Estate Planning

The Fundamentals of Planning for the Preservation and Transfer of Family Wealth

Estate Planning Overview

- Protection, preservation and distribution of wealth in accordance with stated objectives
- Tax minimization is important, but nontax objectives should take precedence
- While planning issues and potential solutions may be influenced by the size of the estate, the importance of planning is universal
- Planning in an uncertain environment is challenging
  - Overly-complex tax laws are changed frequently
  - Politics plays a key role in setting tax policy

Estate Planning Process

- Record a complete inventory of current assets, liabilities, insurance policies, etc.
- Articulate and document personal, financial and estate goals, objectives and constraints
- Analyze current financial condition, structure of estate and review current legal documents
- Evaluate alternative planning solutions
- Develop agreed-upon courses of action
- Implement, monitor and adjust accepted plan

Property Ownership

- Form in which property is owned determines an owner's property rights and privileges
  - Right to improve, rent, partition, sell, bequeath, borrow against, etc.
  - Property laws are not uniform across jurisdictions
- Especially with married couples, determining how property is titled early can facilitate the estate planning process
- Community property laws complicate data gathering, especially with moves into or out of such states

Trusts in Estate Planning

- Creations of law that separate ownership interests in property from beneficial interests
  - Trust creator known as grantor or settlor
  - Trustee holds legal title to trust property
  - Trust beneficiaries possess beneficial interests
- Trusts may be revocable or irrevocable, funded or unfunded, established during life (*inter vivos*) or at death (testamentary)
- Attractive features include asset protection
- Frequently play a significant estate planning role

Role of Life Insurance

- Source of replacement income for survivors
- Provides cash for estate liquidity
  - Avoids fire sale of unmarketable property (e.g., family business, investment real estate)
  - Large retirement plan balances, stock options and other IRD items create significant tax exposure
- Can be used to equalize value of bequests across heirs with different needs and circumstances
- Can replace lost wealth due to taxes

Estate Distribution

- Postmortem distribution of property is governed by
  - Operation of law
    - Joint property with rights of survivorship
    - Retirement plan/insurance policy beneficiary designations
  - Decedent's will
  - Decedent's revocable living trust
  - Laws of intestate succession if no will or living trust exists
- Disclaimers may alter prearranged plan
  - Disclaimant treated as having predeceased other legatees
  - Can be used tactically to achieve superior planning results

Probate

- Process of proving the legal validity of a will with ultimate distribution of estate property
- Becomes a matter of public record
- Personal representative has a number of significant responsibilities and challenges
  - Collect decedent's property and create inventory
  - Pay decedent's debts, expenses and taxes
  - File creditor notices, tax returns and accountings
  - Distribute net estate to proper estate legatees
- Ancillary probate required in states with real property

Last Will and Testament

- Document most commonly used to control postmortem distribution of property
- Revocable until the testator's death
  - Changes in circumstances necessitate periodic review
  - Only the testator can ratify changes to the will
    - Entirely new will may supersede preexisting wills
    - Will may simply be amended via codicil
- Serves other important purposes
  - Designates guardians for minor children
  - Designates personal representative (executor/executrix)

Revocable Living Trust

- May substitute for the will as the primary dispositive document in an estate plan
  - Offers a measure of privacy that a will cannot
  - Property in trust at death bypasses probate
- Trust may be funded or unfunded until death
  - Funding during life by agent under power of attorney may be triggered by grantor's disability and/or incompetence
  - At grantor's death, a pour-over will may direct transfer of remaining property into the trust
- Grantor trust for income tax purposes

Other Will Substitutes

- Pass at death outside of the will and probate
- Joint property with rights of survivorship
  - At death, property passes automatically to surviving joint tenant
  - Overuse of joint tenancy property can potentially increase family's estate-tax exposure
- Postmortem transfer of certain property is governed by beneficiary designations
  - Tax-deferred retirement plans and annuities
  - Life insurance policy proceeds

