2011 and owe the government 55% of every dollar over $1,000,000. Many have suggested that the Estate Tax Act should have been titled the "Throw Momma from the Train Act of 2001."

There was an eight-year phase-out period from the time of enactment to the time the estate tax is fully repealed. This translated into four new congresses and at least one new president before such a law would take effect. Keep in mind, too, that even if the federal estate tax is done away with, there is no guarantee that the tax will disappear at the state level.

D. HOW DO YOU RESPOND TO THE CUSTOMER WHO ASKS, "WHAT DO I DO NOW?"

There are three words your customers must remember for estate planning during the next decade: Flexibility, Flexibility, and Flexibility. As was discussed above, Congress has placed us all in a very awkward position of not knowing what is coming next. Estate plans should be reviewed regularly, and absolutely must be drafted in such a manner as to adjust to estate tax provisions which have become moving targets. Because most analysts agree that the estate tax system now on the books cannot be allowed to stand (due to the inherent inequities discussed above), one of your biggest concerns at the moment is for the customer who drafts an estate plan in accordance with existing law, and who then becomes incapacitated for a period of time before death. Should the estate tax laws change in radical and unforeseen ways after a testator has become unable to revise his estate plan due to incapacity, the results could be devastating. This will become a compelling reason for customers to develop their estate plans in the form of Living Trusts rather than Wills, so that a power of attorney may be appointed with the power to amend the estate plan to comply with changes in the tax laws.

II. TAX CONSIDERATIONS IN ESTATE PLANNING

A. SUMMARY OF FEDERAL ESTATE TAX.

1. Determine "gross estate." (Fair market value at date of death of all property owned by the Decedent, including home, personal effects, investments, death benefits under retirement plans, life insurance proceeds, etc.) In a community property state, include the Decedent's separate property and his or her half of the community property.

2. Deductions from the gross estate. "Gross estate" minus certain deductions equals the "taxable estate."

   (a) Funeral and administrative expenses.

   (b) Charitable gifts.

   (c) Unlimited marital deduction (equal to property passing outright or in a "QTIP" Trust for a surviving spouse). The deduction is the same whether the assets pass outright or to a QTIP Trust.

   However, non-tax considerations often suggest the use of the QTIP Trust:

   (i) Through a QTIP, a person can provide fully for the needs of the surviving spouse. However, if the surviving spouse remarries, the QTIP can ensure that the children from the first marriage will ultimately receive the assets on the surviving spouse's death.

(ii) The QTIP Trust can be a "spendthrift" trust that protects the trust assets from being reachable by creditors of the surviving spouse.

(iii) The QTIP trustee can provide valuable management assistance to the surviving spouse, especially if the surviving spouse later becomes disabled.

(iv) The QTIP protection can help the surviving spouse avoid yielding to pressure from a new spouse to spend or invest in a new "deal."

(v) Where husband and wife are each entering into a second marriage and each has children from a prior marriage, the QTIP can provide for the surviving spouse and later ensure that each one's assets ultimately will pass to his or her children.

3. Credits against the estate tax.

(a) Credit for state death taxes. (Note: Texas Inheritance Tax is exactly equal to this credit for persons who died in the year 2001.) Under the Bush Tax Plan, the credit for state death taxes was reduced by 25% in 2002, 50% in 2003, 75% in 2004, and disappeared in 2005 . In 2005 the credit for state death taxes was replaced with a deduction for state death taxes paid. In states such as Texas which have estate tax tied to the <u>credit</u> for state death taxes, there is no state death tax after 2004 unless the states implement a new tax. To date, Texas has not implemented a new tax.

(b) Credit for tax on prior transfers. This credit applies if the decedent received any assets which were subject to federal estate tax in another estate over the last 10 years of the decedent's life.

(c) "Applicable credit amount." Resulted in an "applicable exclusion amount" (or exemption level) of $2,000,000 in 2006. Under the Bush Tax Plan, this exclusion amount will increase to $3,500,000 by the year 2009, and will be unlimited in the year 2010. If the estate tax repeal is allowed to "sunset" in 2011, it will be as if the repeal never happened.

Year of	Exemption	Top Tax

Death	Level	Rate
2002	1,000,000	50%
2003	1,000,000	49%
2004	1,500,000	48%
2005	1,500,000	47%
2006	**2,000,000**	**46%**
2007	2,000,000	45%
2008	2,000,000	45%
2009	3,500,000	45%
2010	n/a - repealed	n/a
2011	1,000,000	55%

4. As the above chart shows, under the Bush tax plan the top tax rates will gradually be reduced over the next few years.

