ESTATE PLANNING – TIME FOR A REVIEW (2012)

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"The primary goal of estate planning is to protect and preserve the family, not to protect and preserve family assets."

Estate planning involves far more than the drafting of a simple will. Even families with "smaller" estates risk creating substantial costs and time delays by not addressing the full spectrum of estate planning issues.

This article will discuss a number of estate planning issues which you may not have addressed in your own estate plan and it will comment on common estate planning errors which the author has observed. The information is designed to be practical and general in nature. The article assumes that you and your family are all United States Citizens. The rules for non-citizens are significantly different from the provisions of this article.

THIS ARTICLE IS NOT INTENDED TO PROVIDE SPECIFIC LEGAL ADVICE. YOUR PARTICULAR CIRCUMSTANCES OR LOCAL LAW MAY SIGNIFICANTLY CHANGE THE RECOMMENDATIONS. AS WITH ANY PLANNING APPROACHES, YOU WILL WANT TO DISCUSS ANY APPROACHES WITH COMPETENT COUNSEL BEFORE IMPLEMENTING THE APPROACH.

An important perspective should be understood before you start any estate plan. Until recently, the traditional goal of estate planning has often been *"to pass as much wealth on to the next generation as tax-free as possible."* The avoidance of taxes and the passage of maximum wealth are increasingly being displaced by other goals. Personal issues are becoming the driving force in the estate planning process. *"The primary goal of estate planning is to protect and preserve the family, not to protect and preserve family assets."* It is fundamentally about ***"Leaving a Legacy for the Living."*** This does not mean that the preservation of wealth is unimportant, it just pales in significance to protecting and preserving the family. This article will focus on both concerns.

The 2001 Tax Bill

"The trouble with the tax law of 2001... is that Congress had no thought of its ultimate destination."
Alan Reynolds of the Cato Institute

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")[1] included a phased-in increase in the federal estate tax exemptions (to $3.5 million in 2009), a reduction of the transfer tax rates (i.e., the estate tax rate dropped to 45%), the elimination of the credit for state death taxes (effectively eliminating the state death tax in 38 states) and the elimination of estate taxes in 2010. But, to balance EGTRRA's revenue shortfall, Congress did at least two amazing things. First, to balance the revenue shortfall, Congress accepted that there would be an explosion in the number of middle class taxpayers paying the Alternative Minimum Tax ("AMT"). Second, it provided that the entire act would terminate on January 1, 2011.

When EGTRRA was enacted, most advisors expected that Congress would enact some form of permanent transfer tax legislation before 2010 to replace the expiring provisions of EGTRRA. The unfortunate reality is that Congress lacked the ability to adopt permanent transfer tax laws.

In December 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This new law provided for a $5.0 million estate tax, gift tax and generation skipping tax exemption, with a 35% tax rate. It also provided for portability – the ability of a surviving spouse to use the unused estate exemption of their deceased spouse. Unfortunately, Congress once again did not make the law permanent. On January 1, 2013, the US will automatically return to the pre-EGTRRA rules unless Congress adopts contrary legislation – a return to a $1.0

1 Public Law 107-16, 107th Cong., 1st Sess. (2011), 115 Stat.38, effective June 7, 2001.

million estate and gift tax exemption and a top effective tax rate of 55%. Most commentators believe that legislation, if any, will occur sometime in 2013. Effectively, we will conclude 2012, without knowing what the post-2012 estate tax laws are.

As a result of the reduction in the transfer tax exemption from $5.0 million ($10 million for a married couple) and 35% tax rate in 2012 to a $1.0 million exemption and 55% tax rate in 2013, affluent and terminally ill clients should consider the possibility of making significant gifts in 2012 before the changes occur.

What Happens to Transfer Taxes in 2013? What happens to the federal transfer taxes? There are really only two alternatives.

First, Congress could adopt permanent legislation for the federal transfer tax. Most commentators believe this is unlikely because such legislation would probably need to be part of a larger reform of the Tax Code and deficit reduction and most observers do not believe Congress has the political ability to pass such legislation.

The economic meltdown has significantly raised the deficit. Will Congress see the estate tax as a treasure trove of revenue and trade-away the higher exemptions to reduce the deficit? While polls indicate that most Americans want to eliminate the estate tax, few estates are subject to the federal estate tax. The estate tax has a limited impact on the general population, and potential permanent estate tax relief for the middle class could be sacrificed for broader-based tax reform, like an overdue reform of the AMT or the retention of broader-based provisions of EGTRRA (e.g., reduction of the marriage penalty). Because these other provisions affect more Americans, the continuation of EGTRRA's non-transfer tax provisions will carry broader support than will a permanent reduction of the estate tax.

Even in this time of recession and economic turmoil, wealth has exploded in this country. Although estate taxes comprised only 1.1% to 1.3% of the federal revenue during the 1990s, this percentage could increase rapidly as the two wealthiest generations that have ever lived die and pass trillions of dollars to their heirs over the next 40 years. Congress may look upon this wealth passage as a ready source of federal revenue. Given the concerns that many elderly Americans have taken more out of Social Security and Medicare than they put into these systems, some in Congress may view the estate tax as a generational repayment of these distributions.

Warren Buffett, George Soros, William H. Gates, Sr., and over 300 of America's wealthiest citizens have publicly opposed the elimination of the estate tax. They believe that the primary purpose of the tax is not the raising of revenue. Rather, they believe the estate tax prevents creating a multi-generational class of perpetually wealthy individuals in America. Increasingly, the debate on estate taxes is shifting to the taxation of the super-wealthy as a societal issue.

The second alternative is a return to 2001 in 2013. This could occur in two ways. First, intentionally or because of different political priorities, Congress may fail to act. Second, Congress might decide not to even deal with the issue in 2012 and just wait for 2013 to provide for significant increases in income taxes and estate taxes.

But what about 2012? Not even Republicans want to see the macabre results of people committing suicide or children making decisions to withdraw medical support for parents.

Some Of The Results Of a Return to the 2001 Rules. The unfortunate reality of this uncertain environment is that practitioners and their clients need to start planning now for the possibility of a return to 2001 in 2013. A return to the pre-EGTRRA rules creates a number of planning issues for estate planners and their clients. Planners need to consider the possibility that their clients will have become incapacitated by 2013 and therefore would be unable to revise an estate plan that assumed the availability of a much larger estate tax exemption.

Higher taxes. Without the adoption of permanent legislation by the end of 2012, the payment and collection of federal estate taxes will skyrocket in 2013. The federal estate tax rate in 2001 capped out at 55% for estates above $3 million. To make matters worse, estates valued at over $10 million paid an additional 5% surtax designed to eliminate the benefit of the marginal tax rates below 55%. The 5% surtax stopped once the estate's value exceeded $17,184,000.

The combination of a reduced estate tax exemption and a higher estate tax rate can have a significant impact on clients, even in lower valued estates. For example, assume a single taxpayer has a $1.5 million estate in 2012, growing at 5% annually. In 2012, no estate tax is due, but in 2013 the death tax could be almost $280,000. The percentage of the estate passing to heirs will drop from 100% to 83% and even though the value of the estate grows each year thereafter, the percentage which will pass to family will drop – due to the increased tax on each dollar of growth. At higher estate values, the estate tax and reduction in the value of the bequests will be even more severe.

If these higher tax rates come back in 2013, they will create significant liquidity problems for many clients. Planners need to start raising the liquidity issues with clients today. If a client wants insurance to cover the potential increased cost of taxes, the client needs to plan today in case he or she becomes uninsurable before 2013. The ability to plan away the estate tax requires that most clients start planning for the higher estate taxes as soon as possible.

Treatment of insurance. Clients who decide to buy additional life insurance should consider placing the insurance in an irrevocable life insurance trust ("ILIT") to keep the death proceeds outside their taxable estate. Because of the current legislative uncertainty, it may be appropriate to adopt contingency formulas in the insurance trust to provide for how the passage of assets will occur in various scenarios. For example, if insurance is held in an ILIT, but is unnecessary to provide estate tax liquidity to the estate, a formula provision in the insurance trust or the client's will could pass assets on to the donor's favorite charity. Prudent planners seeking flexibility should also include limited powers of appointment in virtually every ILIT.

Many clients have estates, including life insurance, in the range of $1 million to $2 million. Many planners have advised married couples that given a federal estate tax exemption of $5.0 million ($10 million collectively for a couple), they did not need to place their life insurance in an ILIT, because the individual estate tax exemption and/or the joint exemption of the married couple would produce a non-taxable estate. However, a return to a $1 million estate tax exemption could mean that many clients will have a taxable estate, with the result that 41%-55% of the insurance proceeds could be lost to federal estate taxes.

If a client is going to move an existing life insurance policy out of his or her taxable estate by 2013, the three-year look-back provisions of Section 2035(a) mean that the transfer should occur at least three years before the beginning of 2013. That date, January 1, 2010, has already passed. Even so, clients would be wise to make transfers sooner rather than later..

Planning for Qualified Retirement Assets. With the higher exemptions and new rules permitting heirs to make withdrawals from inherited IRAs over their lifetimes, many estate plans have provided that the retirement plan will pass to younger family members (to take advantage of the longer life expectancy) while passing other assets to a surviving spouse. These plans could create a number of problems if the 2001 rules return.