Qualified Disclaimers

- Unqualified, irrevocable refusal to accept an interest in property
- Requirements
  - Must be in writing
  - Must be provided to transferor or representative within 9 months of event giving rise to gift or bequest
  - Disclaimant cannot receive any of the benefits
  - Disclaimant cannot direct where property goes
- Postmortem disclaimer by surviving spouse can fund a contingent bypass trust

Estate Taxes

- An excise tax on the postmortem transfer of property
- Estates bear heavy tax burden
  - Planning can substantially reduce potential estate shrinkage associated with taxes
  - Decreases effective cost of charitable giving
- 2012 American Taxpayer Relief Act provides certainty
  - TRA 2010 had provided for increased exclusion, decreased rates and exclusion portability
  - Without ATRA 2012 rates and exclusion would have reverted to 2001 levels with no exclusion portability

2012 American Taxpayer Relief Act

- $5,250,000 basic exclusion amount in 2013
  - Applies to estate, gift & generation-skipping transfer taxes
  - Exclusion indexed for inflation ($5,340,000 in 2014, $5,430,000 in 2015)
- 40% maximum tax rate on amounts above exclusion
- Deceased spousal unused exclusion (DSUE) amount can be transferred to surviving spouse (TRA 2010)
  - Applies to deaths occurring in 2011 and beyond
  - Exclusion not indexed for inflation following transfer
  - Election made on timely-filed federal estate tax return

Estate Tax Base

- Unified transfer tax system
  - Designed to tax gifts and bequests similarly
  - 2010 exception: gift tax exclusion was only $1 million
- \+ Gross estate (after valuation discounts)

  \- Expenses & debts

  \- Qualifying marital and charitable bequests

  = Taxable estate

  \+ Post-1976 adjusted taxable gifts

  = Estate tax base

Gross Estate

- Essentially all property owned by or in which decedent held an interest at death is included
- Includes interests over which decedent held the right to affect others' beneficial enjoyment
- Transfers with a retained life estate are includible
- Relinquishment, lapse or transfer of certain retained interests within three years of death is includible
- Life insurance payable to decedent's estate or in which decedent possessed incidents of ownership during three years prior to death is includible

Valuation of Property

- Gross estate can be valued at death or six months after death (alternate valuation date)
  - Election is available only if federal estate tax is reduced
  - Property that declines with passage of time ineligible for election (e.g., survivor annuity)
- Special valuation reductions for certain real estate used in a business or farm operation
- Valuation discounts for lack of marketability, control, etc. may apply and reduce estate tax

Deductions from Gross Estate

- Enforceable claims against the estate as of decedent's death
  - Unpaid expenses
  - Unpaid taxes
  - Other outstanding debts (e.g., home mortgages)
- Qualifying marital bequests
- Qualifying charitable bequests

Estate Tax Marital Deduction

- Unlimited federal deduction for qualifying bequests to U.S. citizen spouses
  - Outright bequests (including joint tenancy property)
  - Power-of-appointment or estate trusts
  - Qualified terminable interest property (QTIP) trusts
- Bequests to non-U.S. citizen spouses are nondeductible unless transfer is to qualified domestic trust (QDOT)
- Coordination of marital and nonmarital bequests minimizes potential estate tax exposure