B. SUMMARY OF FEDERAL GIFT TAX.

1. Former law, and law after "Sunset": The unified credit exclusion amount for gift tax purposes used to be the same as for estate tax purposes, and taxable gifts which utilized a taxpayer's gift tax exclusion during life were also counted against the taxpayer's estate tax exclusion amount at death (a "unified" system for lifetime gifts and transfers at death.) No gift tax was imposed until all taxable gifts exceeded the unified estate and gift tax credit amount. This system will return if the Bush tax plan is allowed to sunset.

   New Law: The gift tax will not be repealed, and the unified credit exclusion amount for gift tax purposes will not be the same as for estate tax purposes. The gift tax exclusion amount will remain at $1,000,000, and will not rise to match the estate tax exclusion amount. The top gift tax rates will be the same as the top estate tax rates (see above), and after 2009 (when the estate tax is repealed) the top gift tax rate will be the top individual income tax rate (i.e., 35%).

2. Each person can give up to $12,000 per donee each year to an unlimited number of people without having made a taxable gift. No gift tax return need be filed. Note that there is no gift tax but such a gift is not deductible on the income tax return.

3. In addition, there is an unlimited gift tax exclusion for payments of tuition expenses made directly to the educational institution or payments of medical expenses made directly to the medical provider.

C. ESTATE TAX PLANNING WHEN TOTAL ESTATE OF HUSBAND AND WIFE IS LESS THAN EXEMPTION LEVEL.

1. Less than $1,000,000*: If the total family estate (including life insurance) is less than $1,000,000, estate taxes are not a consideration in the planning process. However, in planning, consider future increases in estate size through appreciation or potential inheritance from parents. *As we will discuss, this number is a moving target. See above chart. **For purposes of this outline, all formulas will be calculated as though the decedents die during a year when the estate tax exemption amount is $1,000,000.**

2. No gifts: Such a family need not give gifts to reduce the estate. In fact, giving a gift of appreciated assets forfeits the opportunity for a stepped-up basis at death.

   Example:

   Stock which was originally bought for $1,000 has an "income tax basis" of $1,000. If the stock appreciates to $12,000, and the owner makes a gift of the stock during his or her lifetime, the donee's income tax basis will be $1,000. If the donee sells the stock for $12,000, the donee must report an $11,000 capital gain. If the donor does not make a gift of the stock, but holds it until death, the stock gets a "stepped-up" income tax basis of $12,000. If the post-death recipient sells the stock for $12,000, there is no taxable gain. Also, all inherited assets automatically receive long-term capital gain treatment when sold.

Note: The step-up in basis at death will end with the estate tax. Beginning in 2010, after the estate tax has ended, property acquired from a decedent will have a basis equal to the **lesser** of the decedent's basis or fair market value at death.

Comment on new tax law: Carryover basis is very controversial. Present law gives property acquired from a decedent a new basis equal to fair market value at death, which could be a step-up or a step-down, depending on whether the property had appreciated or depreciated since being acquired by the decedent. The new law (in 2010) provides for a step-down in basis, but never a step-up, which means that the heirs can acquire the decedent's taxable gains, but never any deductible losses. Because of the complexities and fairness problems of the new carryover basis law, it is sure to be reconsidered and hotly debated in the future.

D. ESTATE TAX PLANNING WHEN TOTAL ESTATE OF HUSBAND AND WIFE EXCEEDS EXEMPTION LEVEL.

1. Specific Bequest of Life Insurance. Make a specific bequest of the decedent's ownership interest in life insurance insuring the surviving spouse to save estate taxes on the survivor's death. This takes one sentence in the Will,

typically leaving to the children the decedent's ownership interest in life insurance policies insuring the surviving spouse.

Example:

Assume Husband and Wife own a $1,000,000 life insurance policy on Husband (with a cash surrender value of $50,000) and they also own $1,000,000 in other assets. Because the policy is community property, Wife owns one-half. If the Wife dies first and leaves all her assets to her Husband, Husband will then own the entire policy. On the Husband's death, the $1,000,000 proceeds would be included in his gross estate. However, if the Wife leaves her one-half ownership of the policy to the children, when the Husband dies later, only $500,000 is included in his gross estate. Following the Wife's death, the children pay half of the premium, and the Husband pays the other half. To illustrate, see the following example:

Total Community Estate

Life Insurance ($1,000,000 death benefit, $50,000 Cash Surrender Value “CSV”)
Other Assets $1,000,000