For example, assume a client in a second marriage had a $1.5 million IRA and $2 million in other assets. Under his current plan, the IRA passes to his children from a prior marriage while the $2 million is held in a QTIP trust for his current wife. At the exemptions in force in 2012, no estate tax would be due at the client's death, assuming his spouse survives him. On the other hand, if the client dies after 2012, a federal estate tax of approximately $210,000 would apply to the transfer of the IRA to the children if the federal estate tax exemption is $1 million. If the children withdraw funds from the IRA to pay the $210,000 in estate taxes, they will create taxable income of $210,000. If the children then withdraw additional sums from the IRA to pay the income taxes, they incur additional income taxes. Each withdrawal from the IRA to pay tax will create a new tax. The plan should be revised either to:

- reduce the IRA bequest to the available exemption,
- pass other assets (e.g., a life insurance policy) to the children to pay the estate tax liability, or
- pass non-IRA assets to the children, while passing the IRA to the surviving spouse, perhaps in trust.

State death taxes. Prior to EGTRRA, the federal estate tax was offset by a credit for state death taxes. Roughly 38 states used the amount of the credit as their state estate tax. These states effectively took a portion of the federal estate tax as their tax. The tax was often referred to as a "sop tax" or "sponge tax." EGTRRA fully phased out, the state death tax

credit in 2005. States were forced either to lose the revenue they had received from the credit or to "decouple" themselves from the federal estate tax and impose new state death taxes. Today, roughly half the states have state estate taxes that are decoupled from the computation of the federal estate tax.

In decoupled states which impose their own state estate tax, there will be confusion because state death taxes will not relate directly to the federal estate tax credit and tax computations. Many decoupled states have lower estate exemptions than the federal exemption. For example, Ohio has a $338,000 exemption. In many of these states, the combined state and federal estate taxes may exceed 60% because state estate taxes will exceed the federal state death tax credit.

Those states which have not enacted a new death tax (and which effectively lost any revenue from the estate tax in 2005), could suddenly see an unexpected return of previously lost revenue. This change will effectively return dollars to the states that did not revoke their state statutes that coupled the state estate tax to the federal credit. For example, according to one source, Florida lost over $1.1 billion in revenue in 2006 from the elimination of the state estate tax credit. That lost revenue could now return to the state as an unexpected revenue windfall.

Family business deduction. Planners and drafters of documents will have to deal with the return of the business deduction for businesses that pass to family members. Perhaps one of the most complicated pieces of federal estate tax legislation ever enacted, the deduction for qualified family-owned business interests ("QFOBI") could be restored in 2013, albeit at a total deduction of approximately $300,000 per decedent. Therefore, clients with closely held businesses should make sure their estate plans contemplate the potential restoration of the QFOBI deduction.

Planning in this Chaotic Environment

Planning in 2012 is going to require not only flexibility, but also a continual review of how the client's estate plan interacts with the changing tax rules. Some of the approaches include the following:

Flexible Planning Before 2012. Flexibility is the key to planning in this chaotic environment.[2] Among the flexible approaches that need to be considered are:

- The expanded use of limited powers of appointment.[3] Such powers of appointment will allow for changes in the estate plan to account for family and legal changes.
- Planning which considers the impact on family asset allocations of first an increasing exemption, then no estate tax, followed by a drastic reduction in the exemption. For example, if the intent is to pass the estate tax exemption amount to children from a first marriage and the remainder of the estate to a spouse from a second marriage, the client must be given information on how the changing exemption amounts will affect the passage of assets to each of the client's heirs. Assume a client in a second marriage has $5.0 million in assets. Does he want $5.0 million (2012) or $1.0 million (2013) to flow to children from a prior marriage? What is the surviving spouse expecting?
- Formula clauses that deal with various potential levels of estate and generation skipping exemptions, depending upon when the client dies. For example, in the above example, the client could create a formula that passes a set amount (e.g., $1.0 million) to his children, while any exemption amount in excess of the $1.0 million to the children passes to a marital trust held solely for the benefit of the second spouse.
- Plans which contemplate the use of disclaimers and Clayton trusts to maximize the tax avoidance possibilities in this unusual tax environment.[4]

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2 Barry A. Nelson & Rosario F. Carr, "Drafting to Achieve Maximum Flexibility in the Estate Plan", Est. Plan., July 1998; Alan S. Acker, "Every Drafter's Dream: The Flexible Irrevocable Trust", BNA Tax Memorandum, 1998, at 295; Neill G Keydel & Frederick R. McBryde, "Building Flexibility in Estate Planning Documents", Tr. & Est., Jan. 1996.
3 William S. Forsberg, Special Powers of Appointment: The Key to Flexibility in Planning, Est. Plan., Jan. 2000; Alexander A. Bove, Jr., "Powers of Appointment: More (Taxwise) Than Meets the Eye," Est. Plan., October 2001; Alexander A. Bove, Jr., "Exercising Powers of Attorney - A Simple Task or Tricky Business," Est. Plan, June 2001.
4 Sebastian V. Grassi, "Drafting Flexibility into Estate Planning Documents After the 2001 Tax Act (with Sample Clauses)," (ALI-ABA 2003)

- Finding creative ways to move appreciating assets out of estates which are expected to be taxable after 2012. Particularly for clients with estates from $2-5.0 million, the current high gift tax exemption and expected increase in tax rates as the estate grows can create an opportunity to avoid the high estate tax cost by moving appreciating assets out of the estate as early as possible.

Income Tax Planning. While the significant estate exemptions last and fewer estates are taxable, much of the tax portion of planning may shift to trying to avoid income taxes rather than estate taxes.[5] For example, instead of lowering the value of assets to reduce estate taxes, clients with estates below the available exemptions may actually want to increase the value of assets to obtain a higher basis step-up at death.[6] The higher basis will reduce the taxes paid by heirs on the sale of inherited assets and create new depreciable values for depreciable assets.[7]

Summary**.** Unfortunately, no one can predict with any certainty what Congress is going to do with the transfer tax rules in the next three years. Virtually every estate plan will have to be re-examined in the next three years either to account for a return to 2001 or to deal with the terms of any permanent legislation that is passed.

Who benefits from this chaotic environment and the return to 2001? Seven groups will reap the greatest rewards: Roughly half the states which remain coupled to the federal estate tax will receive an unexpected revenue boost. Charities will see increased estate contributions (particularly of IRD assets) to avoid estate taxes. Fee-based planners who provide estate planning advice and estate attorneys will be inundated with work. CPAs will have more tax returns to file. The insurance industry should see substantial increases in life insurance sales to fund estate tax liabilities. Politicians will see increased contributions to their campaigns. And the client/taxpayer? He'll be paying for all of it.

The Tables below show the impact of a return to the 2001 rules in 2013 at various values growing from 2007 at an annual rate of 5%. Assume a single person having a taxable estate of $1.5 million in 2007.

	2007	2008	2009	2010	2011	2012	2013
Estate	1,500,000	1,575,000	1,653,750	1,736,438	1,823,259	1,914,422	2,010,143
Exemption	2,000,000	2,000,000	3,500,000	ALL	5,000,000	5,000,000	1,000,000
Top Applicable Tax Rate	45%	45%	45%	0%	35%	35%	55%
Federal Estate Taxes	0	0	0	0	0	0	439,970
Increase in Taxes	N/A	0	0	0	0	0	439,970
Net to Family	1,500,000	1,575,000	1,653,750	1,736,438	1,823,259	1,914,422	1,570,173
Family's % of Estate	100%	100%	100%	100%	100%	100%	78%

If these higher tax rates return in 2013, they will create significant liquidity problems for many clients. Planners need to start raising the liquidity issues with their clients today. If the client wants to insure over the potential increased cost of taxes, they need to plan today in case the client becomes uninsurable before 2013. The ability to plan away the estate tax requires that most client to start planning for the higher estate taxes as soon as possible.

5 See: John J. Scroggin, Income Tax Planning Now That Estate Taxes Are Less Significant, Estate Planning, June 2005; John J. Scroggin, "The New Importance of Basis Planning," Trusts and Estates, April 2005.
6 Code section 1014(a) and Treasury Regulation section 1.1014-3.
7 For more information on basis planning techniques, Scroggin, supra note 31.

Tax Fact: During the 1990s, estate and gift taxes have averaged 1.1-1.3% of the total federal revenue.

Estate planning involves much more than the execution of a will. This material will discuss many of the issues you should make sure to address in your own estate plan.

Medical Directives

"Every human being of adult years and sound mind has a right to determine what shall be done with his own body..." Justice Cardozo

In Cruzan v. Director, Missouri Dept. of Health, 110 S.Ct. 2841 (1990), the U.S. Supreme Court ruled that to be taken off life support (including intravenous nourishment and fluids), you must have declared your desire before becoming incapacitated. Most clients would prefer to decide who will make their medical decisions and, in some cases, restrict the manner that the decisions can be made. Failure to establish a legal structure by which the decisions can be made breeds both additional costs and the potential for family turmoil. For example, a 1994 study reported that having a living will or medical power of attorney saved almost $65,000 per patient in the final stay in the hospital. The average cost from 1990 through 1992 of persons without medical directives was $95,305 versus $30,478 for those who had medical directives. Since 1992, medical care costs have increased at a significant rate.