Charitable Bequests

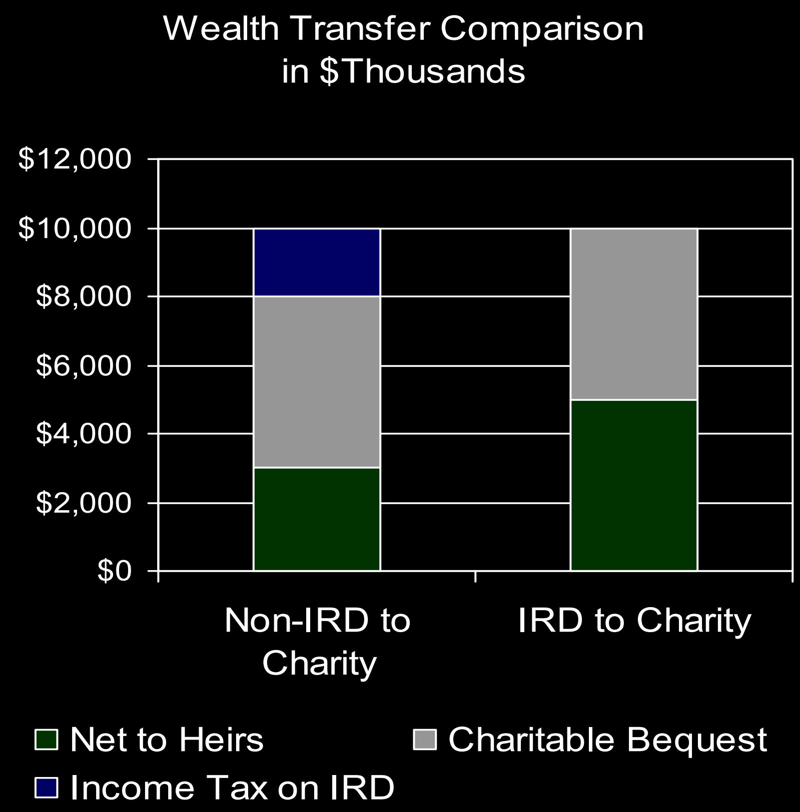
- Taxes reduce the effective cost of charitable giving during life or at death
  - Transfer x (1 – tax rate) = after-tax cost of transfer
  - Bequest of IRD property to charity avoids income taxes that would otherwise be payable by heirs
- Bequests to charity may be outright or in trust, to public charities or private foundations
- Split-interest charitable trusts (i.e., CLTs and CRTs) must meet numerous requirements to qualify transfers for charitable deduction

Income in Respect of a Decedent

- Income recognized upon receipt of certain property by decedent's estate or legatee
- IRD only applies where decedent would have recognized income if he/she had received the item in question during life
- No step-up in basis at death for IRD items
- Income taxes paid by IRD recipient are effectively reduced by federal estate tax attributable to inclusion of item in gross estate

Charitable Bequest Example

- $10,000,000 total property owned by decedent
  - $5,000,000 IRD property
  - $5,000,000 non-IRD property
- Decedent dies in 2014
- Estate plan calls for $5,000,000 charitable bequest at death
- Objective is to maximize combined net bequest to heirs and charity
- Heirs in highest tax bracket