	All to Husband	W's ½ L.I. To Children
W dies first		
Gross Estate:		
½ CSV L.I.	$ 25,000	$ 25,000
½ Other Assets	500,000	500,000
	$ 525,000	$ 525,000
Less: Marital Deduction	(525,000)	(500,000)
Taxable Estate	$ -0-	$ 25,000
Federal Estate Tax	$ -0-	$ -0-

H dies later:

Life Insurance	$ 1,000,000	$ 500,000
Other assets	1,000,000	1,000,000
Total Gross Estate	$2,000,000	$1,500,000
Less: Marital Deduction	-0-	-0-
Taxable Estate	$2,000,000	$1,500,000
Tax	$ 435,000*	$ 210,000*
Tax Savings	$225,000	

* Assumes 50% maximum estate tax rate and $1,000,000 exemption amount.

2. Testamentary Trusts.

(a) QTIP/Bypass ("A/B") Trust Arrangement. By using this technique in a Will, the Husband and Wife team can receive two $1,000,000 exemptions instead of one exemption. For example, Wills with these trusts will cause $2,000,000 to pass free of estate tax. Under simple Wills ("all to spouse"), only $1,000,000 would pass free of estate tax.

(i) "All to Spouse." If Will leaves "all my property to my spouse" if husband (H) dies first, there is no federal estate tax when H dies because of the unlimited marital deduction. However, both H's and W's halves are taxed when W dies. The total taxable pile would, therefore, be thrown into a higher bracket, and the husband-wife team would only benefit from one unified credit exemption level.

This problem is called "estate stacking." Instead, where total estate exceeds the exemption level, H could leave part of his property in trust "A" and the rest in trust "B."

(ii) Trust "B." An amount of property equal to the exemption level goes into trust "B," known as a "Bypass Trust" (also known as a "Unified Credit Trust," "Credit Shelter Trust," or "Exemption Trust").

- Spouse can be the trustee (if the trust is worded very carefully).

- Spouse can receive all income earned on trust principal.

- Spouse can reach trust principal as necessary for "health, support, maintenance, or education" (particularly important not to exceed this distribution standard if the surviving spouse is trustee, or has power to invade principal, or has the power to remove and replace the trustee).

- Spouse can have special power of appointment (inter vivos and/or testamentary) to give trust property away during life or control its disposition upon death (as long as spouse cannot appoint property to self, estate, or creditors of either).

(iii) Trust "A." The rest of the property not given to the Unified Credit Trust goes to trust "A," known as "QTIP" (Qualified Terminable Interest Property) Trust for the benefit of the surviving spouse. This transfer qualifies for the marital deduction when H dies but is taxed when W dies. This portion could be given outright to W instead of in trust, with the same tax consequences. Under a "QTIP" Trust:

- The surviving spouse is entitled to all the income from the property payable at least annually.

- No person has the power to appoint any portion of the property to someone other than the recipient spouse during the spouse's lifetime.

- Upon the surviving spouse's death, the remaining QTIP property passes to the beneficiaries designated by the first spouse to die (in the QTIP Trust provisions of that spouse's Will).

(iv) Example:

Assume H and W own a total community property estate of $2,000,000. H dies first, and W dies sometime later.

	All to Wife	A/B Trust Arrangement
H dies:		
Gross Estate	$1,000,000	$ 1,000,000
Marital Deduction	(1,000,000)	-0-
Taxable Estate	$ -0-	$ 1,000,000

Gross Estate Tax	$ -0-	$ 345,800
Unified Credit	-0-	(345,800)
Net Estate Tax	$ -0-	$ -0-

W dies:

Gross Estate	$2,000,000	$1,000,000*
Marital Deduction	-0-	-0-
Taxable Estate	$2,000,000	$1,000,000
Gross Estate Tax	$780,800	$ 345,800
Unified Credit	(345,800)	(345,800)
Net Estate Tax	$435,000	$ -0-
Tax Savings	$435,000	

*Wife's estate equals original one-half of her property plus amount given to trust "A" under husband's Will. Here, at husband's death, all of his assets went to trust "B" under his Will.

(v) Approximate Tax Savings according to size of estates:

Total Estate of H & W	Taxes All to Spouse	Using A/B Trusts	Tax Savings
$1,250,000	$ 102,500	-0-	$ 102,500
$1,500,000	$ 210,000	-0-	$ 210,000
$2,000,000	$ 435,000	-0-	$ 435,000
$2,500,000	$680,000	$210,000	$ 470,000
$3,000,000	$930,000	$435,000	$ 495,000

(b) Traps in Bypass Planning.

(i) Specific Bequest of Home/Personal Effects. If the decedent's half of the assets will barely fill up a Bypass Trust, remove "boilerplate" specific bequest provisions which could divert needed assets from the Bypass Trust.

