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TOP TEN MISTAKES IN THE NEW AGE OF ESTATE PLANNING

by Marvin E. Blum

I. FAILURE TO ENGAGE IN BUSINESS SUCCESSION PLANNING.

A. FAMILY OWNED BUSINESSES

In the family context, younger generations that are involved in the business may have a vested interest in the business itself. In such cases, the following items should be considered:

- the best way to pass ownership to children who are involved in the business
- equalizing assets given to children who are not involved in the business
- if more than one child is involved in the business, who will manage the business once you are no longer able
- whether any children currently involved in the business have the ability to manage the business
- building relationships between key customers and the children or other successors
- need for life insurance to provide liquidity to enable the business to hire successor managers

B. NON-FAMILY OWNED BUSINESSES

In a business owned by non-family members, the owners should consider a buy-sell agreement, directing that a deceased owner's interest be purchased upon death. One of the biggest issues faced in these situations is determining an appropriate price for the owner's interest. Some buy-sell agreements set forth a formula for determining the price and the payment terms, reducing the possibility of disputes between the surviving owner(s) and the deceased owner's heirs.

Another way to determine price is to include a push-pull provision in the agreement. Under such a provision, the executor of the deceased owner's estate can set a price, for the company and the surviving owners can determine whether to purchase the decedent's

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interest based on that price or whether to sell their interests based on the same price. This method can help reduce the likelihood of price disputes.

Another consideration is maintaining life insurance on key personnel, including the owners. This can provide liquidity to assist the company in purchasing a deceased owner's interest and in replacing other key talent when death occurs.

II. FLP MISTAKES

A. FAILURE TO CREATE A FAMILY LIMITED PARTNERSHIP

B. FAILURE TO DOCUMENT OBJECTIVE NON-TAX REASONS

C. FUNDING PROBLEMS

- overfunding (failure to retain sufficient assets to cover living needs)
- funding with personal use assets (such as residences)
- failure to properly document asset transfers

D. OPERATIONAL PROBLEMS

- commingling partnership and personal funds
- pattern of ongoing distributions to cover personal expenditures (implied retained right to use of assets)
- disproportionate distributions
- failure to observe formalities

E. STRATEGIES FOR STRUCTURING AND OPERATING FLP's TO AVOID CODE SECTION 2036

1. Do not transfer substantially all of the taxpayer's assets into an FLP. In both *Thompson* and *Harper*, the taxpayers transferred virtually all of their assets into the FLP, so it was easy for the IRS to make the argument that there was an implied agreement that distributions could be made to the taxpayer whenever he needed funds.

2. Try to avoid deathbed transfers. In *Kimbell*, the taxpayer was 96 years old when she created her FLP. Although not a decisive factor in the Court's decision, it did point out that the FLP had a 40 year term, which would make the taxpayer 136 years old when the FLP terminated. Likewise, in *Strangi*, the taxpayer was 81 years old and in poor health when the FLP was created by his son-in-law under a power of attorney.

3. Have other family members or other family entities, such as trusts, make contributions to the FLP in exchange for partnership interests. In each of *Strangi*, *Thompson*, *Harper*, and *Kimbell*, the taxpayer contributed virtually all of the assets to the FLP in question. The Courts noted that since there were no other parties involved in the creation of the FLP, that the bona fide sale for full and adequate

consideration was less likely to apply since the taxpayer was essentially dealing with himself or herself. Also, it will be easier to argue that there is a true joint enterprise if there are several different individuals or trusts who contribute assets to the FLP.

4. <u>Avoid transferring personal use assets into the FLP</u>. If a client is insistent upon transferring a personal use asset into an FLP, recommend that the client and the FLP enter into a lease or rental agreement for the use of the property at its fair market value.

5. <u>Do not waive the fiduciary duty of the general partner to the partnership or the other partners</u>. It is difficult for a taxpayer to argue that his or her fiduciary duty to the other partners or the partnership should negate a Code Section 2036 argument, when the partnership agreement expressly waives the fiduciary duty, as seen in *Kimbell*.

6. <u>Require that the either unanimous consent or some other percentage of partnership interests in excess of the client's ownership is necessary in order to remove and replace a general partner</u>. Better yet, why let the general partner be removed at all? As in *Kimbell*, if the client owns a large enough partnership interest, he or she can unilaterally remove the general partner, which will likely invite a Section 2036(a)(2) argument from the IRS.

7. <u>Make distributions pro rata to all the partners</u>.

8. <u>Do not pay personal expenses of a partner with FLP funds</u>.