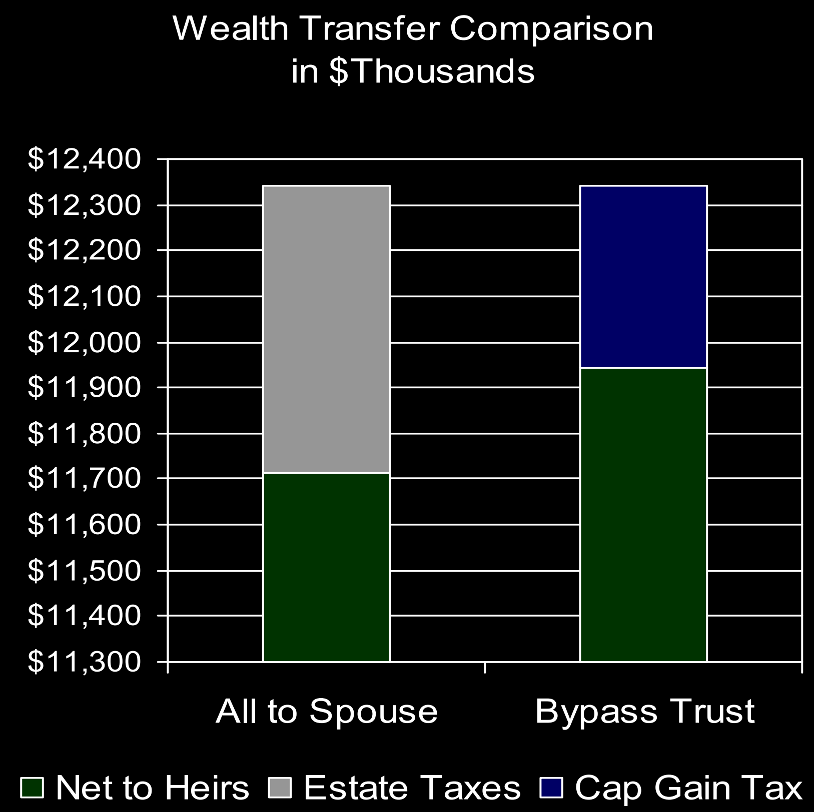


Credit Shelter Bypass Trust

- Funded at death with the decedent's remaining applicable exclusion amount (AEA)
  - Creates a taxable estate, but the federal estate taxes are offset by the unified credit amount
  - Lifetime taxable gifts reduce AEA at death
- Trust bypasses the surviving spouse's estate, but may provide spouse with lifetime distributions
- Zero estate-tax plan combines marital and nonmarital bequests in a way that eliminates estate taxes in each spouse's estate

Bypass Trust Example

- Decedent dies in 2014
  - $5,340,000 stock portfolio
  - $5,340,000 real estate
- Surviving spouse dies in 2015
  - Stocks now worth $7,000,000
  - Real estate still worth $5,340,000
- Objective: maximize family wealth
  - Assume bypass trust is funded with stock portfolio
  - Alternative is a marital bequest of the entire estate with transfer of decedent's unused exclusion
  - Appreciated stock portfolio is subject to capital gain/Medicare surtax in bypass trust scenario



QTIP Trust

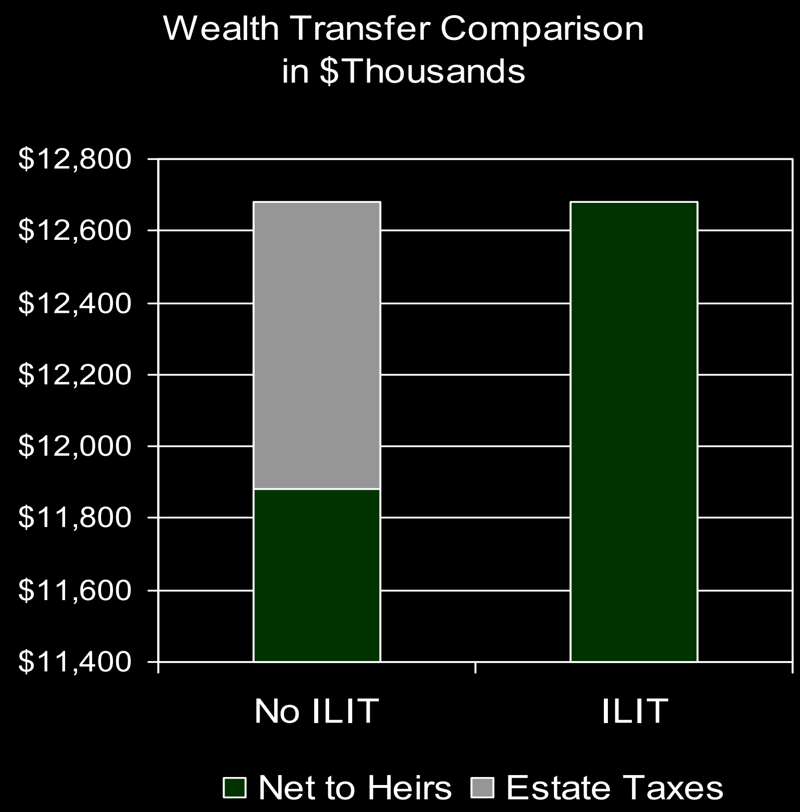
- Trust designed to do the following
  - Qualify for the federal estate tax marital deduction
  - Benefit the surviving spouse exclusively during his/her lifetime
  - Enable the testator to control the disposition of trust property after the surviving spouse's death
- Situations where a QTIP trust may be warranted
  - Testator has children from a previous marriage he/she wishes to benefit after current spouse dies
  - Surviving spouse has potential creditor problems so other types of marital bequests present risks