Example (all community property):

Home	$ 300,000
Other	1,500,000
Total	$1,800000

If H dies and leaves his half of home outright to W, then only $750,000 of H's assets are available for funding the Bypass Trust. Later, when W dies, her taxable estate will be $1,050,000, and $20,500 of estate tax will be due on the portion exceeding $1,000,000. If H's Will leaves the home (along with rest of his assets) to the Bypass Trust, there would be no estate tax at either death.

(ii) Survivorship Bank/Brokerage Accounts. Watch out for these accounts which go automatically to the survivor outright and cannot be reached by the executor to fund a Bypass Trust. This is especially important with the relatively new "community property with right of survivorship" accounts. Accounts should be established as tenants in common instead of joint tenants with right of survivorship.

(iii) Coordinate Life Insurance/Retirement Plan Beneficiary Designations. These assets do not pass under the Will, but pass per a separate beneficiary designation. To get these into the Bypass Trust, the Beneficiary Designation must be worded properly.

Example:

L.I. on H	$1,000,000
Other Assets	500,000
Total Estate	$1,500,000

Assume H dies first and his Will created QTIP/Bypass Trusts.

	Beneficiary Designation	
	"All to W"	"1/2 to W, 1/2 to Bypass Trust"
H dies first Estate Tax	-0-	-0-
W dies second Estate Tax	$102,500	$ -0-

NOTE: There is a dilemma with the beneficiary designation for retirement plans. Whatever goes outright to the spouse can be rolled over into a spousal IRA to continue deferring income tax. However, if all goes outright to the spouses, the bypass trust may be under-funded. Consider: One-half to the spouse (representing the spouse's half of the community property) and one-half to the spouse except to the extent the spouse disclaims, with disclaimed assets passing to the bypass trust. Such a beneficiary designation preserves flexibility and allows for a decision to be made by the spouse at the time of the participant's death.

(c) Disclaimer. If the Will leaves all property to the spouse outright, the spouse can disclaim the assets (or a portion of them) and salvage an extra exemption for the family. This is often called "post mortem" estate planning. The disclaimed assets would pass as if the spouse predeceased. A Will can be drafted "in contemplation of disclaimer" so that if the spouse disclaims, the disclaimed assets pass to a bypass trust for the spouse. The disclaimer must be filed with the Probate Court within nine months of the date of death and must occur before acceptance of the assets.

(d) Generation-Skipping Transfers (GSTs). A Generation Skipping Transfer includes any transfer of property to (or for the benefit of) persons two or more generations below that of the transferor. Generally, lifetime transfers are taxed at a flat rate of 48%. Depending on the type of transfer involved, the tax will be paid by either the transferor, transferee, or trustee.

The most common types of GSTs are:

(i) Direct Skip. Example: Grandparent makes an inter vivos gift to grandchild. Grandparent pays gift tax and generation skipping tax. (If gift is made in the grandparent's Will, the grandparent pays both estate tax and generation skipping tax).

(ii) Taxable Termination. Example: Grandparent's Will establishes a trust for the benefit of child for child's life, and at child's death, trust goes to grandchild. When grandparent dies, the assets are subject to the estate tax, but no GST. When child dies, there is a “taxable termination,” and the assets are then subject to GST.

Exceptions:

(i) Every person is permitted to make a certain amount of Generation Skipping Transfers during life or at death that will be completely exempt from the GST tax. The amount which can be transferred exempt from GST tax is currently linked to the estate tax exemption system, and will rise with the estate tax exemption amount. Married couples may double this amount by electing to treat GSTs as made one-half by each.

(ii) The GST tax does not apply to any outright gifts that are exempt from gift tax because of the $12,000 annual exclusion or the special exclusion for certain tuition and medical expense payments. However, special rules apply for gifts to trusts (trust must be for no more than one beneficiary, and assets must be subject to estate tax when beneficiary dies).

(iii) When a grandchild's parent who is a lineal descendant of the grantor is deceased, the grandchild is "moved up" a generation. Transfers to such a grandchild are not GSTs.

The generation-skipping transfer tax exemption will increase in the same way as the estate tax exemption (see Chart on pp. 2 and 3), and the GST tax rate will decrease along with the top estate tax rate. The GST tax will end with the estate tax in 2010. The repeal of the estate tax and GST tax, but not the gift tax, means that generation-skipping transfers during lifetime will still be subject to gift tax after 2009, but not any additional generation-skipping tax.