III. FAILURE TO PURSUE CUTTING-EDGE PLANNING TECHNIQUES

A. OPTIMIZE USE OF $1,000,000 LIFETIME GIFT TAX EXEMPTION. Even though the estate tax exemption rose to $2,000,000 in 2006, the gift tax exemption remains frozen at $1,000,000 and is not scheduled to increase. Explore ways to leverage it through discounted gifting and freeze techniques that shift future appreciation with no gift tax cost. Consider gift of undivided interest in vacation homes and other real estate to qualify for fractional interest discount on retained portion owned at death.

B. SALE OF ASSETS TO INTENTIONALLY DEFECTIVE GRANTOR TRUST

1. <u>General</u>. The sale of assets to an intentionally defective grantor trust ("<u>IDGT</u>") is another value shifting technique. Unlike the GRAT, the transfer tax implications of a sale of assets to an IDGT are not explicitly addressed in the Code. Rather, the sale of assets to an IDGT exploits the difference in the characterization of trusts for income tax purposes and transfer tax purposes. A grantor establishes a trust which is designed to be treated as a grantor trust for income tax purposes because of the application of the one or more of §§ 671 – 678. The trust is also designed so that the grantor is not treated as retaining any interest in the trust which would cause inclusion in the grantor's taxable estate.

2. <u>Grantor Trust</u>. The following are some methods to design the IDGT so

that the grantor will be treated as the owner for income tax purposes:

a). <u>Spouse as Beneficiary</u>. If the IDGT provides that the spouse is a permissible beneficiary of income and principal, then the IDGT should be treated as a grantor trust in its entirety. § 677(a)(1) and (2).

b). <u>Power of Grantor to Borrow from IDGT</u>. If the IDGT provides that a grantor can borrow from the IDGT without providing adequate security for the loan, the IDGT will be treated as a grantor trust. § 675(2).

c). <u>Actual Loan from IDGT to Grantor</u>. If the IDGT makes a loan to the grantor or the grantor's spouse and the loan is not adequately collateralized, or in the case of a loan to the grantor's spouse, then loan does not require provide for adequate interest, the IDGT will be treated as a grantor trust. § 675(3).

d). <u>Payment of Insurance Premiums</u>. If the principal and income of the IDGT can be used to pay life insurance premiums on the life of the grantor or his spouse, then the IDT should be treated as a grantor trust. § 677(a)(3). The IRS has gone back and forth on the issue of whether just the ability of the trustee to use trust income to make life insurance premium payments on the life of the grantor is sufficient to cause the IDGT to be treated as a grantor trust, or whether actual use of the trust income to make such payments is necessary.

e). <u>Substitution of Trust Assets</u>. The ability of the grantor to substitute assets of the IDGT for assets of equal value will cause the IDGT to be treated as a grantor trust if such power is exercisable in a non-fiduciary capacity without the approval or consent of someone in a fiduciary capacity. § 675(4)(c). The IRS has refused to rule on the question of whether a power can be exercised in a non-fiduciary capacity on the grounds that it is a question of fact. PLRs 9437022, 9524032, 9642039, and 9713017.

f). <u>Power to Spray Principal and Income</u>. If a majority of the trustees of the IDGT are related or subordinate to the trustee and if the trustees have the ability to make discretionary distributions of principal and income, then the IDGT will be treated as a grantor trust. § 674(c).

g). <u>Power to Add Beneficiaries</u>. If a non-adverse party has the power to add beneficiaries to the IDGT, the IDGT will be treated as grantor trust. § 674.

3. **<u>Gift of Seed Money</u>**. The grantor will gift cash to the trust which will be used by the trustee to purchase assets from the grantor. There is no magic amount which the grantor must transfer to the trust. Most literature addressing this point recommend that the grantor make a gift of cash equal to 10% of the total purchase price which provides for a 90% to 10% debt to equity ratio. One attack made by the IRS on the sale of assets to an IDGT is that the sale is not commercially reasonable by claiming that the equity is too low. A larger gift from the grantor can lessen the

likelihood of challenge by the IRS, although the leveraging of the lifetime gift tax exemption is not as effective with a higher cash gift.

4. **Sale of Assets**. The grantor will then sell assets to the trustee of the IDGT in exchange for the gift of cash as well as a promissory note.

5. **Promissory Note**. The promissory note should be for a term of years and should bear interest at a rate in excess of relevant applicable federal rate. The note can be structured to provide for payments of "interest-only" during the term, with a balloon payment of principal at the end of the term of the note. The benefit of structuring the note with a balloon payment is that it maximizes the asset base in the IDGT which will allow for a greater shift of appreciation out of the grantor's estate.