Irrevocable Life Insurance Trust

- Designed to exclude insurance proceeds from the insured's and surviving spouse's estates, but may provide spouse with lifetime benefits
- Trustee is owner and beneficiary of policy
- Policy premiums are typically funded with lifetime gifts from the insured and/or spouse
  - Crummey powers granted to ILIT beneficiaries qualify gifts for the gift tax annual exclusion
  - Large premium-funding gifts may be made when ILIT is combined with other planning techniques (e.g., IDGT)

ILIT Example

- $5,340,000 separate property owned by each spouse
- $2,000,000 life insurance
  - First decedent is insured
  - Surviving spouse is beneficiary
- Each spouse dies in 2014
- Objective is to minimize total estate taxes across both estates
- Each scenario produces identical results whether bypass trust is funded with $5,340,000 on first death or entire estate is transferred to surviving spouse, along with first decedent’s unused exclusion



Family Limited Partnerships & LLCs

- FLPs and FLLCs are popular business entities used frequently today in family wealth planning
- Must have valid business purpose to be respected for transfer tax purposes
- Offer a number of benefits
  - Asset protection (e.g., creditors, divorces)
  - Centralized management of family wealth
  - Facilitates intrafamily transfers of wealth
  - Valuation discounts can reduce estate/gift taxes, especially when combined with other techniques

Valuation Discount Example

- $1,000,000 real estate property held inside an LLC
- $250,000 basis in property
- LP interest owned by client, age 55
- Age 85 life expectancy
- 35% valuation discount
- Highest tax brackets
- 40% federal estate tax rate
- 5% income rate
- 3% growth rate

Lifetime Gifting Overview

- A gift is a lifetime transfer of property from donor to donee without adequate and full consideration
  - May be direct or indirect
  - May be of tangible or intangible property
- Basic gifting alternatives
  - Outright gifts
  - Gifts in trust
    - Donor retains an interest for life or for a fixed period
    - Donor retains no interests in transferred property

Pros & Cons of Lifetime Gifts

- Benefits
  - Donor enjoys personal benefits of assisting donee
  - Reduces taxable estate
  - Donor controls timing of transfer
  - Income-tax savings if donee is in lower tax bracket
- Drawbacks
  - Transfer is irrevocable
  - Loss of income on transferred property
  - Donor may owe gift taxes
  - Carryover basis treatment for donee

Gift Taxes

- An excise tax on the gratuitous lifetime transfer of cash or property
- Tentative tax (before credit) is determined on the basis of cumulative taxable gifts (i.e., progressive)
- Paying gift taxes reduces taxable estate
  - Donor must survive for more than three years
  - Opportunity cost = foregone earnings on taxes paid
- Gift tax rate of 40% on gifts in excess of the exclusion
  - In 2010-2012 tax rate was 35% for gifts > exclusion
  - $5,340,000 exclusion in 2014; $5,430,000 in 2015.