<u>Planning Opportunity</u>: Set up a trust (either during life or at death) with assets worth the Generation Skipping Exemption Amount, and leave the assets in trust for the lifetime of your children. Advantages:

(i) Trust can be a "spendthrift" trust and not reachable by creditors of children.

(ii) Assets are clearly segregated as child's separate property and not commingled with community property in case child's marriage fails.

(iii) Investment and management assistance, particularly if child becomes disabled. (Note: With careful drafting, the child can be the trustee of his or her own trust.)

(iv) Opportunity to direct how assets will pass at child's death unless child is given a special power of appointment to give child discretion over this decision.

(v) Major tax savings can be achieved through use of the $2,000,000 GST exemption ($4,000,000 if both parents create trust for children) – no estate tax on assets when child dies; therefore, much more passes to grandchildren. See the following example:

<u>Example</u>:

After H & W die and after all estate taxes are paid, assume there are $2,000,000 in assets which pass under the Wills to their only child.

	If Wills leave assets outright to child	If Wills leave assets in GST Exempt Trust for life of child
Assets to child at death of parents	$ 2,000,000	$ 2,000,000
Appreciation during child's life	3,000,000	3,000,000
Assets at child's death	$ 5,000,000	$ 5,000,000
Less: Tax at child's death (assuming child dies under $1,000,000 exemption amount)	(2,045,000)	(-0-)
Assets passing to grandchildren	$ 2,955,000	$ 5,000,000

NOTE: Consider using a "Dynasty" trust that lasts as long as the Rule Against Perpetuities allows, so that tax can be avoided for several generations.

(e) $12,000 Gifts. If giving away assets other than cash, try to use higher "income tax basis" property, since you forfeit the "stepped-up" basis. Must be a gift of a present interest. There are four ways to qualify a gift as a present interest:

- outright,
- to a Custodian under the Uniform Transfers to Minors Act (Please note that if gifts are made to a minor through a custodial account set up under the Texas Uniform Transfers to Minors Act, it is a good idea that neither the donor nor the parent of the donee be the custodian, in order to keep the custodial assets from being taxed in the estates of such persons),
- Minor's Trust [Section 2503(c)], or
- "Crummey" Trust, as described in Section 7.c to follow.

- Exemption Gifts. Since the "applicable credit amount" (or estate tax exemption amount) can be used either during lifetime or at death, early use of the credit during lifetime provides the opportunity to shift future appreciation out of the estate. Select assets which are most likely to appreciate. Future income from the gift and future appreciation of the gifted property are shifted to the next generation. The climate for these gifts is especially good when real estate values are low.

Note that assets gifted during life do not get a "stepped-up" basis as is currently available for assets passing at death, but note also that Congress plans to phase out stepped-up basis with the estate tax.

Example:
Husband and Wife own real estate worth $1,372,000 which is almost certain to appreciate. If each makes a gift of one-half to son, each files a gift tax return (Form 709) as follows:

Total Gift	$ 686,000
Exclusion	(11,000)
Taxable gift	$ 675,000
Gross gift tax	$ 220,250
Portion of Unified credit	(220,250)
Net gift tax	$ -0-

Even if the real estate appreciates to $3 million, there will still be no federal estate tax consequences for the parents, and the appreciation will not be taxed in their estates.

3. QPRT: Qualified Personal Residence Trust.

(a) If all the trust property consists of a residence to be used as a personal residence by the grantor, a grantor can transfer property to a trust and retain an income interest in that trust for a fixed period of years (usually 10-15), with the remainder interest passing to other beneficiaries (typically children). The value of the gift is equal to the value of the remainder interest after deducting the value of the retained income interest from the full value of the property placed in trust. Upon the expiration of the income interest, there is no transfer tax imposed. For example, if a house is worth $1 million, appreciates to $2 million, and is owned outright, then at death, the estate tax on the house will be $960,000 (at the 48% rate). If the $1 million house were transferred to a QPRT by a 65 year old owner for 15 years, the value of the 15-year term (determined in accordance with Section 7520) would approximate $785,000, so the taxable gift is only

$215,000 (which is $785,000 subtracted from $1,000,000). (The actual value would need to be determined at the time of the transaction based on then current rates). The house ultimately passes to the children at a transfer tax value of $215,000 instead of $2 million. Note: After the 15-year term ends, the parents must pay rent in order to continue occupying the house.

(b) This planning technique is only available for the transfer of a person's primary or vacation residence. IRS Regulations (Section 25.2702-5(c)) define a personal residence of a term holder to include the principal residence of the term holder (as defined in Section 1034) and one other residence of the term holder (within the meaning of Section 280A(d)(1)).