6. **Risks**.

a). Sale will not be respected. The IRS may attempt to assert that the sale should not be respected because it does not have commercially reasonable terms. The beneficiaries of the IDGT may wish to personally guarantee payments by the IDGT to the grantor in order to increase the likelihood that the sale will be respected.

b). Undervaluation of Assets. If hard-to-value assets are sold to the IDGT and the IRS successfully argues that the assets were worth more than the sales price, then the grantor may owe gift tax if the grantor has fully utilized the lifetime gift exemption. One way to mitigate this risk is to use a valuation adjustment clause in the sale documentation which will comply with the holding in *McCord v. Commissioner*, 120 T.C. No. 13 (2003).

c). Death of Grantor During Term of Note. Unlike the GRAT, if the grantor dies while the note is outstanding, the assets sold to the IDGT will not be brought back into the grantor's taxable estate under either §§ 2036 or 2039. Rather the value of the note will be includable in the grantor's taxable estate under § 2033. However, the IRS will likely assert that the death of the grantor triggers the grantor trust status of the IDGT at the moment of death and that the grantor must recognize income to the extent that the fair market value of the note exceeds the taxpayer's income tax basis in the assets sold to the IDGT.

C. GRANTOR RETAINED ANNUITY TRUST (GRAT)

Create a series of single asset, zero out, short term rolling GRAT's; consider funding with options on assets (even on assets not owned by the client); the "winner" GRAT's (those where value appreciates above the rate of the retained annuity) succeed in shifting excess appreciation to children with no gift tax cost.

1. Requirements. A Grantor Retained Annuity Trust ("GRAT") is a trust designed to comply with the requirements of Code § 2702. Section 2702 provides that for purposes of determining whether or not a transfer in trust for the benefit of one or more members of the grantor's family is a gift, the value of the interest

retained by the grantor will be valued at zero unless the interest is a qualified interest.

a). Payments to the grantor must be made at least annually. § 2702(b)(1).

b). The payments must be either a fixed amount (annuity) or a fixed percentage of the fair market value of the assets transferred to the GRAT at the date of transfer (unitrust). Treas. Reg. § 25.2702-3(b)(1)(ii).

c). Payments from one year to the next may not increase by more than 20%. Treas. Reg. § 25.2702-3(e), Example 2.

d). The trust agreement must prohibit additional contributions from being made to the trust. Treas. Reg. § 25.2702-3(b)(4).

e). The trust agreement must prohibit commutation of the interest of the grantor.

2. Gift Tax Implications. Assuming that the § 2702 requirements are satisfied, then the annuity or unitrust interest retained by the grantor will be a qualified income interest. The value of the remainder interest will be treated as a taxable gift from the grantor to the remainder beneficiaries of the GRAT. The amount of the taxable gift is affected by the following factors:

a). Term of the GRAT. The longer the term of the GRAT, the lower the value of the remainder interest.

b). Section 7520 Rate. The higher the § 7520 rate, the higher the value of the remainder interest. (The § 7520 rate for June 2006 is 6.0%).

c). Annuity or Unitrust Amount. The higher the annuity or unitrust amount paid to the grantor each year, the lower the value of the remainder interest.

3. Zeroed Out GRAT. The Tax Court decision in *Walton v. Commissioner*, 115 TC 589 (2000) now effectively allows a taxpayer to "zero-out" a GRAT– meaning that the remainder interest would be valued zero or slightly in excess of zero depending upon the manipulation of the factors discussed in Section 2 above. Obviously, the grantor cannot adjust the § 7520 rate, so the grantor will have to manipulate the term of the GRAT and the payout amount in order to effectively zero out the GRAT.

4. GST Implications. The grantor cannot allocate any of his or her GST exemption to the remainder interest in the GRAT until the GRAT term ends because of the estate tax inclusion period. Prop. Treas. Reg. § 26.2632-1(c)(3)(ii).