Living Wills. A living will is a declaration not to provide life-sustaining treatment if there is no significant hope of recovery. George Carlin might comment on the incongruity of the name attached to the document. A living will is only operative when its maker can no longer make medical decisions. Although verbal declarations have been approved by the courts (e.g., Nancy Cruzan), Georgia residents are well advised to sign written documents which meet the requirements of the Georgia statutes. Failure to sign a proper living will may result in family conflicts over the clients declared intentions (e.g., the Schiavo case) and necessitate court cases to discern what the client's intentions were.

The Living Will provides that life-sustaining treatment (including nourishment and hydration) can be removed if a person is in a "terminal condition," "coma with no reasonable expectation of regaining consciousness," or "in a persistent vegetative state with no reasonable expectation of regaining significant cognitive function."

Do only elderly clients need to consider living wills? No. Remember, Nancy Cruzan, Karen Ann Quinlan and Terri Schiavo were all in their 20s and 30s when they became incapacitated.

Websites on Aging and Critical Care Issues

www.critical-conditions.org
www.abanet.org/aging/toolkit/
www.ama-assn.org/public/booklets/livgwill.htm
www.help4srs.com
www.mag.org/content
www.nolo.com
www.Medicaldirective.org.
www.caregiver.org

Durable Power of Attorney for Healthcare. A living will is simply a declaration not to use life-sustaining measures. A health care power of attorney (sometimes called a medical power of attorney) is designed to give someone the power to make medical decisions upon incapacity, including the withdrawal of life support. The document can name successor power holders and guardians.

In 2007, Georgia combined their Living Will and Durable Power of Attorney for Healthcare into a single statutory form. The statute provides that forms other than the statutory form will also be enforceable in Georgia if they meet the statutory

requirements. The rest of this section will discuss Medical Directives.

To be enforceable, the document must be executed in compliance with the statutory formalities (e.g., in front of two witnesses who are at least 18 years of age and who are unrelated to the person signing the living will). Only competent adults may sign a health care power of attorney.

Georgia law provide that the person holding a Medical Directives has priority decision making over both the client's living will and any guardian. Unless otherwise provided in an order by a probate or superior court having jurisdiction, the appointment of a guardian does not revoke the Medical Directive. The statute also provides that the Medical Directives can extend beyond the principal's death if "necessary to permit anatomical gifts, autopsy or disposition of remains."

Georgia provides that a healthcare provider or other person who acts in good faith in reliance upon the direction of the decision of the person named in the Medical Directive is protected and released from liability. The statute also limits the liability of agents who act in good faith.

Unless the Medical Directive expressly provides otherwise, if marriage occurs after signing the document, the marriage is an automatic revocation of the designation of any person to serve as power holder other than the principal's spouse. The Georgia statutes provide that if a marriage is dissolved or annulled, the dissolution revokes the principal's former spouse as the principal's agent to make healthcare decisions. Thus, it is important to name one or more successors to a spouse in case a divorce occurs or the named surrogate is not able to serve.

Who should be the power holder? Married clients usually name a spouse. However, if the marriage has not been in existence long, some people will name another family member. We generally advise clients not to name emotional individuals or children under age 30 as power holders (i.e., they may not be able to emotionally handle the required decision-making). Having someone who has medical training can be particularly useful.

It is especially important that unmarried individuals appoint power holders to minimize the risk of fights over who should act as guardian or decision maker. But as the Schiavo conflict demonstrates, questions can even be made about a spouse's right to make medical decisions.

Can more than one person be named as power holder? The statute does not recognize multiple power holders. The statute provides that the power is delegated to "a trusted agent." Therefore, it is generally advisable to appoint one power holder at a time.

> **Recommendation:** Always execute a Medical Directives. In case the power holder is unable to act (e.g., you and your spouse are in the same accident), make sure to appoint 2-3 successors.

Personal Notes. It is also important for clients to leave information for their family on the types of decisions they want to be made if they become incapacitated. For example, "I want to be kept at home as long as possible." Clients may want to consider executing ethical wills in which they discuss their thoughts on receiving life sustaining treatment and other philosophical perspectives.

Other States. Given the mobility of Americans, the question arises of how a Georgia statutory form would be treated in another state. For example, the formal requirement governing living wills can vary substantially from state to state. In Alabama, the witnesses must be at least 19 years old instead of the 18 years of age required in most other states. In Tennessee, the living will must be signed by witnesses and a notary. In some states, in lieu of having two witnesses sign the living will, a notary can acknowledge the signature. Clients should be strongly encouraged to have all of their incapacity documents reviewed if they change their state of domicile.

Anatomical Gifts. In many cases the body of the decedent can benefit others (e.g., cornea transplants). Power holders under medical powers of attorney have the authority to make anatomical gifts. If a client wants only particular parts of his or her body be made available, consider attaching such a statement to the medical power of attorney. In many states

(including Georgia) residents can acknowledge making anatomical gifts by providing a declaration on their driver's license.

The Georgia Anatomical Gift Act provides a priority list of persons who have the right to make anatomical gifts of parts of a deceased relative's body. It provides that if persons having the same priority of decision making disagree, that the gift cannot be made. However, if a person with a higher priority makes the decision, persons down the list cannot stop the gift. For example, a person having a medical power of attorney has priority over a spouse who has priority over children.

Managing Assets Upon Incapacity

"The stakes in conflict do not change. Battle determines who will control the wealth or its equivalent."
Frank Herbert

Durable General Power of Attorney. A durable general power of attorney grants the power holder the right to act with regard to your property and income, even if you are subsequently incapacitated. Although many states provide that a power of attorney survives incapacity (i.e., it is "durable"), some states do not, and the power of attorney should specifically deal with the effect of incapacity.

In many cases, you only want the power of attorney to become operative when you become incapacitated. If permitted by state law, a power of attorney (called a "springing" power of attorney) can provide that the power holder has no authority until you become incapacitated. Some others states (e.g., Florida) do not permit Springing Powers of Attorney.

> **Recommendation:** Always execute a Durable General Power Of Attorney. Using a power of attorney in lieu of guardianship can reduce the expense (e.g., cost of a bond and attorney's fees), time delays, court oversight and transactional restrictions existing on guardians. Many states have adopted special provisions dealing with powers of attorney - make sure your power of attorney is in full compliance with applicable state law.

Gifts Using a Power of Attorney. Under the current IRS position, annual exclusion gifts can be made only if the power of attorney or state law specifically authorize such gifts. A power of attorney granting "all authority" (or similar words) does not appear to be sufficient under the present IRS position.

> **Recommendation:** Because of the substantial estate tax savings from making annual exclusion gifts (see discussion below), make sure your power of attorney specifically authorizes and sets conditions for making gifts.

Broad Authority in the Power Holder. In essence, the purpose of a power of attorney is to place someone in command of your assets if you become incapacitated. Because there are so many issues which the power holder may have to deal with, it is generally advisable to give the power holder broad authority. Moreover, in our increasingly litigious society, people dealing with the power holder may want specific authority in the document to handle the maker's affairs. If you do not trust your power holder's judgment, find a new power holder.

> **Recommendation:** Review giving your power holder broad and specific authority. For example:

- Estate Planning. Particularly if you are facing imminent incapacity, allow the power holder, with written approval of designated parties, to make estate planning based decisions, such as transferring assets to a living trust.
- Beneficiary Designations. The designation of the proper beneficiary can create significant tax and dispositional problems. In many cases, the designation of a beneficiary for a retirement plan or insurance policy does not make sense. Allowing the power holder (with reasonable constraints, such as approval of a third party) to make changes in the beneficiary designation could save your family significant taxes.
- Tax Powers. Authorize the power holder to deal with the IRS. The power of attorney should make specific reference to the particular years (e.g., A1985 through 2025") and tax forms to which the power applies (e.g., "1040, 709, 2848").

- Safety Deposit Box. Give the power holder authority to open any safety deposit box, even if the power holder is not listed on the signature card. Allow the power holder to drill the box if the keys are lost.
- Real Estate. Allow the power holder to “acknowledge” a signature. This is required by some states to convey real estate. In addition, in order to transfer real property, most states require that the power of attorney must be executed with the same formalities as a deed (e.g., two witnesses and a notary).
- Health Care. While the person may have a medical power of attorney allowing someone to make medical decisions for them, the general power of attorney should also allow the power holder to make payments incurred by the health care agent.
- Domicile. The power of attorney may authorize the power holder to change your state of residence (e.g., Florida to reduce income taxes).
- Guardianship. In many states the appointment of a guardian automatically revokes the power of attorney. To avoid back-door contests, specially appoint the power holder as the guardian.
- Successors. In case the power holder is unable to act (e.g., you and your spouse are in the same accident) make sure to appoint 2-3 successors.

Living Trust. A living trust is a revocable trust created during your lifetime to primarily provide for asset management upon incapacity and to avoid the costs and time delays of probate upon death. It is generally more flexible than either guardianship or a power of attorney. Living Trusts are also used to maintain secrecy. Unlike a will (which is a public document), a Living Trust is not generally recorded in the public records.