(c) The requirement that a Personal Residence Trust hold as its sole asset a personal residence can lead to impracticalities that might cause the actual use of this exception to be limited. Recognizing this fact, Regulation Section 25.2702-5 provides rules to address practical considerations including:

(1) The trust may hold cash to cover expenses (including for mortgage payments or improvements) to be incurred in the next three months.

(2) Sales proceeds may be held in trust for two years if the trustee intends to purchase another personal residence within that period.

(3) Excess cash must be distributed to the grantor at least quarterly.

(4) If the residence ceases to be used as a personal residence, the trust must terminate and distribute all assets to the grantor, or alternatively can be converted into a Grantor Retained Annuity Trust (a type of Trust, not discussed here, in which the retained interest consists of the right to receive fixed amounts payable not less frequently than annually).

(5) The trust document must prohibit the holding of any asset other than one personal residence (and cash, as permitted above). Contents of a residence cannot go into the trust.

(d) <u>Important rule for QPRT</u>. If the grantor dies before the trust term of years ends, the entire value of the property is included in the grantor's estate, as if no trust were ever done. Therefore, try to select a term of years the Grantor is likely to outlive. Note: Even if the technique fails, the grantor is no worse off for trying it. As a back-up, consider purchasing term life insurance for the duration of the trust, to cover estate taxes due if the grantor dies early.

4. <u>ILIT: Irrevocable Life Insurance Trust.</u>

When life insurance is owned by the insured, the proceeds are subject to estate tax. To avoid this result, create a trust with an independent trustee. Either have the trustee buy new insurance or transfer existing insurance to trust. The trustee pays all premiums with gifts received from the trustor. The trust is named as the beneficiary of the policy. When the insured dies, none of the proceeds are included in his gross estate because the insured held no "incidents of ownership" over the policy. If the trustor transfers existing life insurance policies to the trust, the trustor has to live three years after creating the trust to escape Section 2035 inclusion in the estate. If Wife is a trust beneficiary, Wife cannot, at any time, make a gift to trust. In that case, husband uses separate property (created through partition agreement, if necessary) to fund the trust. The trust should contain "Crummey" withdrawal rights to qualify the gifts as present interests (eligible for the $12,000 annual exclusion). If the donee can demand more than $5,000 in a calendar year, the excess is treated as a gift by the donee back to the trust. (For GST-exempt trusts designed to last more than one generation, annual demand rights should be limited to $5,000 per beneficiary in order to avoid estate tax when the beneficiary dies.) When the insured dies, the trustee can use proceeds to make loans to estate or buy assets from estate and/or surviving spouse. This creates liquidity for payment of the estate tax.

<u>Example</u>:

H and W own $500,000 life insurance and $2,000,000 other assets -- all community property. Assume H dies first, then W dies sometime later.

If Will says "all to W" and life insurance beneficiary is "to W outright," total estate taxes after W's death are $680,000.

If change Will to include A/B (QTIP/Bypass) Trusts (as described above), total estate taxes after W's death are $210,000.

If also adopt irrevocable life insurance trust, total estate taxes are $0.

If a customer with an existing ILIT no longer has a taxable estate under the new increased exemption amounts, there are non-tax reasons to continue keeping the policy in Trust. By leaving insurance proceeds to one's beneficiaries in this manner the policy proceeds can be protected from the beneficiaries' creditors, and the assets will also be segregated as a beneficiary's separate property in the event of divorce. The assets will also continue to be protected from estate taxation at the insured's death (and at the deaths of his or her children in the case of generation skipping GST Trusts). Lastly, through Trust planning one can provide for the management of assets passing to minor beneficiaries, and protect spendthrift children from themselves through the use of independent third party Trustees.

5. Limited Partnerships ("LP"). The use of an LP may result in significant estate and gift tax savings through valuation discounts of the underlying assets as well as the ability to gift the family business to younger generations while retaining control over such assets. LPs also provide valuable creditor protection. After an LP is set up by following certain formalities, assets are transferred to the partnership in exchange for general and limited partnership interests. Partnership interests can then be gifted or retained until death.

Valuation discounts are achieved under the LP because the attributes of a limited partnership interest make it generally worth less in value than the underlying assets of the partnership. For example, the inability of a limited partner to transfer his or her interest (lack of marketability) and the inability to demand distributions or force a liquidation of the partnership (lack of control) can produce valuation discounts generally ranging from 10% to 65%. As a result, valuation discounts allow assets to be transferred to a younger generation at a reduced value which translates into estate and gift tax savings. For example, if a 40% discount is allowed, the transfer of $2,000,000 in value of underlying assets to a younger generation through an LP will produce a value of only $1,200,000 for computing estate and gift tax. For a person in the 48% marginal estate and gift tax bracket, such a transfer through an LP would result in a tax savings of $384,000 compared to an outright transfer of the actual underlying assets at full value.