5. Ideal Assets. The ideal assets to be used for a GRAT are those with

significant appreciation potential.

a). Single Stock. Particularly effective is the creation of a GRAT with a single stock, since a diversified portfolio will likely not have the significant appreciation potential of a single stock. Since a GRAT can be designed to zero out the value of the remainder interest, the grantor will not "waste" lifetime gift tax exemption by allocating to a transfer in which the assets decline in value or fail to grow at a rate in excess of the § 7520 rate. Thus, a grantor could create a series of zeroed out GRATs which are each funded with a single stock. The GRATs in which the stock appreciates in excess of the § 7520 rate will have achieved the goal of transferring value from the grantor's estate with little or no transfer tax cost. From a transfer tax perspective, the grantor will not suffer because of the GRATs which have stocks which decline in value or fail to grow in excess of the § 7520 rate. The grantor's only loss will be the professional fees associated with the creation of the GRAT.

b). Grant of Option to Acquire Stock. One idea is for the grantor to transfer an option to acquire stock which the grantor owns to a GRAT. The option should be written so that there can be a cash settlement upon exercise of the option. If the underlying stock increases in value, then the trustee of the GRAT will choose to exercise the option.

c). Substitution of Low Basis Assets. If a grantor has established a GRAT with low basis assets, the grantor can retain the right in the GRAT to substitute assets of equal value. Thus, a grantor can transfer cash or other high basis assets to a GRAT before the expiration of the term so that the low basis assets might be included in the grantor's taxable estate which will provide for a basis step up at the grantor's death.

6. Risks of GRAT

Death of Grantor during term of GRAT. If the Grantor dies during the term of the GRAT, then either the fair market value of the assets in the trust will be included in the Grantor's taxable estate under § 2036, or possibly the value of the assets in the GRAT necessary to produce sufficient income under § 2039.

D. LEVERAGE THE GST EXEMPTION

- ILIT's – irrevocable life insurance trusts set up as dynasty trusts
- Inter-vivos QTIP Trusts – fund with entire amount of GST exemption; no gift tax due to marital deduction.
- "HEET" (Health and Education Expense Trust) – supplemental dynasty trust for direct payments of health and educational expenses; include a charity as non-skip beneficiary; no need to allocate any GST exemption.

IV. FAILURE TO PLAN WHEN DEATH IS NEAR

A. SALE OF ASSETS IN EXCHANGE FOR PRIVATE ANNUITY

1. **Description**. In this transaction the seller sells assets to the buyer in exchange for the buyer's promise to provide a stream of payments to the seller which will terminate upon the seller's death. As long as the seller has a greater than 50% chance of living more than one year, then the IRS mortality tables and the § 7520 rate in effect at the time of the sale can be used to compute the annual payment required by the annuity. Treas. Reg. § 1.7520-3(b)(3). Death is presumed to not be "clearly imminent" if the seller lives for at least 18 months after the sale, unless there is clear and convincing evidence to the contrary.

2. **Transfer Tax Consequences**. Provided that the seller can satisfy the health requirements of § 7520 and the annuity payments are computed in accordance with the tables provided thereunder, there should be no taxable gift. Furthermore, since the annuity payments terminate upon the death of the seller, the annuity has no value for purposes of computing the seller's gross estate. § 2039.

3. **Income Tax Consequences**. The seller will have to recognize some amount of income each year depending on the seller's income tax basis in the property sold and the sales price computed using the § 7520 tables. The purchaser's income tax basis in the property purchased is equal to the amount paid.

B. SALE OF ASSETS IN EXCHANGE FOR A SELF-CANCELLING INSTALLMENT NOTE

1. **Description**. Similar to the sale of assets in exchange for a private annuity, a sale of assets in exchange for a self-cancelling installment note ("SCIN") involves the seller receiving a debt obligation which will terminate upon the death of the seller-debt instrument holder, with any remaining balance payable by the purchaser-debtor automatically cancelling. In order to compensate the seller for the risk of cancellation, the SCIN must have a risk premium which can be in the form of a higher interest rate or a higher sale price.

2. **Transfer Tax Consequences**. There should be no gift upon the sale of the assets in exchange for the SCIN provided that the interest rate or principal is adjusted to compensate the seller for the self-cancelling feature. Since the note cancels upon the death of the seller, the note has no value for purposes of computing the seller's gross estate. The use of a SCIN was recognized as a bona fide sale by the Sixth Circuit in *Costanza v. Commissioner*, 320 F.3d 595 (CA-6, 2003), *rev'g* TCM 2001-128. The Sixth Circuit Court of Appeals held that a sale utilizing a SCIN was a bona fide sale of property; however, the Sixth Circuit remanded the case back to the Tax Court to determine if any portion of the SCIN was a "bargain sale " and therefore partially a taxable gift.

3. **Income Tax Consequences**. The seller will recognize income each year depending upon how much of each payment is attributable to interest as well as the seller's income tax basis in the property sold. The buyer will take an income tax basis in the property equal to the sales price and will receive an income tax deduction

equal to the interest paid year, which may or may not be deductible depending on whether or not the buyer has investment income.