> **Recommendation:** When death or incapacity is an imminent possibility, review establishing a living trust as a disability asset management tool and a "will substitute."

> **Tax Fact:** The IRS estimates that it takes 37.5 hours (almost an entire weeks work) to prepare the “average” estate tax return.

Planning for Death

“I will continue to continue to pretend that my life will never end…”
Paul Simon, Flowers Never Bend with the Rainfall

Benjamin Franklin said that only death and taxes are inevitable. Failing to plan for death is certain to create problems for your survivors.

Failure to Have a Will. It is amazing how many people either do not have a will or do not know their prior will was revoked. For example, in Georgia, the marriage, birth or adoption of a child by the person executing the will automatically revokes the will unless the will is specifically in contemplation of the event. Failure to have a will can result in significant problems, including for example:

- In many states, each child and the surviving spouse will inherit an equal percentage (with the surviving spouse inheriting some minimum amount). Thus, for example, in Georgia a deceased husband with no will and two children from a prior marriage may only convey 33.3% of his estate to his surviving wife. Because a trust is not established by a will, any children may be entitled to receive assets by age 18 - before they may be mature enough to handle the money. Ex-spouses may have control of the inheritance until the children reach age 18.
- If a couple with no children was injured in the same accident and one spouse survived the other by five minutes and then died, that spouse's relatives could inherit all of the couple's joint estate with the other spouse's family receiving no assets.
- The courts will have no insights into your choice of guardian for minor children. In the absence of a declaration from you, the courts will have to make an independent judgment, based upon the family members who request guardianship.
- The courts will have to decide on the person(s) to manage your assets for any minor children. Do you really want that brother-in-law who has been bankrupt twice to manage the funds? If you do not leave a will making

such a designation, he could be given control.

- The failure to have a will can significantly increase both the income taxes and estate taxes payable by your family.
- In many states, the estate taxes are an expense of the probate estate. However, if assets flow outside the probate estate, the taxes on those assets may still be due from the probate estate - in effect one set of heirs may receive the assets (e.g., beneficiaries of a life insurance policy or retirement plan), while the probate heirs pay their estate taxes.

Recommendation: There are few situations in which a will (or a "will substitute") is unnecessary. Review your existing estate plan at least every 2-3 years. If you do not have a will, discuss the implications with your accountant or attorney.

<u>Using a Well Crafted Will</u>. It is not enough to just have a will. The will should be drafted to deal with all of the uncertainties that surround your death. Many clients want "simple" wills, but fail to realize the importance of a well drafted will. Your will is your final declaration of how your assets and family should be treated after your death. As such, it needs to be well thought out and deal with all of the potential issues that may face your survivors. For example, we represented an estate several years ago in which a woman had a child by a drug dealer who had been in and out of prison. The father had never seen the child or provided support. The child and the mother were injured in the same car accident. The woman died immediately and the child died 12 hours later. The lawyer who drafted her will provided that all of her assets passed to her son at her death. He held the assets for 12 hours and then, in accordance with state law, the drug dealer inherited the entire estate - including several million dollars from the death of the woman and her child. It was a simple will, but it certainly did not do what she would have wanted.

Many people draft their own wills - called "holographic wills." In many states a holographic will is invalid if it is not executed with the required statutory formalities.

Recommendation: Review your will in light of the ideas discussed later in this article. Discuss possible changes with a competent advisor.

Recommendation: Do not keep your original will at your home (even in a fire proof safe). Either leave it with your attorney or place it in a safe deposit box (and make sure others can get into the box).

Recommendation: Make sure your will has a last page in which you and the witnesses sign a "self-attestation affidavit." In most states, in order to probate your will, the witnesses to your will must acknowledge their signatures after you die. This affidavit eliminates the need of finding the witnesses.

<u>Living Trust</u>. A living trust can be used as a will substitute. In order to work correctly, the living trust must own all of your assets. If you retain ownership of assets, probate may still be required. A living trust does not normally have any significant income tax or estate tax benefits over a will.

Recommendation: When death is an imminent possibility, review establishing a living trust as a "will substitute" to avoid the cost and delay of probate.

Recommendation: If a living trust is used, make sure to also sign a "pour-over" will to transfer any remaining assets in the estate to the trust.

<u>Providing Information to Your Family</u>. Perhaps the most frustrating and time consuming aspect of dealing with the disability or death of a family member is the lack of necessary information. For example, the author has developed and provides to clients as a part of the estate plan a form (completed by the client) which provides information the family needs if the client become disabled or dies. See *www.familyloveletter.com* for a copy of this "Family Love Letter."

Recommendation: Create a notebook containing copies of important insurance, asset, estate and family

documents, including the name, address and phone number of advisors.

Tax History: The first federal estate tax was enacted as a part of the revenue funding for a naval buildup against France from 1797 to 1802. It was reenacted during the Civil War and the Spanish-American war and finally reenacted in 1916.

Ownership of Assets

"Marriage is often due to lack of judgment, divorce to lack of patience and remarriage to lack of memory."

Perhaps one of the areas to which the least attention is devoted in estate planning is how assets are held. Among the considerations are:

Asset Protection Planning. In our increasingly litigious society, a major component of estate planning is structuring the ownership of assets to reduce their exposure to litigation. The manner in which assets are held can effectively reduce or eliminate the claims of creditors with regard to those assets. Among the more common means of insulating assets are the following:

- Holding assets in family owned and controlled entities (e.g., limited liability companies, family partnerships or closely held corporations) which restrict your control and ability to liquidate the underlying assets.
- When assets are transferred to family members with financial difficulties, it is generally best to hold those assets in a "spendthrift trust" which effectively reduces the claims of creditors against the assets. The trust should have multiple beneficiaries and the financially distressed beneficiary should not have the power (as trustee or otherwise) to withdraw assets for his or her benefit.
- In Patterson v. Shumate, 112 S.Ct. 2242 (1992), the Supreme Court restricted the claims of a plan participant's creditors against plan assets in an ERISA-governed plan. However, funds held in an IRA or SEP are not considered ERISA-governed. Generally, the first million of IRA funds have limited asset protection.

Recommendation: If your assets or business make you a significant target for litigation or creditors claims, develop an asset protection plan that includes a risk evaluation, obtaining sufficient insurance coverage and revising the ownership structure of assets.

Recommendation: If you have significant assets, make sure to obtain an umbrella coverage that provides coverage on top of your home and auto coverages.

Owning Assets to Fund the Unified Credit. A husband and wife can each bequeath up to $5,000,000 (in 2012) to heirs without incurring any federal estate tax. Thus, with proper planning, in 2012 a couple can pass by gift or bequest up to $10.0 million dollars tax-free.

However, if each estate does not have at least $5.0 million, or if the parties do not have a will providing for passage of assets into a unified credit trust (also called a "by-pass trust"), the family risks losing the tax-free benefit of the first unified credit when the first spouse dies.

Recommendation: If you and your spouse's combined assets exceed $2.0 million (in 2012), consider having each of you own approximately equal amounts and provide for either the creation of a unified credit trust in each will or allow the surviving spouse to disclaim part of his or her inheritance into a unified credit trust, of which the surviving spouse is a named beneficiary.

Equalization of Large Estates. The federal estate and gift tax is a progressive tax. The more assets that are bequeathed or gifted, the larger the applicable tax percentage.

Recommendation: To reduce overall taxes and allow flexibility in the after-death planning, each spouse should

own roughly the same value in assets. Because of their unique nature, qualified retirement plan assets and IRAs should generally be excluded from this computation.

Jointly Held Assets. Many couples believe owning assets as joint tenants with rights of survivorship is the best form of ownership. Such an approach can eliminate the probate of the jointly held assets, reducing probate costs and time delays. However, it is often not advantageous because:

- If both spouses are killed, the jointly held property will pass automatically to the surviving spouse (however short survival may have been), and his or her family may inherit substantially all the assets.
- Jointly held property does not eliminate the need for a will. As discussed above, a will involves more than the disposition of assets.
- Ownership of jointly held property can substantially increase the estate taxes when the second spouse dies.

Recommendation: If you and your spouse have a combined estate exceeding the Unified Credit, you need to review how your ownership of assets will impact your taxes and dispositions to heirs. See the amount of the unified credit in the table at the end of this article.

Tax Fact: Only 1,221 of the 2.3 million Americans who died in 1997 left a taxable estate of $2,000,000 or more.
Source: Newsweek Magazine, July 3rd, 2000

Lifetime Transfers

For every Tax Problem there is a Solution which is Straightforward, Uncomplicated and Wrong

Making transfers during your lifetime can be a pivotal means of reducing the estate taxes upon your death.

Pre-funding the Unified Credit. You can gift up to $5.0 million tax-free in 2012 to your heirs without paying a gift tax. The benefit of the gift tax unified credit can be magnified by using techniques designed to reduce the value of the asset being transferred.

Recommendation: Where you are facing significant estate taxes, where assets are expected to appreciate rapidly, or where the asset is a family held business, consider funding the Unified Credit during your lifetime (including any phased-in amount) to avoid paying additional estate taxes on the appreciation. It is possible to structure trusts in which the benefits of the income from your and your spouse's unified credits are retained until the death of the first of the two of you.