Gift Tax Exclusions

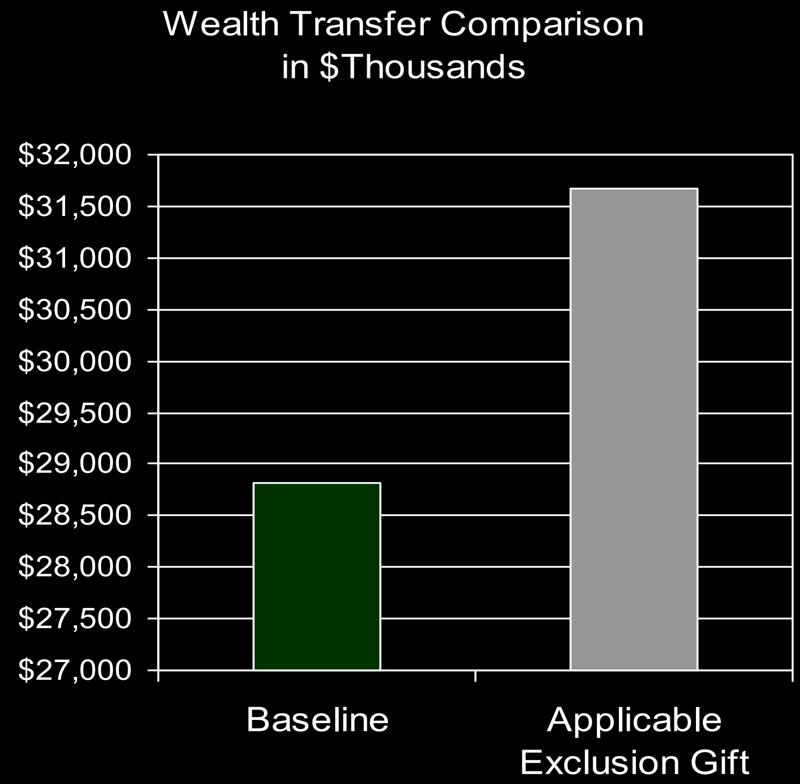
- Annual gift tax exclusion
  - Inflation-indexed exclusion that applies on a per-donee basis ($14,000 in 2013-2015)
  - Only gifts of a present interest are eligible
- Per-donor basic gift tax exclusion ($5,250,000 in 2013, $5,340,000 in 2014, $5,430,000 in 2015)
- Unlimited exclusions for payments of qualified medical and education expenses made directly to provider on donee’s behalf
- Gift-splitting between married spouses effectively doubles available exclusions

Annual Exclusion Gifts Example

- Annual exclusion cash gifts over 30-year period
- 5 donees with gift-splitting
- Highest tax brackets
- 40% federal estate tax rate
- 2% income rate
- 6% growth rate
- 3% annual inflation rate applied to gift tax annual exclusion allowance

Applicable Exclusion Gift Example

- Transfer of marketable securities equal to gift tax applicable exclusion in 2014
- $5,340,000 portfolio transferred
- $4,000,000 basis
- 30-year projection
- Highest tax brackets
- 40% federal estate tax rate
- 2% income rate
- 6% growth rate