4. **Planning Opportunities – SCINS and Private Annuities**. Both SCINS and private annuities present excellent estate tax reduction strategies in this low interest rate environment.

From the perspective of the senior generation family member, a private annuity may be preferable if he or she needs the income stream from the sale to provide retirement income. The private annuity will continue for the life of the senior generation family member even though he or she outlives their actuarially determined life expectancy.

A SCIN may be more attractive to the junior family member if the junior family member has investment income which he or she can offset with the investment interest expense deduction generated by the SCIN payments, as opposed to the private annuity interest payments which must be capitalized. Also, the SCIN provides more flexibility in structuring payment terms. A SCIN can be structured to provide for unequal payments which may be beneficial to the junior family member who is managing cash flow. Also, if the junior family member plans to use the asset acquired in a trade or business or dispose of the asset in a taxable transaction in the near future, the SCIN could be structured so that the risk premium to the senior generation family member is reflected in a purchase price above fair market value with a lower interest rate. By structuring the SCIN in this manner, the junior family member would receive a higher income tax basis for depreciation and sale purposes.

C. INCOME TAX BASIS PLANNING

1. **General**. One area that is often overlooked when dealing with a client for whom death is near is reviewing the separate versus community property nature of the client's property. The surviving spouse's income tax basis of all community property as well as the decedent spouse's separate property will be its value as of the date of death. The surviving spouse's income tax basis in his or her separate property will remain unchanged. These rules provide some planning opportunities. As the estate tax exemption amount increases over the next several years, the estate tax will not be a concern for as many people but income tax planning will still be important.

2. **Spouse with Built-In Gain Separate Property**. If one spouse has separate property which has appreciated in value and the other spouse is in failing health, the healthy spouse can convert his or her separate property to community property. Upon the death of the other spouse, the income tax basis in the property will then receive a full step in basis to its fair market value as of the death of the first spouse. The surviving spouse can then dispose of the property without recognizing gain.

3. **Community Property with Built-In Loss**. If a married couple owns community property which has declined in value so that their income tax basis exceeds its value, the property can be converted to the separate property of the healthier spouse to avoid a step down in basis to the fair market value of the property

at the death of the first spouse if the property were to remain as community property.

D. FLP PACKING

For a client who has established an FLP which is “old and cold”, the client could transfer additional assets into the FLP prior to death. The IRS does not like deathbed FLPs, but if the client had previously created an FLP which satisfies the *Kimbell* test of bona fide sale for full and adequate consideration, the IRS would have difficultly using § 2036 to bring all of the assets back into the client’s taxable estate at their undiscounted value because the original transfer of assets to the FLP should be viewed as a separate and distinct transfer for § 2036 purposes. Another point to bear in mind is that if a client has a shorter life expectancy, he or she will not need to retain as many assets outside of the FLP in order to meet living expenses.

E. IRA ACCELERATION

For certain clients who have IRAs and are near death, it may be advisable for the client to withdraw all of the assets in the IRA prior to death in certain circumstances. The withdrawal will trigger income tax, but if the income tax is payable in the year of the client’s death, then the income tax liability becomes an estate administration expense deductible under § 2053. Since the maximum estate tax rate is 48% and the maximum income tax rate is 35%, the withdrawal may produce an overall tax savings. One other factor to consider is whether or not the client’s designated beneficiaries are likely to withdraw most or all of the IRA balance soon after the death of the client. If this is the case, the value of the ability of the beneficiaries to prolong the income tax deferral on the growth of the assets will be lost.

For example, assume an unmarried client has a $5 million taxable estate, with a $1 million IRA balance. Upon the client’s death, the IRA will generate $480,000 of estate tax. If the IRA beneficiary then decides to withdraw all of the funds in the IRA, then $350,000 of income tax will be due as well (ignoring the effect of the IRD income tax deduction), making the total tax liability $830,000. In contrast, if the client withdrew the funds from the IRA prior to death, the same $350,000 income tax liability would be due. However, only the net IRA proceeds of $650,000 would be includable in the taxable estate, which would generate an estate tax liability of $312,000. As a result the total tax liability would be $662,000 as opposed to $830,000, for a savings of $168,000.