Recommendation: If you are concerned that your spouse may need the assets during life, make the gift to a lifetime unified credit trust and name the children and your spouse as beneficiaries. The trust can have many of the terms discussed later in this article.

Annual Exclusion Gifts. During life or death you can make tax-free gifts of up to $5.0 million in 2012 in assets to anyone other than your spouse through the use of the "unified credit." Transfers to spouses are generally not subject to a transfer tax. In addition to the unified credit gifts, the "annual exclusion" allows you to gift up to $13,000 (in 2012) each year to an unlimited number of donees. Annual exclusion gifts do not deplete the available unified credit.

Married couples can split the gift (even if the asset is owned by one spouse) and increase the tax-free amount to $26,000 per year per donee. For example, a couple with 10 heirs could transfer $260,000 each year without paying any gift tax or using any part of their unified credits.

Recommendation: If your estate exceeds the Unified Credit exclusion amount, review whether to begin an annual exclusion gift program. Each $13,000 annual exclusion gift can save up to $5,850 in estate taxes (at a 45% tax rate).

Recommendation: Because the donee takes the lesser of the donor's income tax basis or the fair market value of the donated asset, make gifts using cash or high basis assets (i.e., assets with little taxable gain for income tax purposes) to minimize the donee's future income taxes. However, if your expected transfer tax bracket exceeds the donee's income tax or capital gains bracket, gifting of low basis assets may still make sense.

Tuition and Medical Gifts. In addition to the annual exclusion, any amounts paid on behalf of any individual for the education or training of the person or for medical care is not subject to a gift tax. Therefore, parents and grandparents can make tax-free gifts of tuition and medical costs for family members without incurring a gift tax, or using any of their unified credit or annual exclusions.

The payments should be made directly to the qualifying medical or educational provider. The tuition exception is limited to tuition costs and does not apply to amounts paid for room, board, books, or supplies. The unlimited exclusion for medical expenses is not permitted for amounts that are reimbursed by insurance.

Two related income tax issues should be noted. First, unless the donee is a dependent of the donor, the donor will not be entitled to a income tax deduction for payment of medical expenses. Second, the amount of the gift could constitute taxable income to any parent who had the obligation to provide that support.

Recommendation: In a 1999 private letter ruling (PLR 199941013), the IRS agreed that a grandmother's advance payment of her grandchildren's tuition at a private secondary school were excluded from her gift tax pursuant to IRC section 2503(e). This ruling offers an opportunity for clients (especially those who may die before the tuition comes due) to reduce their taxable estate.

Recommendation: Education costs may also be planned for using "529 Plans" and Coverdell Education Accounts. Consult with your advisor on the advantages and qualifications of each approach.

Year-End or Death Bed Gifts. A number of courts have ruled that if a donor dies before an annual exclusion gift check clears the donors account (not the donee's account) after the donor dies, the annual exclusion is denied. In Revenue Ruling 96-56, the IRS allowed the annual exclusion if the check was deposited by the donee before year end.

Recommendation: If possible, make checks out in sufficient time to clear your account before year end. At a minimum, make sure the donees deposit the checks in their accounts before year end. If the donor is ill, have certified checks drawn from his or her account.

Discounts on Family Owned Businesses. In Revenue Ruling 93-12 the Internal Revenue Service finally stopped arguing that the lack of marketability and minority ownership discounts were not applicable to family owned businesses. Although this battle is not yet over, with proper structuring it is generally possible to obtain 25%-45% discounts on the gifts of interests in family owned businesses.

Recommendation: Many family businesses do not generate dividends. The true value to family members is often the compensation and benefits earned from the business. Unfortunately, the equity value of the business may be subject to estate taxes of 45% (in 2009) and create significant liquidity problems to the family. Review making lifetime gifts of business interests and discount the value of the gifts for lack of marketability and minority ownership.

Appraisals. The statute of limitations is designed to prevent "cold" claims. It can apply to the government. However, the IRS has been successful in overcoming the statute of limitations on gift valuations by arguing that the "true" value of the gift must be used when the donor dies and the estate tax calculation is made (i.e., the estate tax calculation is partially based upon the amount of prior gifts). Effectively, the statute of limitations for gift valuations does not close if the return does not adequately disclose the manner the gift is valued. If the gift is not reflected on a gift tax return, the statute of limitations does not begin to run.

> **Recommendation:** If there is any issue about the value of a gift, always have an appraisal done, especially with closely held businesses. Keep copies of the appraisal forever! Make sure to properly document the gift on a gift tax return.

Owning Life Insurance. Because life insurance proceeds are subject to estate taxes, it is generally advisable on estates exceeding the unified credit to remove the insurance from the estate through the use of a life insurance trust or by transferring ownership to family members. For example, a single taxpayer having a $5,000,000 taxable estate buying a new $500,000 life insurance policy could place the insurance in a trust and effectively remove the insurance from the taxable estate (in 2012), saving up to $275,000 in estate taxes if they passed in 2013 (using a 55% tax bracket). If you have a taxable estate and individually own life insurance, you are effectively naming the government beneficiary of a significant portion of the insurance proceeds.

> **Recommendation:** If you have a taxable estate, review removing any life insurance from your taxable estate. Any gift transfer of a life insurance policy is pulled back into the insured/donor's estate if the donor dies within three years of the gift.

Crummey Withdrawal Rights. The $13,000 annual exclusion applies only if a "present interest" is given to a donee. By nature, a gift in trust is a "future interest" because the beneficiary's enjoyment of an asset is restricted. Thus, gifts to trusts normally deplete your available unified credit.

In order to change a future trust interest to a present interest and gain the benefit of the annual exclusion, many trusts provide for a "Crummey" withdrawal right. The withdrawal right provides that as each gift is made to the trust, designated beneficiaries can withdraw that gift for a limited time (normally 30 days).

A common error in drafting the Crummey withdrawal right for a trust with multiple beneficiaries is making the withdrawal right equal to $13,000 (i.e., the amount of the annual exclusion). If the withdrawal right exceeds the "five and five" provisions of the Internal Revenue Code section 2514 (i.e. the greater of $5,000 or 5% of the trust principal), the failure of a beneficiary to exercise the withdrawal right can result in the beneficiary being treated as an additional donor to the trust (i.e., the beneficiary's failure to take the money makes the beneficiary another contributor to the trust). Thus, the beneficiary will use part of his or her unified credit each time the withdrawal right lapses.

> **Recommendation:** Make sure that the Crummey withdrawal right has been properly drafted. If the per beneficiary withdrawal right for a trust with multiple potential beneficiaries exceeds $5,000, there may be an error in your trust document.

Crummey Notices. Upon each trust contribution, the Crummey power requires that the beneficiary receive either constructive knowledge (e.g., the beneficiary is a trustee) or actual knowledge of the right to make an immediate withdrawal.

> **Recommendation:** Make sure that annual notices are sent to beneficiaries by certified mail. If the Crummey power is used in an insurance trust, provide at least 30 days notice prior to any insurance premium due date.

Charitable Remainder Trusts. A charitable remainder trust is basically a trust in which you or your heirs receive an income interest for a period of years or for life, with the remainder interest being paid to one or more charities. A charitable remainder trust can provide significant advantages, including:

- You receive a current charitable income tax deduction for the present value (calculated by IRS tables) of the benefit ultimately to be received by the charities. The deduction is at least 10% of the value of the contributed assets.
- You and/or your heirs can receive income from the trust for a period of years or for your lifetimes.
- If the charitable remainder trust sells assets, no income tax is incurred by the trust. Thus, you may avoid the income tax payable on the sale of an asset and earn income on the amount you would have paid in tax.
- With proper drafting, income can be effectively deferred until after your retirement when you may be in a lower

tax bracket.

Recommendations: If you intend to sell an appreciated asset which will be heavily taxed, review transferring it to a charitable remainder trust and have the trust make the sale. Make sure to make the transfer to the trust before you are legally obligated to sell the asset. If a sales agreement is in existence at the time of the transfer, the IRS may still tax you on the sale.

Residences. Your residence is often one of the largest estate assets. Using a qualified personal residence trust (or QPRT), you can transfer your residence to a trust and retain the right to the use of the residence for a period of years. At the termination of the trust, the residence is distributed to your heirs. The gift tax on the trust remainder interest (i.e., what your children will receive in the future) is based upon its present value, resulting in a significant valuation discount. If you die before the end of the trust term, the residence is included in your taxable estate, but generally without adverse tax consequences. If the children have received ownership of the house, you must make rental payments to them.

Recommendation: Whenever your residence constitutes a significant part of your estate, review transferring the residence to your children outright or in a QPRT during life.

Passage of Assets

[The perfect inheritance is] enough money so that they feel they could do anything, but not so much that they could do nothing. Warren Buffett

How you pass your assets can provide either significant benefits or major problems to your family.

Naming Beneficiaries. Perhaps one of the most common mistakes in estate planning is naming the wrong beneficiaries of life insurance policies and retirement funds. You may not remember who you named as beneficiary or previous designations may no longer be valid because of changes in your wealth or family circumstances (e.g., you have been divorced).

Recommendation: Every 3-4 years obtain a written confirmation from your life insurance carrier and plan administrator of your designated beneficiaries. Do not designate minor children as beneficiaries (even as contingent beneficiaries), because they may inherit the assets at age 18. Instead, pass the assets into a trust to be held until the heirs have reached sufficient maturity to handle the money.