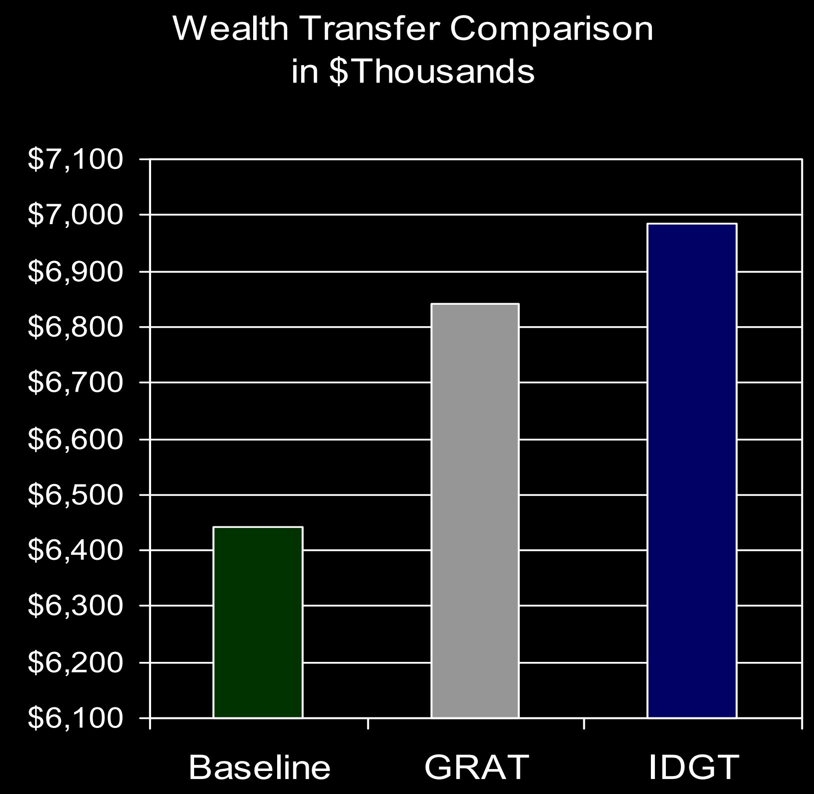


Estate Freeze Planning

- Utilizing lifetime gifting techniques that essentially fix the value of property in the transferor's estate
  - Future income and appreciation (or excess returns) are transferred to junior generations estate tax-free
  - Interests retained or debt received in exchange for a sale of property are includible in the gross estate
- Many techniques involve transfers of business interests subject to valuation discounts
- Examples include GRATs, QPRTs, CLATs, installment sales, private annuities and SCINs

Estate Freeze Planning Example

- 6-yr GRAT vs. sale to grantor trust
- Seller receives 9-year balloon note at 1.8% interest in exchange
- $ 5,000,000 S corp transfer (both)
- 10% of transfer is gift (sale only)
- 35% valuation discount
- Highest tax brackets
- 40% federal estate tax rate
- 5% income rate
- 3% growth rate
- 2% liquid fund rate
- 2.2% 7520 rate
- 10-year projection



Generation-Skipping Transfers

- Lifetime or testamentary transfer of property to a skip person—an individual two or more generations below transferor
- GST planning is designed to bypass estate taxes at the generation immediately below transferor
- Bypassing children (even in part) may be warranted where children are affluent and already exposed to significant estate taxes
- Dynasty trusts are GST-exempt trusts governed by state laws that permit them to last in perpetuity

GST Taxes

- An excise tax on the lifetime or postmortem transfer of property to skip persons
- Tax is applied to the taxable transfer at the maximum federal estate tax rate (40% starting in 2013)
  - With direct skips taxable event occurs up front
  - With taxable distributions and terminations taxable event is delayed until some triggering event occurs
- Exclusions and exemptions are available
- ATRA 2012 provides for a $5,250,000 GST exemption in 2013, indexed thereafter ($5,430,000 in 2015).

GST Planning

- Transfers to skip persons can be made during transferor's life or at death
  - GST exemption is applied against transfers in trust to immunize trust from GST tax
  - Trust can be structured to benefit multiple generations
- Coordinating estate-tax planning and GST planning is important
  - Apply GST exemption to credit shelter trust
  - Apply remaining GST exemption to a separate GST-exempt marital trust (reverse QTIP election)

GST-Exempt Gift Trust Example

- Transfer of marketable securities equal to gift tax exclusion in 2014
- $5,340,000 property transferred & GST exemption allocated
- $4,000,000 basis
- 30-year projection
- Highest tax brackets
- 40% federal estate tax rate
- 2% income rate
- 6% growth rate

State Death Taxes

- All states and the District of Columbia have some sort of death tax system in place
  - Estate taxes levied on the transferor's estate
  - Inheritance taxes levied on the recipient of property
- Federal estate taxes are reduced by state death taxes actually paid
  - Credit was phased-out under EGTRRA (2001-2004)
  - State death tax deduction replaced credit after 2004
- Many states decoupled from the federal system to avert significant loss of revenue

Other Nontax Planning Matters

- A comprehensive estate plan generally includes legal documents that address a family's needs in the event of incapacity
  - Durable power of attorney or DPA (financial decisions)
  - Advance medical directive (includes a living will)
- A principal names an attorney-in-fact (i.e., agent) to make financial and/or health-related decisions on the principal's behalf
- DPA often directs the power holder to fund the principal's revocable trust during period of incapacity

Summary

- Estate planning is an interdisciplinary process designed to assist the client in protecting, preserving and transferring family wealth
- Estates of all sizes can be decimated by taxes, expenses and poor wealth management without coordinated planning
- Creating an enduring legacy for future generations requires clearly stated goals and objectives
- Numerous planning techniques are available to reduce potential estate shrinkage due to taxes