F. PREVIOUSLY TAXED PROPERTY CREDIT

If a partial (or no) QTIP election causes a taxable estate at the first death, and if those assets pass to a bypass trust with mandatory income to the survivor, or stays in the presumptive QTIP Trust which still requires mandatory income to the survivor, the survivor's estate will qualify for a §2013 PTP credit, if the survivor dies within ten years of the first death. The credit is based on the estate tax paid on those assets in the estate of the first spouse to die which were left to the surviving spouse. In this case, the asset is the present value of the stream of mandatory income payments, calculated using the life expectancy of the surviving spouse. As long as the survivor has more than a 50% chance of living more than one year (determined on the date of the first spouse’s death), then the IRS mortality tables can be used. See TAM 8512004 (residuary estate passed to bypass trust providing income to spouse for life; QTIP election was not made, generating estate tax at first death).

The PTP credit applies if the survivor dies within ten years of the first spouse. The theory behind the credit is that it would be a harsh result to subject the same property to estate taxation more than once in a short time period. The following table illustrates the credit's sliding scale.

Number of Years Between Death of First and Second Spouse	PTP Credit
1	100%
2	100%
3	80%
4	80%
5	60%
6	60%
7	40%
8	40%
9	20%
10	20%

The PTP credit is calculated by multiplying the Federal Estate Tax of the first spouse to die by a fraction designed to allocate to the credit the portion of that tax attributable to the property received by the surviving spouse. The numerator of the fraction is the Net Property Transferred to the Survivor and the denominator is the Adjusted Taxable Estate of the first spouse. The following definitions apply:

Federal Estate Tax - the federal estate tax paid by the estate of the first spouse to die (excluding inheritance taxes paid to a state), plus any PTP credit allowed the estate or any credit allowed for gift taxes paid on prior transfers.

Net Property Transferred to the Survivor - the value of the property transferred to the surviving spouse (as such property is valued in determining the federal estate liability of the first spouse), less any debts, expenses and taxes chargeable to such property.

Section 2013(c) imposes a limitation on the amount of the PTP credit. The credit is limited to the amount by which the estate tax imposed on the survivor's estate (computed without considering any PTP credit to which the estate is entitled), exceeds the amount that estate tax would be if it was determined by excluding from the gross estate the Net Property Transferred to the Survivor.

Note that the PTP credit applies as long as assets which were taxed in the first estate

pass to the survivor. There is no requirement that the transferred assets be included in the survivor's estate. In this case, although the stream of mandatory income payments vanishes at the survivor's death, the credit is still based on their value as of the date of the first spouse's death.

V. FAILURE TO ENGAGE IN ASSET PROTECTION PLANNING AS PART OF THE ESTATE PLANNING PROCESS.

Asset protection is even more important since the Bankruptcy laws have been reformed, making it more difficult to obtain a discharge.

A. PLANNING FOR YOURSELF

- Protect your current assets by examining your asset structure
  - identify exposed assets (those reachable by outside creditor claims)
  - identify risky assets (those with potential to generate inside liability claims)

- Employ techniques ranging from simple to complex to lower your risk profile (State law exemptions, partition planning, gifts to trusts, creation of entities, FLP's, protect accounts receivable, Delaware Trusts, offshore planning)

- Protect anticipated inheritances (from parents, etc.) from creditors
  - create a "dynasty" trust, to which your parents can leave your inheritance
  - prevent these assets from being subject to estate taxes at your death
  - protect these assets from the claims of your creditors and the claims of divorcing spouses

B. PLANNING FOR FUTURE GENERATIONS

- create "dynasty" trusts to receive your children's inheritance whenever possible
- utilize spendthrift trusts, which, when drafted properly, are extremely difficult for creditors to invade to satisfy the child's debts
- protect your children's inheritances from the claims of divorcing spouses

VI. FAILURE TO USE RETIREMENT PLAN ASSETS TO FUND CHARITABLE BEQUESTS.

If an individual plans to make a charitable gift at his or her death, naming a charity as the beneficiary of an IRA or other retirement plan can maximize the amount of money the charity receives, as well as the amount of money that the individual's family receives.

In addition, naming one's spouse as the primary beneficiary and a qualified charity as the secondary beneficiary of a retirement plan (or, in the alternative, the charity as the primary beneficiary) provides an individual with an opportunity to benefit their charity of choice with a minimal impact on their heirs.

IRAs and retirement plans are attractive vehicles for leaving assets to a charity because of the double taxation imposed on IRAs at death. Estate taxes are paid by the participant's estate on death, and income taxes are paid by heirs as withdrawals are made. This double taxation makes retirement plans extremely poor vehicles for passing wealth to one's descendants.