Recommendation: In January of 2001, the IRS issued new regulations governing retirement plans. These new rules substantially simplified the rules governing Required Minimum Distributions and the naming of retirement plan beneficiaries. In many cases family members who are named as beneficiaries can take funds from an IRA over their life expectancy - allowing a longer deferral of income taxes. If you have not reviewed your beneficiary designations in light of the new rules, you should discuss your options with a competent tax advisor.

BEWARE: It almost never makes sense to name your estate (or by failing to name a beneficiary naming your estate) as beneficiary of your retirement plans or IRAs. In most cases, it will cause an acceleration of the income taxes that could have been deferred.

Recommendation: If a retirement plan constitutes a significant part of your estate plan, make sure there are other assets available to pay any estate taxes on the retirement plan - otherwise funds will have to be removed from retirement plan - creating an immediate income tax liability.

Tax Fact: The IRS has announced that there are more fiduciary income tax returns being filed than corporate returns. Source: Tax Practice, June 16, 1997.

Spendthrift Trusts. Like virtually every other asset, an interest in a trust can be assigned by the beneficiary, and creditors of a beneficiary may be able to make claims against the beneficiary's rights in a trust. However, if the trust contains a "spendthrift" clause, it may eliminate the negotiation of the beneficiary's rights and restrict the claims of creditors against trust assets. Such trusts can be an effective means of limiting claims of creditors of a debt-ridden heir.

> **Recommendation:** In virtually any trust you establish, it is advisable to include a spendthrift provision.

Marital Trusts. Transfers to a spouse can be made outright or in trust. If the trust is properly structured, there is no transfer tax due on the transfer. The spouse must be the only beneficiary of the trust for the spouse's lifetime, but at the spouse's death, the assets of the trust are distributed in accordance with your wishes. If your spouse owned the assets directly, the spouse could pass the assets to a future spouse or to the spouse's family. By using a marital trust, your wishes direct how the funds will be distributed upon the spouse's death.

> **Recommendation:** Particularly when a spouse is incapacitated or is not the parent of your children, you should consider placing any bequests or gifts to the spouse in a marital trust.

Generation Skipping Trusts. A generation skipping trust is a trust providing income and principal benefits to multiple generations. You and your spouse can each place up to $5,000,000 (in 2012) in a generation skipping trust without incurring the 35% generation skipping tax (in 2012). Such a trust can provide the following benefits:

- The trust can provide professional money management, while providing a "safety net" to descendants.
- The trust assets avoid any additional estate tax (of up to 55% in 2013) on both the value of the assets which were initially placed in the trust and any appreciation which may occur on those assets during the lifetime of the beneficiaries. For example, $1,000,000 placed in the trust growing at 7% a year would be worth $7.6 million in 30 years. Assuming the beneficiary is in a 45% tax bracket, use of a generation skipping trust would result in an estate tax savings of $3.4 million.

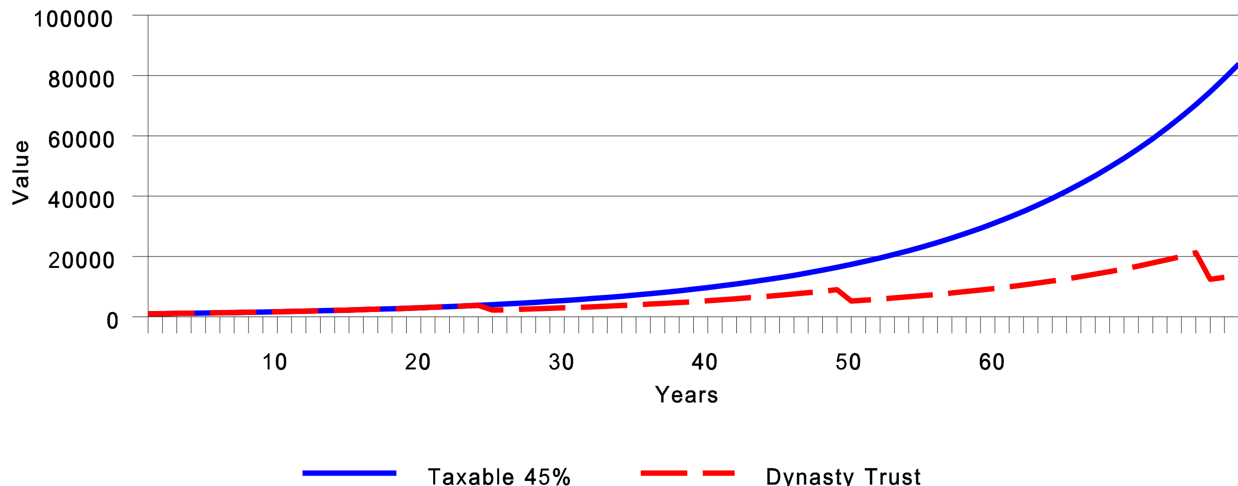
> **Recommendation:** Whenever your estate is significant, descendants have shown themselves unable to handle their finances, or where family (e.g., divorce) or creditor problems exist for a beneficiary, use of a generation skipping trust should be thoroughly reviewed.

Dynasty Trusts. While there has always been substantial focus on saving estate taxes, until recently there has been less focus by planners and clients on the "inter-generational confiscation of wealth". That is, as each generation dies, up to 55% (in 2013) of their estate is taken by the federal and state estate taxes.

A Dynasty Trust is a generation skipping trust designed to exist for the maximum period permitted by applicable state law - the so called "Rule Against Perpetuities." A number of states have eliminated the Rule Against Perpetuities. Generation skipping trusts can be created in these states without being required to be terminated in the future. Especially for family business interests and insurance trusts, this may be an excellent tool to avoid future estate taxes for family members.

If the Dynasty Trust is created as a "spendthrift trust," state law may restrict the rights of creditors and divorcing spouses of family members to access the funds held in the trust. Moreover, because the assets are held in trust and not by the family members, the management of the trust assets may be retained in the most competent hands (e.g., professional money managers, or family members who run the family business versus family members who may be prone to making bad investment decisions).

Why does a dynasty trust make sense? Take a close look at the inter-generational confiscation of wealth as shown in the chart below. Assume a trust starts with $1,000,000 in 2012 and grows at a 6% rate per year. Every 25 years, a generation dies and 45% of the accumulated wealth is confiscated in federal and state estate taxes. The upper line shows the assets held by the trust. The lower line shows the after-tax assets left in the family's name (assuming the family did not spend the funds to support a lifestyle) over 77 years.



Instead of losing 45% of the estate to a confiscation tax every 25 years, the dynasty trust continues to grow and the compounding of the funds which would have been paid in estate taxes results in significant growth in the value of the trust's assets. Virtually every client wants to avoid estate taxes. In the above chart in 77 years, over $80 million is held in the Dynasty Trust versus almost $14.0 million held by the family. Not only did the government take 45% of the family assets three separate times, but the government also receives the benefit of the growth on those assets. Shown the above calculations, many clients have seen the benefit of avoiding the "inter-generational confiscation" of wealth.

Because the trust may exist forever, it cannot be cavalierly created. It requires considerable thought and expert drafting. Because these trusts are irrevocable, many people believe they must be inflexible. This is not the case. Most state laws contain relatively few restraints on what can be provided for in a trust instrument. Through creative drafting, a "***Living***" document can be created - a **PERPETUAL ESTATE PLAN** TM. for future generations. These flexible approaches are discussed in more detail later in the article.

> **Recommendation**: Consider a Dynasty Trust as a part of any significant estate. It can provide a long term legacy to future generations, with minimal tax cost.

Family Incentive Trust. The Dynasty Trust creates an inevitable issue: What will be the impact of that accumulated wealth on future generations? Look at the prior chart. Assume a great grandson has a right to 10% of the Dynasty Trust in 77 years. His 10% interest entitles him to benefits from more than $8 million of the trust principal. With a 6% return per year, his annual income for the rest of his life is over $480,000. When his father tries to convince him to go to college, the son's response could be: *"Dad, I have a half-million a year coming to me - Why do I need to go to college? Why do I need to work?"* This illustration points out the damaging effects of inherited wealth and the reason that so many clients are unwilling to pass all of their assets to family members.

One solution to this problem is The Family Incentive TrustTM (a "FIT"). It is designed to create opportunities and provide minimum protections to family, without supporting future generations with an unearned lifestyle. The FIT is typically a dynasty, irrevocable, generation-skipping trust, which provides benefits across future generations. Unless truly destitute, no family member can live off the trust funds! More information on these trusts can be found at www.scrogginlaw.com.

At its most basic level, the FIT is simply a method of disposing of assets. It addresses the core issue that many clients are concerned about: *"Should I fear the impact of my wealth on my family more than the impact of estate taxes?"* In addressing this issue, the FIT creates a system in which family dispositions are made for three primary purposes:

- To provide a safety net for future generations.

- To create positive incentives to encourage responsible behavior in future generations.
- To provide a fund for family loans and investments in family businesses.

Recommendation: Protecting family from the negative impact of wealth is increasingly becoming a part of estate planning. Carefully consider how the legacy of your assets may impact future generations.