The LP also provides an opportunity to gift assets using discounted values. Annual gift-giving can be simplified through the use of an LP especially for real estate or other assets which are difficult to divide or value. The annual gifts of limited partnership interests are made through a simple form known as an assignment, without the requirement of preparing and recording deeds of undivided interests in the actual property. The discounted value of the limited partnership interests also enhance the amount of property that can be given under the annual exclusion.

Furthermore, by gifting LP interests to children, rather than assets outright, the children will also receive the benefits of creditor protection. If the property were gifted outright, it would be subject to seizure by each child's potential creditors. However, creditors view LP interests as less attractive assets to seize because of their inherent restrictions, and the creditor cannot obtain control over the LP's assets by seizing an LP interest.

6. Gifts that Do Not Work.

(a) Donor Retains Strings. If the donor retains control over the gift, the asset will be included in the donor's estate at the date of death value instead of the date of gift value. Section 2036 catches gifts in which the donor retains rights to the income. Section 2038 catches gifts in which the donor retains the right to alter, amend, or revoke. If the donor serves as trustee of a trust to which he has made a gift, the gift will be included in the donor's estate. If the donor makes a gift of his house to his children and continues to live there, the donor's house will be included in his estate. The donor cannot retain control in any manner, including the right to control the timing or amount of distributions. If the gift is made under the Uniform Transfers to Minors Act, the donor should not be the custodian. If he is, then the assets will be included in the donor's estate if he dies while serving as custodian.

(b) Section 2701 eliminates the "estate freeze" technique for closely-held businesses. If parents retain preferred stock and transfer all the common stock to children, the parents generally will have to report the entire value of the company as a taxable gift. However, Section 2701 does not restrict all planning in this area.

For example, if parents give all their family business stock to children, they may stay on the business payroll under an employment contract. Also, parents can sell their family business stock back to the corporation in exchange for a note.

(c) Gifts Within Three Years of Death. Before 1977, gifts made within three years of death were included in donor's estate at the date of death value if they were found to be "in contemplation of death." After 1977, but before 1982, gifts made within three years were automatically included at the date of death value, except for gifts fully covered by the annual exclusion. After 1981, gifts made within three years of death are not included at the date of death value. Of course, taxable gifts are still included at the date of gift value.

Planning Suggestion: Last-minute ("death bed") gifts result in substantial estate tax savings. If the decedent is in a 50 percent estate tax bracket, last-minute pre-death gifts of $10,000 each will save $5,000 per gift. To save tax, the check must clear the bank before death occurs.

If taxable gifts are made within three years of death, the gift tax paid is included in the estate tax return. This "gross up" prevents the decedent from making a last-minute large gift and excluding the gift tax dollars from the estate.

(d) Life Insurance Gifts Within Three Years of Death. Gifts with respect to life insurance policies that are made within three years of death do not work. The full proceeds will be included in the transferor's estate.

III. SPECIAL PLANNING CONSIDERATIONS.

A. ELDERLY CUSTOMERS OR CUSTOMERS WITH A SHORT LIFE EXPECTANCY.

1. Examine Will. Check signatures (testator and witnesses), notary, etc., to make sure everything is in order and that the Will has a "self-proving affidavit" attached, signed by the testator and the witnesses.

2. Real Estate. Avoid probate by deeding to a Living Trust, or by making a gift and deeding during lifetime (retain a life estate in order to get stepped-up basis). This is especially important for out-of-state real property (including mineral interests) in order to avoid ancillary probate.

3. If one spouse has substantial separate property, and it appears the non-propertied spouse could die first, make a gift to the non-propertied spouse to equalize estates (or at least give the non-propertied spouse enough assets to use the full unified credit exemption if the non-propertied spouse dies first). To save taxes, the Will of the first to die must contain a Bypass Trust.

   Example (assuming $1,000,000 exemption amount):

   H's separate property = $1,500,000
   W's separate property = -0-
   Community property = $ 100,000

	Without Gift to W	H Makes $750,000 Gift to W
H dies first:		
Estate Tax at 2nd death	$ -0-	$ -0-
W dies first:		
Estate Tax at 2nd death	$232,500	$ -0-

4. Utilize losses and avoid basis "step-down" on assets which have declined in value. Either sell the asset before death, or partition the asset into two separate property halves so the survivor's half will not be stepped down.