When an individual names a charity as the beneficiary of an IRA, the IRA is still fully includable in his or her taxable estate, but the estate receives a charitable deduction equal to the amount passing to the charity. Because the charity will not be required to pay income taxes on IRA withdrawals, the charity ultimately pockets the entire IRA. The impact on the individual's heirs is minimized by the fact that had they been named beneficiaries of the IRA, estate taxes and income taxes could have left them with as little as 19¢ on the dollar.

> Example: Donor owns a $100,000 IRA. His wife predeceased him, and he has two children whom he names as beneficiaries of the IRA. If Donor dies with a taxable estate, his $100,000 IRA could be subject to estate taxes as high as $46,000 ($100,000 x 46% estate tax rate). Therefore, only a net amount of $54,000 from the IRA would pass to his children. Distributions that they take from the IRA to pay the estate taxes will be subject to income taxes, as will distributions they take for their benefit during their lives. The income taxes generated by these distributions could be as high as $35,000 ($100,000 x 35% income tax rate). As a result, Donor's children could receive as little as $19,000 net of taxes from the $100,000 IRA ($100,000, less $46,000 in estate taxes, less $35,000 in income taxes). (Note: This example ignores the "income in respect of a decedent deduction" due to its limited benefit as an itemized deduction.)
>
> Instead, Donor could name his favorite charity as the beneficiary of the IRA. His estate would receive a charitable contribution deduction in amount equal to the IRA, and the charity would receive the full $100,000. As the charity takes distributions from the IRA, it will not pay income taxes and will ultimately receive the full amount of the IRA.
>
> *Note: Because of the uncertainty of how much will actually remain in an individual's IRA at the time of death, if a specified amount is desired to pass to charity, the individual should include a provision in his Will leaving the charity of choice the desired amount, reduced by any amount passing to the charity by beneficiary designation on the individual's death.*

VII. FAILURE TO AGGRESSIVELY FIGHT AGAINST IRS IN TAX CONTROVERSY CASES.

- Pursue all remedies and aggressively negotiate for settlements at exam level, appeals level, and tax court level.

VIII. FAILURE TO DO ESTATE PLANNING WHILE WAITING ON CONGRESS TO ACT

- Even if estate tax goes away (which appears highly unlikely), history shows the likelihood of re-enactment.
- Build flexibility into the plan.
- Dangerous to postpone purchase of life insurance
  - may become unaffordable/unavailable
  - lock in coverage now; can always reduce death benefit later; consider term with feature to convert to permanent insurance later
- Non-tax benefits of estate planning – Estate planners often focus on the transfer tax savings of estate planning as an incentive to get clients to begin thinking about their estate plan and then to implement the plan. However, there are significant reasons for clients to engage in sophisticated estate planning outside of any potential estate tax savings.

1. **Protecting assets from creditors of spouse or children**. By utilizing trusts or family limited partnerships ("FLPs") as part of an overall estate plan, a client can protect the inheritance of a spouse or children from being seized by creditors of the spouse or children.

2. **Protecting inheritance in the case of a child's divorce**. By leaving a child's inheritance to a trust rather than outright to the child, the assets will remain segregated from the child's marital assets, protecting the assets from a divorce property settlement.

3. **Planning for blended families**. With divorce and remarriage so prevalent, more and more clients will have a spouse who is not the parent of his or her children. The use of a QTIP trust can allow the client to provide for the spouse after the client's death, but ensure that the spouse will not be able to disinherit the client's children.

4. **Family business planning**. Many family businesses often have younger generation family members who actively participate in the business and others who do not participate. By addressing the disposition of the controlling interests in the family business as part of an estate plan, the senior generation family members can help to ensure a smooth transition of the business to the next generation.

5. **Maximize tax-free growth of retirement assets**. With proper planning the spouse or children of a client can continue to enjoy the tax-free growth of the client's retirement assets as well as insulate the assets from the claims of creditors.

6. **Minimization of probate costs and publicity**. By utilizing a revocable trust, a client can avoid the cost and publicity of a probate proceeding.

7. **Providing for a child or grandchild with special needs**. A client's estate plan can

create a trust to provide for a child or grandchild who may require extraordinary medical attention. The trust can be structured in such a way as to ensure that the child or grandchild may be eligible for governmental assistance.

8. Preventing challenges to the estate plan. Estate planning documents can be drafted which include "no contest" clauses which disinherit a beneficiary who brings a challenge to the validity of the client's dispositive scheme.

- Better to be proactive than reactive.

IX. FAILURE TO ENGAGE QUALIFIED COUNSEL.

- Sophisticated work requires specialists – similar to medical profession
- Underplanning is costlier than planning (in the long run)
- Once the planning team is assembled, have open communication; cannot produce an optimum plan unless client discloses all necessary information.