Choosing Trustees. Choosing a trustee is never easy. From the author's perspective, the practical characteristics to look for in choosing the ideal trustee is someone who:

- Understands that the trustee's role is to protect the heirs from the assets not the assets from the heirs.
- Will help train the heirs in the financial management of the assets which will ultimately be placed in their care.
- Has shown an ability to properly manage assets.
- Generally, the trustee and guardian of minor children should not be the same person so that they can operate as a check and balance on each other.
- Because of the broad discretionary rights in a trustee, someone whose judgment you trust.

Recommendation: Review your choice of trustees every 3-5 years based upon the above characteristics. The use of co-trustees may give you most of the above characteristics.

Staggered Trust Dispositions to Children. When a trust is created for the benefit of children, it will typically either be a generation skipping trust (see above) or a trust which will be distributed during the children's lifetimes. In many cases, the heirs may not have the financial savvy to properly deal with a large inheritance at age 18 (or even age 21). Therefore, consider providing staggered required distributions of an increasing amount as each heir matures. For example, trust funds could be distributed: 10% at age 21, 20% at age 26, 30% at age 30 and the remaining balance at age 35.

Recommendation: Review the terms of any trust every 3-5 years and determine if the amounts to be distributed still reflect your desires and your heirs' perceived ability to manage money.

Recommendation: To add flexibility to the estate plan give a surviving spouse or other family member the ability to reconfigure the disposition plan using a limited power of appointment. A limited power of appointment allows the power holder the ability to change how the family will receive an inheritance from a trust.

Removal of Trustees. For various tax and family reasons, trusts are established as a normal part of the estate planning process. In many cases, a trust will exist for decades, and the initial choice of trustees may prove less viable as time goes on. For example, your trustee may develop health problems.

Recommendation: When a trust is established, review allowing one or more of the beneficiaries to remove a trustee with or without cause. This gives the beneficiaries some degree of control over the trustee and can minimize abuse of the trust by the trustee. To avoid inclusion of the trust funds in the taxable estate of the beneficiary, and to limit their premature access to the trust funds, the beneficiaries right to name a replacement trustee should be restricted.

Transfer to Non-US Citizens. The tax laws governing the gift or bequest of assets from a US citizen and US Resident Alien to a non-US citizen are extremely complex, particularly transfers to a spouse who is not a US citizen. Such a transfer can create significant estate and gift taxes for the unwary taxpayer, including transfers by beneficiary designation (e.g., life insurance and retirement plans), by joint ownership with right of survivorship, by intestacy or by the terms of a will or revocable trust. Consult with a competent tax advisor before considering any such transfers.

Transfers to Minors. Many clients provide annual exclusion gifts to accounts for minors, but fail to examine the long term impact of the gifts. For example, assume a client and his spouse put $26,000 annually in an custodial account or 2503(b) minor trusts for their one-year old child, and the account grows at any annual rate of 5%. At age 18, the child could have over $800,000 in the account. Gifts to custodial accounts or to most minor's trust require distribution to the child no later

than age 21 and may provide that the assets revert to the parent/donor if the child dies before age 21. Will the child be mature enough to make the proper decisions?

Caution: If income from the gifted asset is used to satisfy an obligation of support of the parent of the child, the IRS may rule that the parent is taxable on the income. For example, in Brooke v. United States 468 F2d 1155 (9th Cir. 1982), the court ruled that because the custodian (as required by local law) used the income of the gift to provide for the support of the donor's child, the donor was taxable on the income used for the minor's benefit.

***Caution*:** Do not allow the donor to be the custodian. The retention of powers over the property may result in the gifted asset being retained in the donor's estate for federal estate tax purposes.

Recommendation: Whenever the funds gifted for the benefit of a minor are expected to be significant by age 21, review placing them in a Crummey trust. Provide to the Trustee(s) the right to make discretionary distributions of income or principal. Unlike the minor's trust discussed above, the trustee of a Crummey trust can have broad discretion on distributions of income and principal. The primary benefit of using Crummey Minor's Trusts is the ability of the trustees to maintain the funds well beyond age 21. Distributions can be delayed until the beneficiary, in the Trustee's judgment, has the maturity to be able to handle the funds. Moreover, unlike a 2503(c) trust or a custodial account, the trust may have multiple beneficiaries. Thus, for example, if a child does not go to college, the funds could fund the education of other children who do go to college.

Recommendation: If you have already created a custodial account or 2503(c) Trust, create a Crummey Trust and invest its assets in long term growth assets with minimal income. Make all distributions for the benefit of the minor from the previously established 2503(c) trust or custodial account to reduce its value as much as possible before age 21.

Caution: If a child has unearned income above certain limits, the income may be taxed at the parent's tax rate (the "Kiddie Tax"). Moreover, if a trust is used and income is not distributed, the federal income tax rate on the trust hits the top income tax bracket very quickly. To minimize the income taxes, either invest the assets in capital gain assets and sell assets only when funds are needed, or place the assets in a tax-efficient or tax-deferred investment. A trust is generally taxed at the same capital gain tax rate as an individual.

Tax History: Missouri, in 1821, imposed a dollar tax on every unmarried free white male over 21 years of age and under the age of 50.

Minimizing Family Conflict

"Conflict is inevitable, but combat is optional."
Max Lucade

One of the worst tragedies in the estate process is children who twenty years after their parent's death are barely talking, because of fights over insignificant issues. One important legacy that a parent needs to leave is disposing of such assets in a manner designed to minimize this potential conflict - **LEAVING A LEGACY OF RELATIONSHIPS RATHER THAN A LEGACY OF CONFLICT.** This perspective should be at the core of any estate plan, from the manner that assets are passed to the selection of fiduciaries.

Divorce. A recent study shows that almost 50% of the marriages in this country end in divorce. With such a high potential for divorce, a core perspective of planning should be to minimize the adverse impact of divorce.

Recommendation: If divorce of heirs is a concern, consider holding bequests or gifts in trust to assure that a divorcing heir does not lose the assets. For example, assume a surviving spouse remarries. If the spouse then gets divorced, a portion of the assets may be lost. Instead, using a QTIP marital trust the assets will never be a

part of the spouse's assets and should be beyond the claim of any divorcing spouse.

Recommendation: Pre-nuptial agreements should be reviewed as a part of any marriage, especially when the newlyweds have disproportionate assets.

Recommendation: Irrevocable documents should be drafted contemplating the possibility of divorce. For example, when irrevocable trusts are drafted for a spouse (e.g., an insurance trust), the document may contain language which disinherits the divorced (or legally separated) spouse and removes all rights they have in the trust (e.g., as trustee, or a limited power of appointment) immediately upon divorce.

Blended Families. As a result of both divorces and deaths of spouses, America has an increasing number of blended families. Many parents are conflicted within themselves and even more so with spouses over how each of the family groups should be treated. For example: When the father of a step-child is well off and will pass on significant assets, should the step-father feel any responsibility to pass assets, even when the wife wants equal treatment for her children? Should a step-sister be appointed trustee of a trust for a half-brother? Should *yours, mine and ours* all be treated equally? But what about the fact that the older children have received support (e.g., college educations, cars, etc.) while younger children have not? Who should be appointed guardians? Do you want that former bum spouse to be guardian? If not, is there really anyway to prevent it?

Recommendation: These issues exist even when clients do not want to address them. It is better to have addressed them before death or incapacity rather than having the decision making process taken out of your hands.

Recommendation: If your former spouse was a bum, how do you make sure that your assets do not pass through the mutual child to the bum parent? Use a life estate or trust to control the ultimate disposition of the assets.

Recommendation. If your spouse is not the parent of your children, consider passing assets to your spouse using a marital trust. Using such a trust, you can assure that your spouse receives the benefit of assets during life, but then passes the assets to your descendants, not the spouse's family members.

Guardianship of Minors. A host of issues evolve around the post-death guardianship of minors. A pivotal part of the planning process is to deal with these potential problems. You cannot will your children. The courts will make an independent judgment. But there are things that can be done to influence that judgment and minimize future conflicts. It is interesting that many clients seem to have an easier time deciding on who will be the guardian of their children than deciding who will be the trustee for the minors. As advisors, we need to spend more time discussing these issues.

Recommendation: We typically recommend that the trustee(s) for a minor and guardian for the minor not be the same person(s). First, this reduces the conflict of interest of the trustee/guardian using trust funds for questionable purposes, such as taking the whole family to Europe for vacation. Second, it reduces the possibility of a minor declaring that the guardian misappropriated funds that indirectly benefited the minor. Hopefully, by using separate people, the trustee and guardian can observe each other's behavior and reduce damaging personal or financial decisions of the other person.

Recommendation: Where you have damaging facts which indicate that a family member should not obtain custody (e.g., sexual abuse, alcohol or drug addiction), consider preparing an affidavit during life describing the relevant facts. To minimize family embarrassment, the affidavit can be held by the family attorney, or another person and released only if the subject of the affidavit seeks custody. The more problematic issue is what to do if the concerns are more subjective. For example, a former spouse is too religiously fundamental, or perhaps not religious enough. In such cases, the courts are unlikely to take away custody from a parent.

Recommendation: What happens if you appoint a married couple as co-guardians and they get divorced? Is it better for the children to be raised by one parent, or should they be sent to another married couple in the family?