   Example:

   Stock which was purchased for $10,000 is now worth $1,000. If you sell the stock before death, you get a $9,000 capital loss. If you hold the stock until death, the stocks have a new basis of $1,000 (equal to the fair market value on the date of death). A post-death sale will result in no capital loss deduction. **Note:** Basis step-up will be phased out with the estate tax repeal, except that $1,300,000 of basis will be allowed to be added to certain assets which pass by death, and $3,000,000 of basis will be permitted to be added to assets transferred to a surviving spouse.

5. Make $12,000 gifts to as many beneficiaries as possible (if the estate is over the exemption level). To be recognized by the IRS as completed gifts, checks must clear the bank before death occurs.

6. Examine life insurance (beneficiary designations; increase coverage if there are guaranteed insurability options; convert to permanent insurance if term will soon lapse).

7. Consider conversion of charitable bequests in Will into charitable pledges which will be an income tax deduction.

8. Consider creating a revocable trust (living trust) to manage financial assets in the event of disability.

9. Accelerate Income in Respect of a Decedent on final income tax return to reduce the estate by the income tax due. Example: Take IRA distributions prior to death.

10. Consider community property conversion. Effective January 1, 2000, a new Constitutional Amendment gives Texas residents the ability to convert separate property into community property by written agreement between spouses. (Previously, while community property could be partitioned into separate property, separate property could not be converted into community property.) Spouses may have two tax motivations to enter such an agreement: (1) Both halves of a community property asset will receive a stepped up basis at the first spouse's death while a survivor's separate property does not, and (2) where one spouse's assets fall below the estate tax exemption level and the other spouse's assets exceed the exemption, conversion of separate property to community property can insure that each spouse will have sufficient assets to utilize the full exemption.

B. DISABILITY PLANNING.

1. <u>Power of Attorney</u>. This document allows a person to name an attorney-in-fact to act on his or her behalf with regard to asset care and financial matters. Texas law provides a statutory form for powers of attorney, and this form can be expanded to take into consideration certain issues not addressed by the law (such as authorizing the attorney-in-fact to make gifts on behalf of the principal).

Caveat: It is a good idea to execute a separate power of attorney for each broker or financial institution by using their own form.

2. Medical Power of Attorney. Texas law allows a person to designate the person who will make medical care decisions on his or her behalf in case the person becomes unable to make such decisions. While the Power of Attorney deals with financial matters, it will not be effective for health care decisions. Therefore, it is very important to also have a Medical Power of Attorney (prior to September 1999 known in Texas as a "Durable Power of Attorney for Health Care).

3. "Living Will"/directive to Physicians. This document directs the physician to withdraw or withhold certain procedures which would artificially sustain life in the event of a terminal condition. It is not the same thing as a "DNR," or "do-not-resuscitate" order, which is a form issued by the Department of Health.

4. Declaration of Guardian. Some states (such as Texas) allow a person to designate, while still competent, the person who will serve as his or her Guardian of the Person (for personal matters) and Guardian of the Estate (for asset management matters). Doing so could avoid family squabbles over who will serve as guardian at the time of incapacity.

5. Living Trust. Transferring assets to a revocable living trust during life avoids probate at death and even more importantly, avoids guardianship in the case of disability. Deeding out-of-state real estate to the living trust avoids costly ancillary probate at death.

The person creating the trust typically names himself (or another) as the initial trustee, than begins transferring assets to the trust. The trust provides that upon the disability or death of the trustee, a successor trustee automatically begins serving.

The trust defines disability and establishes a procedure for determining if a trustee is disabled (without the involvement of the Probate Court). If the trustor becomes disabled, there is no need for a court-supervised guardianship administration. This can be a disincentive for a recalcitrant child to declare a parent incapacitated in an attempt to gain control of the parent's property.

Assets transferred to the living trust during the trustor's lifetime escape probate when the trustor dies. This is especially important for out-of-state real estate.

While the trustor is alive, the trust is revocable, so the trustor can change the provisions in any way. The income of the trust continues to be taxed to the trustor, and (if the trustor serves as sole trustee) there is no need to file a Form 1041 (Fiduciary Income Tax Return) or obtain a tax identification number for the trust.

Upon the death of the trustor, the trust directs the passage of the assets similar to a Will. Any assets not in the trust on the trustor's death pass under the Will, and the Will provisions simply "pour over" those assets to the trust.

The trust also preserves confidentiality, since neither the trust nor an inventory of the trust assets is filed with the court.

The arrangement works best if combined with a Power of Attorney, giving the attorney-in-fact power to transfer assets to the trust.