X. FAILURE TO START PLANNING EARLY.

One of the most important aspects of estate planning is to start early. For example, Sam Walton created a multi-billion dollar company and made each of his children billionaires. The Forbes 400 Richest Americans lists Christy Walton, worth $15.7 billion, at #6; Jim Walton, worth $15.7 billion, at #6; Rob Walton, worth $15.6 billion, at #8; and Alice Walton, worth $15.5 billion, at #9.

By planning early in his life, **SAM WALTON TRANSFERRED ENORMOUS WEALTH TO HIS CHILDREN AND NEVER PAID ANY GIFT TAXES DURING HIS LIFE, NOR DID HE PAY ESTATE TAXES AT HIS DEATH**, saving over $28 billion, using today's tax rates.

Total Wealth of Children	$62,500,000,000
Current Estate Tax Rate	x 46%
Estate and Gift Tax Savings	$28,750,000,000

MARVIN BLUM

BIOGRAPHICAL INFORMATION

MARVIN BLUM is the founder of THE BLUM FIRM, P.C. The firm, comprised of ten attorneys, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning.

Blum, an attorney and certified public accountant, is Board Certified in Estate Planning and Probate Law and is a Fellow of the American College of Trust and Estate Counsel. He received his undergraduate degree in accounting at The University of Texas at Austin where he was Valedictorian of his graduating class and was named Ernst & Ernst Outstanding Student in Accounting. Blum received his law degree from The University of Texas School of Law where he graduated second in his class and was named the Prentice-Hall Outstanding Student in Taxation. Blum is a frequent speaker and author on estate planning and tax topics, and served for sixteen years on the faculty of the Texas School of Trust Banking. He is now in his twenty-seventh year as Treasurer of the Fort Worth Symphony and served for five years as President of the Board of Trustees of Trinity Valley School. Blum also serves as Chairman of the Fort Worth region of the National Conference for Community and Justice and on the board of the Van Cliburn Foundation. He and his wife, Laurie, are the parents of Adam, an investment analyst with the New York office of Goldman, Sachs, and Elizabeth, a junior at New York University.

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TOP TEN MISTAKES IN THE NEW AGE OF ESTATE PLANNING

Young President's Organization
May 31, 2006

by Marvin E. Blum

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TOP TEN MISTAKES
IN THE NEW AGE OF ESTATE PLANNING

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TOP TEN MISTAKES
IN THE NEW AGE OF ESTATE PLANNING

EXECUTIVE SUMMARY

I. FAILURE TO ENGAGE IN BUSINESS SUCCESSION PLANNING

A. Family Owned Businesses

B. Non-family Owned Businesses

II. FLP MISTAKES

A. Failure to Create a Family Limited Partnership

B. Failure to Document Objective Non-tax Reasons

C. Funding Problems

D. Operational Problems

E. Strategies for Structuring and Operating FLPs to Avoid Code Section 2036

III. FAILURE TO PURSUE CUTTING-EDGE PLANNING TECHNIQUES

A. Optimize Use of $1,000,000 Lifetime Gift Tax Exemption

B. Sale of Assets to Intentionally Defective Grantor Trust

C. Grantor Retained Annuity Trust (GRAT)

D. Leverage the GST Exemption

IV. FAILURE TO PLAN WHEN DEATH IS NEAR

A. Sale of Assets in Exchange for Private Annuity

B. Sale of Assets in Exchange for a Self-Cancelling Installment Note

C. Income Tax Basis Planning

D. FLP Packing

E. IRA Acceleration

F. Previously Taxed Property Credit

V. FAILURE TO ENGAGE IN ASSET PROTECTION PLANNING AS PART OF THE ESTATE PLANNING PROCESS

A. Planning for Yourself

B. Planning for Future Generations

VI. FAILURE TO USE RETIREMENT PLAN ASSETS TO FUND CHARITABLE BEQUESTS

A. Escape Taxation on IRAs and Retirement Plan Assets

VII. FAILURE TO AGGRESSIVELY FIGHT AGAINST IRS IN TAX CONTROVERSY CASES

VIII. FAILURE TO DO ESTATE PLANNING WHILE WAITING ON CONGRESS TO ACT

A. Repeal is No Longer Considered a Realistic Possibility

IX. FAILURE TO ENGAGE QUALIFIED COUNSEL

A. We Live in an Era of Specialization

X. FAILURE TO START PLANNING EARLY

A. Remember, Sam Walton never paid any estate or gift taxes, yet his children are worth over $60 billion.