What happens if the former in-law was actually the better parent? What happens if the guardians raises the child for 10 years and then get divorced, but the alternative married couple either have little contact with the child, or are themselves divorced?

Tax History: The Internal Revenue Code (as passed in 1913) was only 14 pages long.

Personal Property Dispositions. The attention paid by heirs to personal property after your death is often disproportionate to both its focus in the pre-death estate plan and its appraised value. This imbalance is a result of the undue conflict which often accompanies the passage of personal property. One of the more interesting dynamics of estate planning is that in many cases, the greatest intra-family conflict is not over a large inheritance or the placement of assets in spendthrift trust, but as an unexpected result of personal property dispositions.

Caution: If an asset is in the decedent's home, the IRS provides that in the absence of evidence to the contrary, the asset is treated (solely for tax purposes) as a part of the decedent's taxable estate. The burden lies on the executor or others to prove that ownership did not rest with the decedent. If an asset is "given" to a family member but retained by the giver, the Tax Code provides that the gift was never completed and the asset remains an asset of the giver's estate. This is often a problem when jewelry or collections are "given" but transfer of control is never made.

Clients should document the ownership of their assets. For example, if a daughter has loaned you a china cabinet, it needs to be documented somewhere that the china cabinet belongs to the daughter and not you. In the absence of such written information, it would generally be presumed that it belonged to the person in whose home it was found.

Caution: To the extent the personal property is subject to estate taxes, the client needs to deal with who is responsible for the transfer tax on the property. In many wills (and in some state statutes), special bequests do not pay estate taxes, effectively resulting in other residuary heirs assuming the tax cost of the special bequests of personal property.

Recommendation: To the extent you want a particular asset to go to a particular person, provide a legally enforceable document that passes that particular asset (defined with specificity) to a particular heir. This is especially important when assets are being transferred to more remote heirs (e.g., family friends or remote cousins).

Some states will enforce an external list of how the personal property will be transferred if the will references the list. But other states (e.g., Georgia) do not permit such a list. In those states, you either need to list the personal property dispositions in the will or if the Executor can be trusted to follow the legally unenforceable wishes of the deceased, an external list of how assets should be disposed of can be prepared. In such a case, the persons on the list must be listed as potential personal property heirs in the will and the executor should be given total discretion in deciding which assets will be distributed to the listed heirs - hopefully based upon the list prepared by the decedent. The choice of a child or second spouse as executor may sometimes create a conflict with the other heirs and may not be the best choice.

Recommendation: You are strongly encouraged to talk to your adult children about which assets they want to receive upon the parents' death. These desires should be documented. This brings to the fore prior to your death any ownership conflicts that may exist. Because you resolve the conflict, any long term damage in the children's relationships can be minimized.

Recommendation: To the extent the particular assets are to be passed to the children, we typically recommend that either a digital or video-tape be made of the object and a notation be made of which family member receives that asset. Through the video representation of the asset, there can be little question as to which asset is being passed. Moreover, if a video camera is used, it is an excellent way of providing the legacy of any

heirloom assets so the heirs understand the family history of the particular asset.

Recommendation: If a married couple has children from a prior marriage, they should create a notebook with pictures of their important assets (as defined by the family), noting the heir of the asset. Each spouse should sign a document irrevocably relinquishing the right to the other's assets, except where a written statement is signed by both.

Recommendation: Some clients want to give a life estate in personal property to a spouse and then pass the property to their family. Unfortunately, this is a terribly cumbersome approach. What happens when the object breaks, is stolen or lost? Particularly with an heirloom and emotionally significant assets, it is generally best to pass them at death to the end recipient.

Family Love Letter. One of the inadvertent sources of conflict is the lack of information which the family has to deal with when a family member dies or is incapacitated.

Recommendation: At my website is a form we call the "Family Love Letter" for clients to fill out and provide to their families. It contains much of the information needed when a client becomes incapacitated or dies. Copies of this form can be found at www.scrogginlaw.com.

Tax History: Federal income taxes were originally imposed during the War of 1812, and were re-imposed during the Civil War. The tax was ruled unconstitutional in the 1895 when Congress attempted to re-impose them in the 1890s, requiring a constitutional amendment for their imposition. The 16th Amendment was approved in 1913 and the first income tax was paid in 1914.

Choice of Fiduciaries. The choice of fiduciaries is one of the most important decision a client can make. The choice of the right fiduciary can either avoid or create conflict.

Recommendation: In choosing a fiduciary, spend time reviewing the possible problems the fiduciary may have. For example, if a trustee will receives assets after your spouse's death, is that trustee the best person to make decisions on what distributions your surviving spouse will receive?

Ownership of Family Businesses and Properties. ***"Conflicts are inevitable between operators of the family business and family members who are outsiders."*** Many entrepreneurs intend to pass down their businesses to one or more designated individuals who will run their business after the entrepreneur's death or retirement. But because the business is often the largest single asset of the estate, the owner may also pass ownership in the business to other family members. During the owner's lifetime the owner has been able to make sure that there is peace in the family and serve as the "benevolent dictator" of the family business.

Unfortunately, this powerful role disappears with the entrepreneur's death or incapacity. Sibling rivalry and other issues then begin to come to the fore, particularly between those who operate the business and those who are outside the business. Almost inevitably, the outsiders feel that the compensation and perks provided to the insiders are "excessive." Outsiders will question the business decisions (e.g., capital expenditures) of the insiders even when they know little about the business's operations or competition. Outsiders often believe that the income paid to them should match the compensation paid to the insiders.

Meanwhile, the insiders (who often feel they are working much too hard) resent that their sweat is increasing the value of the business interest of the outside family members who are continually asking for more and more income to which they are not "reasonably entitled". The insiders often fail to see that the outsiders have a right to a return on their investment in the business. Many family businesses have paid inordinate legal fees because of these conflicts and/or have been forced to sell the business to alleviate the problem.

This conflict is inevitable as each business owner attempts to direct his or her own financial destiny and feels increasingly

unable to do so because of the common ownership with other family members. This is not a matter of "good" and "bad" family members. It is a matter of increasingly different life goals - a normal part of life.

> **Recommendation**: The solution lies in setting up a structure in the estate plan which assures that those in the business own and control as much of the business as possible, while giving outsiders other assets so that they can effectively control their own financial destiny. Life insurance if often a necessary element of this planning. This planning process traditionally must be done by the entrepreneur during life so the entrepreneur can dictate the terms to family members.

Cost and Competence

"Those who have large estates and watchful lawyers will find ways of minimizing these tax burdens."
Robert H. Jackson

Perhaps the two greatest impediments to starting an estate plan are the perceived cost and locating competent counsel. Consider the following:

- Go to www.naepc.org to find a local attorney who specializes in estate planning. Another website, www.martindale.com not only will allow you to locate an attorney, but it also allows you to see how other attorneys rate the attorney for competence and integrity. See also: www.Superlawyers.com and www.AVVO.com.
- Ask friends who have estate issues similar to your estate (e.g., second marriage and multiple children) and your advisors for recommendations.
- On smaller (e.g. less than $1.5 million for a couple) and less complicated estates, the attorney should be able to complete the estate planning analysis and document preparation for a fixed fee quoted in the initial interview.
- Look for an attorney who does not charge for an initial meeting and who agrees to quote you a fixed fee or a capped fee.
- Prepare a list of written questions for the initial interview. If you are unhappy with the answers, find another attorney.
- Look for an attorney who has developed a comprehensive form system in which you provide initial information (thereby reducing your cost of his preparing information) and who uses computers to reduce the time in document preparation.
- While a second opinion is often advisable, beware of duplicating costs by having the lawyer and other advisors do the same work. Much of the tax advice on smaller estates should be done by the attorney as part of the document preparation. If the attorney does not provide tax planning advice, look for another attorney.
- Look for an attorney who has adopted innovative programs for the reduction of fees such as providing estate planning to the major executives of a corporation at a discounted price, with client meetings being held at the offices of the corporation.
- Check with your employer and determine if the company pays any part of your estate planning costs.
- Look for an attorney who will translate the legalese of estate planning into an understandable language. For example, the author generally requires his clients to have a meeting in which each paragraph of the estate planning documents are "translated," prior to their execution.

- Never lose sight of the fact that you get what you pay for, and unfortunately, not all attorneys are skilled in the proper drafting of estate planning documents or providing practical advice on the consequences of the decisions you are making. This is one area where the cheapest cost can result in terrible consequences for your family.

SUMMARY

These estate planning "bullets" are intended to provide you a quick insight on some of the tax planning issues you may not have addressed. Make sure to discuss all of the ramifications of any planning idea with your counsel before implementing. Finally, always remember that estate planning is an on-going process, not a conclusion.

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Tax History: How did A1040" become the most dreaded form number in history? It has been reported that the Form 1040 relates to Lady Godiva riding through the streets of Coventry, England, in A.D. 1040 to protect the people from taxes. It has also been reported that the prophet Samuel, in 1040 B.C., told the people that their decision to have a King would result in their having to pay taxes. However, the IRS indicates that it provides a standard four digit numbering system to all forms released by it, and the next number up was number A1040" when the return was originally put in use in 1913.

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